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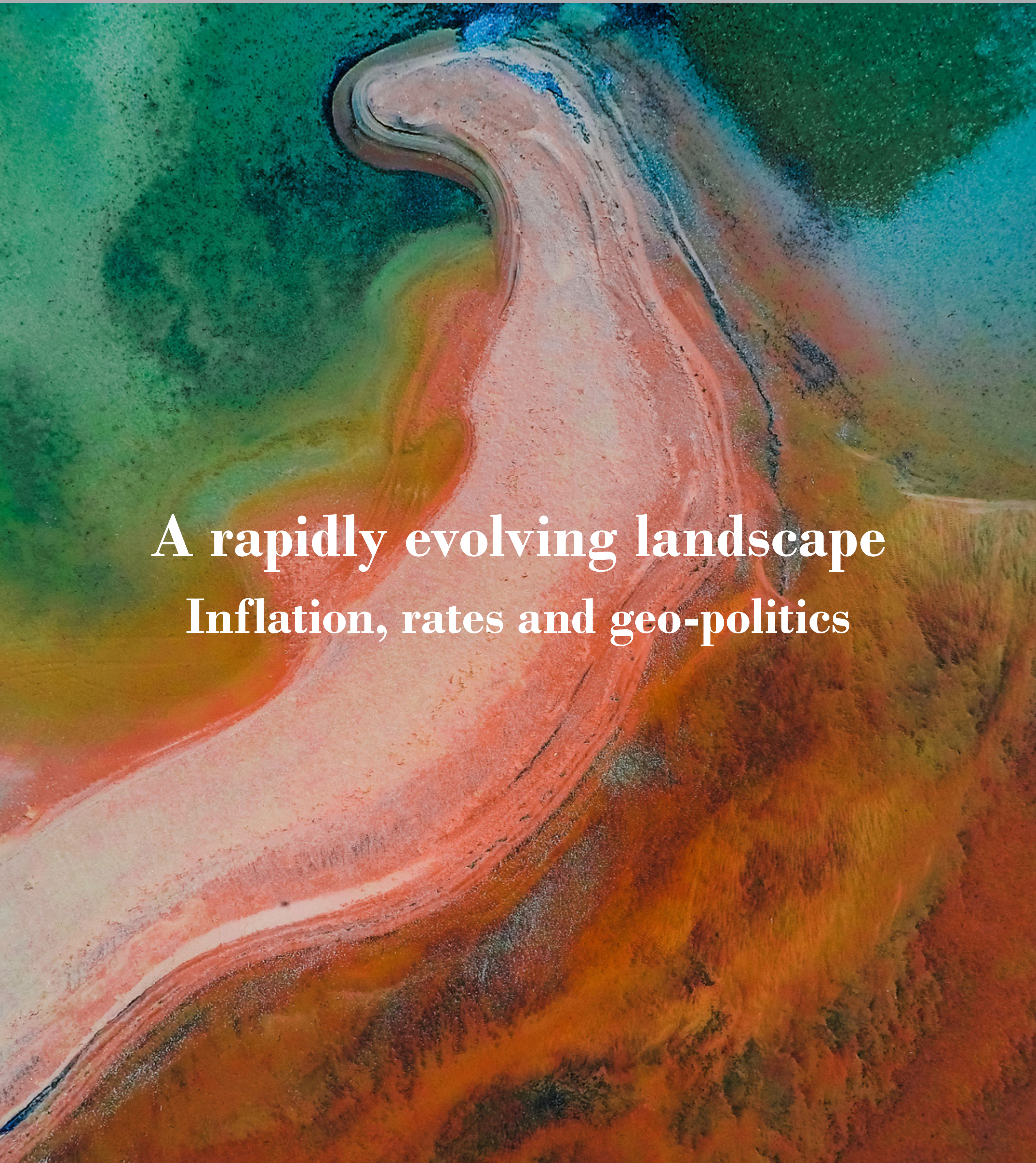
Around the table

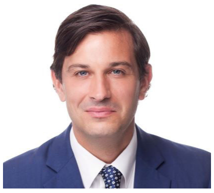
AN EXCHANGE OF INVESTMENT IDEAS
CRESTONE INVESTMENT FORUM / MARCH 2022



A rapidly evolving landscape

Inflation, rates and geo-politics

OUR PANELLISTS



BEN POWELL

BLACKROCK INVESTMENT INSTITUTE
CHIEF APAC STRATEGIST
BLACKROCK

Ben Powell is based in Singapore and contributes to the formation of BlackRock Investment Institute's tactical investment views across the whole portfolio. He is responsible for communicating the team's macro-economic and financial market outlook to investment professionals and the media throughout the Asia-Pacific region.

