TRANSCRIPT

Inflation's flying first class, will global growth find a ride?

Featuring:

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Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry.

Adam Bass (00:13):

I'm your host. Adam Bass and today is January 13th, 2022. Happy new year. As we've come back, investors have been doing their best Jan Brady impressions, screaming, "Inflation, inflation, inflation." In the latest release from the US Federal Reserve, the word transitory was dropped in relation to how long they expect rising prices to last. Higher rates could be on the way, and of course, over the holidays COVID reminded us all that it won't be ignored. That means we still need to talk about a couple of different possibilities for economic growth in both developed, as well as emerging markets. So as we get into it, welcome back, an old friend Hitendra Varsani. Hitendra, of course, is part of MSCI's global research solutions team.

Hitendra Varsani (01:10):

Great to be back, Adam.

Adam Bass (01:12):

If you all remember, the end of the third quarter of last year, well, it threw us all for quite a loop. I started by asking Hitendra to reflect on that fast moving week and whether Q4 was anywhere near that exciting.

Hitendra Varsani (01:28):

So global equity markets posted positive returns in the fourth quarter of 2021 with the MSCI ACWI index, the all country world index, returning 6.8% over that 3 month period. But despite that healthy headline return, we've seen strong divergence in regional performance. MSCI China was down 6%, ending the year in bare market territory while MSCI USA returned 10%.

Hitendra Varsani (02:04):

I do recall us discussing China in the previous podcast and the risks it faced with the real estate sector. We've seen China's real GDP growth now below pre-pandemic levels, sub-5%. Having been consistently above 5% for several years. So, whether China's economy can maintain high levels of growth has come into question.

Hitendra Varsani (02:32):

Now more broadly, the combination of Omicron infections, slowing economic growth more globally, and high inflation, have central banks focused on the trajectory of interest rates going forward. We've already seen the Bank of England raise rates to 25 basis points in the middle of December. The US fed is expected to raise rates three times later this year, whilst the ECB may do so late in the future.

Hitendra Varsani (03:02):

From a top down perspective, global investors are taking a more regional view given the different stages of recovery in the local economies and how they're managing COVID and local lockdowns for bottom up investors. How corporate of factors are reflecting the changing macro backdrop have been critical and impacted portfolio allocation decisions.

Mark Carver (03:28):

I think in many ways, the macro environment was the biggest driver of markets, and some listening might say, "Well, isn't that always the case?"

Adam Bass (03:38):

Our second guest making his second appearance on the program is?

Mark Carver (03:44):

So I am Mark Carver. I'm the global head of equity factor products, as well as equity portfolio management here at MSCI. The macro environment was the biggest driver of markets, and some listening might say, "Well, isn't at that always the case?" The answer is, yeah, it's often the case. But what's fascinating is that at the beginning of the year, there was a lot of optimism and the optimism was centered on the vaccines, which would lead to vaccinations, markets reopening, and that should bode well for the so-called reopening stocks or the things that I think about, our value stocks. We saw that at the beginning of the year value did extremely well. We ended the year with a slightly different perspective, not so much optimism, but rather uncertainty.

Mark Carver (04:38):

This time, the uncertainty was related to maybe two things. One is the sustainability of the reopening because we had new COVID variants, and what did that mean for the macro environment? But a problem that we haven't seen in many, many decades was very high inflation rates. So when we look back Q4, we'll say, "Oh, quality stocks did extremely well." But at the end of Q4, it was the value stocks that did well not because of reopening, like we saw at the beginning of the year, but rather because of worries about inflation. There was a sell off in growth stocks and a rally in value stocks in December that was quite significant. So it's funny in that the macro environment went from hopeful to uncertain, and in both cases, particularly at the end of Q4, value doing well at the beginning of Q1, value doing well, but for extremely different reasons.

Adam Bass (05:40):

One of those reasons, perhaps one of the most important reasons was inflation, which just kept going up.

Mark Carver (05:49):

When we saw the November CPI number in the US, it was the highest I believe since 1982. Very few people listening to this podcast will have been working in 1982, an even many people listening might not have been born in 1982. As a result, in some ways, we're seeing things that are unprecedented in our work/life or potentially in our lifetime, and that leads to a level of uncertainty. Clients are thinking about this. They're thinking about ways to reallocate their equity programs to reflect an environment that they've never lived through, that they've never invested through. Obviously, in that type of scenario, clients do a lot of deep thinking, a lot of analysis and they're talking to a lot of people to try to understand that dynamic.

