Perspectives Podcast

"Investment Trends in Focus Quarterly Roundtable"

October 12, 2023

Adam Bass (00:03):
This is MSCI Perspectives, your source for insights for global investors, and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is October 12th, 2023. Back in August, we introduced you to MSCI's Head of Research, Ashley Lester. Today we introduce you to a new quarterly feature on Perspectives.

(00:30):
Our investment trends and focus roundtable looks at the markets, like the patchwork quilt of unique but interwoven parts that it is. This quarter's discussion looks across developed and emerging markets, across equities, fixed income and real estate. It is led by none other than Ashley Lester, whom we turn to now.

Ashley Lester (00:54):
Thank you, Adam. These are tumultuous times in markets, and so we will commence our in-focus discussion without further ado. Last quarter, the big news of the quarter was the increase in interest rates, particularly in the United States. Over the weekend, we were all shocked by the news of war in Israel and the Gaza Strip.

(01:11):
Last time there was a similarly significant military incursion into Israel, was the Yom Kippur War, which started almost exactly 50 years ago today, and which in some ways lay behind the infamous inflationary shocks of the 1970s. With interest rates heading north and war in the Middle East, are we headed for a repeat of the 1970s?

(01:32):
Is stagflation just around the corner? Thomas, perhaps I could ask you to start by providing some perspective on the increase in rates we saw last quarter?

Thomas Verbraken (01:41):
Thank you, Ashley. I'm Thomas Verbraken and part of the Solutions Research Group at MSCI. Policymakers have been increasingly signaling that they want to keep policy rates higher for longer. The chief economist of the Bank of England actually made a nice comparison, saying that he rather sees the interest rate path as the tabletop mountain instead of the Matterhorn.

(02:01):
Meaning he rather keeps rates at this level for longer, than increasing further and then having to cut. We've seen markets adjust to that. It took a while. But nowadays, implied expectations for the policy

rates are aligned with what the policymakers have been saying for longer. Namely, that rate cuts are not to be expected before mid-2024, and this is true across various regions.

(02:29):
It's true in the US, UK, and the eurozone, but I think the more recent story, what we've seen in the past week, is the surge in longer Treasury rates. We've seen a flattening in the yield curve, again, not only in the US, but also in the UK and the eurozone. That begs the question, what is driving that? Because monetary policy rates tend to affect the shorter end of the yield curve.

(02:54):
But now we've seen 10-year and 30-year rates going up quite a bit as well. Now what I want to mention is that the 10-year breakeven inflation rate has remained relatively flat over the past week. That means real rates have gone up. They're now actually at the 15-year high in the US, at a 12-year high in the eurozone, and at the 13-year high in the UK. Now, what could have driven that?

(03:20):
According to the New York Feds model, the US term premium has gone up recently. It's now in positive territory, which means that investors demand a premium for holding longer maturity treasuries. Many factors could play a role, but the few that come to mind are shifts in supply and demand of Treasury bonds. US Treasury issuance is high, given the fiscal deficits.

(03:46):
Quantitative tapering is going on, and foreign holdings of treasuries are declining. A more controversial take is that it could be related to uncertainty around solvency. We had the Fitch downgrade in August, so you could argue that investors are increasingly worried about the US government missing a bond payment. Although I must say, it still seems unthinkable that the US government would default on its debt.

(04:18):
We're not sure if that's really the reason for the surge in longer rates. Ashley, I'm just going to say one last thing and then I hand it back to you. Because if you focus on the really long end of the curve, the 30-year note, then we see that that one went up slightly more than the 10-year rate. If we look at the breakeven inflation curve, I was mentioning that 10-year breakeven inflation rates have been relatively flat over the past weeks.

(04:47):
But the gap between the 30-year and the 10-year breakeven inflation rate, has actually increased by about 20 basis points since mid-September. This might be suggesting that in the much longer term, investors are pricing in longer inflation than before, and that may play a role as well.

