

SPEAKERS

Philipp Salman, Taylor Pearce, Max Castelli

00:00

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Taylor Pearce 00:24

Hello, and welcome to the OMFIF Podcast. I'm Taylor Pearce, Senior Economist at OMFIF's Economic and Monetary Policy Institute. Here with me today is Dr. Max Castelli, head of strategy sovereign institutions at UBS asset management, and Phillip Salman also on the team at UBS. We'll be discussing the public investor outlook for 2024. Welcome, Max. And, Philip, it's a pleasure to have you.

Max Castelli 00:47

Thank you very much. The pleasure is ours, despite

Taylor Pearce 00:49

Despite another somewhat challenging year 2023 ended relatively positively for global markets as inflation continued falling and the US economy remained resilient. Max, how would you say public investors performed last year,

Max Castelli 01:05

I would say that unexpectedly because the expectations were not very high at the beginning of 2023. Actually, I think they've been doing quite well. And let me elaborate on that. Because 2023 was for sure, a very sort of a roller coaster year. And the way when we discuss with our clients about the year that just passed is that we really had the different phases. It started with the idea that we were in a sort of a Goldilocks type of environment, then they move in the first part of the year to sort of anomaly in the narrative, when expectation of interest rate actually went up pretty dramatically to more than 6%. Then in March, we had the US mid size banking crisis, which shocked the market, and also led the investor to think the central bank, once again, would come to the rescue with a decrease in interest rates. Actually, in the end that this did not happen that the the crisis in the end remained pretty confined and didn't become systemic. And actually, what happened is that as we move into the summer, we saw some more sort of inflation pressures building up so that the sort of a higher for longer narrative that once again, too cold. And we actually had the we arrive in October when interest rates, particularly loan interest rate actually went slightly above 5%, which is actually a level which was prevailing before the great financial crisis, then what happened is that in the last quarter of 2023, we had a very good number on inflation. So there was more solid evidence that Indian inflation was transitory in the sense that it is not really that we were not moving into a new regime characterized by a very high level of inflation, as was fear, just the year before. And also the central banks have become a little bit more dovish in their communication, the market was convinced that rate basically peaked and actually

expectation for rate to fall in the first part of 2024 helped a lot the fixed income market, and also equity market were supported by the fact that interest rates were not rising more than expected. And as well, the fact that probably the most important one that the US economy did not fall into recession, as was fear at the beginning of the year. What that meant for sovereign investor is that according to our estimates, as you know, in our department, we model different type of portfolio basically, we had the quite a recoup of the loss is quite an almost complete recoup. It depends of course on the institution, they actually recoup the main or the losses that they had in 2022. For instance, for reserve Manager, which are largely exposure to fixed income government bonds and over fixed income asset they had a return which oscillate between 5% and up to 10%. For the most diversified the central banks, and for sovereign wealth funds, we had the return which are slated again between eight and 9%, up to 1415 16% for the best performing institution to remark so it was a good year better than expected very important also, after, as I said that the difficult 2022 But there are two important factor that I would like to mention. The first one is that both in 2022 and 2023, the correlation between stocks and bonds has been positive. Of course in 2022, they were both negative in the sense they both experienced negative return in 2023. They both experience a positive return. This is a very important element when we think about the future when we think about how things are going to develop. Because as you know, this is a dramatic change compared to where we were before in the previous regime when the stock bond the correlation was negative. The second point that I think is also very important looking ahead is that thanks to rising interest rate, what we call in the jargon, the illiquidity premium, which is basically the premium that you get when you invest into illiquid alternative asset classes, has fallen. And this is something which I think it is unusual. And of course, the big question for the future is whether these illiquidity premium will start to rise again, once eventually, interest rates will normalize.

Taylor Pearce 05:38

Yeah, thanks for laying that out. A lot going on. A lot happened last year. So definitely fair to characterize 2023 as a roller coaster, what would you say is the outlook for 2024 for global markets? And where do you see opportunities for public investors in this coming year? Yes.

