

Taylor Pearce: Hello, and welcome to OMFIF podcast. I'm Taylor Pearce, Senior Economist at OMFIF's Economic and Monetary Policy Institute. Here with me today is Dr. Elliot Hentov, head of macro Policy Research at State Street Global Advisors. We'll be discussing the interplay of geopolitics and financial markets and how investors are responding. Welcome Elliot, it's pleasure to have you.

Elliot Hentov: Thank you for having me.

TP: At the beginning of this year, it seemed like inflation was coming down interest rates seem to be on the path of normalisation without severe contraction in economic activity. But recently, inflation seems to be on a bumpier path. Monetary policy expectations are a bit in flux. And there seem to be persistent geopolitical frictions. So perhaps earlier expectations were a bit too optimistic. What is your core macro outlook?

EH: Of course, our macro outlook is actually quite sanguine. And I say that because I have a feeling as this podcast progresses, that sanguine tone may diminish a little bit when we talk about geopolitics. But our base case for the macro is that we've managed the soft landing of sorts, basically, inflation has come down, we don't think it will go all the way, it will stay sticky at levels that are higher than what we've experienced for the past 15 years, but certainly at levels that are quite comfortable and manageable both from a macroeconomic as well as from a financial market point of view. And that also means from an investment point of view, we are very much close to the consensus of the market rally, particularly large cap US equities and technology stocks. And I emphasise this because as I talk about the other issues -- just because we like the base case doesn't mean we are blind to the risks and the alternative outcomes that could still come with us.

TP: Right. So you say that there's a soft landing of sorts. But what could offset that view?

EH: What could offset that is basically... the soft landing means that at least peak monetary tightening is behind us. There's a lot of recalibration in terms of how much easing we may get, if at all. But what would upset it is anything that would reverse kind of the growth inflation mix. And we're less worried from a macro analysis point of view, we do not think there's a credible inflation revival in the US or elsewhere globally, that we do not think that the labour market dynamics and others justify worries about inflation rising again, or about growth dropping off a cliff as a result of different pressures. That's why.

What does worry us is what exogenous shocks could suddenly change that growth inflation makes and that they will all come from the geopolitical or political arena.

TP: What are some of the geopolitical risks?

EH: There are basically three that coincide. The first one is a global energy supply shock. The second one is just a repricing of risk premia globally, triggered by a reevaluation of some local or regional crisis. And the third would be risks associated with the US election. Let's go one by one in evaluating them.

The first one is the global energy supply shock. We know what that looks like. It's a 2022 redux, so to speak. You have a war that escalates and it disrupts either parts of energy transport, or even energy production. Listeners will know what I'm speaking about. The Middle East is the candidate for this, and it always has been, and we've been worried since October 7: Israel has bilateral conflict, spiralling out of control and eventually drawing in Iran, the US and other regional actors. And that regional war could lead to the closure of shipping lines, which would already be enough, I think 1/5 of global oil shipping goes through the Straits of Hormuz. So even there you would have to at least attach a risk premium if not revalue energy prices up that would obviously feed into inflation. We

already see the kind of the recovery in energy prices from roughly \$75 to \$90 a barrel oil already making itself felt in monthly CPI prints. So that effect would be much more magnified. And that would be a profound risk to kind of the base case.