Ashley Lester (05:05):
What are we seeing in riskier assets in fixed income? Are we seeing IG or high-yield spreads move wider on the back of these moves?

Thomas Verbraken (05:14):

It's actually interesting that if you look at credit markets, that credit spreads are relatively flat. We haven't seen huge spikes there. Also, emerging markets, credit spreads seem relatively flat. One spread, which I want to call out, is the Italian sovereign spreads over the German bond yield.

(05:32):
That one has gone up and that one actually is also related to something happening last month. The fiscal deficits in Italy and the plans for more government borrowing, have made investors a bit more nervous, and that has pushed up the Italian sovereign spread. But apart from that, I haven't spotted big moves in the credit markets.

Ashley Lester (05:57):
There aren't huge moves in the riskier parts of fixed-income markets. On the other hand, in equity markets, we saw a decline overall in most equity markets last quarter. Of course, in the benign correlation environment that we've all got used to over the last 10 or 15 years.

(06:12):
We would typically see equity markets do well in the context of on market falls, but that wasn't the case last quarter. Just how unusual is that and what are some of the implications of what we're seeing for equity markets? Anil, can I bring you in on this topic, please?

Anil Rao (06:28):
Yeah, sure. My name's Anil Rao. I'm part of the Equity Research team here at MSCI. Yeah. Just to level set, how did equity markets perform throughout this year? I think you mentioned, Ashley, last quarter's decline. Just as a sense of scale, I looked at this morning, year-to-date major market returns. The US is up around 14%. The growth segment of the US market's up around 30%.

(06:54):
US value stocks decline around 2% loss. Surprisingly, Europe and Japan this year, have actually rebounded quite a bit from last year, so they're up 6%, 7%. Kind of lagging the pack are Australian equities that are down 3% or 4% this year. You mentioned at the outset, Ashley, this moment compared to the 1970s. One of the things that I like to look at is just how unusual is this moment?

(07:21):
One way that I think about this or one way of thinking about the stretched valuations and just the run-up in stocks this year, is this growth to value premium. That is how much more are investors paying for a dollar of a firm that's growing its earnings, versus let's say a value firm? That spread today or that premium, is matching levels from the 1970s. That is investors today are paying almost 150% more for a dollar of growth earnings versus value.

(07:55):
Historically, that spread's around 50%. That's interesting because that's at a peak and there's an interest rate component to that, as you mentioned. But I think more interesting is just as we dial back in time, we look at that spread that's matching levels from the 1970s, in fact, from the late 1970s. I think investors are starting to price in a risk of reversal there.

(08:20):
As you mentioned over the last three months, most of the major equity markets around the world have actually come off a bit, 3% to 5%.

Ashley Lester (08:28):
That's fascinating. Sorry. Go on, Thomas.

Thomas Verbraken (08:30):
Yeah. If I can maybe weigh in on this, I'd like to maybe zoom out a little bit to the multi-asset class perspective, because I think that the bond-equity correlation is indeed something that investors are very often looking at, because of its importance for diversification in portfolios. We were used to the regime where when equity sold off, bonds gave that cushion.

(08:53):
That was basically true from 2000 to, I think, 2021 when the economy was mostly driven by demand shocks, but it hasn't always been like that. We can go back to the '70s, '80s, '90s when the bond-equity correlation was positive. Actually, if you look at the bond-equity correlation over time, then we see that recently in 2021, it again has moved into positive territory.

(09:20):
That has important implications for this diversification role, especially if you think about the traditional 60/40 portfolio. Last year, for example, that portfolio took a really hard hit, because last year was really bad for bonds and for equities. I think the question is if we go back to a regime, which is more similar to what we saw in the '70s, '80s, '90s, will that have implications for the 60/40 portfolio and for the role of bonds as a diversifier?

Ashley Lester (09:50):
That's a great lead into another line of inquiry, which is that if a liquid 60/40 portfolio may not fulfill a diversification role that it has over recent decades, are there other places to look?

