Transcript

The Ideas Exchange

Episode 23: Headwinds and tailwinds driving the economy and markets

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Rory Cunningham (00:00):

Welcome to the Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I'm Rory Cunningham, senior manager of investment products at ASX. This is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

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Rory Cunningham (00:35):

Hello and welcome to the Ideas Exchange. My name is Rory Cunningham from the ASX and I'm very pleased to be joined in the studio today by Gemma Dale from nabtrade. Gemma, welcome.

Gemma Dale (00:45):

Thank you. Great to be here.

Rory Cunningham (00:47):

So Gemma, it's basically almost six months to the day that we've had you on the show. Last time that we had you, you had just done a presentation at Investor Day called Headwinds and Tailwinds. Basically, the premise to that presentation, it was looking at the macro environment and talking investors through what the current situation was both in Australia and around the world, and then calling out some key considerations for those investors as they look to prepare their investment portfolios.

(01:17):

Now, we have just had Investor day again, same premise for the presentation, headwinds and tailwinds in the market, and also talking through what investors need to be mindful of. So it feels like over the last six months everything has changed, but yet nothing has changed. So I want to start off, Gemma, can you talk us through the current market environment, but perhaps let's focus first on inflation because it seems like as if that is the core to what's driving everything else that's happening in the market, particularly over the last six months?

Gemma Dale (01:45):

Yeah, absolutely. You couldn't be more accurate. I'm not entirely certain the ASX has moved at all point to point in terms of where share prices are from the last time we spoke. But everything is happening around it and there's been a whole lot of volatility during that period. So you are absolutely right. Everything's happening, but nothing's happening. It's like the duck swimming, right? It's floating on the top of the water, but underneath there's a whole lot of crazy stuff going on.

(02:15):

The macro environment is all hinged on inflation at the moment and I find this fascinating. I studied economics at university and I actually have a degree in economics. I don't even think you can get a degree in economics anymore, do commerce or business or something. Inflation is one of the absolutely key principles in economics, basically how much prices move up over time and how much they increase over time. We spent years studying it at a university and there were all of these lessons and assignments and tutorials and God knows what else talking about the impact of inflation on economies, how much rapidly rising prices destroy the wealth of individuals, right?

(02:56):

The reason that we worry so much about inflation is it destroys your wealth over time unless asset prices are keeping up, which they usually don't in a high inflation period. Central banks were generally created with the express purpose of keeping a lid on inflation, trying to keep it low. After learning about it and spending all of this time working on it at university, frankly, there's been zero inflation of any material type for the last 20 years. Inflation has been extremely boring and if you saw it on the news at all, the CPI figures in Australia only brought out every three months. So every quarter, and it would be like, oh, they're just 2%, 3% annualized.

(03:33):

The RBA has been trying to keep inflation in a 2 to 3% band since its inception in the early '90s, and for most of that period it's had absolutely no trouble whatsoever. The biggest issue was in fact that inflation was too low, not high enough. Now suddenly in the last 12 to 18 months post-COVID and as the market has, well, the world has returned to pretty strong levels of economic growth, we've had these extraordinary events of massively impacted supply chains due to COVID. We've had the war in Ukraine. We've had a whole series of different things that have suddenly kicked off inflation in this really dramatic way.

(04:11):

It's gone from being a boring, irrelevant factor in markets and in the economies to becoming the only thing we care about and we care about it very, very much because the only tool that central banks have to manage rapidly rising inflation is interest rates. We care a lot about interest rates. They matter very much. So interest rates globally have been close to zero during COVID, and in some honestly major economies, they've been below zero for quite some time, certainly real interest rates. Now central banks go, "We don't have a choice anymore. We can't keep rates super low."

(04:46):

Inflation is far too high and it's rapidly rising and it's not transitory, which was the term that the Federal Reserve used. This idea that it's just going to go away. It's only supply chain issues. It's only COVID driven. It's going to go away. It's not transitory. So in Australia at the moment, we have inflation around 7% on an annualized basis. In the U.S. it's over 8% on an annualized basis. It was over 9% earlier in the year. These are huge numbers. In the UK, it's well above 10%. So prices are increasing 10% every year.

(05:24):

If you're looking at specific underlying factors, particularly energy, which is a huge issue if you have to heat your home for six months of the year, energy prices have risen dramatically and they're causing huge problems. Little data point that I saw yesterday was that UK restaurants are now collapsing at a faster rate than they did during COVID. So even in lockdowns, they didn't collapse as quickly as they can, and rising energy price is one of the major factors.