STEVEN WATSON

PORTFOLIO MANAGER
CAPITAL GROUP

Steven Watson is an equity portfolio manager at Capital Group. He has 32 years of investment experience and has been with Capital Group for 30 years. Earlier in his career, as an equity investment analyst at Capital, he covered Asian property and transportation, as well as European transportation and utilities companies.

CATHERINE LEGRAW

ASSET ALLOCATION STRATEGIST
GMO

Catherine LeGraw is a member of GMO's Asset Allocation team. Prior to joining GMO in 2013, she worked as a director at BlackRock. Previously, she was an analyst at Bear, Stearns & Co. She received her BA and her BS in Economics from the University of Pennsylvania and is a CFA charterholder.

BILL CALLAHAN

CHIEF EXECUTIVE OFFICER
SYZYGY INVESTMENT ADVISORY

William Callanan is the Founder and Chief Executive Officer of Syzygy Investment Advisory. He built the award-winning alternative asset manager and advisory firm on the foundations of an investment management career spanning over 20 years, specialising in identification and monetisation of structural changes in long-term macro-economic trends.

SCOTT HASLEM

CHIEF INVESTMENT OFFICER
CRESTONE WEALTH MANAGEMENT

Scott Haslem leads the Chief Investment Office at Crestone Wealth management, covering strategic and tactical asset allocation, portfolio construction and manager selection across equities, fixed income and alternative assets. He has more than 25 years' experience in global financial markets and investment banking, providing extensive economics research and investment strategy across equity and fixed income markets, engaging with fund managers, superannuation funds and wealth management clients.

STAN SHAMU

SENIOR PORTFOLIO STRATEGIST
CRESTONE WEALTH MANAGEMENT

As part of the Investment, Product and Services team, Stan Shamu works closely with Crestone's investment advisers to understand individual client goals and to deliver suitable portfolios. With 12 years' experience in financial markets and managed investments research across multiple asset classes, Stan has a wealth of experience in constructing portfolios and developing strategies for clients.

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A rapidly evolving landscape

Inflation, rates and geo-politics

At the latest Crestone Investment Forum, held on 22 February 2022, we asked panelists to share their views on the likely path of markets and the global economy in 2022. Key issues focused on the likely persistence of inflation, whether central banks could manage inflation lower without damaging the economic recovery, and when fixed income assets would become attractive.

Since the beginning of the year, risks have been intensifying. Inflation has been persistent, leading the market to accelerate pricing for interest rate hikes. And in the days following our forum, Russia invaded Ukraine, causing wild swings in equity markets in the immediate aftermath.

Our panellists viewed the immediate few months as challenging and questioned the extent equity markets would be able to trend higher in the face of near-term headwinds. However, while the outlook was not without risk, centred around inflation, they were broadly constructive for the year ahead. As the world enters H2 2022, our panellists see a more supportive environment for risk assets, helped by strong, above-trend global growth and an expectation inflation would moderate.

Four key themes emerged from the forum

- **Monetary policy should remain accommodative**—Panellists were split on whether inflation would remain persistent or if it was more transitory in nature. Although interest rates are expected to rise this year, monetary policy should remain accommodative, and households and corporates have enough firepower to withstand the likely tightening.
- **Equity markets now face several headwinds**—After benefiting from an extremely favourable stimulatory environment, equity markets now face several headwinds. A focus on quality and value were persistent themes during the discussion, as well as the need to broaden exposure beyond the US. At the time, the Russia/Ukraine conflict was viewed as largely priced in.
- **Alternatives remain attractive**—Panellists were broadly constructive about alternatives and the opportunity set they offer. However, given the current gap between public market and private market valuations, manager selection will remain key, as well as the need to be selective about investment opportunities.
- **Fixed income remains challenged**—Rising yields are expected to continue to pressure bond prices, creating challenges for fixed income investing. Given the higher yields on offer in emerging markets, panellists indicated a preference for selective opportunities in this segment.

HOW CONCERNED SHOULD WE BE ABOUT PERSISTENT INFLATION?

In recent months, inflation has proved stickier than expected, and renewed upward pressure on inflation has added to the risk that central banks may accelerate tightening policy—or indeed, actively slow growth to contain price pressures. Understanding the panellists' views with regards to inflation was key to framing the discussion. We asked how concerned they are about persistent inflation, at what level they see it normalising, and how they think central banks will balance rising inflation risk against the increased impact of rising interest rates on household leverage.

HOW CONCERNED ARE YOU ABOUT PERSISTENT INFLATION?

