Making Sense of Markets and Policy Change

Disruptive Forces in Investing **October 11, 2022**

Anu Rajakumar: In recent weeks, global markets have been roiled by volatility. In addition to continued elevated inflation and declining growth expectations, there have also been a number of significant monetary and fiscal policy actions around the world that have concerned investors. From the Bank of England's historic fiscal stimulus package to China's currency maneuvers, to the Fed's ongoing hikes, how should investors make sense of policy actions occurring around the world right now? And what are the implications for portfolios looking ahead?

My name is Anu Rajakumar, and today, I'll be discussing these volatile market dynamics with Robert Dishner, Senior Portfolio Manager for Multi Sector Fixed Income based in London. Rob, thank you for joining us today.

Robert Dishner: Happy to be here.

Anu: So, to start our discussion, Rob, why don't you give us a quick summary of some of the underlying roots of the market volatility that we've been experiencing recently? What have these central banks around the world been doing?

Rob: Sure. I think it's really important to, you know, maybe take a step back and-and look at this in context. At the start of the year, we were expecting maybe 100 basis points hikes from the Fed and we're now gonna be on the precipice of our fourth 75-bp interest rate hike from the Fed.

So what we've seen here is a large change in what central banks are willing to do in terms of trying to beat unexpectedly and continued high inflation, at least perceived by the markets, and then secondarily at the expense of growth. And so when you're hiking rates into a slowing growth economy, that's gonna create volatility. Furthermore, we've had the war in Europe, which has exacerbated the energy crisis.

And then, third, I would note liquidity. And if you think about liquidity in markets in some of the most liquid future markets, you know, transaction costs are running above three-year averages. Bid asks are widening and market depth is a lot lower than historic. So small trades can start moving markets.

So, as things start accumulating in CTA strategies, and if there's a pivot, for example, like the RBA in Australia did yesterday and only hiking 25 bps, we saw significant rallies in rates. Or if it's something like the Bank of England had to come in and do to support markets last week in providing liquidity to the long-end, that's gonna create volatility in markets, particularly when positioning is fairly one-sided.

Anu: Yeah, thanks. And maybe just to expand a little bit on the Bank of England and the UK situation, cause it was interesting, you know, there was a spending package introduced that would increase the trade and fiscal deficit gap, which really lost the confidence of investors. Could you just elaborate on that a little bit more?

Rob: Sure. So, the UK's really almost had a problem since Brexit became official in 2020. And what we've seen since 2020 is a deterioration in the UK current account. And in addition, debt to GDP has been rising in the UK. So this is the fable so-called twin deficit type dynamic here in the UK.

So, you had a weakening pound even before the fiscal budget was announced or the mini-budget was announced. And you've also had the Bank of England, which on the spectrum of central banks had not really been all that hawkish. They had been worried about growth, they'd been forecasting greater chances of recession. And one of the things that we were looking at was, you know, during these times of rising rates and 1994 was probably the most recent version where we've had an accident, you know, then we got the Tequila Crisis. In this scenario, you know, it's sort of the-the gin crisis, right? So you've gotten either bond vigilantes if you wanna call them, or, you know, the pound going down. At this point in time, you know, the UK is in a really tough situation economically, again, to fund these twin deficits.

Anu: Great. Thank you very much. And I-I like that, the gin crisis us Brits know how to make the best of a tough time. At the midst of all of this, we've also seen the dollar soaring. Looks like there could be a risk of breaking markets, US dollars up nearly 20% against major currencies. So, maybe speak a little bit about the US dollar, some of the factors pushing the dollar higher, and then importantly, what do you think stops the dollar advance at this point?

Rob: Sure. So, on the dollar, it really takes two to tango, and what we've seen from other central banks- we could talk about The Bank of Japan who's let their currency depreciate fairly substantially, which has put pressure on other Asian currencies, whether that be, the Chinese Yuan or in Korea, but additionally in Europe where we've seen the Euro weaken. And part of this has been either lack of hikes, for example, take Japan, or more timid hikes in the case of the ECB. The ECB was buying bonds through June. So we haven't seen the same type of forceful action by other central banks.

