IMAP Independent Thought Podcast
Episode 23: Positioning Portfolios for Tough Times

Alex Ventelon (Morgan Stanley) discusses:

- Interest rates: Have the RBA and Fed gone too far?
- Is recession likely?
- Can inflation return to target soon or are we in for an extended period of 3-4% inflation (or higher)
- Asset allocation views at present
- Domestic vs international exposure in equities and bonds
- Expected returns for portfolios over the next few years

Moderated by David McDonald, CFA IMAP

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David McDonald - IMAP: (00:17)
Welcome to this podcast in the IMAP independent thought series. Today I'm joined by Alex Ventelon from Morgan Stanley, and we are going to be discussing the outlook for local and global economies and how portfolio should be positioned in these difficult times. Alex is the head of research and Investment Strategy for Morgan Stanley Wealth Management in Australia. Welcome, Alex.

Alex Ventelon - Morgan Stanley: (00:42)
Hi, David. Very glad to be here today with you.

David McDonald - IMAP: (00:48)
So, Alex, obviously the big thing at the moment everyone's talking about is the economy, inflation, interest rates, et cetera.

I guess that's probably a good place to start. I mean, maybe interest rates initially, we've seen the Fed's signal that they're at least going to pause.

The RBA doesn't seem to know whether it wants to stop or go. But both seem to be suggesting it could be more hikes. The question, I guess is do you think they've gone too far in both cases? Are we looking at recessions locally in the US globally?

Alex Ventelon - Morgan Stanley: (01:26)
Right. Well, there's a lot to cover here, David, and yes certainly worth a deep dive. First and foremost though, as you know, I need to state this verbal disclaimer, I'm the Head of Research. I'm not a financial advisor, so I'm in no position to provide financial advice. So the views that I'm going to present today are research views. If you are seeking personal financial advice, please speak with a financial advisor.

Now, with that behind us let's get on to the more interesting part, which is certainly the fact that we are anticipating global growth to be slowing down. And that's mostly on the back of the massive push in terms of interest rate hikes that we've had in the last 12 to 18 months. To your point about whether we've seen the end of it, it's quite hard to say as we are of the view that we are going to see more interest rate hikes in Europe, and certainly in Australia.

Alex Ventelon - Morgan Stanley: (02:32)
But in the US our view is that the Fed should be on post from here, and we've seen the peak interest rate. Now, I'll be honest with you, although inflation data seems to be showing a lot of progress, and that's very much our expectation is that at the headline level, there's a number of mechanical aspects that will make it such that inflation will continue to drop considerably in the US.

But the same way it really ballooned last year. So it's sort of a disinflation, or deflation of this balloon if you want, that we are going to witness this year. However, the Fed is now very much fixated on the core component of inflation, and that's been a bit more problematic. When we see at their preferred measure of inflation, the core PCE, it's only gone down to 4.7% from a peak of 5.4% in February of last year.

Alex Ventelon - Morgan Stanley: (03:41)
So in a little less than 18 months, we've had only 70 basis points of improvement in terms of core inflation. So the progress have been very, very gradual. So even if headline inflation seems to be headed in the right direction, it's too early to claim victory on the US side. And to be honest, we think that the risks are more skewed to the upside in the US in terms of seeing a few more hikes.

So maybe one we don't see a lot more, but maybe we could see one that will be of course data dependent. And that's why it was interesting to witness the debate post the Fed meeting on the skip versus pause, right? Suddenly, if they were to resume interest rate hikes after this pause, this announcement would have a very negative bearing on markets. In the case of Australia, we are not in the same situation here.

Alex Ventelon - Morgan Stanley: (04:52)
Both headline and core inflation do not seem to be yet under control. The last leading inflation data or partial inflation data showed a bit of a bump in Australia, and therefore the RBA pushed another hike and came up with a more hawish tone. Our view is that they should go all the way to 4.6%, but again, here there will be a lot of what we call optionality.

This optionality is probably skewed towards doing more, as again, inflation is not yet under control. And when we saw the employment data last week, it was still very strong.

So no doubt here that the RBA needs to do more and probably even a bit more than what we have in our numbers.

David McDonald - IMAP: (05:43)
Yes. Okay. Thanks for that. Look, maybe we get back to talking about the impact of these rate hikes on economies. It's a little bit more the inflation side though, I think is interesting. You talked there, Alex, about how it's come down a bit in the US and not so much here the next two, three years.

Do you see inflation getting back to where central banks would like it to be, or do you think we're sort of stuck in a 3%, 4% or worse? And does that mean therefore probably higher rates for longer?

