

Transcript

The Ideas Exchange

Episode 26: Macroeconomic environment and global SMID opportunities

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Jacinta Schlosser (00:01):

Welcome to the Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I am Jacinta Schlosser, business Development Manager, investment products at ASX, and this is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

Disclaimer (00:21):

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Jacinta Schlosser (00:49):

Welcome to the Ideas Exchange. My name is Jacinta Schlosser and I'm your host today. In June last year, Vaughn Nelson, a Houston-based investment manager, launched the first actively managed ET TF in global small mid-cap stocks on the ASX, the Vaughn Nelson Global Smid Fund under tick code VNGS Vaughn Nelson managed around \$21 billion of equity and fixed income products across several products. And our guest today is Chris Wallace, chief executive officer, chief investment officer, and a senior portfolio manager at Warren Nelson Investment Management. Chris serves on the portfolio management team and as a member of the firm's management committee. He joined the firm in 1999 and was previously employed by Simmons and Company International and Coopers and Lybrand. He has over 25 years of investment management, financial analysis and accounting experience. Chris received a Bachelor of business administration from Baylor University and an MBA from Harvard Business School. He is a CFA charter holder and a member of the CFA Society of Houston. Welcome to our podcast, Chris.

Chris Wallis (01:58):

It's great to be here. We've got lots to discuss.

Jacinta Schlosser (02:01):

We certainly do, don't we? Well, where should we start? I'd really like to start the conversation with the current macroeconomic environment, of course. Now, in preparing for this, I was thinking about how there are people out there who entered the workforce in a decade long, low interest rate environment, but the investment landscape is rapidly changing with seemingly unending rising interest rates. Can we dive into the questions everyone's focused on presently?

I'm sure you've been asked these a lot, the impact rising interest rates have on company earnings and therefore investments, and what will it take for inflation to peak and interest rates to stop rising?

Chris Wallis (02:39):

Yeah, sure. Great question. I think that's at the forefront of everybody's mind. I think fortunately, let's take the second part of your question first, which is when inflation's going to peak, and we already think it has. Just a little bit of background on the macro work we do, we have pretty good leads on peaks, both in economic activity and when we could be going into recession and similar on inflation. And what it would tell us is yes, inflation has peaked, it's probably peaked back in the third or fourth quarter. It's still elevated, it's still sticky, it's going to decline at a pretty good rate only because of base effects. And the real key is to whether or not we have long-term relief from inflation, it's going to have a lot to do with central bank policy and the reaction to some of the current crises that are developing currently.

As far as interest rate increases, we've witnessed a lot of volatility in the US banking system this week with the failure of Silicon Valley Bank and others. Our US Treasury is not in a dissimilar position than those balance sheets were of those banks. The difference is those banks had depositors to withdraw cash, but they were still upside down. They were at a mismatch in their funding and in their liabilities. The US Treasury has the same issue. Our federal government can't withstand the current elevated interest rates either. It's just a matter of time before that puts enough pressure and is going to force the Fed to either reverse their quantitative tightening, accelerate QE and re-accelerate inflation or dramatically cut interest rates and it's anybody's guess as to what was going to be their modus operandi. It really depends on whatever's most politically expedient at the time, but I suspect we're going to have more losses and as such we may get interest rate cuts much sooner than we think.

Jacinta Schlosser (04:34):

Look, I'm going to also throw in here just for some of our viewers who are new to investing. Recession is generally identified by a fallen GDP over two successive quarters. How do you view the risk of recession at the moment? Obviously you're talking from the US view, but also in Australia.

Chris Wallis (04:50):

Yeah, and let's separate it into two different components because as an investor, you really should be more focused on an earnings recession than an economic recession because earnings really are going to drive risk asset prices, whether that's equities or fixed income. And we're already in an earnings recession. We saw the US move into an earnings recession in the fourth quarter with the issues surrounding the war in Russian Ukraine. We've seen a large other regions already move into an earnings recession even earlier than that. I quite frankly think the US is going to have an economic recession beginning as early as this current quarter, meaning I think when we start to see February and March date, it's going to be indicative of recessionary conditions.