Separately, US growth is probably holding up a little bit better than was expected. So if we think about a slowing global growth environment, the US remains sort of the best house in a bad neighborhood. And so capital's trying to find its highest level. In addition, real rates because the US is seeing inflation at least stable, albeit at high levels where inflation is still accelerating in places like Europe and Japan. And so, what changes this? Two things. One of which is when and if the Fed slows the pace or stops the pace of hiking rates and other central banks catch up and we see inflation changes elsewhere.

The issue is, it's probably gonna be a bit volatile until that happens. And the risk is for a continued strength in the dollar through, perhaps, the first half of next year. Once we see the fable long and variable effects of interest rate hikes play out in the US and we have to see really what condition the European economy is after the winter and see what happens there as it pertains to their energy situation.

Anu: Yes, sure. Absolutely. You know, I was actually in Turkey last week, which is seeing huge inflation there. I wanted to see if you could also touch a little bit on local emerging market currencies. What are you seeing there?

Rob: Sure. So one of the things that we've been looking at here is, you know, as the Fed is closer to the end of their hiking cycle, and many EMs, Turkey is not one of them, by the way, have been aggressive in terms of hiking rates. It may be the case that EM local, meaning EMFX and, perhaps, EM rates, local rates may have a chance to outperform, you know, again, maybe not immediately, but at some point in the future.

A number of these countries in, whether it's Mexico or Brazil, or a few other places, have really been fairly aggressive about interest rate hikes, and so that's one thing we're watching is when that pivots into next year, given that the carry in a lot of these countries has grown fairly substantially.

Anu: Okay, great. Thanks very much. All very helpful context, Rob. Maybe let's transition and talk a bit about the broader implications to portfolios. From your seat as a global fixed income portfolio manager, how has portfolio positioning changed in terms of the fixed income allocation this year?

Rob: Sure. So, to start the year, we certainly had a different view on rates and one of the things we had come into the year is fairly short duration. As the years moved on, however, and rates have moved up, that's become a more difficult trade. And when US rates hit around 4% tense, it's really difficult to sort of say, "Is that a-a short? Is that going to 5% or is it gonna rally back to 3?"

So it's a tough environment right now, and as we noted at the top, with a lot of volatility. It's tougher to have big positions, particularly given the VAR regimes that many firms operate under. And by VAR I mean value at risk.

And so when volatility is greater, position sizes need to be smaller. So, to a certain extent, some of the positions have moved away from rates. And as we think about how to invest in credit and how to invest in FX and, in addition, how to invest in local emerging markets, those have been some interesting opportunities. So, probably more than any other point in the past couple of years, the amount of budget that we think about allocating to more active management has gone up.

And so there's just been a lot of opportunities for bigger size trades, but have only really worked for maybe two weeks or a month at a time as opposed to our typical three to six-month type outlooks for a trade.

Anu: You know, you mentioned local emerging market currencies, are there any examples that you want to highlight there?

Rob: Sure. So, there, we're looking for places that have orthodox central banks. It's not suggesting overweights, but certainly in the context of underweights, perhaps getting to more neutral. So, places like Mexico or Korea, where we've seen orthodox reactions to inflation and inflation expectations.

It's really about focusing on those places where we understand the reaction function of central banks. That's a key differentiator across some of the spectrum and that you don't wanna be surprised either negatively or positively by central bank because you haven't articulated the reasons for that. And so, really, it's focusing on those places that have done sort of the orthodox textbook-type reaction.

Anu: Terrific. Now, Rob, as we look forward to outlook and how investors can position ahead, can you provide any historical context that investors should be mindful of? I know history can or cannot repeat itself, but are there any lessons that-that you found particularly interesting as you think about portfolio positioning in this new regime ahead?