Alex Ventelon - Morgan Stanley: (06:19)
Yes, well, again there, there's a few things here at play. Certainly I'd agree with you that probably the new normal for interest rates is going to be higher than what we've had in the post GFC cycle.

We don't think we are going back to this below 1% environment for interest rates. There are a number of structural forces that will likely keep inflation above, or at the higher boundary of the target for most central banks. And as a result the new neutral for central banks will be probably higher than what it was in the past.

Now, in terms of curbing inflation, clearly the objectives of the central banks are very clear. If we once again focus on what's happening in the US, and in Australia, we've had at different times, but we've had a very similar tone from both J Powell and Phil Low in the sense that inflation will be prioritised overgrowth, right?

Alex Ventelon - Morgan Stanley: (07:34)
Central bankers in both countries are trying their best to engineer a soft landing in the economy, meaning, losing as little jobs as possible to get inflation back under control.

But if they have to over tighten to get that outcome, (which is to bring inflation back to the range), they will go in this direction. So that's why in any case, we think they are going to be successful at bringing inflation back to target because they will commit, and they'll do sort of whatever it takes to get there and with the risk of that turning into a recession.

Now, the point that I want to make is that curbing core inflation especially, which is very much tied to the strength of the employment market will take time, and we are not expecting the US or Australia to be close to target this year. We think it will be by the end of 2024 that will have inflation rates slightly above, but very close to the central bank's target in both countries.

David McDonald - IMAP: (08:49)
Right. And if the central banks maybe have to go further to control inflation, we've already had people talking about recession risk and so on. But then on the other hand, as you've mentioned, employment's strong here, it's still strong in the US. How does that tie together?

I mean, when we talk recession, are we talking about, a quarter or two of minus 0.2 or three? Or are we talking about unemployment going up dramatically and things really slowing down?

Alex Ventelon - Morgan Stanley: (09:22)
Listen, at this stage we are of the view that in terms of growth, risks are tilted to the downside whilst on rates, risks are tilted to the upside, and both are interconnected. So if we envision a world where the central banks have to do more than what's in the code, suddenly we're looking at no longer a soft landing, but more a recessionary environment where we have the unemployment rate going higher than the 1% that we have in our forecast for Australia and the US.

That would be the sort of environment. We still believe that both economies, (Australia and the US), are on solid footing. Employment markets are quite strong in both countries, and therefore even with a few more hikes, it's hard to see a very, very bad recession here.

But we have to be careful because in previous times, in previous cycles, we have seen environment where the economy was probably just weak and vulnerable with PMIs below 50 and the yield curve inverted, and then something came out of left field and sent us to a harder recession than what we forecasted. So at this stage, I would say, yes, if there's too many hikes, we could envisage a mild recession, but we are not of the view that ahard recession is a high probability.

David McDonald - IMAP: (11:08)
Okay, thanks. Look, so that economic background, I guess moves on to the next big question in terms of portfolio positioning. I am just interested in where Morgan Stanley sees things at the moment. What sort of sectors do you prefer? Do you like equities, bonds, local, global?

Alex Ventelon - Morgan Stanley: (11:31)
Yes. So let's start with equities. That's usually what people are interested in the most. We have been admittedly a bit too defensive in our positioning. We thought that the US economy and US corporations would be running out of steam a bit earlier.

Certainly the last two months I've heard a lot about the breakthrough in the AI world, and that's pushed markets, especially the US market, and the US tech new economy world very strongly to the upside.

If it wasn't for that, markets would've been a lot more muted for this year to date, and even in the past couple of months. But certainly, the economy has been more resilient. Corporations have been quite proactive in terms of cutting costs and protecting their earnings.

Alex Ventelon - Morgan Stanley: (12:37)
Therefore, we are probably a little less wary or concerned about the potential for a harsh selloff than we were a few months ago.

So we are still cautious in the short term, especially right now as we are speaking, technical indicators show that there's been a lot of late cycle buying into this rally, and markets look stretched and over bought.

So we are also seeing the liquidity deteriorating in the next couple of months. So we've advising our clients to be really conscious of the levels when they are putting more money at work. And if anything, we have been looking at deploying money in areas where markets are not as expensive, and where we see sort of a multi-month, or a multi-year potential upside.

Alex Ventelon - Morgan Stanley: (13:38)
So we are still a little bit cautious in equities, but we are happy to be overweight in a weight in Japan, which is a beneficiary of the strengths of growth that we are seeing in Asia this year and the next, as well as emerging markets. They both trade very cheap. Expectations from an earnings standpoint are a lot more depressed compared to the US where it's the opposite for us.