The second scenario is much more abstract because in the second scenario, actually nothing happens -- Nothing material happens. But it's the one that actually, from a probability standpoint, we're even more worried about. Because risk metrics have just been so favourable, risk premia have been low and compressed across the globe. If you look at financial markets, actually, by the time of this recording, the middle of April, some of the gaps have closed. But until the end of March, we were at ultra-low levels in volatility and not only equities, but particularly commodity oil volatility at very low levels. We were seeing spreads on sovereigns and corporates, even among emerging markets that that are a bit more crucial, highly compressed, very tight, really hard to justify with a world that's fragmenting and falling apart. And so wherever we've looked, the only thing you saw was gold prices slightly elevated. That was the only indicator that there are some worries in pockets of the market about risk. So risk is low or underpriced, and that is the starting point. So our worry is simply markets are underpricing. It's just a normalisation of those risk premia. That is basically what we're worried about, and what would trigger that. What will trigger it is simply, you get some event risk, where markets say, Oh, actually, maybe this, we are a little bit more concerned about that, for example, I'll just throw out a few random examples. North Korea, South Korea. North Korea allows, you know, not only launches missiles, but one lands on South Korean territory breaks it a 25-year precedent, something like that with nothing happens, nobody gets killed, no severe damage. But just breaking the precedent would force markets to reevaluate the risks that we're looking at, or China stages and exercise in the Taiwan Straits that leads to a very short-term closure of the straits maybe even just a day or two or a couple of days. But simply that alone would be a signal like, are we really pricing the odds of things properly? And if you think about it, back to the base case, if you think what's been the market drivers, the large tech stocks, the AI-powered rally, those two would be affected by a reevaluation of those supply risk and Nvidia received almost half of its inputs from Northeast Asia. So any type of risk premia repricing would have a magnified effect across all asset classes. And the problem here is that when you move from a low-risk regime to even a normal one, it doesn't happen gradually. It's not like you, you go from like 10 to 11 to 12 to 13. No, you have a fairly sudden repricing, and that repricing in itself has cascading effects, as it forces large institutional investors to rebalance and therefore has knock on effects. So basically, we're just worried about markets waking up and saying, Hey, risks underpriced, let's, let's reprice it higher, suddenly. And then of course, finally is the US election. But maybe we leave that for later.

TP: I was just going to say before we come to the US election, why do you think that risk is so underpriced currently? Could you just elaborate on that?

EH: That's a tough question. We have as part of State Street, the custody bank has visibility on a very large share of global institutional holdings and flows. So we have insights into positioning. And from that positioning, we can tell that some of it is the fact that investors are relatively cautiously positioned to begin with, even if you think about the overweight in US tech, to some degree, if you think about the world fragmenting. Again, the US is a little bit more insulated than anywhere else. Technology is a little bit less input intensive, since a large cash pile has strong positive earnings. So in some ways, it's not even such a risk asset per se, it has a little bit of a hedge built into it. But investors have high cash levels still, they are underweight, classic of risk assets, you know, emerging markets, some of the other beta economies around and so that is one explanation.

The other explanations are a little bit more contentious around what's driving some of it. One could argue that the monetary policy settings globally actually have not been as tight as perceived because

there's been repeated liquidity injections for last year in the US because of the regional banking crisis. There's been episodes in China. And so as a result, you basically have actually a little bit easier financial conditions than previously thought. And that would obviously also, price premia were lower. But there's no great answer, that's what I'd like to communicate here.

TP: Yeah, that makes sense. Thanks for going through some of those factors that could be contributing that. I would like to talk about the US election. Where do you see the risk there? What would be the implications for markets?

EH: So there, we have basically three vantage points. Well, the first is, most importantly, and it ties into the first two risks very, very intimately, is that presence of the election itself is a risk factor for global geopolitics because it's an incentive for actors across the globe, to entertain more adventurous policies, because those could impact on the election. So if you are a small, midsize or even large actor on the geopolitical scene, in 2024, you have the opportunity to basically intervene in the US election, either by doing things that favour the incumbent or where we can come in from your perspective, that alone means the odds of something happening are higher. And that that is something to take into account. And frankly, if you look at the recent events in the Middle East, some of it is thought through the prism of 'how does it relate back to the US and US election dynamics'. I can certainly tell you that the US administration is clearly framing policy very much with the November election in mind. So that's the first, most acute thing, more things are likely to come to a boil simply because there's an election.

The other thing to drive is to what degree the election tilts domestic policy there, it's a little bit less, we've been of the belief that if data really is on the verge, we think the Fed will be tilting slightly dovish, because of the election in the backdrop of their minds, they don't want to be responsible for an economic downturn, they may be slightly worried about the inflation agenda presented by the challenger. And they may also be a bit concerned about their institutional independence, too. So we think if data really is on the border, we think it will tilt dovish.

And then of course, that's just the run up to the election, then you have financial market pricing of the outcome, frankly, we have a look at a myriad of indicators in trying to forecast election outcomes. We did very well in 2020. And I say that only because our current dashboard models, so to speak, is very close to 50-50. So we're going to be very tight. So that alone means that's the second point, you will have some uncertainty premium that gradually sneaks into markets, markets that are sensitive to regulation to the fiscal monetary mix of the US. And to some degree, also to the US foreign policy stance. That uncertainty premium from our historical studies starts in the second quarter right about now, it starts to sneak in, and it melts away, meaning markets catch up with it as you get closer to the election and markets gain confidence around the outcome or in terms of forecasting probability.

