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Insights: Magellan Minutes

Part 1. Global macro update with Arvid Streimann, Head of Macro and Portfolio Manager

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Arvid Streimann, Head of Macro and Portfolio Manager
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Jennifer Herbert:

Hello, and welcome to our investment insight series, Magellan Minutes, in which our investment team dissects the markets and takes a deeper look into sectors and stocks in our global portfolios. My name is Jennifer Herbert, Key Account Manager at Magellan. And over the next 10 minutes, I will speak with Magellan's Head of Macro and Portfolio Manager, Arvid Streimann, about our macroeconomic views. Thanks for joining us, Arvid.

Arvid Streimann:

A pleasure, Jen.

Jennifer Herbert:

Arvid, perhaps we could start with an update on Magellan's economic outlook. How different is the economy looking now compared with the pre-covid-19 landscape?

Arvid Streimann:

When we think about the economic outlook, it's obviously going to be a lot slower than it was before the crisis. And there's a few reasons behind that. The first reason why it's going to be slower than what many people think or perhaps even hope is because we just don't know how this virus is going to pan out. First and foremost, this shock is a health shock, which has caused an economic slowdown. We really need to know what's going to happen with the virus, and to be frank, no one really knows. We do hope, of course, that there's going to be some sort of vaccine or even a cure, but the timing of that is uncertain and whether that occurs, no one really knows. In the meantime, what you're going to see is a staggered reopening of economies and potential second waves of infection.

The second reason why this recovery may be a bit slower than what people expect is because of the size of the slowdown. We know that a lot of businesses are not making money at the moment, and we know a lot of workers have been furloughed. And what furloughed means is that they haven't been sacked, but they're not getting any hours at the moment. So, we can think of them as workers that are on hold. Now what happens to those furloughed workers is really important, and of course, that really depends on what happens with the virus. And again, we've mentioned earlier that that's fairly uncertain. The other thing that the big slowdown has caused is a very large change in consumer and business behaviour. We know that consumers are probably saving a bit more money than usual and so are businesses, and what that means is less spending, which means less activity and lower GDP.

The third and final thing that I'd like to point out here is that the coronavirus has caused plenty of risks to occur. Now, we know that when you get into a low-growth environment, risks increase and we categorise two types of risks. The first is existing risks, which the coronavirus has inflamed. And some of those risks would be things like the US-China trade war, and perhaps also the frictions between the members of the eurozone, most notably Germany and Italy. So the coronavirus is inflaming some of those existing risks. But the interesting thing here is that it's also creating risks as well. And some of the risks there that we're thinking about, for instance, such as the high-yield bond market, may be under more stress than they were before. And perhaps also in emerging markets that need US dollars, perhaps there's a US-dollar shortage, and that may lead to some currency crises within emerging markets and perhaps even a contagion effect, which would be really bad.

Jennifer Herbert:

What do you think about the V-shaped recovery that a lot of people are talking about and hoping for?

Arvid Streimann:

Yeah. Good question. We'd be a little bit cautious on that, Jen. When we think about how the world may pan out here in the next few years and how the economies might recover, we generally think that there's four different types of outcomes. The best outcome would be a V-shaped recovery, and that kind of looks as though something like that is being priced into asset or equity markets at the moment. The next scenario would be a U-shaped recovery. That would be something that is a little bit of a slower recovery than a V-shaped recovery. Then you would get into perhaps a deep and prolonged recession. That would be the third scenario. And then the worst scenario, or fourth scenario, would be something like a depression. So, we think of the great depression and that would obviously be a bad scenario.

When we think about what is the most likely of those four scenarios, our current thinking is that the best scenario, which is a V-shaped recovery, and the worst scenario, which is the depression, are probably less likely than the two middle scenarios. And it's actually pretty hard to figure out or guess with conviction which of those two scenarios is more likely because there is just so much uncertainty around. What we are more confident in saying is that what has happened with the coronavirus is going to lead to lower interest rates. So all of the things that we've been telling our clients about low interest rates has only been reinforced by what's happened with the coronavirus.

Jennifer Herbert:

Perhaps we could drill down on different regions and how they're managing during the pandemic, which economies are faring better than others, and how different will the recovery look for each?

Arvid Streimann:

Yeah, that's a really interesting question, Jen. And if you'd asked me this question two months ago, I would have said that we would think that developed markets would be doing better than emerging markets when it comes to the pace of the recovery and the intensity of the economic slowdown. Right now, we would say that that is still the case. We still think that developed markets will on average do better than emerging markets. And so let's think a little bit about those emerging markets. We know that in the emerging markets some of them are still going through their first infection wave whereas many of the developed markets have already gotten through that first wave. So these emerging markets are still dealing with the first wave, which could potentially be the worst wave. The second thing is that the developed markets have been better at instituting lockdown, so the emerging markets don't have lockdowns that are as big or pervasive.