(10:03):
Jim, I might bring you in at this point, given your expertise in asset classes, aside from liquid bonds and equities.

Jim Costello (10:10):
Hi. Yeah, I'm Jim Costello. I'm with the Real Assets Research team. I am based out of New York and a suitcase from time to time. I am listening to these guys and thinking about, "What is going on today versus the past in the '70s?" This is a topic that I've been addressing in my presentations to clients. There are things that rhyme in every downturn. I think sometimes investors get caught up in the things that rhyme.

(10:39):
Just look at analogies to previous periods and thinking everything from a worst case and a previous downcycle will happen again, and that the investment opportunities will be the same. But there are different initial drivers in every one of those downturns, so you got to look below the headline figures.

That's a fancy way of saying, "This time it's different." The inflation trends of the '70s, we had other things driving them that weren't in place today.

(11:04):
This inflation trend in the last couple of years, I look at it as really just a function of the aftershocks of the COVID crisis. When you shut down the global economy and have everybody stay on their couch for months at a time, you're going to have some shocks afterwards. The inflation shock that happened first was an energy shock. If you take all the CPI stuff and you look below the numbers, you start disaggregating what's driving CPI?

(11:32):
The first thing that was really driving it was an energy shock. Nobody was driving into the office, that we weren't driving around. You didn't have as much energy demand, and so oil firms stopped drilling. It's not like turn on the tap of water where you just turn it back on when you need it again. The Baker Hughes numbers show that they stopped drilling for new oil wells. It took time for that investment to ramp back up to get more energy delivered into the economy.

(11:57):
We saw a housing shock. That's one third of the CPI in the markets of North America and Canada in terms of how they calculate it. We had a record shutdown of housing construction. It zoomed back the other way. It's zigging and zagging back and forth like a rubber band. You have this initial shock and it just reverberates out in a series of decreasing waves over time. The housing shock we're still dealing with. That is a huge component, that one third of the CPI.

(12:24):
It's growing at a faster pace because we have limits on how much supply is out there, at a time when the demographics suggest there should be more demand. This is all different than the '70s when you had an energy shock, that was not something that was going to be dealt with more investment. That was a political issue. Then you also had this contract issue with the labor markets and how firms had to continually push price increases along.

(12:53):
Different sets of situations, and I think it just has different implications for how people invest and how they should be thinking about the future.

Ashley Lester (13:01):
Still, Jim, as you say, history doesn't repeat but it rhymes. On one level, the rhymes start to get a bit almost uncanny with the political sources of energy price shocks, the UAW strike in the states.

(13:15):
There's definitely a strong sense of rhyme, which perhaps is leading some investors, at least, to get a bit anxious here. How's that playing out in the commercial real estate market, especially given this very key point you made that much of what we're seeing today is the aftershocks and the reverberations of the pandemic?

Jim Costello (13:34):
Commercial real estate markets are slower moving than the other asset classes. When I talk about what's happening in real estate, sometimes these guys, they snicker a bit because I could talk about prices last quarter. They could talk by the minute. It's a different asset class. The property prices were down 6 1/2% globally in the second quarter of 2023. Again, we're in October, we're talking about this.

(14:00):
This is the most recent read we have and investment returns are down, but they're a bit lagging. The fundamental demand is still facing challenges and investors are slowly coming around to where they need to be to have the market clear. The market's not clearing. We're at a reduced level of activity. Potential buyers are looking at assets and thinking, "I don't want to go in at the current prices." Because of all the negatives you pointed, Ashley, on the UAW strike.

(14:26):
All the demand factors changing. If they're looking at an asset, they're thinking, "I'll pay 30 cents on the dollar relative to what you paid for it, just to cover all the risks and all the uncertainty I'm taking on. Because I don't want to jump in and be the person everybody talks about five years from now who overpaid for an asset." As opposed to current owners, it's not like in the stock market where they have to mark everything to market right away.