Scott Haslem, Chief Investment Officer at Crestone Wealth Management, opened the conversation, explaining that the global economy looks primed for ongoing, strong above-trend growth this year, even if it is a bit slower than last year's recovery. Key drivers include the fading impact of the Omicron variant of COVID-19, consumers flush with cash, and production needing to respond to low inventories. Despite the likelihood of rising rates, he explained that monetary policy should remain accommodative, but this is not without risks.

"Some risks are geo-political in nature, but the other key risk is that central banks will need to do more than is currently priced into markets to lower inflation."

"Some risks are geo-political in nature, but the other key risk is that central banks will need to do more than is currently priced into markets to lower inflation."

SCOTT HASLEM, CRESTONE WEALTH MANAGEMENT

Catherine LeGraw, asset allocation strategist at GMO, feels the persistence of inflation has been concerning. At GMO, they are most concerned about wages. She explained that, with rising wages, consumers would have more power to bid up prices, which can then drive wages even higher. This constant wage price spiral is the real risk for persistent ongoing inflation.

"If we see a wage price spiral then that could indicate we are in a more persistent episode of inflation."

Bill Callanan, Chief Executive Officer at Syzygy Investment Advisory, believes inflation will persist and the US Federal Reserve (Fed) is significantly behind the curve. Agreeing with **LeGraw**'s view on wages, he feels we are clearly in a high-pressure economy where we have "gone from slack to all types of elements of constraints that are self-evident in the different pricing metrics".

Callanan explained that the Fed initially held the view that inflation would be transitory, largely as the transition from goods to services continued and supply chains began to normalise. With US wage growth now rising at 10% nominally, he explained the pie is large enough to get very decent goods and services spending. The Fed also expected consumer goods spending to slow, but what it sees in its survey work is that capital goods can pick up a significant portion of that due to an increase in capital expenditure. He believes households and corporates have enough firepower to withstand tightening—together they hold over 85% of US GDP equivalent in cash, so there is a significant amount of ammunition to offset some of these inflationary pressures.

AT WHAT LEVEL WILL INFLATION NORMALISE?

Keeping in mind the Fed's long-term inflation target is 2% and we are currently seeing 5-7% prints, panellists were asked if 3% is what high long-term inflation looks like. **LeGraw** feels that inflation of 3% is a high figure when we have been close to zero for a decade. For GMO, the issue of inflation is a real concern and its portfolios are running with extremely low inflation risk. **Callanan** feels inflation will be higher than the Fed's median forecast (approximately 2.5%) and will be a source of pressure. He feels there are limited ways this issue can be rectified—incremental supply substitution or demand destruction (but this will take time in a strong economy and would actually push inflation up).

Steven Watson, Portfolio Manager at Capital Group, is more relaxed on inflation. "Just a year or so ago we were never going to see inflation again. A number of people could not even imagine the US 10-year [bond yield] rising above 150 basis points. Now, the end of the pandemic is in sight and the global economy is restarting in a staggered manner."

"Firstly, oil is nature's interest rate and high prices could result in some slowing. Secondly, the yield curve is telling us we don't have much to worry about."

STEVEN WATSON, CAPITAL GROUP

Watson explained that this has resulted in labour market disruptions and supply-chain difficulties. He feels current inflation has a strong transitory element to it, and there is significant disparity in rate hike expectations in the market. He suggested market participants may have become too relaxed last year and are perhaps now a little over-excited. Two things give **Watson** comfort: "Firstly, oil is nature's interest rate and high prices could result in some slowing. Secondly, the yield curve is telling us we don't have much to worry about."

Ben Powell, BlackRock Investment Institute Chief APAC Strategist, sees supply as the main culprit. "If supply is the issue, you can raise rates as much as you like but that's not going to immediately solve for ports congestion, for example. The two things are unrelated. You can destroy demand to achieve lower inflation, but that will cause consequences—some of which are less desirable and socially disharmonious."

While there is regional disparity, **Powell** explained that the US has appeared notably fragile due to multiple decades of underinvestment in infrastructure and a tight labour market. Asia has not suffered from the same very high levels of inflation we are currently seeing in developed markets. The US has shown itself to be particularly vulnerable, given it is the world's hyper-power.

HOW WILL CENTRAL BANKS BALANCE RISING INFLATION WITH INCREASED HOUSEHOLD LEVERAGE?