Adam Bass (06:46):

What is it about fear of inflation that bodes well for value?

Mark Carver (06:52):

The concern around inflation, as it relates to investing is what would be the erosion of your potential earnings power, but also the cash flow. So in that way, you might value more known cash flow than uncertain cash flow that could be many years into the future. So as a result, in many periods of rising inflation, the value stocks that might have more higher cash flows or more certain cash flows in the early years can do better.

Adam Bass (07:29):

Spoiler alert, we'll dig into Mark's point about why value later on in the show when we talk about central banks raising rates to try and fight inflation. But for now, I'd like to stay focused on Mark's explanation about the fear of inflation and how that could lead to a shift toward value. For more on the significance of the highest headline inflation in 40 years, we turned to MSCIs resident inflation expert and student of the fed.

Andy Sparks (08:01):

My name is Andy Sparks. I work in the MSCI research effort. My particular focus is solutions research with a heavy tilt on fixed income, as well as multi-asset class portfolio construction.

Adam Bass (08:18):

Just what did Andy think about Mark's observation about how many people working in finance today had never seen such high inflation?

Andy Sparks (08:27):

I can remember when it was that high before too, so I'm dating myself a bit. But doesn't seem that long ago to me. It's high, not just in the United States, but it's at generally historically high levels and in quite a number of developed market countries. The causes of this inflation are varied, but it's perhaps driven first and foremost by massive amounts of central bank monetary stimulus since the onset of the COVID crisis. Along with the stimulus, we've also seen aggressive fiscal policy and government spending to restimulate economies. The important question for investors is how long inflation may stay high and how might it be brought under control. In the US, market implied inflation expectations over the next year are approximately 4.5% and over the next 10 years are around 2.5%. So the market sees gradually declining inflation over time headed towards the fed's 2% inflation target. This is consistent with the view that the market has confidence that the fed will ultimately be able to successfully reduce inflation.

Andy Sparks (09:42):

So the question is, is whether central banks will be able to reign in the monetary stimulus and whether inflation will be coming down in a moderate way. We'll ultimately have to see. But also take into count that that year over year inflation, it has two legs. You have current prices, but you have prices as of a year ago. One year ago, we were still coming out of the COVID crisis and the economies generally strengthened a lot during 2021, and so partly comparing the current price to the price from a year ago is, I wouldn't say it's misleading, but the prices were exceptionally low then. So given the market generally has a view that inflation will be declining, albeit gradually, I think that is consistent with the view that it's thinking that a lot of the surge in inflation will be temporary and was caused by exceptional circumstances that are unlikely to be repeated going forward.

Adam Bass (10:53):

Hitendra seemed to agree with that assessment.

Hitendra Varsani (10:56):

Inflation is typically observed on a relative basis compared to where we were a year ago. We've been living through exceptional times with unprecedented events. So once some of these inputs roll out of that annual figure then inflation could subside.

Adam Bass (11:20):

Though, he also came at the question from a slightly different perspective. He noted that the absolute inflation number might not be the right place to focus. I asked him about the importance of that distinction.

Hitendra Varsani (11:34):

So we think it comes down to expected inflation or unexpected inflation and the context in which it's used. So markets will already price in expected levels of inflation and that's somewhat transparent through liquid instruments. But it's the unexpected inflation that can capture investors off guard. You can think of the inflation surprise as the difference between the inflation that's realized versus what was priced in or the expected levels of inflation.

Adam Bass (12:10):

All told, the consensus from all three of our guests was that investors are facing what Mark referred to as a moment.

Mark Carver (12:19):

There are certain moments in time or moments that count, as I like to say. The concept's really simple. Every one of us has these particular things that we do that form an impression that allow people to make a judgment about us. Maybe the easiest analogy is sports. We judge a professional athlete based on how she performs on the field in that critical moment. What we know talking to athletes and people who coach athletes and are around them, that the game's often won well before the ball is dropped or the puck is dropped, or whatever sport might be your preference. So what it tells you is it's the preparation that wins the game, that wins the moment. So it is a critical moment in time. It happens to be at a period where clients are naturally going through the reallocation process and trying to think about the way they can reflect their investment views.