I think the damage we've already done from the higher rates working on a lag that negative wealth effects means we're going to start to see those

recessionary conditions at an economic level, at least in the third quarter for the US I think Europe is going to remain in recessionary conditions with the ongoing struggles both from the Russia Ukraine war, but just the Herculean task that was taken to reduce some of their industrial activity this year in face of shortages with natural gas and other key commodities. And unfortunately that's going to be with us again as we get into and move through the rest of 23. I think Asia, specifically with China leading, is about the only large area that has a chance to start re-accelerating. I think that's why we saw some initial strength out of the Chinese equity market when the rest of the markets were enjoying a bear market rally, but nothing of any sustained move higher earlier this year.

Jacinta Schlosser (06:37):

Okay, thank you. Look, I've been listening to recent Vaughn Nelson podcasts and you mentioned a few interesting things that I'd like to unpack. You commented in early January that all we've priced in at the moment is higher rates and not the economic fundamentals yet, which leads on from what we were just talking about. Can you elaborate please?

Chris Wallis (06:57):

Yeah. And I think it gets back to... I think we have two reasons we really haven't priced in a lot of these future deteriorations and earnings. One, we have a whole generation of investors that really haven't been through a significant economic cycle yet. And so, I think they take management's guidance to heart early in the year and they really aren't familiar with the level of misallocation of capital, the level of credit losses, and honestly the ongoing contraction and liquidity that's going to further pressure corporate profits and quite frankly, investors risk [inaudible 00:07:36] as we move through the year, so that's part of the reason.

I think the other reason is passive has gotten to be such a large percentage of market flows and passive does not discount the future. It just says, "Give me a dollar and I'll invest it or let me sell a unit of a security if you need a dollar." And so, we don't have the same level of discounting mechanisms as we had in the past. We haven't repealed the laws of economics. It's very simple. There's leading indicators that are indicative of what demand's going to be like in the future. Employment and inflation are the most lagging indicators you could possibly focus on. And when we look at the leading indicators around investment, when we look at the leading indicators around profits and margins, they all point to the same direction, which is much, much weaker.

If I look at the typical lags between when credit starts to tighten up, meaning the interest rates increases are really starting to bite and impact investment or lending activities, that really only began in the second half of 2022. If we follow the typical leads and lags, we're really going to start to get some more recessionary data in the second and third quarter. And I really think that's why corporations have been holding onto their employees. They've given significant raises. It's been very difficult to hold on to talent. They are loath to start cutting that employee count yet, but I think ultimately they're going to have to succumb to those pressures in the second and third quarter, because quite frankly I just don't think we're going to get the recovery that's currently priced in.

When you look historically when we have a recession, even a mild recession, you would expect earnings to decline 15, perhaps as much as 25%. And we're still projecting earnings to be relatively flat to higher for 23 for most of the sector's X energy, and that's just not going to happen. I mean, we have a pretty good idea after the last week what's going to happen to financial earnings and they're a very, very important part of the global economy.

Jacinta Schlosser (09:45):

Yeah. That leads to what's happened over the weekend since Friday. But before, in introducing that in some of your commentary in your podcast you also talked about the Fed is not our friend and that it needs to break stuff. I think we witnessed that just for those two who are still catching up on it. Last Friday morning US time, which was the 10th of March, Silicon Valley Bank collapsed. SVB was the 16th largest bank in the United States at the time. And then over the weekend, Sunday, New York Bay Signature Bank followed suit. This is, to me, seems like an example of the fed breaking stuff. What does this mean for financial sector or financial SOCs? Bearing in mind that Biden came out late yesterday, Amer US time and said his guaranteeing deposits, so there's a lot of moving parts.

