Post-Crisis Investing for the Long Haul

Disruptive Forces in Investing **May 4, 2021**

Anu Rajakumar: Following the immediate draw down at the onset of the pandemic, global equities returned over 50 percent in the one year ending March 31, 2021. A key factor driving those gains is the actions of the Federal Reserve which for years has been taking steps to help increase the money supply. And much of that has found its way into the stock market. But what happens when the Fed is ready to take its foot off the accelerator? My name is Anu Rajakumar and to discuss that topic and more, I'm pleased to be joined by Robert Surgent, head of tactical asset allocation with Neuberger Berman's multi-asset class investment team.

Bob Surgent: Thanks, a lot, Anu. It's great to be here. Always good to speak to you.

Anu: Now you and I are part of the multi-asset class team here at Neuberger Berman, and we've been talking recently about the potential of being in a multi-year inflection point. So I'd love for you to explain what you mean by that, and maybe for context, let's go back to the global financial crisis and how the pandemic impacted where we are from a macro perspective.

Bob: Yeah, that would be great. Thanks a lot. You know, it's an incredibly interesting topic. We often are very myopic because of the need to generate shorter-term returns. But it is very possible in my view, quite probable, that we're at a significant inflection point in markets for exactly the reason you outlined at the beginning. You know, the monetary policy accommodation and the reliance upon it since the global financial crisis is pretty much unprecedented. And I think we're moving from a point where we really exhausted what monetary policy can do despite, you know, central bankers will say they can do much more. And now we're kind of shifting into this move from monetary policy accommodation into, you know, fiscal stimulus where any sense of fiscal profligacy is thrown to the wind. And the two are now combining and the result is MMT or modern monetary theory. So what's interesting about this is you'll often see these trends – whether they're price trends or trends in investment regimes – they end in some type of exponential move. And last year if you look at what the Fed did – you know, the Fed in six weeks bought more treasuries than in the 10 years under Bernanke and Yellen which is quite incredible. They also bought investment grade credit to the point where at some point the Fed was actually buying Apple bonds which is kind of crazy, right? It's like telling me to help Bill Gates out with his credit card debt.

And we've also seen in the fiscal stimulus move though, a move towards like universal basic income almost which was considered something that was just a discussion experiment due to tech disruption and the amount that it hurt a typical wage earner when you get these disruptions that there are people that are just left behind. And now if you look at the stimulus checks and the CARES Act – the CARES Act – not even the infrastructure program now. This is just income relief – increased the deficit by more than the last five recessions combined. That's every recession since 1973. That's pretty incredible. And yet it's become fully embraced. And, you know, you mention that we had a recession and people talk about what an incredible reaction by the stock market. But I think we have to use that term recession very loosely because what recession do you see disposable income increase? What recession do you see corporate borrowing increase by almost half a trillion dollars? That's not truly a recession. I think that was more of a shock. But what happened is that the Fed and other central bankers went to the toolkit which used to be considered quite kind of innovative, you know, monetary combination like QE (quantitative easing) and just really dived in quite deeply. And so, we've seen these exponential moves and I think that's why this could potentially be a market inflection point of what the world is like going forward.

Anu: Absolutely. And looking forward there could be some huge implications in different areas. Inflation, growth, productivity come to mind. Let's maybe start with inflation. Talk about some of the implications of this inflection point on inflation specifically?

Bob: Yeah inflation's a tricky beast, isn't it? Because when you speak to different people about inflation, I'm not so sure they even know what they're talking about. I mean what is it? Is it the Fed's measure of inflation? Is it core PCE? Is it five-year break evens? This is one thing I do know. Given the amount of liquidity provision that's out there, how dependent on it, given the amount of how easy financial condition indices are, and given just where term premium and global yields are which is negative to zero at best. I mean when have we seen this amount of negative debt in the world?

You just can't have inflation because everything we've come to depend upon and everything that allows the present value to be discounted by such an accommodative discount rate, relies so heavily on the fact that there's no inflation. So the people that talk about oh, we can get like a type of move into an inflationary environment. They'll look at past analogs where you've had that. And equity returns have been ok for that. But it's completely the wrong analog. It's like, you know, saying lightning and lightning bug sound alike so if I get struck by each one, it must be the same results. It's just not true.

Right now, we're in such an accommodative position that any hint of inflation really will significantly move your discount rates. Let's look at just what happened in December 2018 when the market finally realized that real rates are too high. So, you know, we're not making a call on whether inflation is going to get out of control, whether we're seeing it. But we definitely are making a call on 60-40 portfolios, or risk parity portfolios, are incredibly sensitive and dependent upon the fact that we just can't have inflation. And so, that's why I think sometime over the next few years, if we do get anything in terms of the increase in the velocity of money just with how much liquidity is out there, and just given the set-up that we have, markets will be hyper-sensitive to that and previous analogs are just not going to be appropriate in terms of looking at what the implications would be, especially on equity portfolios.