Mark Carver (13:27):

So the preparation for that, the analysis that they're doing, is in some ways, very, very unique to what we are hearing from clients in the past. I don't want to suggest that clients don't prepare, of course they do. They do deep research when they allocate capital. It's just a bit different and the importance of it maybe feels a little different. Clients are asking for stress tests and they're asking for historical simulations of periods of rising inflation, and they're asking for that across geographies, because we know that it will not be the same in every region. The importance of understanding the way some of these characteristics that we call factors will behave in these environments is critical to them. What's interesting is that somebody listening today will say, "Well, of course, we've had these types of inflation rates," and they'll name an emerging market that maybe has had hyper inflation or high inflation. But that's been different in Europe, in the US, and the big markets where a lot of the allocation is actually made. So consequently, this demand for scenario analysis, this stress testing, and historical simulations is taking on renewed importance.

Adam Bass (14:58):

In many ways, the questions clients have around inflation stress tests have embedded in them the more specific questions of what is the fed going to do about it, and how might the actions, or lack of action, affect my portfolio.

Andy Sparks (15:16):

Our MCI research team did perform a stress test this past summer, where we looked at potential fed responses to inflation. Yes, I think this analysis is still very applicable in today's market environment. We specifically looked at several different scenarios for how monetary tapering and rate hikes might be realized. Ideal timing is the name of the first scenario. In this scenario, markets perceived that the fed tapers asset purchases and hiked rates at the right time to keep inflation controlled while helping economic growth remain stable and robust. Investors are confident, equities gain, and long term rates increase slightly. So in this case, there's a negative return correlation between stocks and bonds. I think this would be a good example of let's call it a strong fed.

Andy Sparks (16:18):

At the other extreme, we modeled the too little too late scenario. In this scenario, markets perceive that the policy path is too slow, which brings inflation worries to the forefront. So while short-term growth is studied, long-term forecasts are hit. Higher inflation and a diminished growth outlook increase equity risk premium, equities decline while long-term interest rates pick up significantly resulting in a positive bond equity return correlation. We think it's a useful way for investors to try to look at how their portfolios might behave in different inflation scenarios.

Adam Bass (17:02):

Hitendra and his team, they've also looked into this question and bringing this research together could be truly helpful. It's certainly timely. We have near confirmation from the fed that we could see a rate hike as soon as March, which may be why.

Hitendra Varsani (17:19):

We've seen a number of clients that have shown an interest in how factor indexes perform in different yield curve regimes. The way we define these regimes is in terms of how short-term rates respond and how long-term rates respond. We've defined four economic regimes based on the changes in the yield curve. These are bare flattening, bare steepening, bull flattening and bull steepening.

Hitendra Varsani (17:51):

So what we've seen over the last few months, particularly in December, is that when the long-term yields were rising, value has outperformed growth. Why is that? Growth is based on forward looking expectations. Sometimes those earnings are in the distant future. When rates rise, those expectations get discounted. Whereas, with value stocks, they tend to have earnings that are growing less and so are less sensitive to rising rates.

Hitendra Varsani (18:27):

Now, when we looked at data sense 1994, over the long-term, we actually saw this play out. Enhanced value delivered positive, active returns in a rising rate environment. Now what distinguished two types of rate rising environments was how long-term rates respond. When long-term rates were rising faster than short-term rates, then we saw quality and lower size stocks also do well. Whereas, when the long term rates were seeing more moderate increases, perhaps reflecting a slower economic growth or inflation environment, then it was defensive factors like minimum volatility that are performed,

Adam Bass (19:14):

Like most discussions about investing, we can't really stop there. It's not as simple as inflation goes up and the fed raises rates hopefully at the right time and in the right amounts. Another aspect for investors to consider when it comes to this inflationary environment is what type of economic growth they feel the world may be headed into.

Mark Carver (19:38):

Are we going into an environment that we refer to as heating up where, yes, inflation goes up, but the economy is strengthening. So consequently, there are specific factors that will do well, or even sectors historically, that have done well in those periods of a heating up economy. The converse to that is rising inflation with low growth. That is stagflation and that's what some clients are the most profoundly worried about. The second question is a little bit harder to understand because we haven't had many periods of stagflation.