Max Castelli 05:54

First of all, our baseline scenario is over soft tissue lending, in the sense that we'd still believe that there is a probability of a recession in the US simply because probably we have not seen the full impact of the more stringent monetary condition basically, the higher interest rates, but I believe it is, the probability of a recession is still lower than the one over softish landing. Actually, the data that we are getting in support this view, global growth has low no doubt, particularly compared to 2022. Some European countries are flirting with recession. Actually, the Germany, for instance, has been in a small recession based on the latest four quarter data. France is stagnating, Italy, stagnating, but let's say the resilience of the US and the European labor market, they're still expanding service sector and rising real income, it points to more resilience as we move into 2024. Actually, the IMF itself, in his latest World Economic Outlook is slightly increase the expected growth for 2024 for the global economy, largely reflecting the better than expected the performance of the US. On the other end, if we look at inflation, global inflation is definitely peaked and contain falling, we think it is likely to contain but I think it's fair to say there is still uncertainty where you will set the over the long term. So let's say over the next 18 to 24 months, there is definitely evidence of cooling and global demand, which I think will support the chance of interest rate cuts in 2024. But also on this front, so we have a little bit of

uncertainty about the timing. As you know, the market expects the cat says earlier in the spring of this year, why the central banks are allowed to be more cautious, probably because they don't want to repeat the mistake made in previous episode like for instance during the 80s when they lose in too early. And then they were forced to to tighten again and more aggressively. Now in this in this type of environment, which is relatively benign, of course, politics and we know that we have a big 2024 is a so called election year, with of course, the big focus on the US presidential election we might see some volatility, but from a purely economic and financial perspective, I would say that we have quite a benign outlook for the year 2024 And for 2025. So, if this is the picture from a macro financial perspective, actually reserve manager and the so called Stabilization Fund, which are the one with a large exposure to fixed income asset, they can expect quite good return in 2024. And naturally in 2025. As I mentioned, we carry out to some estimates of future return for the typical Central Bank's portfolio. And in in this softish, lanisha scenario we expect for the most conservative portfolio of central banks, which is largely cash and short duration government bonds to enjoy a return over the two years of around the fall of more than 4%. And for the most diversified the central bank's portfolio, which is the one including an allocation to equity, we expect more than 5%. Just to put things into perspective, particularly for the most conservative portfolio, the return over the last 15 year for central banks have been much lower. The problem, I think, is that there are more challenges instead the four sovereign wealth funds. So and the reason is that of course the sovereign wealth funds face two challenges. The first one is that equity evaluations are not let's say incredibly high or incredibly stretched, but definitely they of course they are quite rich also reflect In the positive performance of the equity market in 2023. And they also face the ongoing price adjustment in the alternative asset classes space, which is still unfolding is already pretty advanced in real estate is still going on in private equity and infrastructure. And then of course, we have to see how what will be the final lending in order to have an idea about the impact on the portfolio of the long term investor like sovereign wealth funds. So what does it mean in terms of opportunities for central banks, for sure, there is definitely very positive environment, they can rig generate a very good return by investing into cash and money market and short duration bonds. We are seeing it as we speak an increasing focus on extending duration, of course, reflecting the fact that interest rates are perceived to have peaked, and they can eventually fall from the camera level. And they also we're seeing some pockets of opportunity, which I think are particularly interesting. For instance, an asset class that we're discussing a lot with central banks with reserve manager is in particularly emerging market depth in our currency, which is an asset class, which has generated very good return in 2023. And we believe it can continue generating the good return in 2024 and 2025. Largely because the emerging market economies came out of the current interest rate, I can cycle in quite a good shape. And maybe we can discuss about this a little bit later. With regards to sovereign wealth funds. I think what we're seeing is that the fact that the public markets very well in 2023, why the alternative asset classes suffer, they'll be more because of this price repricing that I mentioned to you before. This is important because we have a rebalancing between liquid and illiquid parts of the portfolio. And so they probably find themselves now with the level of illiquidity which is in line with their asset allocation. What we are seeing there and we are seeing a really a continued focus on thematic on teams, where technology digitization, sustainability, the energy sector transition, we are definitely seeing a lot of sovereign wealth funds searching for this opportunity. This has actually never gone away, which also gives an idea why these type of investor are the truly long term investor in global capital markets.