Anu: Yeah, it's really interesting to see. You know, no one knows what will happen with inflation, but you make some great points there. Also curious, Bob, if you could talk about the effect of this expanded balance sheet. How has that affected the U.S. dollar and maybe even gold as well? I'm just curious for some context about what's been happening with those two.

Bob: Yeah, you know what? That's like a great, interesting macro question because one would expect that if you have a corporation or any entity that is increasing the debt levels and therefore, you know, lowering the credit quality of that underlying entity that whatever the credit instrument that is used to measure the credit quality of that entity would decline. And yet, we've seen the U.S. issue more and more debt. I don't know if anyone fully expects the U.S. to ever be able to pay that debt. But the servicing on the debt as long as rates stay low is ok, and yet the dollar has increased. You know, it kind of breaks all economic 101 rules that we learned in school. So why is it that the dollar continues to strengthen? I think the dollar continues to strengthen because for better or for worse, whether it's right or wrong, the dollar really is traded off of growth differentials. You know, the last kind of significant real dollar move – I know there was one last year, but it was probably, you know, in the 2017 period. And that's when you saw growth rates outside the U.S. exceed those of the U.S. What's different about this recovery, is that the U.S. growth rates exceeded, even China's growth rates for certain quarters. So if you have a reserve currency in a period of uncertainty – and I know a lot of people question the reserve status of the U.S. dollar – but the truth of the matter is you don't have an option right now. We don't need to go into whether China could become a reserve currency or Europe could become a reserve currency. But ask anybody "where would they rather have their money for the next 10 years?" It's very hard, right, to compare the issues in Europe and in China with the inability sometimes to remove your capital. To see a significant depreciation in the dollar despite everything suggesting you should is two factors: That the growth differential that exists and just the reserve status in a period where one, there is so much more paper currency being created that has to go somewhere and two, the growth differential on the quality of that growth. Just look at what the technological innovation – where is most of disruptive tech which we do think is something that's definitely a macro trend that's here to stay. And where is the hub of that? It's the U.S.

Anu: Yeah, absolutely. Going back to the comment earlier about the immense amount of monetary policy that we've seen, if we're going to be rotating into more of a fiscal stimulus world, what are some of the implications that investors should be thinking about there?

Bob: I think that's the billion-dollar question. And I think the theme of our inflection points – whatever the inflection point is – I feel very confident that 60-40 portfolios are going to have to be significantly different, i.e., the styling, the ability to identify the sub-levels of the equity market that are going to benefit from this is going to be much more important than your passive decision. And we've seen that this year, right? It's like the battle of middle earth between like cyclicals defenses value to growth, re-openings. Never in my career have I seen so many baskets created. And very good baskets. Like the sell-side is incredibly helpful with this. And we're talking more and more about equity baskets than we ever have. I mean one of our largest positions right now, right, seems like it being a very nuanced position which is reopening to the stay-at-home names versus the old cyclicals to defensives. You know, there's a huge disconnect in what's happened. So people will talk about top down level of cyclical defensive, but there's very much been a separation between early cyclicals and those cyclicals that are more subject to reopening the economy. And a second theme is going to be I think at some time over the next one to three years – a lot of the money that's gone into disruptive tech reminds me a little bit of a microcosm in 2000. Disruptive tech is here to stay but how much of that money has been excess speculative capital? And there's no doubt that we have a lot of excess speculative capital in the market. Look at Game Stop. Look at Crypto. But, you know, what we saw in 2000 is the Intels and the Microsofts – Google wasn't around yet. But they got hit and the baby got thrown out with the bath water.

And so, when we do get an eventual correction – and I think that the correction that we do get at some time – will make December 2018 look like child's play. It will be very important for investors to say ok, now I need to reset. What is true, disruptive technology? Because what's called disruptive now actually is bricks and mortar of the future. So it's a long-winded explanation but I think it's a very good point and one that really is going to require a lot more active engagement and active managers as opposed to reliance on passive returns. The set-up for passive returns here is rather poor. It's actually scary poor. If we look at just what a real PE [price-to-earnings] is in the S&P, it's kind of at the highest levels it's been, and we haven't gone to these levels since 2000. I always look at the bund. I mean I don't think there's any more mispriced instrument in the world, but shooting against it is incredibly dangerous because the pure driver of the bund is the man that's created by an external buyer that really has no care in the world about the economic value of the instrument. And so, we're in kind of a precarious position where prices are being driven by price-setters that have no care of what the true economic value of that instrument is. And then you have other prices and risk assets being set because the discount rate is set by that asset and so therefore you get some pretty extreme valuations. So we need to be cognizant of it.

