Transcript

The Ideas Exchange

Episode 35: Rates, Recession and Recovery

December 2023

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, and 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 (00:48):
Welcome to The Ideas Exchange. I'm your host, Rory Cunningham from ASX. 2023 saw a rise in interest rates designed to reverse the pandemic era excesses. And yet, growth in the economy has remained relatively strong through the year. However, as the economy moves into the slowdown phase, investors are left trying to figure out how this will impact markets and how they should position their portfolios. To discuss this, I'm joined by Julia Lee, SPDR ETF Equity Investment Strategist APAC from State Street Global Advisors. Julia, welcome to The Ideas Exchange.

Julia Lee (01:27):
Great to be here. Thanks for having me, Rory.

Rory Cunningham (01:29):
So before we get into it, can you provide us for our audience some background to State Street?

Julia Lee (01:35):
Sure. So State Street Global Advisors has served the world's governments, financial institutions as well as advisors. We really are

pioneers in terms of index investing as well as ETF investing. And as a result, we've become the world's fourth-largest asset manager with over 3.5 trillion US dollars under our care. So quite a large organization. And it's great to talk to you today about the outlook for the economy.

Rory Cunningham (02:04):
No, and thanks for being here. It's great to have a speaker with your experience here educating our audience about the economy.

Now, Julia, you were recently a presenter at our ASX Investor Day series, which takes part in Brisbane, Sydney, and Melbourne. In your presentation, you talked a lot about economic cycles. So I thought before we start discussing the recent performance and outlook for the economy, can you please give us some background to the different types of cycles economies tend to go through?

Julia Lee (02:34):
Sure. I think as investors, it's really exciting to be able to understand the economic cycle and also the economic environment. As investors, it means that we get an idea of whether it's relatively easy to make money or relatively difficult to make money. And by understanding the economic cycle, which does tend to repeat after time and time again, investors can get comfort in terms of their investment strategy as well as their investments.

So I guess if we have a look at most things in life, it moves in cycles, and the economy is the same. When we look at the boom times, and I guess for me the most fun part of the cycle is the growth phase of the cycle where we are seeing the economy growing and economic conditions are relatively good. But after that growth, usually we see a slowdown phase. And then after that slowdown phase, we sometimes see that recessionary phase. And then after recessionary phase, we go into recovery. So those four distinct phases of the economic cycle do tend to repeat. And there's been a huge body of research in terms of what investments tend to do better or worse at different phases of the economic cycle. So from the recovery phase back into growth and then back into slowdown and then back into a possible recessionary phase again.

Rory Cunningham (03:52):
Excellent. And we'll explore some of those cycles as we move through this conversation. What we thought we might do for the conversation was to break it into three parts. So first, we'll ask Julia to reflect on the global economy, then we'll move to the domestic economy and look at what's happening in Australia, and then talk about what investors should be thinking about as they look to position their portfolios given

that backdrop. So Julia, let's start with the global economy. How did we go in 2023?

Julia Lee (04:21):
Well, first of all, it's important to look at the global economy even for Australian investors because Australia plays such a small part in terms of the world economy. We have a look at population. Our population is less than about 0.4% of the world's population. And if we have a look at our economy, less than 1% of the global economy. So to get an idea of the global economy is to understand the big pond in which we play, where we are just still a bit of a drop in the ocean. And I guess when we have a look at the global economy, we know that things are slowing down. We have a look at growth last year in 2022, real GDP growth, which is how we measure how the world economy is growing with 3.4%. We think that's going to slow down to 2.8% when the final numbers come in for 2023 and then a further slowdown next year.

But having said that, different places in the world are in different phases of the economic cycle. And to give you an example, we saw Germany going into recession early in 2023. And then if we have a look at the forecast for next year, it's actually forecast to be looking at recovery. We know that also China came out of the pandemic a little bit later, so it's looking towards normalization so their economic cycle is a little bit different. And then the US is quite interesting as well. The US is the only major economy which has seen recent upgrades in terms of 2023 forecasts, and it's the only developed economy to be able to see actual upgrades in terms of 2024 forecasts.

So I guess the message here is that the US economy is still very relatively strong compared to other major economies. Different countries are moving at different paces, which means they're at different phases of the economic cycle. And I think it really underpins the importance of diversification across different countries for investors when we do see these different economic cycles playing out at different times for different places in the world.