Rob: Sure. I think two things. One of which is this is gonna be its own unique situation and it's different than the '70s in a lot of ways. And a lot of people want to compare this to the '70s. One thing that this doesn't have which the '70s did was a big increase in the working force population. So, if we think about the labor force in the US, that increased fairly substantially from 1969 to 1981, and that was due to the Boomers entering the workforce. In fact, that was a little bit more of a global phenomenon. And this is unique by just the sheer amount of fiscal stimulus that was put to work in the context of COVID.

So, it's really tough from an analogy point of view. Now, I will say, in the US, in particular, it is gonna be different. If we think about 1969, nominal GDP in the US was about $1 trillion. There were about 22 million goods workers. Today, nominal GDP in the US is about $23 trillion, and we still just have a little over 20 million goods workers. So, it's a different economy in a lot of ways, and the way monetary policy reacts is gonna have a different effect.

And I know there's been some discussion about low R-star in the context of the mid-2010s. And effectively, without getting into the all the math, it means the economy is less interest rate sensitive. And so, if that's the case, you actually need to raise rates by a greater amount in order to have an impact on the economy. So this, really, is without comparison, in my view, and it does have some similarities to the '70s but not enough to call it. We need the exact same prescription. And the final note on this is, in the 1970s, we hadn't gone through the Volcker Disinflation. So no one knew it could be done.

So an important point is that people believe central banks can get inflation under control, which may mean we may not need to go as high as we did at that point in time in order to get inflation under control. And that's one of the benefits of central bank credibility and we're seeing that play out, in particular, the US right now.

Anu: Perfect. So, Rob, as we wrap up this episode, give our listeners a summary of-of maybe three key takeaways that you want them to leave this episode understanding.

Rob: Sure. So one of the things is, we started with volatility, and volatility is likely to be with us for the near time, but eventually, it's going to have to come down. Either we're going to break something or we're gonna have a soft landing in which case we'll know what the trades are. And so, it's going to be difficult for central banks to continue to surprise either hawkishly, although we did get the surprise from the RBA dovishly. So that's one thing to think about going into next year is, what's the level of rates volatility, and will accounts be able to take bigger positions?

The other thing that we need to focus in is the Fed is in a bit of a race against realized inflation, and will the Fed over-tighten and force a recession? And I think that's one of the questions that we're analyzing constantly in that all accounts. And then the final is what we referenced earlier, which was the focus on fundamentals across countries. And we will see differentiation across geographies and even within geographies as it pertains to 2023.

Anu: All right. So what's the level of rates volatility? Will the Fed over-tighten and force recession? And looking at the fundamentals across countries. Great. Thanks very much, Rob.

Before we officially close the episode, I do have a bonus question for you, Rob. At this time, it seems like your day job is probably pretty stressful, particularly being in the UK where there's been so much happening every single day, rates bouncing up and down. So my question for you is, what do you do to rest and relax?

Rob: Sure. So one of the benefits of moving here versus the US is just the time zone. So it's great to get the morning workout in and that's key every morning, whether it's spin class or the gym. You come in with a fresh mind, and-- versus in the US when you get in and you get data sort of within the first half hour or 45 minutes and you're off to the races.

Here it's just a better chance to prep for how the day is going to evolve. And really for trading macro, London despite the UK problems really is uniquely one of the epicenters for getting things done and really getting your thoughts clear on how to approach markets.

Anu: Perfect. Excellent. I always think exercise is a great reset for your body, for mental health, and everything. Glad you're finding time to incorporate that into your very busy day job. Rob, thank you so much for joining me on today's episode to discuss some of these implications of the current situation in markets. Hopefully, we'll see some easing in the upcoming weeks and months as I know things will continue to unfold.

Rob: Thanks, Anu. This was great.

Anu: And to our listeners, if you've enjoyed what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple Podcast, Google Podcast, 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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