(14:49):
As long as they're current on their loan, they could just sit on the asset and wait and see what happens. You have this expectations gap, there's very little liquidity in many asset classes. There's some that are a little bit different. Some individual property types are a bit different. There's been more of a move towards industrial properties. Think about warehouses. It's a cheaper asset to build. You don't have to spend a lot to keep it current.

(15:15):
You don't have to invest a lot to keep it going, and apartment buildings because there's still a lot of demographic demand. Those two factors are sending investors a little bit more towards those two sectors, compared to things that are dependent on business cycle like offices and a convention center or hotels.

Ashley Lester (15:32):
I wanted to pick up on two themes that you mentioned, Jim, and ask Hitendra to comment. One was on the lack of liquidity in real estate markets. Hitendra now is an expert in more liquid markets again, but I wonder what's happening to liquidity through all of this period?

(15:49):
The other is you mentioned things zigging and zagging all over the place. What's happening to market perceptions of volatility, as we go through this series of shocks and this unusual set of correlations between interest rates and equities?

Hitendra Varsani (16:03):

I'm Hitendra Varsani. I'm part of MSCI's Global Solutions Research team based in London. One of the challenges for asset allocators is the fail of diversification.

(16:13):
When I was at school, one of the free lunches in finance was diversification, and that's evaporated not just last year but this year as well.

(16:22):
Not just from an equity-bond perspective, but also within equities as well, we saw in the first half of the year the most concentrated rally we've seen for many, many years led by the Magnificent Seven and artificial intelligence.

Adam Bass (16:35):
Hey, Adam here. Just a quick refresher. The Magnificent Seven are, well, seven mega-cap stocks including AI-driven Nvidia.

(16:46):
These stocks have driven equity performance for a lot of the year. You can read more about it by heading over to MSCI.com. Anyway, let's get back to the panel.

Hitendra Varsani (16:59):
At that time, active managers were finding it very challenging to beat their benchmarks if they were not exposed to those names, but that's changed in the last three months. We've now seen factor premiums come back. Whether it be value, whether it be yield or low vol, quality and even growth, all across the board besides small caps, factor premiums are back.

(17:22):
For long horizon investors, maybe diversification remains to be the free lunch in finance, that's to be seen. When we think about equities versus bonds, as Thomas has highlighted and Anil has highlighted, and Jim as well, yields are up. When yields are up, that puts pressure on equities. One, because valuations are discounted by long-term rates.

(17:45):
Two, the cost of financing goes up and so companies have to reengineer their balance sheets to adjust to a new environment. But thirdly, from an asset allocation point of view, equities are expected to deliver a higher return compared to bonds. If that hurdle goes up, that makes it more challenging for equities. We highlighted, I don't know, a few weeks ago how unusually valuations were high, market volatility was low, interest rates are rising.

(18:13):
The cost of buying protection in the [inaudible 00:18:15] market was really low. It almost felt like there was a dislocation. It felt like there was complacency in the market. Fast-forward, what we've seen, given the continued stress in the bond market, is now volatility has started to rise. The VIX curve is inverted for the first time in several months.

(18:35):

Despite us still being in a relatively low volatility environment, we could see hedging activity return, given the declines in bonds and equities that we've seen in recent weeks.

Ashley Lester (18:46):
For those of us who were around in 2008 and perhaps some of the other crises, wouldn't be the first time that we'd seen equity markets apparently lagging some of the anxieties that were being felt in fixed-income markets. You mentioned that value has started to outperform, albeit in a context, which as Anil highlighted, is from an astonishingly lower base.

(19:06):
Value has had a pretty terrible 15 years or so, and over recent years, it's come to be seen as pretty much a short duration play. Do you think that that's behind the recent rally in value? Do you think that type of trend or continue to play out? Or do you not really buy into the idea that value over any longer run is actually a short duration?

