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Investing in a multipolar world

Difficult dynamics also harbour opportunities

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Between still high levels of inflation, fast-tightening central banks, a growing energy crisis in Europe and slow growth in China, it is easy to imagine a bleak growth outlook. But these difficult dynamics also harbour opportunities often masked in exaggerated mispricing based on fear and confusion.

To be sure, the Federal Reserve (Fed) blew bubbles both in the equity and bond markets, but these bubbles have largely deflated with valuations aligned more closely with fundamentals—but not all. Still, the world is changing, and price discovery will have to consider more persistent inflation dynamics driven by deglobalisation—when a finely-tuned global supply chain enabling cheap goods necessarily has to reconfigure, offering investment opportunities but also risks in the journey to the other side.

While we see unusual risks, we also see ample opportunities

Conventional approaches to multi-asset may expect a reversion to historical norms. However, such expectations may not survive as volatility, correlations and notions of "safe assets" shift to accommodate multi-polar dynamics requiring forward-looking and adaptive thinking to adequately seek returns, while mitigating risks that aren't necessarily revealed in backward-looking models.

While we see unusual risks, we also see ample opportunities, chiefly in China but also more broadly. Some are geographical but others are sector and security-specific—those that harness what the world needs for the future and are also prepared to manage and navigate the difficult conditions over the journey. We aim to look forward and spend less time waiting for historical norms necessarily returning; this requires an adaptive approach to taking risk to achieve return targets while adequately protecting the downside.

Adjusting to a multipolar World

Starting with US-China trade wars that began in 2018 only worsened by increasing geopolitical tensions, COVID and the Russia-Ukraine war, deglobalisation is accelerating. Supply chains are being rerouted to friendly allies with many production functions being onshored in the name of national security. This requires investment, which is good, but it also requires resources, and in some pockets a painful economic adjustment.

The impact cannot be overstated. While US consumers had feasted on inexpensive goods from China that benefited from higher real wages and Europe benefiting from cheap energy from Russia to produce goods for China and elsewhere, these symbiotic deflationary dynamics are being unwound.

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Deglobalisation is inflationary, particularly for the investment required to execute the transition while accessing the necessary ingredient of commodities that is fundamentally lacking investment in the West to increase production capacity to meet the ultimate demand. In the long-term, increased investment will generate growth and improve productivity, which is disinflationary, but this will take time. Policymakers are currently behind the curve in setting policy to align with the coming this transformative shift.

In the East, the transition is likely to be easier. So far, sanctions on Russia have not had the intended result, which is that exports have failed to be notably hindered to bring Russia to heel. New alliances are being formed. China has been adjusting its economy for more than a decade, relying less on infrastructure and property investment and more on quality investment to climb the value chain as well as building consumption to generate more self-sustaining growth, less vulnerable to external shocks. Still, the journey is not complete with painful adjustments in process and likely ahead, but the direction seems more correctly aligned with the ultimate end-state required.

An extended path to lower inflation

Inflation is expected to decline in the US, due to excess inventories and outsized profits being drained, but given the new multipolar dynamic, inflation is unlikely to return to historical norms of around 2%. If there is a recession, inflation could fall quickly, but any return to "non-inflationary" growth will be difficult to achieve given the above-described multipolar dynamics.

The US is better positioned for an adjustment, in our view. Central banks will indeed continue to tighten, sopping up excess liquidity that needs to be drained. However, the world is still awash in liquidity for the massive stimulus that followed COVID. Private sector balance sheets remain quite strong, which is quite different from the credit-driven bubbles such as back in 2007-2008 which perhaps mitigates the risk of a protracted slowdown. However, policymakers will need to respond with measures to promote investment and improve productivity and not with the traditional stimulus of years past (or even now) designed to support consumption, which will be inflationary.

Europe has a more immediate need for coordinated policy to alleviate its short-term pain which includes an energy crisis that is adding to inflation. Perhaps its green energy initiatives that will work over the long-term, but in some sense Europe and the US will need to coordinate their policies to meet their collective needs, which is to ensure that near-term energy needs through increases in conventional (sometimes non-green) production capacity that mainly comes from the US, Canada and OPEC.

Through the removal of easy policy, particularly the shift from quantitative easing to tightening, central bankers are returning price discovery to the markets

The China-Russia collective and those participating in trade for cheaper energy from Russia may be at less risk of inflationary pressures given the natural resources that remain relatively more abundant on their side of the new multipolar structure. The challenge for China is navigating to more balanced growth, which includes returning the property market to stability while reducing its current dependence on export demand that is likely to decline—particularly in the event of a US recession.

Higher risk premiums, volatility and shifting correlations

Through the removal of easy policy, particularly the shift from quantitative easing to tightening, central bankers are returning price discovery to the markets. This is most clearly evident in the rates market also but is also transmitting to other asset classes, such as richly priced equities.