Chris Wallis (10:35):

There's a lot of moving parts and this is where... When you have a bank panic, there really is nothing positive you can say because if you come out and reassure people. They assume you're naive and you don't understand what's going on if you come out and say, "Yeah, it's terrible, but we really think we have the tools," they're going to assume you don't. I certainly don't want to blame the president, but any of the regulators are oversee. It's really just a no win situation and these initial bank panics, and just the emotional elements of behavioral finance have to play themselves out.

Our theory coming into 23 was that the banks were going to have significant problems by the back half of the year because of all the reasons that were accelerated with the demise of Silicon Valley Bank, which is just a duration mismatch. And quite frankly, when you have the Fed raising rates at such an aggressive level and shrinking the money supply for the first time since I've seen data recorded all the way back to the 1960s, that means there's not as much money to go around. As you mentioned, something has to break. Well, it was Silicon Valley Bank. They are at the absolute heart of the bubble this cycle, which was venture capital investing, hope-based investment philosophies. And they unfortunately got caught in a very difficult position because they just had a lot of deposit flight. Organically, they had a lot of deposit flight. Certainly, it does present a lot of pressure for the banking system. Every bank has similar degrees of this pressure. And what it means is now, and I believe this is the stage of the credit cycle we're entering, which is the loss recognition stage.

And you're right, we've believed the Fed has needed to break things because they needed to break the inflation psyche. But what's really important for investors to understand is the Fed's number one job is to finance the government. It's not to target inflation and it's not to maintain healthy levels of employment. It's to ensure that the sovereign can borrow at as lower rate as

possible to sustain its deficits. And unfortunately for the Fed, a combination of fiscal policy and the monetization of that policy really did trigger significant non-trans inflation. And that's still very much an issue, although we're on the downhill side of it. And so, the Fed was hoping and needing to be able to break something, to break the psyche of inflation without causing any systemic damage. And it's a fine line and this is when you get into the element of unintended consequences.

I think it's important when you look at the US banking system to understand when they say it's well capitalized, yes, that's true. There's plenty of capital, but there's probably not enough liquidity if everybody wants their deposits. That's just the nature of a fractional banking system. I think that the regulators did the right things this weekend, putting in backup liquidity facilities, but it doesn't change the embedded losses that are in the system. Yes, the banks won't have to sell their investment portfolios at a loss to meet demands out of depositors, but that's not the issue. The excesses this cycle I think are going to be in the private credit environment, meaning the credit that is originated outside of the regulated banking system, the credit in and around the levered loan market and private equity, I think we're going to see significant issues in and around commercial real estate.

I think that's the next stage of this and that should start to play out. I think we'll see evidence of it certainly in the first half of 23, but you get into these negative reflexive events. And what I mean by that is yes, there was tightening liquidity conditions and there was marginal pressure on top line coming into last week. Now that we had two bank failures, that means every bank and every lender is going, "Uh oh, maybe there's more. Let me tighten my lending standards, let me hoard my capital." An operating [inaudible 00:14:51], an individual that was going to be able to make it through the difficult times without that incremental tightening isn't and so we're going to lose someone else, we're going to have another bankruptcy. It doesn't have to be a bank, it could be another entity.

And then that's going to be indicative or confirming to those that are concerned that there are other issues out there, and so they'll tighten up again. And so, you get into this negative feedback loop and I think that's what we're doing. We're entering that negative feedback loop. And it stops once we've cycled through all those weaker credits or it stops when we get a more significant policy response. My own belief is that we're going to get a more significant policy response. And I think unfortunately because of our federal deficit position and because of the misallocation of capital, which is a global issue, it's going to require some fairly binary choices out of central banks and fiscal authorities. They're going to have to choose more corrosive disinflationary conditions or they're going to have to choose inflationary outcomes. And that's a very difficult choice for investors. Those are binary paths with very different winners and losers. And so, investors really need to be forward-looking, don't get caught by lack of failure of imagination and have a plan as those choices are made and be ready to execute it pretty quickly.