The other thing is that the emerging markets, of course, have weaker health systems. So, if they do get an outbreak, they're less well placed to deal with that. And then the last thing with emerging markets is that to the extent that the government needs to provide a relief or a stimulus program, they're probably in a worse position to be able to do that. And that means that they have to borrow money from foreigners in order to stimulate their domestic economies. And when it comes to borrowing money, it becomes harder to borrow from foreigners if one or more of these three things occurs.

The first is if you're not borrowing in your own currency, and emerging markets, by and large, generally borrow in US dollars, which is obviously not their currency. The second thing is if you have a high level of debt, and many emerging markets have high levels of debt, which makes it a bit harder for them to borrow. And the last thing is if they have undiversified economies. And what we mean by that is if you look at an oil-exporting country, its exports are dependent on one commodity. That means that it's harder for that country to get loans from the international community because it's a riskier proposition to lend to.

Another risk the emerging markets have at the moment is that they really need US dollars to pay for their imports. And to the extent that they can't get those US dollars and the Federal Reserve is not able to give it to them, then that may cause an emerging-markets currency crisis, which we mentioned earlier. If we think about emerging markets and developed markets, it's obviously a spectrum. Some developed markets on average are going to do better than some emerging markets, but you might also get the case that an emerging market is doing better than a developed market. It's a bit of a spectrum there. And I would call out Italy as a developed market that's struggling. And if we think about Italy in terms of those issues that we mentioned earlier, it shares a currency with Germany and the rest of the eurozone, the euro. Italy doesn't have its own currency. So that makes it a little bit harder for Italy to borrow.

Jennifer Herbert:

And where does China fit into all this?

Arvid Streimann:

China's an interesting one. We would say that China's in the better-placed category and there's a few reasons for that. The first reason is that China has shown a very strong ability to lock down its economy when there are outbreaks. China did that very early when the virus first started, and authorities are also doing or displaying their ability to do that in Beijing at the moment. That's a very big positive in terms of stopping the spread of the virus throughout the economy.

The second thing is that China has a closed capital account and also a very large stock of forex reserves. And why that's important is that China is less reliant on foreign countries when it needs to borrow money to stimulate its economy. So, all of that risk for emerging economies that we talked about earlier, it doesn't really apply to China. The offset to that of course is that there are potential second waves. I mentioned that there is a second wave in Beijing at the moment.

And of course, China is a very big exporting country. So the pace of China's recovery is going to depend on how well its exports go, which of course depends on how fast its trading partners grow as well. So China seems to be better placed than most. And when we think about China, like every other country, we think that the coronavirus has reduced its growth rates over the next three to five years. But China still has a relatively attractive growth rate relative to the rest of the world.

Jennifer Herbert:

Finally, we have spoken about how low interest rates have made equities more attractive in valuation terms. Do you think this schematic still holds true?

Arvid Streimann:

Well. Jen, the first thing I would say in relation to that question is that the coronavirus is really reinforcing this lower-for-longer interest-rates story. I think that's the first thing that we should say. The second thing is that I agree that what we've been saying before about lower interest rates supporting price-earnings ratios, I think that is still holding true. And let me just go into that a little bit or unpack that a little bit. When we think about PEs, there are three things that drive PEs. The first is interest rates, and that's what we're talking about now, obviously. The second is the earnings outlook; obviously a better earnings growth outlook means that P/Es go up. And the last one, or the third one, is risk premiums.

Now, if things are risky and all things are uncertain, then PEs are lower because people don't really want to pay up for a dollar of earnings. Now, before the covid-19 crisis, it was really easy to see the impact of lower rates pushing up PEs because there's two other factors. Your earnings growth outlook and risk premiums were really relatively unchanged so it was easy to see that relationship. But during the corona crisis, when risk premiums went up and earnings growth outlooks deteriorated, both of which tend to push down PEs, you couldn't really see this impact of lower interest rates anymore because that was getting overwhelmed by what I just described. So it was really in the background there.

Jennifer Herbert:

What will the PEs look like when we finally get to the other side of this crisis?

Arvid Streimann:

If you think about the three things which I talked about earlier, it's going to be a lower interest-rate environment, which pushes up PEs, but it's going to be a lower-growth world, which pushes down PEs. So you have something pushing up PEs and something pushing down PEs. So the net effect is uncertain. And one thing that you might be able to do is you go, well, it really depends on which company you're talking about and what the impact of the coronavirus on its growth outlook is. For instance, some companies are less affected by the coronavirus or perhaps they're even a net beneficiary of the coronavirus. And if you just need to think about what, how your own life has changed, perhaps you're using more of the digital economy, maybe these companies are doing better now.

Perhaps these companies come out of this with a higher PE because their growth rate is higher. And of course, there's a flip-side argument to that. There are some companies whose growth outlooks have deteriorated or have been very hard hit by what's happened such as airlines and those in the travel industry. And you would think that their earnings-growth outlooks have deteriorated. So probably their PEs may fall. As for the market overall, as the market is an average of all of the companies that are in the market, it really depends on how many winners and losers are in that market overall.