Developed market (DM) government bonds are traditionally considered a safe asset in the sense that default rates are extremely low (partly for the ability to print money). However, inflation uncertainty is a new feature requiring risk a premium that may not be fully priced. A 3% 10-year US Treasury yield may have looked attractive over the last decade when inflation was tame, but it looks much less attractive given current inflation dynamics that are well ahead of that level sought with an uncertain path to the return to "normal" inflation.

Whether the Fed tightens too much or too little will not be known until after the fact, making DM bonds in many ways a "riskier" asset, meaning that outside of low default risk, they are prone to significantly higher volatility given the uncertainty.

Higher yields also transmit to a higher risk premium on the equity side given the rising cost of capital, which in turn means that equities priced at a high earnings multiple are risk of further derating—something witnessed acutely year to date. The trajectory of rates is likely to continue to be a key driver of the fair value of the growthy segment of the equities market; however, earnings are certainly a key risk given the anticipated slowdown.

As bond and growth equity risk premiums expand in parallel, correlations are likely to remain positive, offering less protection in a conventional multi-asset portfolio. If there is a recession, there could be opportunities in bonds, but this will be tricky depending on the Fed's reaction function concerning whether inflation has indeed reduced (enough) to target. The greater risk is that any attempt to ease may simply reignite inflation dynamics that will force the Fed to tighten again before the economy has fully recovered—not unlike the 1970s.

In short, traditional DM duration is less a safe asset until inflation dynamics are fully resolved, which will take time. Whereas in China, inflation dynamics are far more favourable while the People's Bank of China is adhering to orthodox monetary policies that are less prone to policy error. Other emerging market central banks also run more orthodox policies offering yield opportunities but are less defensive given their markets' dependency on external demand, making them vulnerable to a strong dollar, a hawkish Fed and slowing global growth.

Systemic crisis risks

A key risk is the speed at which policies are being tightened and while private sector balance sheets seem less at risk, public sector balance sheets have been ballooning. Europe in particular seems at risk of removing easy policy too quickly given the heavy degree of reliance on quantitative easing to stabilise the European Union for the last decade.

European growth is already slowing while the energy crisis is ongoing. The European Central Bank is tightening while actively trying to manage relative spreads between the core and periphery, a newly created tool that may not prove adequate to stem the flows that seek better credit quality from the periphery to the core.

Japan is also strained with keeping its policy easy against tighter policies virtually everywhere else. The yen has already massively underperformed YTD, so if policy gets significantly tighter outside of Japan's borders, the strains could grow.

Any such systemic crisis could lead to a deflationary shock, which could interrupt the Fed's tightening path. This may be perceived as bullish for equities over the short term if the event is deemed more exogenous to the health of the US economy. But the US is not immune from external shocks, and while any easing may ameliorate the shock, it does not solve the inflationary dynamics that will need to ultimately be solved by coherent policy.

The role of a multi-asset investor is changing, where relying on historically normal patterns of volatility and correlation may not protect a portfolio

Multi-asset adaptive approach in a multipolar world

The role of a multi-asset investor is changing, where relying on historically normal patterns of volatility and correlation may not protect a portfolio while return profiles and notions of safe assets are quickly changing. Moreover, while we seek to achieve target returns while mitigating downside, we must be cognizant of the client's need to preserve purchasing power.

In our current construct, we see China bonds a safer asset than DM peers, insofar as taking duration risk where correlations with equities is still protective. Gold is also a protective asset particularly for systemic and geopolitical risks that are on the rise, but with headwinds from rising real yields driven by Fed tightening.

For growth, we like defensive equities that are less exposed to the European and US economic cycle. Quality companies with strong balance sheets and steady cash flow are preferred but challenging to identify at a reasonable price—though opportunities are emerging. Value assets, overall, are preferred.

Commodity-linked equities play an important role in the portfolio both as an inflation hedge as well as having strong earnings and very cheap valuations. The challenge is that they are quite volatile—particularly in the event of deemed rising recession risk or a systemic shock. Risk needs to be monitored closely.

We are most constructive on China equities given Beijing's control over inflation (helped through alliances with Russia to access cheaper energy), orthodox policies and conventional means of lifting sustainable growth as opposed to an unsustainable credit binge. We are certainly mindful of huge policy challenges including the ongoing headwinds in the property market, but the banking system is healthy, and they are working their way through it. In other words, China is on a credible sustainable path to growth. If China gets it right, which we think it will, the reach of opportunities extends considerably.

Europe and the US have some work to do. While China has been in the process of rebalancing its economy for more than a decade, Europe, and to a lesser extent the US, need to shift from a consumption model to an investment model that will eventually ameliorate inflationary pressures. In the meantime, it will be tough to unwind unconventional policies of easy money that will take time to digest in capitalistic and risk-taking mindsets. This shift has broad implications for demand.

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