Jacinta Schlosser (16:20):

Yeah, this is something that we've touched on our podcast previously, is having that discipline and holding your steel in times of volatility. I can't take credit for

that phrase. It was Chris Mackay who I used to work with who rolled that one out, and I really like it. Just finishing off, we want to talk about some other things today, but finishing off on that, so that signature policy response you reference, will that be enough... To people talking about the fear of contagion? Will that be enough to contain that?

Chris Wallis (16:52):

I don't think we should think of it for the contagion of what's happened to date as it's going to be a systemic banking crisis issue. I think we can fund our way through that. We can do patchwork and we can deal with that. It doesn't mean other banks don't fail, but this is not the GFC. The GFC was a loss of liquidity and that loss of liquidity was shutting businesses down. And because of the GFC, because of the facilities other central banks have put in place, there is liquidity. It doesn't mean equity holders and debt holders get made whole, but the economy will have the liquidity it needs to function as we allocate losses.

The contagion from this is exactly that. What we are going to see is losses start to be taken. You're going to finally start to see real estate developers who were holding out hope that they would be able to lease up more than they otherwise would turn the keys back to the lenders and let the lenders know, "Hey, you now own a building." And that's the loss recognition and the allocation process of this, and that's where we're headed. That's just the next stage of what has been a very, very generous long bull cycle with plenty of liquidity at ultra low rates. And we either have to go back to those conditions to avoid those losses, or we have to accept that they're coming our way and deal with them as they do.

Jacinta Schlosser (18:18):

Thank you. Look, I'm going to switch gears now and move us into talking about Vaughn Nelson's methodology, stocks, sectors where you're finding value. Firstly, we've been seeing a rotation from growth to value stocks as rates rise. How do you see this playing out?

Chris Wallis (18:36):

Look, I think it's very consistent with where we are in the longer term cycles. I think we often split the world between growth and value, but essentially, what we're saying is value is cyclicals, industrials, commodities, and typically your financial entities because banks do well when those heavy industrials are doing well. And the other thing that's a factor when that those sectors are doing well, it's because growth is broad across the economy. And what typically drives that value cycle is the commodity cycle. And commodity cycles are very long in nature. It takes several years of higher prices to incent an industry to spend tens of billions of dollars to add productive capacity. Inevitably, as you get to the end of those cycles, they overcapitalize the industry, they create too much excess supply, and then you go into the downside of the cycle.

They're always led by the fossil fuel industry because that's the leading commodity for most industrial societies. You typically have a seven to 10 year up cycle, then you have a seven-year down cycle, a two or three year pacing cycle, and you kick it all off again. That's really what we started doing. We were going to kick it off at early in 2020, but COVID disrupted that. When you're on

the downhill side of that commodity cycle, which is what we really were from the middle of the last decade up through 2020, 2021, you have very disinflationary conditions. You have falling interest rates, falling inflation, falling growth. Central banks provide a lot of liquidity in those conditions. They can because it's not an inflationary backdrop, and they cut rates. And investors crowd into what limited areas that can grow, and they talk themselves into new narratives and themes and everything's going to grow forever and tams and the whole nine yards. And so, we've seen this cycle repeat on and on.

When you make the transition to a new commodity cycle, it does take a couple of years to kick it off, and that's when you get a bigger rotation into the value sector. Typically on a real basis, if you're looking at the US for example, the S&P 500 will fall 30 to 50% on a real basis over that transition period. And really what that is, it's all those investors that were crowded into our large cap tech, that were crowded into some of the more me oriented stocks start to suffer losses. And the process of selling in those cap weighted industries to move back into industrials and other cyclicals, that rebalances the indices but also means value significantly outperforms growth.