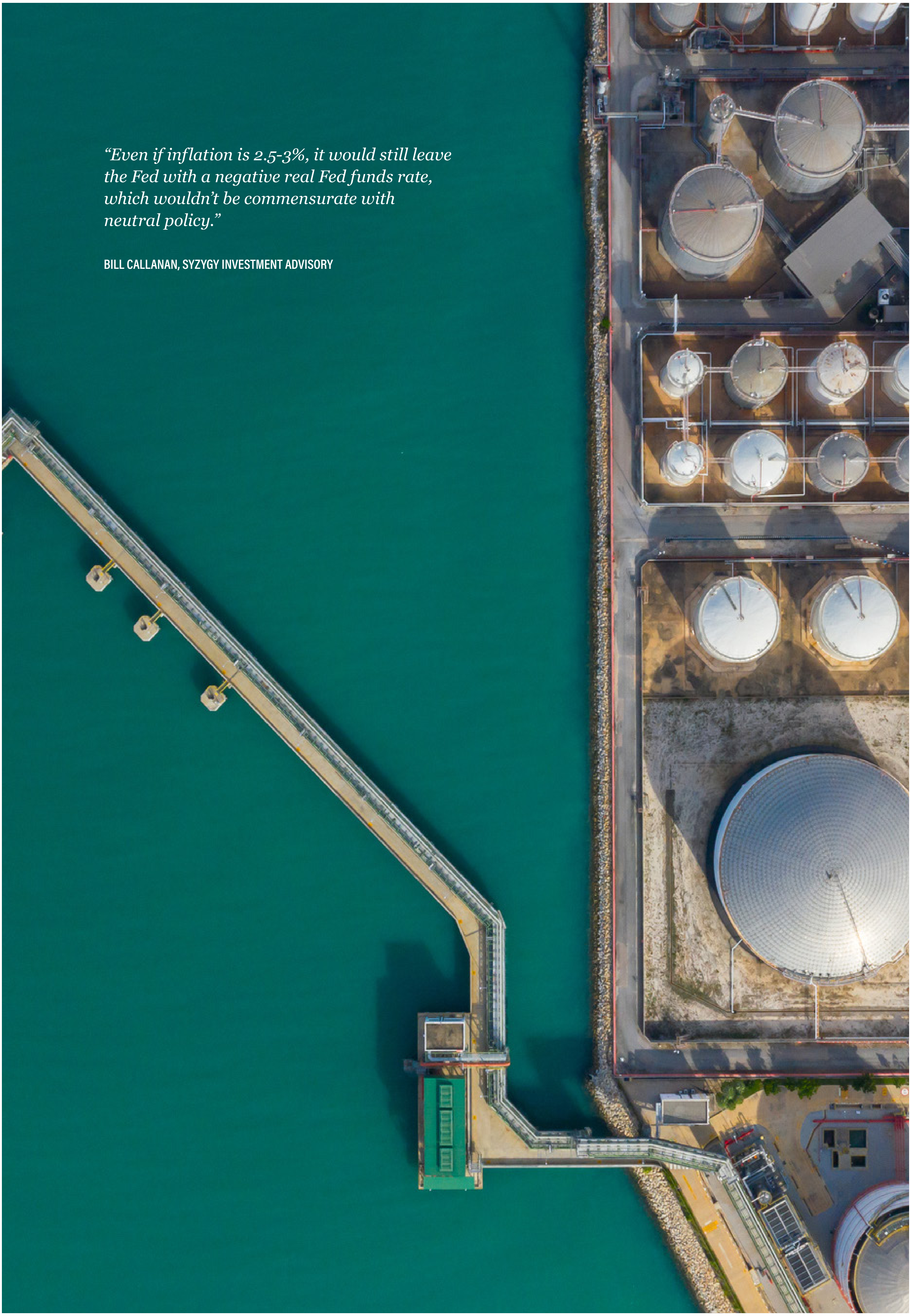
Callanan suggests there is now a different interest rate buffer and possibly less convexity to Fed rate hikes compared with any other time since the GFC—this is whether you look at it from the perspective of corporates or households. With record margins and very flush balance sheets, corporates are likely to be much less affected by rising rates over the next decade. In the US, 90% of household mortgages are fixed rate, which presents a different type of stock and flow issue for the mortgage and housing market. Household balance sheets are now in much better shape with a better starting point in terms of debt servicing costs. Interest costs as a percentage of debt servicing costs are low and wages are growing rapidly. Whether one adjusts debt servicing costs by CPI (consumer price index) or by wages, mortgage rates are now negative, which means the risks in terms of leverage are much less than in the post-GFC period.

Callanan explained that when you have real yields in the US at their lowest level since the 1970s, and an implied Fed funds forecast of 1.70% or 1.80%, market pricing is not that aggressive, given the persistence we are likely to see with inflation.