Rory Cunningham (05:47):

I heard your son had an interesting inflation story.

Gemma Dale (05:52):

He did. This is so good. The best description of inflation you'll ever get for all those people who've never had to think about it in their entire adult lives was my son said to me, "Oh mom, I used to be able to buy a slushy at the canteen." He's nine. "A slushy at the canteen for $2 when I was a kid." In the last two years, obviously. "I could buy a slushy for $2 and now it's $4.50 and it's smaller." That's my favorite thing. It's not just inflation. It's fairly dramatic inflation as well, $2 to $4.50.

Rory Cunningham (06:22):

It is actually, yeah. Yeah.

Gemma Dale (06:23):

That's not 10%. But also it's shrinkflation, this idea that you get less. so what used to be a product of a specific size, the size is now smaller, but you're paying the same or more. So your Tim Tams used to be 13 in a packet or something and now they're 11 which caused outrage.

Rory Cunningham (06:37):

There you go. Even children are feeling the pressures of inflation.

Gemma Dale (06:40):

They're feeling the pain. Poor kids.

Rory Cunningham (06:42):

Now, you mentioned that one of the only tools or perhaps the only tool that central banks have to battle inflation is interest rates. So where are we at with interest rates at the moment? Perhaps from an Australian perspective, how does that compare to the rest of the world and where are we going to get to?

Gemma Dale (06:58):

Yeah, such a good question. I mean I love where are we going to get to, but we can take a guess. So in Australia, rates have risen dramatically from close to zero. The most challenging part of this was that the RBA, which is Australia's Central Bank, about which we've had very much over the last 12 months, has been very wrong about its own intentions. I mean, they're the ones that change rates, but they've been a little bit too explicit I think for some people's liking about what the future look like. So Philip Lowe, who's the governor of Reserve Bank of Australia has come out and said, "We don't anticipate raising rates until 2024," said this last year.

(07:34):

Now it's currently 2022, and they have raised rates multiple times and we have gone from close to zero to close to 2% and now everything has changed. If you are a borrower and you are not on a fixed rate, many Australians are on a fixed rate, the cost for you of maintaining your mortgage is so much higher than it was. Now, the tricky thing is they're not planning to stop there. He spoke yesterday very recently and made further comments that there is further to go with raising rates. If we genuinely need to bring inflation down to that 2 to 3% band, then we need to keep raising rates until we've got a real lid on it.

(08:16):

Now, cash markets effectively bet on where they think rates are going to terminate, I like the term terminate, when they're going to stop increasing. The current estimate is close to 4%. It's really high. It is much, much higher than we currently are and that would dramatically change the impact on households and businesses of how they manage their cash flows. Now, in terms of your question about where we are compared to the rest of the world, we're actually way behind everybody else. In the U.S., they started raising rates somewhat earlier than we did, but they've also been much more aggressive. We've had 25 basis point increases. They've had 50 and 75 basis point increases.

(08:54):

So they're far ahead of us and they're higher already, but the expectation is that U.S. rates are going to terminate around 5%. They are not there yet. The UK is the same. They've also started earlier and gone harder. New Zealand, the Bank of New Zealand's gone harder and earlier as well. So we are quite a way behind the rest of the world and we've been not just slow to start, but more careful in the increments. So we are a long way behind. There's no requirement that we catch up to everybody else in terms of higher rates, but we don't operate in isolation in Australia. Markets do absolutely price things off interest rates. It does have a huge impact on investors.

Rory Cunningham (09:36):

So from a historical perspective, I mean, 4% isn't out of line with if you go back long enough, I suppose the challenge is it's the rate of change from where we've started only 12 months ago.

Gemma Dale (09:50):

You're absolutely right. The rate of change has been really dramatic. But I think the other issue is how indebted households are. Businesses are far less indebted than they have been in previous hiking cycles. If you look back to the early '90s, a lot of Australian businesses, particularly banks, held a lot of debt. They were also lending a lot to corporate developers and so on. It got a lot into trouble. We don't have that same level of corporate debt anymore. Corporates have been reasonably conservative, but households as a result of rising house prices, although they somewhat feed each other, lower rates feed house prices, then you borrow more in order to afford them. Households are hugely indebted in Australia, and so that's a massive issue. It puts huge pressure on the consumer. They can spend less because all of the money is going into the mortgage.