Hitendra Varsani (19:28):
When we think about what's driving markets, we refer to our global equity factor model, because that's a place where you can isolate trends in equity markets. Since the reopening of economies post-COVID and the rise of rates, the pure value factor performance has actually done remarkably well and has continued to do well throughout this year. Now, hearing Anil's comments about how well growth style has done versus value style, that may puzzle some investors.

(20:00):
The USA value has outperformed USA growth by 35%, but the pure factor in value has actually done well year to date, and that has actually outperformed growth. When we think about value as a factor, its value within picking stocks, removing all other side effects, but the style indexes actually have very significant sector biases. Given the concentration of the rally we've seen in the Magnificent Seven, in the technology sector, in the mega-cap space, that has overshadowed the value premium.

(20:37):
The value premium has been there in this raising right cycle, but it's just become more evident now we've seen the tech selloff in the recent weeks.

Anil Rao (20:47):
If I could just add one comment to that, Hitendra, value is particularly interesting to me right now. One narrative that we hold onto, is that cheap stocks perhaps are in structural decline, maybe they're saddled with debt, or they're in low growth or no growth in markets.

(21:05):
But in fact, if we look at the last decade, value stocks in the US, outside the US and even in emerging markets, have actually had robust top line sales growth and margin expansion. So what gives? Why are they laggards? The answer is their valuations have barely budged in almost a decade.

(21:27):
We have a landscape now going into 2024, where value stocks are actually quite profitable, yet they're cheaper than they were in 2014.

Ashley Lester (21:37):
If value is actually doing well as a factor, and yet the Magnificent Seven, which I don't think anyone would argue are priced as value stocks continue to outperform, what is it that makes the Magnificent Seven so special?

Hitendra Varsani (21:52):
When we look at the value factor performance and it being positive over the course of the year, that's across an entire broad universe of stocks. Now, when we look at Magnificent Seven, by definition, that's only seven mega-cap stocks. Given the weight of those stocks in those indexes, you could in some sense, think of them as a factor in themselves. They represent over 26% of the US market cap, and actually larger than the small-cap index all put together.

(22:24):
When we look at long only performance, we're not in a long-short world. You have your portfolio, you have your reference benchmark, you try to outperform your reference benchmark. But if the benchmark itself is highly concentrated, that doesn't allow the investor to express the factor view more efficiently, because if they're underweight those Magnificent Seven, they get whipsawed by that performance.

(22:49):
The challenge for factor investors now, is how can you outperform a benchmark that's highly concentrated? I think that's a big investment challenge.

Ashley Lester (22:58):
Anil, did you have any thoughts?

Anil Rao (22:59):
Yeah, let me start by looking back where we were just a year ago. If we were to dial back in our time machine, tech stocks and growth stocks were largely giving back a large part of their COVID era gains. Value stocks, long dormant that we just talked about, long dormant over the preceding decade, were actually faring quite well. Then November 30th, 2022 happens, and that's the day that ChatGPT is released.

(23:30):
I think it's actually going to go down as one of these seminal moments, if you look at the day the vaccine is announced, November 9th, 2020. I think this day you can almost do many event studies on. Because initially, slowly, and then all of a sudden, investors start resetting their expectations of who the winners will be from this seemingly alien technology. My colleague, George Bonnet, has actually built a very useful tool and it's a crowding model.

(24:00):
That allows us to essentially people watch in real time. Into December last year and then all throughout 2023, as Hitendra mentioned, we can watch certain stocks, certain industries, say semiconductors, media and entertainment. Certain themes, say robotics or autonomous industries,

we can watch them get more crowded. Valuations are bid up, short interest spikes, momentum surges, sentiment surges.

(24:27):
Where does that leave us now? In the US at least, those stocks, those handful of stocks have accounted for the bulk, maybe 50% of the overall return. Assessed globally, Hitendra mentioned, those stocks now make up over 20% of the market capitalization. We started out, Ashley, you mentioned at the start here, "How does this moment that we're in feel like compared to previous moments?"

