Takeaways from the Australia Market Summit

by Robert Huebscher, 2/25/19

A roster of top economists and strategists highlighted a day of in-depth analysis of the key trends in the global markets.

Those presentations took place at the Markets and Finology Summit in Sydney, Australia on February 19. As I noted in the companion to this article, I attended this conference and highly recommend it. It is as good as any U.S. conference for those interested in research on economics, investing and behavioral finance.

I've highlighted many of the most interesting views from those presentations.

Stephanie Kelly, the senior political economist at Aberdeen Standard Investments Research Institute, spoke about an ambitious effort her firm has undertaken to normalize ESG/SRI data on an international scale. The problem is that ESG data is not sufficiently clear or rigorously built by any single research provider. This makes comparisons of ESG scores for countries difficult and potentially meaningless. To address this, Aberdeen has collected data on 135 countries over 10 years. Norway, Denmark and Sweden are at the top among countries. The U.S. ranked 22nd and China ranked 106th. She noted that ESG performance has improved a lot among small emerging market countries, including Honduras and Senegal.

David Bridges is based in Boston and a senior geopolitical analyst at Fidelity Investments, as well as a 25-year CIA veteran, having served in Bosnia and the Balkans. He predicted that the U.S. and China are entering a new era in their relationship, characterized by brief moments of detente and long periods of conflict. The U.S., through its tariffs, is deliberately "throwing sand in China's economic gears," he said, to prevent it from achieving its goals and to foment social unrest. The U.S. wants China to shift its focus from growth to dealing with social unrest, according to Bridges.

Chris Watling is the founder of London-based Longview Economics, an economic research and consulting firm. He echoed the familiar refrain that quantitative easing (QE) and cheap money in the post-financial crisis era has fueled the growth of asset bubbles that are slowly popping. "The system is unanchored," he said, and the "debt super-cycle" has driven bubbles and financial repression. Bubbles will burst when cheap money is withdrawn, Watling said.

Indeed, monetary policy has already tightened based on increases in the Fed funds rate and the slowing global M1 money supply growth, which he said "is as low as it gets in recessions." Cheap money has inflated the corporate debt market, created zombie companies (ones, for example in the fracking industry, that would not exist were it not for low-interest debt) and bubbles in housing in the U.K., Australia, Sweden and Canada, and in private equity. Watling's most interesting comments were about some of the most speculative private equity-funded ventures, such as WeWork, which provides flexible office space. WeWork, he said, is facing enormous losses, but sidestepped them and reported a profit by using what it called "community-adjusted EBITDA," which removed all growth-related expenses, such as sales and marketing. Companies like WeWork are coming to the

public market, he warned. Another deflating bubble is in Italy's debt market, according to Watling. Italian bond spreads are rising sharply and credit conditions are tightening. The European central bank (ECB) is not buying any of Italy's bonds, whose economy hasn't grown in three years.

"Never open the door to a private equity salesperson or anyone selling Italian debt," Watling said. In a poll taken immediately after he spoke, 75% of the audience indicated that they were convinced he was right and either are, or will be, implementing a policy to address his thesis.

Jacob Mitchell is the chief investment officer and a portfolio manager with Antipodes Partners, a Sydney-based asset manager. His remarks paralleled those of Watling. The cause of populism is wealth inequality, he said, and QE has accentuated this inequality by boosting asset prices instead of economic growth. QE has been disruptive to manufacturing and services, he said, to the extent that it has caused capital to support otherwise non-productive investments.

An interesting point Mitchell made was that the valuation of the top 20% most profitable U.S. companies is at its most extreme level in 30 years. At the same time, the dispersion of top-minus-bottom quintile stocks based on P/E ratios is at a similar record high. The latter, he said, is driven by a "need for certainty" in response to high volatility; money has flowed into U.S. equities, particularly those with the highest P/E ratios. Conversely, the P/E ratios of domestic-facing equities outside the U.S. are the cheapest level since 1995; capital flows to U.S. stocks have cheapened non-U.S. equities.

Brett Lewthwaite, an executive director and head of Macquarie Investment Management, fixed income and currency, had views similar to those of Mitchell. He spoke about the asset flows that resulted from QE, but he questioned whether central banks are fully committed to quantitative tightening (QT). "There could be ebbs and flows creating a liquidity shower," he said. He noted that the ECB has stated that it finished its QE, but Europe has a "growth and inflation problem." Lewthwaite said that may force the ECB to disengage from QT. A Chinese stimulus could be a "wild card," he said. There could be a repeat of the "Shanghai Accord" of early 2016, when central banks agreed to cut rates and expand their QE programs in response to perceived economic weakness.

For those worried about a recession in 2019 or 2020, the answer is "no," according to Bob Michele, a managing director, chief investment officer and head of the global fixed income, currency and commodities group at JP Morgan. He said interest rates in the U.S., U.K. and Europe are trending down in a "disinflationary spiral." Michele showed a graph that plotted the average of the U.S., U.K. and E.U. 10-year yields since financial crisis against yields in Japan. The two lines were nearly identical. That suggests, he said, that central banks will either stop QT or will ease monetary policy, which is what the Bank of Japan is doing.

"It could take decades to back away from unconventional policies," he said. Michele cited a slew of other non-recessionary signals: the yield curve is not inverted, based on the three-month to 10-year spread; corporate earnings are up 14% and revenues are up 7%, so corporate profitability is strong; two-thirds of the economy is at full employment (based on labor participation rates); fiscal and monetary policy still support growth (and the Fed acknowledges it can't run its balance sheet on "autopilot"); and real interest rates are very low.

Given a dovish Fed, a healthy consumer and strong corporate profits, Michele asked, rhetorically, "How can the U.S. run into a recession?" Even in Europe, governments have turned to fiscal stimulus as a cushion, so they have policy flexibility to avert a downturn. China, he said, has "a lot more policy levers" it can pull to strengthen its economy. Those levers include its reserve ratio, official deposit rate and infrastructure spending. Michele predicted that the tariff situation will be resolved soon and that China is "holding back" on policy changes and waiting to see how trade negotiations are resolved.

Michele backed up his forecast with an investment recommendation: Buy junk bonds. The high-yield spread is at 445 basis points, and defaults are only 2% and are going to 1%. With no risk of recession, defaults are unlikely to rise. Emerging-market debt (which carry real yields of 5%) might be an even better opportunity, he said, but investors will have to cope with the uncertainty of how the trade wars will be resolved.