Rory Cunningham (06:24):
Okay. So would you categorize it as overall you'd categorize it as a slowdown in the global economy, however, there'll be pockets of strength?

Julia Lee (06:32):
So we are looking at overall slowdown for the global economy. And I guess when we have a look at that slowdown phase, what does that entail? It sort of means that economic growth starts decelerating, which we're starting to see, but still remains positive. And we are still seeing that being positive. And the economy tends to be running beyond full

capacity. But what happens is that monetary policy, which is really just interest rate policy, starts to become restrictive. And we know with interest rates, they tend to bite six months after we've seen the move. So we're going to start to see those high interest rates taking effect in the economy. So those interest rate hikes that moved very rapidly upwards in 2023, they're really going to start to have its full impact in the first half of 2024.

Rory Cunningham (07:21):
Okay. There's lots of market commentary that certain countries, perhaps including Australia, are forecast to enter a recession at some point perhaps next year, perhaps further into the distance. Can you explain to us why do economists and market commentators think that certain countries are going to enter a recession? What are they using as their leading indicator there?

Julia Lee (07:43):
Well, if we have a look at that recessionary phase and what tends to happen in that recessionary phase, what's usually forecast is a rise in unemployment. So the jobs picture usually slow down in terms of retail spending. And if we have a look at Australia as an example, we've started to see some softer retail sales numbers. Unemployment is forecast to rise up to 4.25% by the RBA at the end of next year, and that means things are expected to slow down. Having said that, while Australia's probably in a per capita recession, which means that if we measure output on a per person basis that we are probably in a recession because of the strong record migration that we've seen, we're not forecasting that Australia will go into recession next year.

So the base case is that Australia will slow down but probably avoid a recession. And I guess there's a reason why Australia's called the lucky country. While we've seen a recession quite frequently for the US every eight to 10 years, Australia's managed to at times avoid recession for around about three decades. So just because the rest of the world goes into recession or the US goes into recession doesn't necessarily mean that it's going to happen over here. Having said that, it's probably going to feel like a recession because we are going to see the unemployment rate likely ticking up and also retail spending likely being soft, and households of course coming under pressure as those interest rate hikes that we saw last year really start to buy.

Rory Cunningham (09:16):
Okay. Keeping on interest rates for a second and recession, oftentimes our audience may hear a market commentators talk about the yield curve and also the inverted yield curve and how economists use that as predictive, I suppose, of an upcoming recession. Can you talk a little bit about that?

Julia Lee (09:36):
Yeah, I think the inversion of the yield curve is such a fascinating concept. When we think about it, usually when we're investing our money at a shorter timeframe versus a longer timeframe, we expect to be rewarded with greater returns when we're investing over a longer timeframe. And that's a normal yield curve where short-term rates are lower than long-term rates. And you usually see that when you go to put your money in a term deposit where a one-year rate will be a lower interest rate than a 10-year rate where you usually get rewarded for investing for a longer period of time and having your money at risk for a longer period of time.

An inversion of the yield curve is when that relationship flips over. So what you're seeing is that short-term interest rates are higher than longer-term interest rates. And this usually happens because investors expect interest rates to fall in the short-term because of difficult economic times. Actually, the inversion of the yield curve has predicted every recession in the US since 1955.

Rory Cunningham (10:38):
Wow.

Julia Lee (10:39):
So that's the reason why investors look at that inversion of the yield curve as a forewarning that recession is going to hit. Having said that, it's an extremely blunt timing tool. And if we have a look at the global financial crisis as an example and the inversion of the US yield curve, which is usually the inversion of the two to 10 year yield curve, what we saw is that inversion happened 24 months, so two years before the recession actually hit.

So for investors, you know this recession is coming. You just don't quite know when, and it could be a couple of years after that first inversion of the yield curve. Having said that, what's also quite interesting is that in the 37 years before the pandemic hit, the yield curve has not been inverted for a single day of any US recession. So at the moment we are still seeing an inversion of the yield curve. Usually when you see a flattening and a normalization, that sometimes acts as a signal for investors to start adding risk to portfolios, which usually means adding things like equity investments as well as property investments to their portfolio and moving away from some of the low risk curves. So that's more if you're looking at a tactical viewpoint. But certainly the inversion of the yield curve I think is an extremely interesting concept for investors because it means a flipping of that normal relationship between short-term and long-term interest rates, and also just as a forewarning, especially around a US recession.