I think we're in the latter part of that second year of making that transition. I think every cycle's different. And the difference this cycle is we have a significant credit event that could unfold and we're seeing it in the banking sector. We'll see it in real estate. I think we're going to see it in the form of sovereign defaults. They typically don't choose to default. They choose very pro-growth, inflationary policies, but they have to do it with fits and starts, and with a political calendar. If they go down that path of reflation to address these imbalances, it's only going to accentuate that commodity cycle and it's only going to accentuate that transition from growth to value.

I think we're otherwise, I think you have a normal value beats growth cycle X the financials, they're going to have their own set of issues. But you take out the financials, I would rather own industrials, there's key components of technology in and around hardware and outsourced elements that are going to do phenomenally well. If you look at the valuation disparities currently between the larger cap indices and the smaller cap indices, smaller caps are clearly or more at attractively valued and they benefit disproportionately from a fiscal response are these reflationary policies. I think we're going to see an environment not too dissimilar from the transition we made from the late nineties into the early 2000s.

Jacinta Schlosser (22:59):

Thank you. That leads nicely, I think into where I wanted to head with our next question, was we touched on earlier about the potential economic recession heading into this quarter and next quarter. But how is the year shaping up from where you sit and where are you finding value at the moment? Just recapping that global [inaudible 00:23:18], so small and midcaps is your area.

Chris Wallis (23:20):

It is. We've been invested in the small cap space for well over two decades. And so, this isn't our first cycle. It's not even our first banking crisis. And I've been through banking crisis in a prior career as well.

Jacinta Schlosser (23:34):

Me too.

Chris Wallis (23:36):

I feel very comfortable with what I'm going to describe as a very difficult macro environment because we understand it, we have the data, and we can play off our front foot. We don't have to react to the market elements of this. I also feel very good in that the depth and breadth of the team and the research and the native language capabilities. When we, as an example, look at a supply chain. Let's say we've been very interested in the semiconductor and semi cap equipment supply chain for a number of years because we've figured out in the latter part of the last decade, "Hey, these are going to be strategic national assets. How do you want to make money?" Well, you can make money all through that supply chain at different areas and different regions of the world.

You can imagine there's companies in Europe where you're really going to focus in on some specialty chemicals. There's companies in the States that are really focused on the manufacturing of sub-components that are used to construct semiconductors. There's companies in Asia that manufacture and design those semiconductors. Now, we can talk about all the difficulties that are going to happen with banks. We can talk about all the demographic challenges around the world. There is no way we're not going to be using more semiconductors three years from now, five years from now, and 10 years from now than we are today. That's almost a given.

We look for opportunities all across the globe where we're comfortable that the end market demand for the next three to five years is healthy. And then we find those individual companies that are, I would call, the 400 pound gorilla, 200 pound gorilla in these smaller niche markets. And when we get the valuation opportunity, we need to hit our return hurdles, we move in. And for us, we look for 50% upside and only 10 or 15% downside. We need asymmetry. We only use absolute valuation measures. We don't focus on relative valuation and we use a pretty high hurdle as far as a cost to capital, because we really do want to compound it at least 15%. And with that, we're very fortunate, the global [inaudible 00:25:50], universe of several thousand companies, we benefit, and I think we're in a sweet spot from this standpoint. In the US the small and mid-cap stocks are going to outperform the large cap, and it's because of everything we previously discussed, which was the crowding in and the excessive valuations as you move up in cap range in the US.

If you look in the rest of the world, primarily in the developed markets, the small and mid-cap sector not only outperforms the large cap space, and it does so because the large cap is often dominated by state-owned enterprises or the financials. You think the US has a difficult position with its banking system? Europe's got some very significant challenges, as has other parts of Asia. Those will be an anchor. But when you look at higher rates of growth, fabulous secular trends, very profitable entities. You're looking ATAs in the high single digit, it's in the small mid-cap space, XUS. And ironically that small mid-cap space, XUS has lower volatility than the non-US large caps, and are less correlated with US assets. And I will be the first one to say every US investor is overexposed to the

US, but quite frankly it's hard for nearly any investor even outside of the US to get away from the impact of US equities and the US dollar because of what's transpired for the last 10 years.