Anu: I'm glad that you brought up the bund example because I did want to talk about trends outside of the U.S. You know, another area that I know we've been talking about within our team is Japan as well. Explain to our listeners why Japan and its equity markets are relevant to today's market conditions as well.

Bob: Yeah, I think Japan is a phenomenal example. When I talk about engaging in MMT and how long can we do it, everyone will point to Japan and say well look how far their debt to GDP ratio has gone. But, I think it's much different in an economy in isolation with that type of savings backdrop and demographic set up. It's different than when the whole globe does it. But what's really interesting to me about Japan is I remember the Koizumi Reform in 2005. And that's when you really had a true growth rate in Japan. Regional banks were up like 60 percent. TPX outperformed Nikkei. If you just look at a simple chart of TPX to Nikkei, TPX has underperformed the Nikkei since 2005 in a straight line. And I think it's a phenomenally interesting relationship to watch because the third arrow of Avonomics which really never got fully implemented under him which would be much more beneficial to the TPX names just because you can actually increase ROEs by simply doing some private equity activity where you just restructure the capital structures by adding on debt to companies with tons of cash and you have a higher ROE. Is that actually now taking place in Japan? It's interesting that our private equity people for the first are starting to see a lot in middle market Japan. And so from a top down level, I'm very intrigued by the TPX-to-Nikkei ratio. If that starts to move. And investors start having this belief that actually we can increase ROEs, and Japan has re-rated already. But it can continue to re-rate more. And so, I think you know watching TPX to Nikkei is just like bund yields – it's one of those things that we constantly watch to see when does the public market really hop onto this. You know people want to talk about the Russell and you have small cap Japanese equity teams out there that are outperforming the Russell. So I think Japan really is kind of interesting to watch in terms of, you know, it has been the hat everyone's kind of put their head in saying that "Oh, we can go about this MMT for a while…" so, let's see if Japan actually is one of these inflection points that we're talking about.

Anu: Yeah, terrific. Very helpful. And just as we wrap up here, Bob, I want you to share sort of your key takeaways that listeners and investors who are tuning in today should really be thinking about and preparing for in the years ahead as you look at the global macro picture.

Bob: So I guess one of the key takeaways is I think you need a bit of a different barbell strategy. Like the barbell strategy that worked in passive was like if you were along NASDAQ and Russell 2000, look at that versus the S&P outright. It's outperformed every single year, and again, it's exponential. Oil went negative last year. You know, the 10-year rate went below the policy rate. There are a lot of signs that we look back 10 years from now and say, wow, didn't people realize that was the end. And so, the takeaway here is be more active in the equity allocation. But also, the barbell side of it is towards like kind of the disruptive tech but being selective of that. That would be number one.

Number two, I do think you have to have inflation tail risks in the portfolio; not because I think we're going to get it, but if you start to get it, it's going to be so fast and violent given, you know, that we've been able to do this MMT experiment purely because there's no inflation. So it's kind of like, we're leaning on Mike Tyson but make sure if Mike gains 500 pounds, we realize he's not the fighter he used to be. When inflation comes along, all of the stuff we've been leaning on is kind of gone. We can't use it anymore. So the next recession is going to be incredibly interesting. What do you do when you've already got all your gears going 200 miles an hour? At some point – this is not going to fall because of a policymaker coming out and doing the right thing and any fiscal profligacy being shared. Because it's impossible to get elected or even be a member of central bank anymore unless you buy into the Kool-Aid. You know, doing the right thing and the tools required to do the right thing are antithetical to actually getting elected and keeping your job. And so, the market's going to force this. It's either going to be a fiat currency issue, the inflation doesn't even have to come through wages. It can just come through a failed bond auction somewhere or the bund moving towards one percent like it did a number of years back. Those will be the tells that we need to look for.

Anu: That's perfect, Bob. You know I think as we wrap up here, I think some of the big takeaways that I'm certainly walking away with and hope others are thinking about is that the return environment in the next 10 years could look drastically different than they have in the last 10 years.

Bob: Absolutely.

Anu: And so, as a result, there are lots of considerations. I think you made some really good points about having active management can be key to riding out whatever the next recession looks like and the need for inflation hedges. So Bob, this has been really eye-opening. Thank you so much for joining me today and hopefully our listeners are thinking about these global macro issues and certainly we can always talk offline if folks are interested in hearing more from Bob, our global macroeconomics professor at Neuberger Berman. Thank you, Bob.

Bob: [Laughs] Thank you very much. It's an interesting topic and it's great to be able to talk about long-term themes that truly matter. Sometimes we get too lost in the short-term and therefore we've got to be very cognizant of these. Thank you.

Anu: Great. Thank you very much, Bob. And to our listeners, if you've enjoyed this episode of disruptive forces, I encourage you to subscribe to the show via Apple Podcasts, Google Podcasts or Spotify or you can visit our website www.nb.com/disruptiveforces for previous episodes as well as more information about our firm and offerings.

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