(24:50):
We have to go back almost 50 years to find a similar level of concentration, back to the late 1970s when US industrial blue chips reigned supreme, like Eastman Kodak or Standard Oil. What do we know about history? What tends to happen after periods of market concentration or elevated concentration, we found that more often than not, those leaders struggle to keep pace with the rest of the market. That to me is actually fascinating, that sometimes that reversion is very sudden.

(25:23):
Think of Lucent Technologies and then the early 2000s, or sometimes it's very gradual like Japanese banks in the 1990s. To me that's fascinating because that's just part of creative destruction. Incumbent firms are challenged from these upstarts, and they struggle to keep up with the market once they've reached the top, but related that concentration is crowding and they're not the same. One is a measure of an overall index.

(25:47):
The other is a stock-level measure. But right now, there are some signs that those largest stocks, the AI winners, so to speak, are at elevated levels of crowding.

Hitendra Varsani (25:57):
On the point of crowding, I think when you look at AI stocks in particular, they're based on forward expectations. They're imagining a world that could be but hasn't been realized, and investors put a premium on those stocks. Now the question is which of those stocks are going to remain profitable? Are they going to realize that earnings growth going forward? What we've looked at recently, is can you think about crowding in combination with fundamental metrics like quality?

(26:26):
There you see a complete distinction. You can see herding around crowded stocks that have strong balance sheets, that are profitable, that have low earnings variability, and maybe their valuations are justified. That's to be seen. But then there is another camp of stocks that are crowded, that may not be profitable, that have terrible earnings trajectories. The question is which of those camps is more at risk?

(26:51):
Our evidence shows that highly crowded stocks that have low quality, have systematically underperformed the broader market over the long run. Whereas low-crowded stocks with high quality have outperformed over the long run.

Jim Costello (27:08):
I was going to say, I find the discussion on the industry concentration is fascinating, because it has an implication in the real world, just in the space markets and where people live in different cities. Because when you're thinking about the concentration of different industries, certain cities are one-horse towns. If you think about auto manufacturing, there's certain cities that that's concentrated in.

(27:30):
There's big Rust Belts in the UK and the US, where former industrial towns, that economic demand fell apart. Then the need for the real estate fell apart later. That's all real estate is, it's just a box where the economy lives. If the stocks and everything tied to a particular industry are growing, there's more demand. If it's falling, there's less. That's been fascinating because we had this runup then from the 1980s till recently in the financial sector markets.

(28:00):
There were two markets in the real estate world globally, central London and Manhattan and everything else and that's fallen apart. You now have a much more diverse set of markets popping to the top of investors' preference lists. All this investment in vaccines and the biotech, that's driven investment in places like Cambridge and Kenbridge. It's these areas where smart people, getting together.

(28:29):
You can't work remotely doing biotech unless you're in Breaking Bad or something. It's something that you need to be in a lab space. There's been tremendous investor interest in going into that medical life and all the lab science stuff. The traditional office is people moving away from that. It fits everything you're talking about on that change in the investor landscape for the performance of the firms.

(28:54):
You look at the performance of the firms and the types of things that are growing, there is a real estate analog that goes with it.

Ashley Lester (29:01):
Jim, that's absolutely fascinating, because on the one hand, what we're hearing from Hitendra and Anil is about this incredible concentration of modern capitalism in just a handful of mega firms.

(29:16):
But what you're telling us is that maybe the geographic concentration of post-pandemic capitalism can actually be more spread out than we've seen over the last 40 years or so.

(29:26):
Where the vast majority of the gains arguably went to just a few of the largest and most cosmopolitan cities. Is that right?

Jim Costello (29:33):

It is changing, and part of it too is just the nature of the firms. If you have these high-tech firms, they're labor base is a little bit more dispersed. They're trying to find coders and smart people. They're not all in one city. It used to be they'd hire people, bring them into Silicon Valley, but that was just too much of a concentration.