The ability to move down cap, get better returns, get better levels of profitability, better secular growth rates, better valuations, and hopefully dampen down a lot of that correlation that comes from those larger cap stocks makes a pretty compelling opportunity.

Honestly, outside, the only thing we really are avoiding right now are banks. I mean, we have exposure to financials, but our financials are usually in and around insurance services, things of that nature, stock exchanges that benefit from the volatility, things like that. We're really deemphasizing exposure to the traditional banks. We're overweight industrials and technology, but there really isn't any single region that dominates. And I think there's another piece of this that's important. We have a very robust risk framework. It doesn't mean we don't have market risk, we do, we own the equities. But what it means is we understand our factor exposures. And let me talk about why that's important.

As an example, we were bullish on fossil fuel prices early in 22, but by June it was very clear there was going to be a significant correction in energy prices. Well, we know what companies are directly exposed to that sector, industrials or others. But if you have exposure to the Norwegian kroner, that has a very heavy factor waiting to energy prices. You may have exposure via other companies or other mechanisms that you may not realize, so when we look at this global portfolio, we look at it at a factor level to understand the myriad of 100 plus factors and exposures, we have to make sure we don't have any unintended factor bets. Because like I said, I don't think we're through with the volatility, I unfortunately don't think we're through with the Sunday headlines and you wake up Monday in a different world.

That's okay. I mean, we're comfortable with that. It's in our process. We deal with it by looking at balance sheets and where people could be in trouble and where they couldn't. And quite frankly, for the first time and well over 10 years, we're having a lot of fun. It's not fun when everybody gets a trophy for just owning equities because everything goes up and to the right. You got to know what you're doing now. And so in that sense we like the volatility.

Jacinta Schlosser (29:50):

And that's been the challenge presently, like you said, I probably was guilty of it too. You almost forgot after that 10 year run of things were just up, up. And to look for, I just want to mention here for our listeners, the Global Smid Fund fund fact sheet detail, some of those sectors and breakdowns, which gives a good overview understanding of how the portfolio is put together and positioned. Now, the other thing I noticed on that fact sheet I wanted to ask you about, just before we wrap up today was you state that we trade time for value. What does that mean from your perspective?

Chris Wallis (30:27):

I think there's only three ways you can make money without speculating. And it's either you own a company that has very predictable and very attractive

growth outlook, meaning it can earn well above its cost to capital and it can continue to redeploy that capital into its balance sheet and its earnings are going to grow, and you're not paying for any of that future earnings growth. Well, in that sense, the only way I'm going to make money is I'm going to make an investment and I'm going to wait. And while everybody else is worried about what's going to happen next where we have that great visibility, we'll just wait. We'll be patient, and we'll trade time for value. And as time passes, our companies are going to become worth more money.

And then another area where that's the case is where you get deep value opportunities and significant sell-offs. There are people selling securities today that aren't banks, not because they don't like the security, it's because they need the money. All these securities are a temporary unit of account to hold currency. And when they need currency to meet those withdrawals that they may be facing, they have to sell securities. Well, we're going to take advantage of that. And again, it just provides us the ability to trade that time for value. We don't have to panic. We can wait and capture some of these deep cyclical when they get sold off when there's too much panic in the streets. But what we don't do is guess. I'm not here to guess what a price is going to do this week, next week. I'm not going to guess who's going to beat any quarterly earnings in what the stock reaction's going to do. That's all speculative. We construct a portfolio that via just passing time and that passage of time is going to be worth more. And in that, we can trade time for value.

Jacinta Schlosser (32:17):

Thank you. I like the phrase, so I think that was really helpful for those of us out there just still learning about more about Vaughn Nelson and what you do. Thank you, Chris. I really enjoyed our conversation and I wish you and your colleagues at Vaughn Nelson well as you navigate this year.

Chris Wallis (32:32):

Thank you.

Jacinta Schlosser (32:33):

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