Rory Cunningham (12:13):
Okay. Let's bring the conversation to the Australian economy. Now, 2023 obviously has been the year of inflation and interest rates with all, any of us that have a mortgage has seen that firsthand. So first question is why have we seen such high rising inflation in Australia and also rising interest rates to battle that? And have we seen a peak?

Julia Lee (12:38):
Oh, you've opened up a can of worms here. Usually they say that inflation is first of all a monetary phenomenon. And if you think back to COVID and what happened there, it was we saw the largest amount of stimulus we've ever seen for the Australian economy. Not only did we see a large amount of cash being handed out to businesses and households, but households weren't necessarily able to spend that cash. We weren't able to go on holidays, you couldn't go out to restaurants. Because of lockdown, it meant that we weren't able to spend that cash. As a consequence, households had this massive savings buffer, they had a lot of money to spend. And once lockdown came out, we sort of went into overdrive. I don't know about you, but I keep on seeing pictures of holidays and things from families and friends. So I guess as a consequence, things started to get really overheated. So as a result we saw inflation, interest rates rising to try and combat that.

But let's, I think, go back a step and talk a little bit about inflation, what it is and the experience we've had in Australia because I think that tells us a lot about why it's so important to tackle inflation. And inflation is when you get less for your money. Deflation is when you get more for your money. And if we look back over time since let's say 1980, but even if you go back even further than that, usually we are always looking at inflation. You're always looking at a situation where inflation is above zero. It's very, very rare that you get inflation falling below zero, which is deflation. So that means constantly over time you're getting less for your money. And that's why investing is so important to try and make sure you can keep up with inflation so that your money still has the same spending power in 10 years time, 20 years time, 30 years time. So the value of your money is constantly decreasing.

Also, if we have a look at inflation, we're talking about inflation rates over the last 12 months in that 4 to 6% range or even higher than that. But if you look back to the 1980s, here in Australia, inflation was above 10%. At times it was above 12%. And back in the 1980s, there was a very different policy where it was generally accepted that inflation was okay as long as you got a good employment or job situation. But what happened back in the 1980s is because of that expectation that higher inflation was okay, that actually generated higher and higher and higher

inflation. And as a consequence, policy changed. And the RBA, the Reserve Bank of Australia, now has a 2 to 3% target in terms of inflation. And actually post the early 1980s, inflation has been relatively stable until COVID happened.

So why is it important to tackle inflation? I think inflation, first of all, sort of hits the people with the least amount of money. So people who are doing it tough, do it even tougher just to spend on essentials. I mean, if we have a look at statistics like coming through from charities or even governments around homelessness and financial difficulty, these things are spiking. New South Wales' government does a count of people sleeping rough. The last count they did was in February of 2023. So no doubt when they do account next year that things will change. But the February count compared to the previous year in 2022 was up by a massive 34%.

Rory Cunningham (16:27):
Wow.

Julia Lee (16:27):
So I think that really demonstrates why it is important to tackle inflation. It does have a really destabilizing impact and a really impact on households, people's living situations and their ability to spend as well. And of course, it causes instability because it does hit the most vulnerable part of our country a lot harder than it does with people with a lot more wealth. So inflation is quite a destructive force, which is why it's so important to tackle it. And no doubt that a lot of households, well probably all households, are feeling the pinch, but certainly there are people who are struggling a lot.

Rory Cunningham (17:08):
So we've got a higher rate environment, high inflationary environment. And this is naturally going to, as you've mentioned, have an impact on households, an impact on the economy, an impact on businesses. So what have we seen directly in terms of that impact, whether it's GDP growth, savings, rates of households, unemployment rates?

Julia Lee (17:33):
Sure. Well, I don't know about you, but I know that all my friends and neighbours are obsessed with property, and property prices are pretty much at record highs. So I think just starting with housing. Sharp increase increases in asset prices together with a very speedy expansion in credit often coincide with a big accumulation in debt. And it sounds like I'm just sort of describing what's happened here in Australia. But as you see companies as well as households getting overextended, then you start seeing difficulties in paying back some of those obligations.