(29:57):
It's easier, in some cases, just open a campus in Vancouver or Mumbai, or any place else where there's a concentration of smart folks, and let them collaborate a little bit remotely. It's a little bit the technology hitting the real estate markets and allowing firms to disperse their activities to some degree. In some sense though, we've seen that for a very, very long time.

(30:26):
There's some evidence showing that back in the 1950s, half of the US financial sector, for instance, was on the island of Manhattan. Then the introduction of high-tech tools like fax machines, long distance phone calling, allowed them to disperse and send lower value-add activity to remote areas where labor costs were lower. But now it's just hitting more the knowledge sector workers as well.

Anil Rao (30:48):
Not to be lost on this, our markets outside US equities, if we look outside US large caps, my colleague, Katiara, has looked at this recently. Small-cap stocks tend to be much less concentrated, and as our international developed, as I mentioned. But emerging market stocks, we might think of that as maybe a safe haven from concentration.

(31:09):
They're actually at similar levels of US concentration. Think there of Taiwan being dominated top-heavy by TSMC, Korea by Samsung, China by its tech giants. The one area or the one geographic region, I should say, that maybe doesn't suffer the effects of concentration right now, are international developer world ex-US stocks, so Europe and Japan.

Hitendra Varsani (31:32):
Yeah. Staying with the concentration, it's not only the multi-asset allocated that's looking for more diversification or the global investor that's looking at the geographic allocation, but companies themselves are looking to diversify their supply chains. We've learned from COVID that if you over-rely on a certain supply chain and that breaks, that's the business risk.

(31:55):
We're now seeing assets being repriced to reflect that diversification need in supply chains. Whether it be looking at emerging markets ex-China or the China Plus One, thinking about rewiring of the economy into India, Taiwan, Indonesia, Mexico, how do you actually assess that? Well, we look at economic revenue exposure and track that through time, to see how that rewiring of the economy is actually taking place.

Jim Costello (32:21):
Hitendra, that has an analog again on the ground, my colleagues in North America do an industrial development in leasing.

(32:30):
They talk about how in Mexico, they're seeing more activity now than they have for years. People trying to build the infrastructure there, that maybe seven or 10 years ago would've gone to China.

Ashley Lester (32:45):
Well, that's the other paradox that is underlying our conversation. Because on the one hand, we're talking about further globalizing forces.

(32:53):
But of course on the other, some of geopolitical tensions which have manifested themselves over recent years, have led to the rise of concepts like friendshoring or nearshoring, are pulling back on these types of ideas.

(33:05):
Can we map the effects of that through in any stock market action that we see? But then also I want to bring you back, Thomas, on the fixed-income side as well, but stock markets first.

Anil Rao (33:17):
One way that I've thought about this, and I'll take a stab at this, is within the emerging markets, I think of almost three groups that are forming, domestic Chinese shares, offshore Chinese firms, and then the rest, which are EMX China. If we were to look at just to say the past five years through the COVID era, A-shares, those domestic shares, they've grown in sales, they've had some multiple expansion.

(33:43):
Offshore shares have had actually margin compression, sales decline, valuation compression. It's been that third piece, emerging markets ex-China, that have really hit the trifecta and largely due to what Hitendra mentioned, this rewiring of supply chains. They've had earning expansion, multiple expansion. Really, the only drag on their returns was from currency, from the perspective of a dollar investor.

Ashley Lester (34:10):
Traditionally, when there were signs of stress in fixed-income markets in the developed world, those signs of stress would be amplified and magnified in emerging markets.

(34:20):
Are we seeing similar developments, for instance, over the last quarter in emerging markets, or are they proving resilient to the rising rates that we're seeing in places like the US?