Taylor Pearce 12:34

Yeah, thanks for playing. Now, I'd like to come back now since you mentioned the emerging market debt, compared to previous tightening cycles in advanced economies, and especially the Fed emerging markets have been pretty resilient over the last few years, despite the rising interest rates in the US and the strong US dollar. Do you expect this trend to continue this year? Or where do you anticipate volatility?

Max Castelli 12:57

That's a very good question. And I already alluded to the fact that we are pretty positive about emerging markets, both for fixed income and equity. And the reason is that when the US interest rate hiking cycle started, when you couple that together with the strength of the US dollar, I mean, there was a wide consensus that the emerging market would have been impacted pretty heavily. I mean, if you remember the taper tantrum time, it was just enough to mention interest rate hikes to have immediately panic among investor and investor pulling out of emerging market setting mass. Actually, this didn't happen this time around, of course, we had the summer selected emerging markets facing problems. But I believe that these were largely reflecting the bad policy choices. But overall, the macro performance of emerging market has been pretty good. And the question that we need to ask ourself is why? And the reason I think that over the past 40 years over the past few decades, many countries in Latin America and also in other emerging market experienced a very high inflation with a lot of cyclicity and volatility and economic and financial crisis. Central banks in these countries develop hands on experience dealing with inflationary regime and as well with financial instability issue, certain countries as you know, adopted inflation targeting approach from developed market that basically recognize the key role of the central bank's monetary policy in determining inflation rate to the importance of independence of central banks. So, controlling inflation is basically been one of the driver of the rapid growth and stability now put unemployment in several emerging market economy. What should actually we should also not forget that to to put inflation under control, many emerging markets central banks started raising policy rate as early as 2021, when instead the developed market economy, developed market central banks were still are grappling with how to best respond to the rapid increase in price level. So I believe that this action has played really a big part in elevating the credibility of emerging markets sovereign, their credit rating, and then not only actually for the sovereign bonds, but also for the corporate bond market in emerging market. Finally, we also had the inclusion of the so called GCC Gulf Cooperation countries in the index of the sovereign emerging markets over a month, which has actually far really boosted the credit profile of this asset class. As you know, these economies are doing very well, not only on the back of high commodity price, but as well, because there is a sort of domestic reform agenda, which has attracted the attention of many or many investors. So from their point of view, we are we think that emerging market represented definitely an opportunity for investors going forward. And this is true from a macroeconomic point of view. But it's also true from a purely financial market point of view, many emerging market equity have not yet benefited from stopping the rise of interest rates that is visible in the performance of stock market in advanced economies. So valuations are pretty good. And I think there is an opportunity for investor who wants to enter this asset class with a long term investment or reason to really enter at very good valuation. Finally, about two sovereign bonds. I mentioned that we like very much emerging market depth in our currency, which basically means largely in dollar. In 2023, this asset class invested in grade sovereign emerging market sovereign bonds, delivered a return of around 7%, which is nearly 2% More than advanced economies government bonds. And I think this outperformance will contain as we move into

2024 and 2025. And this is definitely an opportunity which investors should take. So probably the distinction between emerging markets and advanced economies should be in some way thought through once again, because there are many emerging market economies just think about the level of debt, public debt, which is prevailing in many of these economies, which is actually lower than in many advanced economies. And over the long term, they will face less problem in terms of depth sustainability, compare, for instance, to countries like Italy, France, and even the US.