We are seeing multi earnings compression double digit earnings compression this year versus the market that sees a little bit of growth. So again, opportunities in Japan and Asia, Europe in the middle. Not a very strong conviction either way. In terms of Australia, for us, the country has been quite resilient and it's usually a resilient economy.

Alex Ventelon - Morgan Stanley: (14:37)
The issue is that with more hikes to come through not fully discounted by markets and probably the RBA having to then keep interest rates at this high level for longer. We're not expecting the RBA to be getting this year, then that might come as a disappointment. That will be a slow grind, and a burden relief for the discretionary side of the economy. We see also lower demand for loans affecting especially the banking sector.

So at the index level, we expect muted returns from the ASX 200. There will still be the dividend component, that should kick in, and provide decent income. But we are not too enthusiastic about the outlook for Australia. In terms of sectors, we are defensive in areas where we think we're going to see the most growth slowdown, namely the US In Japan, in emerging markets where we see the cycle turning. We are looking at opportunities into the growth, space and a bit of tech at the global level.

We think also it's a good time to be invested in what we call the quality factor i.e. Companies that have stronger earnings growth on average, more consistency in their earnings, and also cleaner balance sheets, which is very important, lower leverage when interest rates are going up. So that's our key positioning right now.

David McDonald - IMAP: (16:15)
Now at the start of the year, or even the end of last year, Alex, there was a lot of talk about bonds are back, people saying that yields have got to levels where it was worth looking at bonds again, is that something you agree with, or do you think the outlook for higher rates still is may be putting a dampener on bonds?

Alex Ventelon - Morgan Stanley: (16:36)
Well, you know, last year we came out with that call on government bonds when we had both US and Australian 10 year government bonds trading above focused and yield. We thought this was really a very strong entry point into markets, into these markets, and that played out very nicely.

Now with the resilience of inflation and the expectation that central banks would have to do more, we've seen a backup in bond yields, but if anything, we are looking at this as an opportunity for investors that have missed out on these first entry points to reenter the bond market. It has got to be gradual. I'm not saying that we have seen the highs in terms of bond yield. This is still going to be a volatile trade into the next six months, most probably we will see inflation data, and the central banks' response probably shaking the market.

Alex Ventelon - Morgan Stanley: (17:43)
But certainly on a 12 month horizon, we see a very good potential return since our target for the US 10 year Bond yield to be at 3.3% by the end of June next year, and 3.6% for the Australian 10 year government bonds.

So I think it's a good opportunity. You have a bit more income, and carry with this yield around the 4% mark. That's something we haven't seen in years.

And also it will give us good downside protection in case the economy slows down more than we have thought. Second to that, we have investment grade bonds where for really the top, highest quality companies, we see, the entry point as well as quite attractive yielding around 5% and still having the stability to give you a bit of downside protection from the duration component. So these are the two key sector in the bond market that we've been recommending to clients, and in the long space, that's our preferred asset class.

David McDonald - IMAP: (18:56)
So you prefer bonds over equities, is that right?

Alex Ventelon - Morgan Stanley: (18:59)
Yes, absolutely. Equities, we have a mild underweight to the equity market, but we have another weight on government bonds and on investment grade bonds.

David McDonald - IMAP: (19:16)
And in terms of actual return expectations, Alex, I don't know how far ahead you look, but I was at a recent event where Mark Delaney from Australian Super said that people are not going to be getting 8, 9, 10% for the next few years, it's going to be 5 or 6%.

Do you forecast this sort of expected returns for portfolios for clients?

Alex Ventelon - Morgan Stanley: (19:42)
We haven't finalised our return expectations for the Australian asset class, but what I can tell you is that for the global asset class in the next 12 months, we are seeing mid single digit type return on both equities and bonds.

Hence the reason why we are also favoring bonds, and equities is that if the return expectation is about the same, then on a risk adjusted basis, we like bonds better of course, given the lower volatility and the ability to surge in periods of higher risk aversion.

I think though that we should still witness high single digit type return on prime. I'm insisting on that on prime alternatives asset class, not only for for this year, but for the years ahead. So yes volatility, probably the starting point as well on equities is higher than where we'd like it to be. But we are still expecting modest return for the 12 months ahead.

And then as we move on to the next cycle, we are actually quite constructive and we are expecting to see wide solid returns, especially coming out of alternatives markets.

David McDonald - IMAP: (21:14)
We've also seen sort of quite strong correlation recent years between lots of asset classes. I mean, is that something you see changing now or do you think that's still going to be a factor in the year or two ahead?