At the moment, we haven't seen a massive spike in defaults. If we have a look at the banks and their profit reports, we haven't seen a huge increase in terms of defaults as yet, but there are still signs that things are getting tougher. And one of the things we can have a look at is the household savings rate. What we saw during COVID was the excess stimulus combined with the inability to spend by households meant that we saw the household savings rate actually rising above the long-term average, in fact, to almost record levels. But then since then we've seen the household savings rate actually deteriorating. It's now below that average rate are moving very rapidly towards that zero rate, which means that households don't have that comfortable buffer that they had post-COVID. So that's something that is a danger.

And then of course, the other thing that we're watching is the job situation. And the unemployment rate still very close to 70-year or all-time record lows. But if we have a look at what's expected to happen in terms of jobs, well the unemployment rate is expected to go up to 4.25%. So that's quite a big rise. So that combination of that savings buffer having disappeared for households together with rising unemployment means that it's going to be much tougher for households in 2024.

And in the end, that's all reflected in GDP, which is how we measure what's happening in terms of the economy. So we are expecting to see a slowdown for the Australian economy, but we are still expecting to see growth coming through, and that's as a consequence of that massive amount of migration that we saw. But also Australia is very much dependent on its exports. And if we have a look at things like iron ore exports, gas exports, well, we know that that's very much dependent on China. And China moving towards normalization and also looking at stimulus in terms of its economy because it's having trouble with the property space probably means an extent of support for the Australian economy.

Rory Cunningham (20:37):
Okay. Let's try and bring it all together, Julia, so that we can, I suppose, give some practical guidance here for our audience with that backdrop, which is globally, we're seeing countries move into slowdown. Certain countries perhaps forecast to enter into recession, touch wood that Australia avoids that. We'll see how Australia goes. But as countries move from slowdown into perhaps recession, what sectors tend to outperform?

Julia Lee (21:10):
It all sounds pretty depressing at the moment, doesn't it? The first thing I guess for investors to take into account is that the share market is forward-looking. You almost have to look at what's going to be

happening in 12 months time. So although the global economy and the Australian economy is in slowdown at the moment, the key question to ask is, is that already priced in and are markets already now starting to price in recovery? So I think if you position for recession when you're actually in a recession, you're already too late to the party because the market's already priced that in. So you almost have to look into the crystal ball to look at where we are going to be in terms of the economic phase in 12 months time. So quite possibly you are almost looking at an opportunity to position for recovery over the next six months.

I think one of the most exciting things about working for State Street Global Advisors is the amount of academic work and studies that they have. And one of my favourite pieces is looking at the four phases of the economic cycle and then going back to have a look at whether there are certain sectors of the stock market that tend to outperform and underperform at the different phases of the economic cycle.

This particular study was done on the US stock market and the US economy only because there's been a lot more frequent recessions. We tried to do the same study in Australia, it'd be quite hard because we didn't have a recession for around about 30 years or three decades. So having a look at the results of this study, which crunched the numbers from 1960 to 2022, what we noticed were there were distinct sectors of the market that tended to outperform. So we're in the slowdown part of the cycle at the moment. Traditionally and historically, the top three sectors that have outperformed at this phase of the economic cycle are the defensive areas, things like consumer staples, healthcare and industrials. They're called defensives because usually you have to spend on these, whether there are good or bad economic times, things like healthcare, things like buying bread and milk. So these are called a stable spending or consumer staples.

Also, if we have a look at the worst performing sectors, these have tended to be materials, consumer discretionary, as well as real estate. Going into recession, then usually we still find that those defensives outperform, so consumer staples, utilities and healthcare. And then going into recovery, we start to see some of those cyclical areas of the coming into focus. These are sectors of the market that rely on the economic cycle to outperform and underperform. So things like consumer discretionary, so they're things like retailers, JB Hi-Fi, real estate, which are very much dependent on interest rates. The material sector, these tend to outperform during the recovery phase. And then in the expansion or the growth phase, then usually financials, technology and communications. Now it's not always the case, this is just what's happened historically.