Taylor Pearce 17:33

Yeah, that's a good point about the dichotomy between emerging and advanced economies and maybe emerging economies are looking more stable in the current period. You touched on a couple of specific markets, but I want to come to China, China appears to be struggling still from COVID related lockdowns and that fallout and foreign investors have seemed to turn more cautious recently toward investing in China. What do you think, will be the outlook for China's economy in 2024? Are you anticipating a strong recovery?

Max Castelli 18:04

Well, I mean, I'm actually back from a week in China, where we had our annual UBS conference, the Greater China Conference, which is an opportunity also for me to meet with, first of all, several institutional investors in China, but also officials, from the government, from the regulators to discuss, of course, the outlook for the year. What is interesting is that in most of the meetings that I had with the Chinese, the officials were very, they were more keen to discuss about our views about China, then the global economic outlook. And this also gives an idea of our interests are the Chinese, who also hear from international institutions like UBS their views about what's happening in China also, together with the fact that that was for the first time able to enter China without a visa thanks to my Italian passport. These give an idea of the growing openness of China after years of COVID related lockdown. So let me try to in a few remarks to put together what what are my main takeaways from this conversation? First of all, is that there is a clear awareness in China that the old growth model no longer works. So China has a lot of private saving, which in the past, there was channeling to export an infrastructure, which has basically fueled this spectacular growth of the last few decades. These two factors of growth were supported by an unprecedented period of globalization. Basically, the Western world was completely open to Chinese exports, and they needed to catch up in infrastructure as a country moves up from the low level of income. Now both of these drivers a week, either globalization ended with growing protectionism, particularly against Chinese growth and friendly offshoring by Western corporations. Infrastructure spending is which is limited. I mean, I drove it from Macau to Hong Kong in a beautiful way recently build a motorway, which has cost several billion dollars and I haven't met one car for kilometre one really wonders whether many of these infrastructure ultimately were really needed and what is the impact they have in terms of productivity and growth? Now, the question becomes what will be the drivers of growth in the future? And here there is also Yeah, there is awareness that, and there is a clear conviction that there are two fundamental drivers domestic consumption and the green transition. Domestic consumption, as you know, is being hampered by the highest savings among the household. So the big question that we should also determine the outlook for 2024 is why Chinese consumers have not increased consumption, after years of harsh lockdown exactly as the counterpart is in the western world they've done once the cognitive restriction has been lifted. And yet, I think there are both structural and cyclical factors at play. First of all, we know