"Even if inflation is 2.5-3%, it would still leave the Fed with a negative real Fed funds rate, which wouldn't be commensurate with neutral policy."

While **Powell** agrees with **Callanan**'s comments, he sees two potential scenarios playing out—and with each scenario, there are those who would be negatively impacted. The first scenario concerns the effects of unemployment among minorities. He explained that, in the current socio-political climate, the Fed is extremely aware of the negative consequences of being excessively hawkish and how this could impact employment among minorities. In the second scenario, with the average maturity of Treasury debt being seven years, if rates were to rise to even 2.25%, interest expense would become the biggest line item for the US Government, and through the pandemic the Government has taken on a lot more debt. **Powell** feels that if the Fed were to hike rates aggressively, this would create a political issue with every government department ranking junior to interest expense (the latter being more relevant in a fiscal conversation).

The Crestone view: *We believe that inflation globally will moderate into mid-year as supply-chain rigidities begin to ease. This should see interest rates continue to normalise at a moderate pace, supporting an above-trend growth outlook in 2022.*



"Even if inflation is 2.5-3%, it would still leave the Fed with a negative real Fed funds rate, which wouldn't be commensurate with neutral policy."

BILL CALLANAN, SYZYGY INVESTMENT ADVISORY

HOW SHOULD INVESTORS BE POSITIONING WITHIN EQUITIES?

After benefiting from an extremely favourable stimulatory environment, equity markets now face several headwinds. We discussed how investors should be positioning within equities for the next 12 months, and whether the Russia/Ukraine conflict will likely have a longer-lasting effect on markets. Panellists generally feel that equities remain an attractive proposition. A focus on quality and value were persistent themes during the discussion, as well as the need to broaden exposure beyond the US.

HOW SHOULD INVESTORS BE POSITIONING WITHIN EQUITIES FOR THE NEXT 12 MONTHS?

LeGraw feels that monetary policy is unlikely to have too much of an impact on corporate investment, but investors should be concerned about asset prices. "Assets, including equities, can face a painful repricing as rates rise."

"Assets, including equities, can face a painful repricing as rates rise."

CATHERINE LEGRAW, GMO

She explained that GMO is focused on quality and value, and investors should be looking at the quality of their assets and how much they pay for them. "Quality assets are strong brands with moats around their businesses and significant pricing power. These give you comfort in an inflationary environment."

LeGraw also explained that the assets most vulnerable to repricing are those that are expensive and trading at high multiples today. She also explained that in an inflationary world, Australian investors would benefit from exposure to resource stocks, where there is a natural inflation link. Investors should also consider adding renewables, such as wind, solar and biodiesel. Whilst these have a link to fossil fuel prices, they diversify the portfolio in a different way.

Although valuation spreads are wide across all regions and sectors, **LeGraw** feels Europe is priced to win. GMO feels the US is in a very expensive 'super bubble', but there is a silver lining, given how wide valuation spreads are within countries and sectors, particularly on a value-growth dimension. While **Watson** agrees that quality is important, he is cautious about focusing solely on this.

"There are segments within quality that also deserve attention, such as the re-opening of companies related to travel, as well as energy."

STEVEN WATSON, CAPITAL GROUP

"There are segments within quality that also deserve attention, such as the re-opening of companies related to travel, as well as energy. Overall, we are in the early days of a significant rotation in the market."

Despite the presence of some strong companies in the US, **Watson** feels it is an expensive market, even on a like-for-like basis within sectors. He sees much greater value outside the US. At a headline level, he feels it is disappointing how weak European returns have been, but that there are still some very good companies to invest in, such as utilities businesses with strong and growing renewables portfolios where you are paying for low debt and double digit price/earnings multiples. He has stronger conviction in non-US markets, is mildly bearish on the US dollar and feels there are great opportunities in emerging markets that have been neglected over recent years.

Powell is favourable on equities and explained that BlackRock recently upgraded its strategic view on equities to a 'maximum bullish' level for a multi-asset portfolio. He believes the environment will remain very challenging for bonds, with yields more likely to rise than fall.

"If you're trying to solve for liabilities, you've got to keep up with inflation. Bonds at close to zero are not going to get it done. Investors need to be investing in assets that can give them a chance at achieving portfolio ambitions, which is primarily to fund liabilities."

Powell explained that a preference for real assets within equities is one way to achieve this, and that the recent pull-back in markets presents a good opportunity to strategically add to real assets/equities.