Rory Cunningham (10:41):

So you mentioned there in your comments that asset prices get priced off the cash rate. Would you mind explaining what that actually means and how that works? Because I think that's going to dovetail nicely into the next bit of the conversation around equity market performance.

Gemma Dale (10:56):

Yeah, sure. So if you're a purist, you compare the value of every asset you're interested in investing in to a discount rate, which is boring and doesn't sound very interesting. Discount rate is effectively the money that you can get in a safe asset. So it's usually U.S. treasuries we compare it to. You could compare it to a term deposit, if you're an individual. If I can get 4% in a term deposit guaranteed and I'm going to get that back in six months or 12 months time, then why would I put my money at risk in another kind of asset which is not going to give me a material premium? It's not going to pay me a lot more for the risk I'm taking.

(11:42):

If I invest in equities, the value will go up and down. The dividends may go up and down. Unless I'm pretty confident they're going to give me an amazing return, maybe I would prefer to keep my money in a term deposit. So everyone tends to make that trade-off between the safe return you can get in something that's priced off the basic interest rates set by the central bank versus a riskier asset. What's happened over the last 10 years post the global financial crisis is as interest rates are falling, and you made the point that 4% is not particularly high in a historical context, anyone who's older and listening will remember the days of the late '80s and early '90s when interest rates were incredibly high in Australia.

(12:26):

I still remember my parents being terribly proud of fixing their mortgage rate at 13%, because even I was terrified by as a child. This idea that 4% is not particularly high, but as rates fell too close to zero, it made everything else look super attractive. Super attractive. Suddenly equities look amazing. If you can get a dividend yield of 5% plus the benefits of franking versus zero in the bank, that's amazing. Whereas when interest rates are 4% or 5%, you can get that in the bank doing nothing. Maybe you're not willing to wear the volatility.

Rory Cunningham (13:03):

So leading on from there, you introduced to us the TINA principle six months ago.

Gemma Dale (13:10):

Yeah.

Rory Cunningham (13:11):

Do you want to explain to our any new listeners that didn't listen to that podcast what TINA was back then and what TINA is now?

Gemma Dale (13:17):

Yeah, yeah. Well, the irony is TINA's probably never going to be heard from again. But TINA is the idea is there is no alternative. When rates were zero or close to it or even 1%, there was no real alternative for investors. Particularly when you think about the sheer volume of retirees in the world who need to live off their investments, they don't have a choice. They're not going back to the workforce. They had no alternative but to chase yield and chase returns in less secure assets than they might have preferred. So there was no alternative to investing in growth assets.

(13:58):

You had to be in property, you had to be in equities, because if you were in cash, you were getting no return. Even though inflation at that point was really low, you were still getting a less than zero return after inflation. So there was no alternative. But as rates rise, there are lots of alternatives and that suddenly sucks a lot of the joy and a lot of the future potential out of some of the alternatives that you previously thought you were stuck with.

Rory Cunningham (14:23):

So there is an alternative now and the age of cheap money has ended.

Gemma Dale (14:28):

Yeah.

Rory Cunningham (14:29):

So if we look at asset class performance year to date, with that kind of macro environment, it's been actually challenging. I don't think it's a single asset class year to date that has outperformed.

Gemma Dale (14:41):

So the only thing that has a positive return year to date in 2022 is cash. That's it. Everything else is underwater. That is as a result, and quite dramatically underwater, some asset classes. So in Australia, the ASX is held up really well relative to other asset classes. You may, if you bought the ASX 200 on the 1st of January, only have lost a couple of percent, and by the time you add dividends back, actually be above zero in the benefits of franking. You probably didn't buy in the 1st of January though, let's be honest. But you haven't done terribly relative to other markets.

(15:20):

If you only held U.S. dollars, by the way, which we may or may not consider an asset class, you would also doing super well. But property is underwater and that is a global phenomenon, not just in Australia. So in Australia, we estimate about 10% fall so far. We know that the U.S. markets, even though they've had some rallies, the S&P 500 is off about 20%. The NASDAQ is off about 30%. It's quite extraordinarily how quickly different assets have been repriced as a result of these moves in interest rates. So it sounds boring, the macro stuff, but the impact has been absolutely dramatic.

Rory Cunningham (15:59):

Okay. So despite all those asset classes being negative performance with the exception of cash, things are actually pretty good from an economic point of view. We're actually not in a recession. I mean, you look at some of those key indicators, actually things are quite nice.