Hitendra Varsani (20:22):

In our recent blog, "Hotter Inflation Set Some Styles and Sectors on Fire", we presented two states and the first was stagflation, and the second heating up. Now, using scenario analysis, we've seen that it can differentiate index performance in different states of the world and using scenario analysis can help better make better investment decisions from a holistic asset allocation point of view.

Hitendra Varsani (20:49):

Now using MSCI world factor and sector index data since the 1970s, which captures multiple economic cycles, and we do need to go back to the 1970s to find those high inflation periods, we find that in heating up scenarios, value, quality, momentum alongside IT materials in financial sectors outperformed. In stagflation, it was quality, momentum and minimum volatility alongside healthcare, consumer staples, utilities, and energy that outperformed. Now, those are those of you that are listening very carefully, will have identified quality and momentum have outperformed in both scenarios, whereas, in a heating up scenario, value enters the equation, because historically it has outperformed during periods of high economic growth. So combining indexes like we've seen like value and quality, could offer more diversification than relying on one particular state of the world.

Adam Bass (22:01):

We've spent most of the program so far talking about rising inflation and rising rates, and with the good reason. If Rip Van Winkles great, great, great, great granddaughter, I think that's enough greats, well, if she fell asleep in January 2021 and woke up today, she would be very surprised at the level of inflation, as well as the anxiety behind investor's outlook on the subject. She would also note that yields are much higher than they were one year ago. But as Andy pointed out.

Andy Sparks (22:37):

I do think it's also interesting to ask what hasn't changed. One of the most important market barometers is the real yield curve, which currently shows significant negative yields across maturities. For longer maturities, real yields are similar to where they had been one year ago, and for shorter maturities, they're even more in the negative now.

Adam Bass (23:03):

That raises the question because this is, as you mentioned, a story, the search for yield that we've been talking about for a while, certainly a year ago. What's the connection though between that search for yield and the high valuations that we've seen in equities, real estate, across asset classes, really?

Andy Sparks (23:23):

I think they related. Negative, real, fixed income yields will result in investors looking for value in other sectors, including equities, real estate and private assets. As this occurs, valuations in these other sectors may be pushed to higher levels. So these higher valuations across sectors ultimately pose major challenges to allocators trying to decide which sectors to invest in. It could also entail looking at new strategies. It could entail using strategies with leverage, for example. But I think the market is really trying to grapple with new ways of generating returns, given a negative real yield environment.

Adam Bass (24:16):

Now, I apologize in advance because I know many of you were promised there would be no math, but this notion of higher valuations, it brings us to an equation that Hitendra mentioned during our conversation, namely higher inflation plus higher rates, plus higher equity valuations equals higher volatility. I asked him if he could expand on that.

Hitendra Varsani (24:44):

Sure. So volatility can manifest itself in different ways. It could be an exogenous shock, like COVID, or some other unexpected event, or it could be an endogenous shock within the financial system itself. While uncertainty over COVID has dominated the last couple of years, how the world normalized itself has become more relevant.

Hitendra Varsani (25:07):

So where are we today? As you mentioned, we see elevated equity valuations supported by healthy earnings expectations by analysts. So the surge inflation can place pressure on central banks to raise rates, to overcome our overheating economy. So central banks could take their foot off the accelerator while keeping the economy progressing forward. You can think of that as a pathway to normalization.

Hitendra Varsani (25:37):

Now, key risk for investors could be mistiming. So for equity investors, there's uncertainty over rates rising during slow economic growth. Perhaps, it could raise rates too fast, too early, and that could pop the equity bubble, and we could see higher volatility. However, if rates are rising in that steady growth environment, then volatility could be contained.

Hitendra Varsani (26:04):

In the last quarter, we saw the VIX rise above on the first day of December and that's after MSCI AQI reached an all time high just a couple of weeks earlier. That combination of high equity valuations and uncertainty about the macro picture could lead to higher volatility and what we've seen could be a taste of what's to come in 2022.

Adam Bass (26:30):

Let's continue to stick here with this factor residual volatility. First, if we could just take a step back and define it for those who may not be familiar.

Hitendra Varsani (26:43):

So residual volatility is not something people wake up and think about every day, but many investors, particularly stock pickers, have been exposed to it. Residual volatility explains returns associated with high volatility stocks that are not captured by the [inaudible 00:27:03]. So intuitively, you can think of these stocks having very unique characteristics that are not explained by the broader market.