Callanan feels Europe could be a flow beneficiary, should the US dollar weaken and US indices decline. This scenario could result in the marginal dollar of global flow reverting to those areas that may be at a different form of growth inflection. From a European standpoint, he believes there are some very interesting idiosyncratic stories and explained that Syzygy Investment Advisory is trying to be more targeted in its approach, targeting, for example, Greek banks and large energy restructurings.

Callanan feels that as we move through the year the rotation from growth to value will continue. He also sees the energy sector as an interesting place to invest, with a host of companies generating free cash flow above 20%, as well as buybacks and high dividends. Pricing, volume and margin are all favourable across the energy supply chain. He feels there is a capital intensity story for the oil service companies unlike anything he has seen in the past decade, where they are benefiting from conventional and unconventional sources, such as renewables.

"If you want to get half pregnant with emerging markets, then the FTSE 100 is a good way to go about it. It also has reasonable yield."

BEN POWELL, BLACKROCK

"These all present a much better opportunity set than high-growth sectors, where negative or zero rate policy really just allowed science fiction to become science fact for a period of time."

In discussing UK equities, **Powell** feels the main challenge is that the UK economy is mostly unrelated to the FTSE 100 index, and is much more of a play on China stimulus, emerging market growth, and energy prices. Essentially, these are huge global companies disproportionately geared to emerging markets.

"If you want to get half pregnant with emerging markets, then the FTSE 100 is a good way to go about it. It also has reasonable yield."

According to **LeGraw**, GMO sees the same wide valuation spreads in the UK as elsewhere. However, as it is such a narrow and concentrated market, investors should exercise some caution.

WILL THE RUSSIA/UKRAINE CONFLICT HAVE A LONGER-LASTING EFFECT ON MARKETS?

The speakers shared their views on the Russia/Ukraine conflict. We note that these comments are as at 22 February, prior to Russia's invasion of Ukraine on 24 February and the subsequent sanctions imposed on Russia.

LeGraw noted GMO is overweight Russia from an equity perspective. "Russia has a 'fortress balance sheet', as well as fiscal and current account surpluses."

Watson agrees and added "the bus that knocks you down and kills you probably isn't the one you see coming down the road". The Russia/Ukraine conflict is not a surprise to the market, and chances are the market has priced it in more or less adequately.

Callanan suggested that market pricing perhaps has less to do with the conflict in Ukraine and more to do with a much larger geo-political and geo-economic pivot. The Putin-Xi Jiping relationship could substantially raise the tail risks where you have a different form of multi-polarism developing in global geo-politics.

"The Chinese are going to be watching very closely what happens in Ukraine vis-à-vis Taiwan, and this raises all sorts of geo-political tail risks in terms of the West's reaction function. This could have significant ramifications for macro investing."

The Crestone view: *While we remain constructive on growth, we feel that near-term uncertainty warrants a neutral equity stance. We continue to look for the opportunity to move overweight equities (potentially in Q2 2022), but in the meantime, we hold underweight positions in US and emerging market equities, offset by overweight positions in both the UK and European equity markets.*

ARE WE AT AN INFLECTION POINT WITH ALTERNATIVES?

Given their low correlation to traditional asset classes, alternative investments have become popular among investors who are looking for ways to offset market volatility and generate higher returns during periods of low yields. While panellists were broadly constructive about alternatives and the opportunity set they offer, there was some concern about current valuations. Panellists highlighted the importance of manager selection and the need to be selective about investment opportunities.

Watson is concerned about private market valuations, particularly given the current gap between public market and private market valuations. The market has been enthusiastic about alternatives for a long time and he feels returns may disappoint. He feels there are plenty of listed companies that provide exposure to long duration assets at attractive prices.

Powell is positive on alternatives, particularly in the context of bonds not generating enough return for portfolios. However, he recognises that private markets do not offer the same degree of transparency as public markets. Processes will need to be put in place so investors can sift through opportunities more rigorously and identify the better investments. He cautions that it is not an asset class where one can take a blanket approach to investing.

"We are all obliged by the math to be a bit more creative in where we source income and broader portfolio returns."

"We are obliged by the math to be a bit more creative in where we source income and broader portfolio returns."