that in China, there is a problem of a weak welfare state, which basically forced the Chinese household to save in order to form the pension health education of their kids. This is a structural problem. So every time there is some additional income generated in China in this case was generated because they were in because of the lockdown, it will basically accumulate it and not spend it. It's very different, for instance, for what happened in the US. So from their point of view, this also means that the policy responses should be more about the rapid expansion of the welfare state. And then the second problem, of course, is the problem in the real estate sector, which ended the rising yo for employment, which has made the household the more risk averse. So I think in order to answer your question about the outlook for 2024, I think it is very important to see what will happen in terms of the real estate sector, whether these excesses supply will be reabsorbed the prequel quickly or not. And also whether you'll find employment will fall so that to support the willingness of the households in China to consume, I believe that we are going to see probably we're going to be in the middle because I don't think the real estate sector story will end in 2024, for sure, the worst is behind us. But probably there is still more time to go before these excess supply. Is that is a reabsorb. And also from the youth unemployment two perspective, I think it is very difficult to foresee a dramatic turnaround. Now, where are the bright spot on the green transition? I mean, if you drive in Beijing and Shanghai nowadays a year, it's impressive to see how many number of electrical SUV you see around also brands that we never heard in Europe and in the Western world. So we had the greater chance of conference, we had the standard of BYD build your dream and one of the largest car producer there, there is no doubt that China is really investing a lot on that. And of course, they also expect it to and they also investing a lot in the transition in the energy sector. This is definitely something which will drive growth, a lot of the investment is also coming from the private sector as well. And the question is, will be trying to be able to sell all these electrical cars around the world that are here, I have my doubts, because I can really see in the debate of the Western world, the potential protection is to stop China from taking advantage of this competitive advantage in in the Evie sector. The other bright spot is in the in the sort of value chain reconfiguration, particularly in the move into the tech sector. Here, according to what I hear from the official 50% of the investments of the private sector investment are in the sector. And this, this is of course, something that I think also over the medium long term will have an impact on the growth potential of China. So these are these are the bright spots. But I think he also this will take time to in some way to see the impact really in terms of growth potential. So what will be the outlook for 2024? I believe there will be an improvement as the real estate crisis gradually gets reabsorbed. I believe we're going to see more policy response from the authorities. According to discussion I had that the monetary policy response so far has been pretty weak, largely because of the fear of the broadening too much the interest rate differential with the US and also to protect the RMB from devaluation pressure, but I think we're going to see an improvement but they will not expect a dramatic turnaround. Final point about Chinese assets, as you mentioned for investors have been pulling money out of China, particularly from the equity market. So when I talk to investor globally there is a universally bearish view about Chinese assets in particular about Chinese equity. This is something which is normally unusual. Normally we have always the pessimists the optimist, so this also means so that if there is a slight improvement, there will be a big impact in terms of the performance of the equity market. That's why we're seeing select a number of institutional investor looking at China as an opportunity to really enter at very attractive valuation and key and stay there for the long term. Thanks,

Taylor Pearce 25:18

Max. So yeah, sounds like you're relatively cautiously optimistic on China this year, Philip to turn to you. Now, I'd like to come to the super election year this year on also recently released our q1 bulletin publication on the global election cycle this year, covering a range of elections as half of the world's population heads to the polls this year. What do you see will be the ramifications of the election year in terms of disruptions to the global economy? Or where do you see other main macro risks in 2024?

Philipp Salman 25:53

All right. So in general, as Max already mentioned, that the big surprise last year and when, at what many people got wrong is the resilience and particularly of the US economy, but the strength of the of the consumer the strength of the labor market. And right now the chance of a recession, at least in the next six months really appears to be quite low. Now, when you look at the the manufacturing cycle, or the inventory cycle, capex cycle housing cycle, you really would not think that we had one of the fastest hiking cycles ever. But some of that also goes for the wealth effect, which never really had much of a dampening effect on growth for financial conditions, which are now really quite loose at the top of the hiking cycle. So you really wonder what, what role the federal other central banks will play to bring down inflation? And what transition mechanism? Do you think they really influenced? And that in itself is maybe a bit scary? And it reminds me of an audience question that we asked at our last reserve management seminar to over 60 central bankers in the room, which was to monetary authorities really fully understand the nature of the current inflation outburst? And 76% said, No. So the first thing that we need is maybe a bit of humility, and we should not pretend to be fully understand all of the mechanics that are going on right now. But unfortunately, we currently have quite some big tectonic plates that are on the move on the in the global economy. Now, there are those who say that, that it would be absurd to think that that's such a credit driven economy, like the US would be immune to the effects of such a dramatic increase in rates. So of the key questions, and therefore the key risk for 24 will be the question, are we simply observing delayed effects of a monetary policy, and then suddenly, the labor market and ultimately the economy come down harder than anticipated? On the other side? And also not great? What if you really start a new upswing in the business cycle from here, but then prices and wage growth move up much faster than expected, from a higher plateau and inflation? Now, the mechanics of the fixed income market will play a crucial role. Yeah, we have to see our companies will handle the pent up refinancing needs and at what rates they will be, will be able to refinance this year, especially because at the same time, the US government will also have to take on a lot of debt and structural bias that were out in the past. And now, one more missing. But because you asked about the role of the election year specifically, the one thing that Janet Yellen will be focused on this year probably will be to prevent Trump from winning. And Paul might be quite aligned with that goal. And so the the somewhat paradox impact from the risk that is coming from the US election could be that it is a short term, stimulative because there's a big temptation to win fiscal and monetary side to run the economy a bit hotter than they should, which, however, causes quite some some long term risks. But as we remember, Trump always explicitly highlighted the economy and the stock market in particular as his key metric. So it is possible that that a lot of levers will be pulled over the next month to avoid a recession and maybe also a bigger decline in the stock market before the elections. And in particular, Yellen and her team seem to be quite quite skilled in managing the sentiment in the in the fixed income market with their quarterly announcement about debt issuance. And they might also wrote tactically rundown the Treasury general account, again, which is now nicely filled up with 800 billions, especially in case the market struggles with the amount of debt that has to be issued. So US elections will be a