Mark Carver (27:13):

The factor historically does not earn a premium for investors. But what we saw coming off of the market bottom in March of 2020, residual volatility had its best performance you might say ever. But in four decades had its best performance. What that means is high risk stocks did extraordinarily well, so much so that like inflation, very few listeners on this call would ever have worked in an environment where high risk stocks did as well as a group as we saw in 2020. What that meant is a lot of clients who are MSCI clients would ask us about minimum volatility, the opposite of that.

Mark Carver (28:06):

Why did minimum volatility not do better in 2020? Well, the reason is high vault is so exceptionally well. Now, the outcome of that was probably some things that people don't see or it won't be as obvious. The first it is that there are some assets that did extremely well in 2020 that people wouldn't even have thought about as factors. Those were some of the thematic portfolios that have gained so much attention over the last couple of years. These portfolios had very high exposure to the residual volatility factor and those were outsized winners in 2020,

Hitendra Varsani (28:49):

In 2020, high res vol stocks were the best performing style factor. At the end of 2020, the MSCI crowding model indicated that res vol was amongst the most crowded factors. It turns out in 2021, res vol was actually the worst performing style factor. This has practical implications. When we analyzed top 10, US ETFs with the highest res vol exposure, 25% of their 26% drawdown in Q4 2021 was simply attributable to the res vol factor. These ETFs typically have names that have high growth expectations, and with the prospect of higher rates, that may have popped the bubble or at least let some air out.

Mark Carver (29:45):

I think it is reflective of a few things. One, know what you own. Know the exposures of those things you own, and sometimes those exposures will not be obvious to you. So the importance of looking beyond names, but actually to the drivers of the risk in return, the factors that might influence that portfolio that you wouldn't expect.

Adam Bass (30:10):

Know what you own. Whenever we find ourselves at these critical moments, if I can draw on Mark's turn phrase, once again, those fundamental principles become all the more important. Another important one is to learn from the mistakes of others. After all, who has time to make all the mistakes on their own?

Adam Bass (30:30):

Some of you may recall that the last time Andy was on talking about inflation, it was back in April of last year when people wondered how long it would last and would it be like the cycle we saw in the 1970s and 80s all over again. Andy mentioned then that there were some important differences between then and now and made it seem like those comparisons, while understandable, they might not be directly applicable. But given where we find ourselves today, I asked Andy whether it was worth considering those comparisons once again.

Andy Sparks (31:08):

Yeah, very, very important question. So basically, one year ago, the market thought inflation was going to be a lot more benign than it turned out to be. That undoubtedly hurt some of the credibility that the market had in the fed. But a lot of investors were caught on the wrong side and going forward, of course, it continues to be a hugely important issue.

Andy Sparks (31:37):

The real question is, is the current high level inflation going to be persistent or is it going to gradually decline? If you just look at the current level and shape of current yield curves, they are consistent with the view that today's high inflation will be short-lived and will gradually evolve closer to central bank targets. Now, I think it's important to look at the current environment and go back to the 70s and 80s.

Andy Sparks (32:10):

I do think there is some fundamental differences between now versus then. I'd say most importantly, we did not have the market governments. Central banks did not have inflation targets, by and large, in the 70s and 80s. These inflation targets were generally adopted after the great inflation of the 70s and 80s because market participants, consumers, policy makers, didn't like the effect that out of control inflation had on incomes and employment.

Andy Sparks (32:48):

So broadly, most central banks in the 90s and into the 2000s adopted explicit inflation targets. These are typically around 2%. Again, these were largely nonexistent in the 70s. So just by the mere fact of having these inflation targets insulates central banks from politics, and it also gives central banks a measure of independence to take forcible action to reduce inflation.

Andy Sparks (33:18):

So some might say I'm just an optimist when I talk about this, but I actually do believe that we have learned a lot about the determinants of inflation, and over time, various central banks have adopted I think very practical measures to be very disciplined about inflation. That may be one of the primary reasons why inflation going back to the mid 1980s has been relatively benign.

Adam Bass (33:54):

That's all for this week. A big thank you from co-producer Joe [Collevecchio 00:34:00] and me to Hitendra, Mark and Andy. And of course, to all of you for listening. For more insights on this topic, check out the Markets and Focus webinar on January 26th with Mark and Hitendra. You can register today at msci.com. We'll be back with a new episode the following day, January 27th. Mark your calendar. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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