BEN POWELL, BLACKROCK

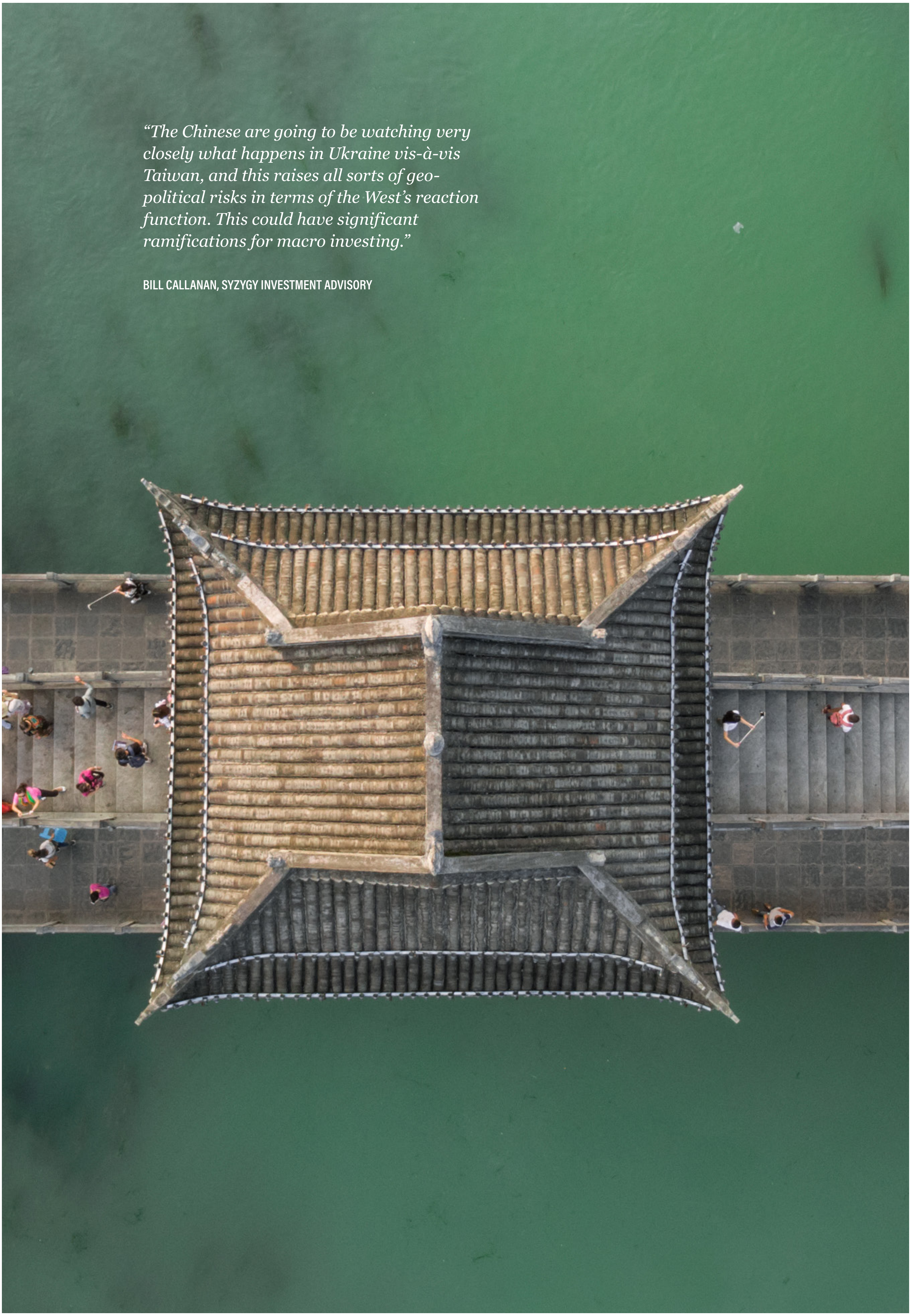
As we appear to be at an inflection point, **LeGraw** is very cautious about long duration assets and locking up capital. She sees value in being nimble and commented that some investors feel their private market portfolios are 'growthy'. This is prompting them to look at ways to balance this at an overall portfolio level, since exposure to private markets cannot necessarily be trimmed.

She feels that liquid alternatives present a great opportunity set—spread strategies that take advantage of the spread in valuations are top decile or quartile opportunities because the spread is so wide. Examples of this are merger spreads, spreads within commodities, and spreads within currencies. **LeGraw** remains cautious on real assets, where she feels there is just as much volatility and repricing risk although this might not be felt immediately. She maintains that if equities are expensive, so is everything else.

Callanan added that liquid alternatives are particularly attractive as they are more competitively priced. They also provide sources of alpha to long duration pools of capital and offer a transparent research process, better alignment of fees, and are not just a management fee aggregation process. The business model is also changing for liquid alternatives where you have much more sophisticated long duration pools of capital in terms of how they allocate.