key factor this year. And one should not underestimate the role that they that they might have for the for the business cycle in the short term, but therefore, also on the flip side, for the longer term inflation outlook, because adding much stimulus and that would, of course, only adds to the longer term challenges for central banks. And it will probably even more shift the focus of the market to the question, at what level will inflation really settled in the long run? Because in an ideal world, central banks now really have to wring inflation completely out of the system before the next upcoming starts. And that means they really have to destroy Roy, the idea that we now live in a world where prices go up and up and that wages should follow. If they don't do that test to risk that they will start the next business cycle from a higher level. And then we might really follow the 1970s playbook where we had three waves of inflation, each starting at a higher level than they were before. At the key risk that is lurking here is of course, damage to the, to the long term inflation fighting credibility of central banks, because of that is lost and the term premium but will arise and the bond vigilantes would really come back. And because of that, we also have to be closely watching for any stress events that might require sudden measures by the Fed or other central banks, because they might have bigger consequences than in the years before. The market is now very sensitive when it comes to inflation. And it might not be so easy as the past to solve the next crisis simply by dropping money on it. And in any future crisis will be more difficult to handle if it has an inflationary component to it. For example, when energy prices go up massively, and that is why geopolitics have to be watched closely this year. It is an area that can be ignored most of the time, but sometimes it comes back in a dramatic way. And then all it is all that matters for some time. But the biggest risk really might be if during the next accidental crisis, the bond market suddenly gets spooked by the massive stimulus that they expect from from monetary and fiscal side. And then you suddenly see a bond sell off at a time where you would expect to fly to safety or fit into government bonds, that would really mean that we have a major problem. And it could trigger the next chapter in the, in the sake of unconventional policy measures. Now, maybe just finally, because there's probably no podcast that doesn't mention AI right now. So when you look at the risk, that from the risk side, and then 2024 could also very well be the year where we're gonna see the decision if you're currently following the boom bust pattern of the of the.com crisis, or if there's really now a new productivity Miracle are right around the corner, we just had kind of the missing link that could really make the soft landing work and transition into us into a low inflation growth phase and also validate the lofty valuations in the tech stocks that next mentioned, within your capex cycle. And then the large scale adoption that is spreading fast. But while nobody doubts that the impact of AI will be massive, the key question will be if these changes happen over the next two years or the next 20 years, and if we will have several bigger reality checks in between a lot. And yeah, we might be probably get closer to that answer 24. But it will definitely be a very interesting year.

Taylor Pearce 32:47

Thanks, Philip for adding in a bit of an AI that's definitely an important question this year. Sounds like elections used to introduce more uncertainties and into the economic outlook in emerging markets. And we didn't used to worry so much about debt to student ability in advanced economies, but from what you max and Phillip have said, seems like maybe we need to reconsider our thinking on this as we think about the public investor outlook this year. So thank you both very much. It's been a pleasure. Thank you. And thank you to our listeners, be sure to subscribe to our podcasts on Spotify, iTunes or wherever podcasts are available.

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