Gemma Dale (16:17):

It's such an extraordinary paradox at the moment. So the U.S. did actually have two negative quarters of growth. So the technical definition in Australia, there's two quarters of negative growth. The U.S. does not use that definition. They just make up their own definition at the time and they didn't like it. So they decided they'd not been in a recession. But unemployment is at extraordinary historic lows. We won't say if you want a job, you can get one. But the population is extremely well employed by historical standards. So unemployment's incredibly low. Consumer spending, even though we talk all the time about inflation and we talk about pressure on the consumer, consumer spending's holding up really well.

(16:59):

One of the things NAB's economists are looking at all the time, because we have exceptional data about what people spend and how they spend it, is how and why consumers are holding up so well. Consumer confidence is terrible. It's at COVID and GFC levels. So consumers will tell you they're feeling dreadful and they're absolutely not going to spend. But when you look at what they're actually doing, they're spending. Businesses are also not feeling super confident, but their conditions, so we look at business conditions as well as business confidence, business conditions are actually pretty good too.

(17:34):

Most businesses are making money and they can see their markets growing and so on. So it's paradoxical. We have not found ourselves in a recession in Australia. There are absolutely lots of people doing extremely well. Unemployment is extremely low, but you can feel the anxiety coming through in a lot of the surveys.

Rory Cunningham (17:54):

Okay. Let's switch our focus to market. So start with Australia. As you mentioned, it hasn't been too bad in terms of the performance year to date on the ASX. What about from a sector perspective?

Gemma Dale (18:07):

Yeah, the joy of the ASX is that the sectors are dramatically different to a lot of the other developed markets around the world. So when you look at the S&P 500 and go, "Oh my God, that's terrible." You look at the ASX and go, "Gosh, that seems to be holding up quite well." The underlying sectors have performed very, very differently. Energy has been the absolute standout, and the obvious reasons for that are that coal prices have gone through the roof. Oil prices are very strong by historical standards. Gas prices are extremely strong at the moment. That's entirely down to the war in Ukraine and it's not a great reason. No one's happy about it, but it has absolutely supported companies that work in these sectors.

(18:47):

So energy's up about 35%, which is just incredible, right? That's a hell of a return. Terrible five years leading up to this, but done extremely well. Financials are holding up okay, off a little bit. Banks tend to perform quite well in a rising interest rate environment to a point. They will come a point where people stop borrowing. But we still have extremely low defaults, extremely low bad and doubtful debts. So people are absolutely keeping up with their mortgages as rates rise. Banks can now charge a little bit more on their mortgages and they don't give all of it back in term deposits so they can make somewhat more on their books. So banks actually tend to do reasonably well.

(19:29):

Between financials and materials, which are also holding up okay, the Australian market, that's sort of 50% of what you're invested in, add in energy, you're doing okay. So when you look at the major sectors, you're doing relatively well in Australia. Healthcare's being crushed relative to people's hopes that it would hold up. But that's largely due to a lot of U.S. dollar earnings and sort of global issues there. Then also there is the sectors that have not done well. Tech's been absolutely hammered, and also consumer discretionary because there's this real concern that consumers will come under pressure.

Rory Cunningham (20:04):

So speaking of tech, if we shift our focus to the U.S., their market has been under real pressure year to date.

Gemma Dale (20:11):

Yes. So the U.S. is a completely different story. If you had looked at the multiples people were willing to pay for U.S. high growth tech companies a year ago and look at them now, you can see exactly why it's fallen so much. People were paying 300 times for Tesla and that's one example. I mean, it's car manufacturer, right? Yes, it's a growth story, but it's a car manufacturer. There are very specific constraints on how many cars they can make. People were willing to pay hundreds of times earnings. They're paying 60 and 70 times for pretty solid businesses, but they were not growing that quickly.

(20:54):

So there's been a real reduction in the amount people are willing to pay for that growth. That's really what's happened. It's not that the business is necessarily falling over, although we're starting to see significant layoffs in the tech sector in the U.S. So they're feeling it now, but it's not that the companies are falling over. It's just simply people aren't quite willing to pay so much for them anymore.