Alex Ventelon - Morgan Stanley: (21:29)
I think what's happened is that in the post GFC environment, we've had almost a continuous period of stimulus coming out of central banks around the world from post GFC all the way to Covid and even in post-Covid, the central banks have been easing nearly continuously and especially the US Fed. Now we've entered a period where we expect inflation to be structurally higher.

Just by the fact that it should be at the higher bound of the central bank target means that it will be substantially higher than in the previous cycle, meaning the central banks will not be able to run as loose a monetary policy. And in that context, we should see the return of negative correlation between equities and bonds.

Alex Ventelon - Morgan Stanley: (22:38)
Right now we are in a context where inflation has probably peaked around the world and central banks are not too far from also reaching their peak in terms of cash rates.

So from here we should see a disinflationary process and we should see central banks pausing, which is a bond positive. If the economy was to weaken further, we'd expect bond yield yields to rally, and bond prices to go up, whereas equities should be under stress.

So that's what I'm thinking in terms of the return of the negative correlation, which would be the complete opposite of what we had last year with inflation shooting up, central banks tightening very hard, and both bonds and equities selling off at the same time.

David McDonald - IMAP: (23:35)
Right. Thank you. I guess the one topic we haven't touched on yet is the Aussie dollar.

It seems to have struggled to get up off the floor despite the RBA talking about more rate hikes and so on. What is your Aussie dollar outlook, Alex?

Alex Ventelon - Morgan Stanley: (23:52)
Well, we have an outlook for the Aussie dollar, which is quite benign for the next12 months. Our view is that because markets are going to remain volatile because the US should be still yielding a higher rate than the RBA. All that should be more US dollar positive.

We are seeing the US dollar to be quite positive in isolation. Anyway, behind that, the Australian dollar will likely struggle with a weakening economy. Maybe, you know, still heightened risk aversion in our view, we don't think that, markets are going to move towards a enthusiastic mood, at least in the next six months. That means that we should see the Australian dollar maybe revisit the low sixties, versus the USD.

Alex Ventelon - Morgan Stanley: (25:03)
And from here, a gradual recovery as the RBA will be on hold whilst the US Fed will be talking about cutting interest rates by the end of this year in terms of talk... And actually starting to cut in March of next year, whereas we don't see the RBA cutting before August of next year. So this should unwind gradually into next year.

Clearly we must acknowledge though that if we were to see even more stimulus and even more aggressive policies coming out of China, boosting commodity prices and unwinding the recent weakness, that could be a bit more supportive to the Aussie dollar than in our base case. But at this stage, we are not expecting a massive rally from current levels of the Australian dollar.

David McDonald - IMAP: (26:03)
Yes. China obviously is trying to pull out all stops to get the economy going, but there are obviously longer term things going on there in terms of demographic changes and things like that, which perhaps means we're not going to see the growth we saw in the past.
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So would your outlook for the Aussie dollar to perhaps even struggle a little bit more in the short term, do you recommend clients hedge offshore ahead of possible rebound later? Or what sort of views do you have on hedging for foreign investments?

Alex Ventelon - Morgan Stanley: (26:38)
Well it really depends on how much one has in terms of exposure to foreign currency.

But I would say in a neutral asset allocation right now, we'd be happy to own another way to foreign currency versus the Aussie dollars. So being mostly unhedged, that's what it means.

That is really on the back of the view that we are expecting markets to show a noticeable pullback within the next three to six months by then.

Depending on where it falls again, if it's around the low sixties, that would probably be a very interesting entry point to the international equities portfolio, assuming everything else is consistent of course.

David McDonald - IMAP: (27.36)
Alright, that's great. Look, Alex, thank you. We've covered a lot today. I think a lot is going on in the world, and we've covered a lot of it. So thank you Alex Ventelon from Morgan Stanley for joining us today and giving us those insights into risks and opportunities ahead for financial markets.

Just finally from me, a reminder of upcoming IMAP events. We have a webinar series in the week beginning the 26th of June. How's it going in 2023? A webinar will be on Monday, Wednesday, and Friday lunchtimes, looking at what has affected markets this year so far, and what the big issues are for the rest of the year. Monday we'll look at equities.. Wednesday fixed income ,and in the Friday webinar we'll look at real assets such as infrastructure and property.

Also, we have the IMAP Advice in Action Conferences coming up in Melbourne on the 18th of July, Sydney the 20th, and Brisbane, the 25th of July. These conferences focus on how advice businesses can stay relevant and attract tomorrow's clients while servicing existing clients.

The IMAP website **https://imap.asn.au** has all the details, and you can register there. Thank you.

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