And then, of course, really, the big thing is, well, what's the impact of the outcome? What policies will change and as a result, what assets have to be repriced given that they'll have either a regulatory or fiscal, the foreign policy dimension that that affects their valuation? And so that in there... I think there are two [risks] I think: markets or misunderstanding what's at stake this time.

TP: That makes sense. So a lot of moving parts here. But you touched on, as the big themes, a potential energy supply shock, risk premium repricing and the US election. So what are investors doing as a result of all these challenges?

EH: As I just said, that they're not doing that much. We've seen some hedging on gold. But by and large, that's a little bit we've seen some, just recently now in April, we've seen some catch up in

volatility metrics, in some risk premium, but it's just kind of the beginning of what we think will be a longer road. On the US election, we see nothing so far, in terms of investors placing bets accordingly. And that's it's also a little bit early for that. Traditionally, US elections are best expressed through US equity sectors, kind of, you know, which sector benefits from a change in government policy and regulation. We think, in the past dispersion between kind of the top sector and the worst sector was quite large around the election, particularly in 2016 and 2020. We actually think that dispersion will be smaller this year. It actually won't be as great as in the past, but that type of thing. Best behaviour, we only start to see the second half of the year when kind of the real bets on the outcome are placed.

TP: And to follow up on that, what do you think is different this time than in 2016? When it comes to that divergence or dispersion between the top and worst sectors in US equities?

I think that's what's different is the right question. And what's different is the backdrop. So if you remember, there was a big market rally when Trump and the Republicans won in 2016, unified government around a very clear policy agenda that both tax cuts and deregulation, markets loved it and markets were right, because tax cuts came, and you basically had a real strong rally multiyear rally on the back of that. The difference in 2016, and 2024, is that in 2016, the US was had the highest corporate tax rate in all the OECD, it now is right around the average or slightly below that there's not as much fat to cut. And so the goodie bag will have to be smaller, by definition. So that's one big difference.

But the other two differences are even more stark. The second one is that the fiscal deficit was running at close to 3% of GDP, the primary balance was just slightly negative in 2016. It's a completely different world today, we have a deficit in excess of 6% of GDP, the primary balance itself alone is above 2%, this is a very, very expansionary fiscal stance during an economic recovery. Actually, it's unprecedented to run these types of deficits during the economy that's actually doing quite well. And so how much deficit expansion can you really tolerate? If that's your starting point? I would argue quite, very little.

And the third one is, what were the financing costs for the deficit in 2016. I do remind listeners go back the US 10-year was at 1.8%. In the wake of the US election, where's the US 10-year, now? It's north of 4.5%. And so what you could get, if the, if we had the same election outcome in 2024, you will you would get the return of the famous bond vigilantes, you would get a little bit of a bond revolt. And that is obviously not great for risk assets for equities as well. And so we think that's one thing that has not been it's gradually sinking into the discourse. But I don't think it's fully appreciated yet. That the potential for a positive fiscal impetus is just much, much weaker in this type of election route.

TP: Great. Well, thanks so much for going through all of those factors. You said at the start of the podcast, that your view is sanguine, but walking through all of these potential outcomes, it sounds actually quite, quite unclear, quite uncertain. I don't know if you have any last minute, any final remarks before we wrap up?

EH: The final remark is simply that insurance has been cheap AI to hedge against bad outcomes has been has rarely been this cost effective, is particularly cost effective. Because, you know, typically, when you're buying options, you have to roll them over. It's very expensive, if certain time contracts you have to observe and so therefore, it can feel like it's a drag on your portfolio. But this time, we know that risks will ebb by year and so it's an easier way to kind of frame your most acute risks.

Hedge accordingly. And again, we're sanguine about the base case. But we do feel like one has to have a little bit of production.

TP: Make sense. Well, thanks so much, Elliot. It's been a pleasure. Thanks as well to our listeners, be sure to subscribe to unfound podcast wherever podcasts are available. And be sure to check out our coverage of public investors asset allocation decisions in our upcoming report, global public investor, which will launch June 4. Thank you.