Callanan added that the venture capital and private world is already witnessing a scramble for cash and capital calls. This will likely put a lot of pressure on endowments and larger institutions that are over-invested in the private and venture space. This will be exacerbated by the fact their public equity portfolios will also be down significantly, leading to a race for cash and creating a significant source of stress.

The Crestone view: *Within alternatives, we continue to favour core real assets and private debt, while highlighting the ongoing importance of manager selection.*



"The Chinese are going to be watching very closely what happens in Ukraine vis-à-vis Taiwan, and this raises all sorts of geo-political risks in terms of the West's reaction function. This could have significant ramifications for macro investing."

BILL CALLANAN, SYZYGY INVESTMENT ADVISORY

IS THERE VALUE IN FIXED INCOME?

A rising rate environment can present challenges for fixed income investments. Although rising yields are expected to continue to pressure bond prices, panellists highlighted the importance of exposure to this asset class for liquidity purposes.

Haslem highlighted the challenges around investing in fixed income in a rising rate environment.

"While bonds may look unattractive from a return perspective, there are many positives from a multi-asset perspective, including the importance of liquidity and the ability to make tactical moves."

Powell feels that 'defensive' is an interesting term for fixed income, as it is relates to the price you have to pay. At BlackRock, they are underweight developed market government bonds due to price. From a valuation standpoint, China government bonds yield a higher return in a currency that has been too strong from the authorities' perspective. Generally, emerging market local currency debt looks interesting, given yields are much higher. **Powell** explained that if you believe US debt is over-priced and needs to moderate, there are opportunities elsewhere. BlackRock would rather play in emerging market local currency debt, given the world is now re-opening and the impetus that Fed repricing would create. Looking further afield, gaining exposure geographically is much more prudent, as some developed market government bonds are generating negative or zero returns in real terms.

"While bonds may look unattractive from a return perspective, there are many positives from a multi-asset perspective, including the importance of liquidity and the ability to make tactical moves."

SCOTT HASLEM, CRESTONE WEALTH MANAGEMENT

Watson agrees and believes the role that bonds play in a diversified portfolio are to act as a form of insurance. While he feels that bonds are an essential part of a diversified portfolio, he does emphasise the need to be more selective with investments. He feels there are some interesting corporates but is biased towards emerging market debt.

"We all know you always pay too much for insurance until you need it, then you didn't pay enough and you don't have enough."

LeGraw explained that, for the first time in its history, GMO does not currently have developed market government bonds in its unconstrained portfolios. Instead, they are finding select pockets of alpha opportunities in emerging markets. While the spreads on offer are not fantastic relative to history, there is the opportunity to generate good alpha. Corporate or state-owned enterprise or quasi-sovereign risk is well priced today so GMO is overweight this segment.

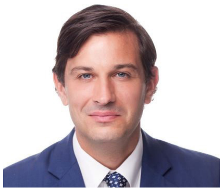
HOW WILL CREDIT SPREADS RESPOND TO RATE HIKES?

LeGraw explained that, within emerging markets, the spread between high yield and investment grade debt is much wider than normal, which can create opportunities. Stressed credit opportunities and structured credit can be interesting on a selective basis, but there is nothing attractive from a traditional fixed income perspective.

Callanan is not too concerned with the impact of rate hikes on credit, particularly given the weighting of energy in high yield indices. Additionally, the weighting of energy in investment grade indices is no longer as high as it used to be. In terms of opportunities, investment grade ex-energy and high yield ex-energy could be very interesting for absolute or relative value trades within the credit spectrum. In emerging markets, state-owned enterprises versus non-state-owned enterprises in mainland China present an opportunity as these debt markets open up and the different bond segments gain critical mass.

The Crestone view: *We expect yields to continue higher, pressuring government bond prices and supporting our current underweight. We believe investment grade and high yield credit will underperform as yields grind higher, so we maintain underweights to those sub-asset classes.*

WHERE WOULD YOU ALLOCATE YOUR INCREMENTAL DOLLAR?



BEN POWELL

BLACKROCK INVESTMENT INSTITUTE
CHIEF APAC STRATEGIST
BLACKROCK

"I would invest my incremental dollar in China tech."

STEVEN WATSON

PORTFOLIO MANAGER
CAPITAL GROUP

"High quality, privately-owned Chinese property developers."

CATHERINE LEGRAW

ASSET ALLOCATION STRATEGIST
GMO

"Quality and value, paired with a short in speculative and extremely expensive global growth stocks."

BILL CALLANAN

CHIEF EXECUTIVE OFFICER
SYZYGY INVESTMENT ADVISORY

"I would play a dual binary option on the oil services industry being up 20% and the Nasdaq being down 10% for a 13-1 pay-off."

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