Rory Cunningham (21:12):

Yeah. So a little bit of a summary here, because there's a lot of moving parts. We've got rising inflation, rising interest rates in Australia and around the world to battle that. That's creating a lot of market volatility. Having said that, the lead economic indicators look fairly positive in Australia and around the world, though there are some challenges when you kind of scratch the surface. Australian equity market has performed okay. U.S. equity market has performed poorly, but across all asset classes, actually year to date, it's been a challenging environment because only cash is positive, all the rest are negative. Can you help our listeners with that as a backdrop? I mean, what should they be focused on? What should they care about when they're looking at what they do with their investment portfolio?

Gemma Dale (22:01):

Yeah. It's a really, really good summary. When you step back, what has happened is exactly what you would expect to happen in a rising rate environment. If inflation hits hard, rates rise and you reprice everything you want because you're no longer willing to take the same amount of risk because the return expectations are lower and you can just get a good return in the bank, right? It's very, very simple on that basis. It doesn't, for long term investors though, dramatically change what you should be doing. You are, however, perhaps not going to chase the super exciting tech stocks anymore. That clearly was a winning strategy for a period.

(22:43):

Now investors, and you can see it very clearly, they are focused on quality. They are looking for companies that have earnings, that are profitable, that are going to be around in five and 10 years time. That shouldn't be shocking, but it does feel a bit shocking over the last few years. We had a few years where we didn't worry too much about profits. Now we're very worried about profits. We want to see those, right? So we're focused on the quality of the company. We want to make sure that what we're investing in is going to be around in the future and that it also can ride through some volatility in an economic downturn.

(23:15):

So when you're looking at your investments, you want to think long and hard about whether or not a company can survive a coming economic storm or a significant downturn if it happens. You are also going to look at your diversification. If you have been riding a really narrow wave of opportunity, and a lot of people were heavily exposed to the stuff that was doing really well, as that has fallen to earth. One of the major reasons the U.S. has fallen so much is because it outperformed all other markets, right? Tech was where it was at. It's not where it's at anymore.

(23:46):

So you're looking across your portfolio and going, "Do I have exposure to a range of sectors and a range of things that can perform for me through different periods of time?" Because if you were only chasing the winners, then you might have had a rough year. I think the thing that investors need to keep in mind, you do need to protect your downside. There may be further downside, not least for the ASX because it hasn't fallen terribly much. It's been relatively resilient. There may be further volatility to come, right? That would not be unexpected. But equity markets do turn. They tend to turn very quickly and you don't see it as it's happening.

(24:25):

It feels like it might be another false dawn, and people sit on the sidelines and then wait, and they may have missed the first 20% upside. So I think if you are an investor, you have cash. Most of our investors on nabtrade have a ton of cash at the moment, absolute ton of cash. They've been sitting on it for quite a while. You want to be very alert to the green shoots, as we love to say in the market, to the market turning around. The market turns around much more quickly than the economy. It tends to move six, 12 months in advance.

(24:58):

The slightest tint of good news is enough for the market sometimes. This idea that we are buying the future, we're not buying today's earnings, we're buying future earnings, and therefore we're looking through to what is going to be around and what is going to be profitable for us and what's going to be generating great returns in one, three and five years time. So even though there's a fair bit to worry about and the headwinds are not insignificant, as an investor, this is probably the time to be very aware of the opportunities that may present themselves.

Rory Cunningham (25:31):

Well, I think also for a particular segment of investors, and I'm thinking pre-retirees into retirees, there is now an alternative to having to take on too much risk. When they look across asset classes, they can now create a diversified portfolio and get a reasonable return from those more conservative asset classes.

Gemma Dale (25:54):

I think that is so important. We talk about the impact of rising rates on mortgage holders because they're the ones who are going to feel the most pain, but we don't talk too much about the people who are getting the most benefit, and they are the people who've suffered through the last five to 10 years of falling rates. Retirees and people who need more secure assets, they didn't want to be taking that level of risk, right? It wasn't really appropriate from a historical perspective, but you're not willing to wear five plus years of negative real returns in cash and so you had to chase it. For those people, this is an amazing opportunity, as you say, to build a much better diversified portfolio across asset classes. That gives you a bit more security. Bonds have not done well this year, but it won't always be that way.

Rory Cunningham (26:37):

Gemma, thank you very much for coming in. We always appreciate your time. You always give a lot of your time for Investor Day, for the Investor Update Newsletter and also on this podcast. So thanks for coming in and I hope our listeners got a lot out of that conversation.

Gemma Dale (26:50):

I love working with you guys. Thank you.

Speaker 2 (26:53):

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