I think another interesting part of this study is that energy never features in the top three or bottom three for any of the economic phases, which suggests to me that energy rather than being influenced by what's happening in the economy, is more influenced by demand and supply, which is I think also an interesting part of this study. But if you are interested, please go to our website, SSGA.com, to have a look at this study. There's a lot of detail on it, but I think it gives investors sometimes a roadmap.

It doesn't always happen like this, and this year you might say, "Well, it's been information technology, communications, and consumer discretionary that have outperformed." And I guess the earnings picture also comes into focus there. And the reason why those three sectors have outperformed in the US is because they're very mega tech as well as tech heavy. If you look at Amazon, that falls in the consumer discretionary sector. And then of course, companies like Apple, Microsoft where AI, which is more of a structural rather than a cyclical trend, very much coming into focus.

Rory Cunningham (25:24):
Okay. The other piece of research that I've seen, I believe, comes out of State Street as well is how institutional investors are allocating their capital. Do you have any insights to share on that front?

Julia Lee (25:35):
Sure. So State Street Global markets takes data that it has and then it has a look through at holdings and flows. So it has a look at what institutional investors are holding, and it represents around about 11 to 12% of the listed equity markets. So it gives us a real insight into what holdings institutional investors have. And then flows has a look at where the money is flowing.

So if we have a look at holdings relative holding versus the last five years, to give us an idea of where institutional investors are overweight and underweight and then have a look at flows to see where the money's been flowing over the last three months, it gives us an insight into what particular sectors have the potential to see greater profits.

So the research we've done has shown that when institutional investors are underweight and then you start to see money flowing in, so inflows coming through, then usually the money you can make from that space is usually a lot greater than if institutional investors were already overweight and you saw money flowing through, then the potential profit there is usually smaller than an underweight and inflows coming through position.

So if we have a look at where institutional investors are overweight at the moment, information technology, energy and industrials. And if we have a look at where they're underweight at the moment, real estate materials and consumer staples. I think some of the interesting areas are real estate as well as consumer staples in healthcare. These are areas where they're relatively underweight, but inflows have been coming through over the last three months.

On the other hand, industrials is a space where they're relatively overweight and we've been seeing outflows coming through. So that gives us a bit of a guide map in terms of where the demand as well as the supply is and the potential for growth in some of those sectors.

Rory Cunningham (27:35):
Fantastic. Some great information there for investors to take a look at. Julia, just in closing, it seems like as if the key takeaway may be that high level it could be quite depressing if you're seeing that economies, and Australia included, are moving into a slowdown phase, potentially a recessionary phase. But the silver lining here is to remember that economies moving cycles. And through those cycles, there are pockets of opportunity and there's plenty of research to back that up. Is that right? And is there anything else you'd like to add in closing?

Julia Lee (28:10):
Yeah, I think if the whole goal of investing is to buy low and sell high, surely during the more slowdown recessionary phases, asset prices are relatively low during the cycle. And then during the growth and the expansionary phase, asset prices are relatively high. So I think by understanding the economic cycle, we understand that markets slowing down, economies slowing down isn't something to be fearful of, but something that happens time and time again. Cycles are happening in life. And the economic cycle hopefully can be something that investors use to become a lot more confident in their investments to be able to keep to their financial goals and their financial plan for the long term rather than panicking because we are seeing a slowdown or a loss of jobs.

So I think it's important that as we do see this slowdown phase, that investors remember that it won't last forever, and the next phase hopefully will be the recovery phase, which is a lot better for cyclical stocks. But certainly understanding that cycle I think can be important for generating greater returns for investors.

Rory Cunningham (29:20):
Julia, thank you so much for joining us today.

Julia Lee (29:22):
Pleasure. Thanks, Rory.

Rory Cunningham (29:24):
I might just also add at the end, for anyone that is interested in finding out more information or seeing Julia present on this topic, Julia kindly presented at ASX Investor Day and presented slides. So anyone interested in finding that, just go onto the ASX website and look for ASX Investor Day on demand, and you'll see a video of Julia presenting that information.

And just in closing, I'd like to thank all of our listeners for your support throughout the year. Have a Merry Christmas, Happy New Year, and we look forward to seeing you next year on The Ideas Exchange.

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