Hitendra Varsani (34:31):
I can comment here. We've seen very strong dollar strength year to date, which means we've seen a merger market currency weakness against the dollar, and that's an overhang for emerging market equities. There's import prices have gone up. We've seen oil prices go up. We've seen more restrictive stance from the Middle East on oil. All of this is adding to inflation pressures in emerging markets. Emerging markets, central banks are having to increase rates to attract foreign inflows.

(35:03):
Given the high rates we've seen in more safer haven markets like the US, that overhang has actually led to a significant valuation discount across many single countries in the merger markets. There's a few exceptions here like Taiwan and India, given their domestic growth story. But if you look at the rest of the merger markets, we're seeing very low valuations from a historical context. Again, it comes back to what is my allocation? How much am I exposed to that?

(35:31):
How can I find ways to diversify away from those risk factors? We're going back to portfolio 101 almost and thinking, "How do I rebuild my portfolio to be more resilient, more diversified, and tap into alternative return sources?" Maybe perhaps beyond public markets going into private markets.

Ashley Lester (35:51):
Which is interesting, because we're seeing a big run-up in rates. As Thomas mentioned, we haven't seen a big increase in spreads, so there's not necessarily at this stage, much sign that investors are pricing in a lot of distress in assets over the near term. But at the same time, we are seeing significant falls in many parts of the commercial real estate market.

(36:13):
We're seeing what would certainly be associated traditionally with financial distress in emerging markets. We're seeing an absolute tidal wave of floating rate credit being sent into the way of smaller companies through private credit and direct lending by associated companies. This sets us up for a very interesting, I would say, 12 to 24 months in the future.

(36:37):
Particularly, perhaps as borrowers start to face those increasing rates if they're on floating rate loans, or if they start to face some resets if they're on fixed rate loans. Jim, do we have any information about any of that prospect for the commercial real estate sector?

Jim Costello (36:54):
I think the biggest investment theme that people are focusing on in commercial real estate right now, there is an interest to move into real estate in that, not in the sense that they see tremendous economic growth. It's more the financial aspects because everything has not been repriced yet. There's the thought that when distress hits on the debt side, maybe I'll be able to pick it up for 30 cents on the dollar, and be able to generate some returns that way.

(37:22):
The markets are really opaque for commercial real estate. The data's just not as good compared to other asset classes. Then on the debt side of the equation, it's even worse, but in the United States, we do have information there. It's looking like in the next two years, we think there's 1.5 trillion coming due on commercial property debt. A lot of it was short-term debt originated in 2021 and 2022 at excessively low rates.

(37:52):
Investors are trying to target which properties are there that are, where it's someone ahead of their skis. Do the investors need help or is it something that I can step in and provide some rescue capital,

maybe take control of the asset myself? Even globally, some of the same issues exist. Different debt markets globally, different types of approaches to debt, but anything bought in 2021 and 2022 when rates were low and people were getting a little bit aggressive, people are kicking the tires on those assets as well.

Thomas Verbraken (38:24):
It often happens that when yields move, that something breaks. We've seen a couple of examples like the regional US banks crisis. We're not sure that that's fully over yet. The other example last year in the UK, the LDI pension fund crisis where a move in yields, then the combination of leverage, crowding and some liquidity constraints, had this negative feedback loop. I'm curious if more of those events will happen.

(38:58):
Some people are concerned about the batteries that hedge funds are taking in the US Treasury market, these basis traits where also huge amounts of leverage are being used. If there something similar happens where this negative feedback loop would also lead to quickly unwinding selling treasuries, where treasuries are probably a lot more important for the financial system than the yield markets, given their massive size.

(39:26):
Those type of events might also happen. I hope not, but I think that's also something you could look out for.

Anil Rao (39:33):
I would also just add that I feel like we're in an era of mixed signals right now. Earnings forecasts are still pretty bullish. Analysts, of course, are historically known to be quite optimistic, but there's positive earnings forecasts the US, Europe, Japan, Korea, India, Taiwan. Earnings analysts haven't really reset their expectations based on rates yet.

Ashley Lester (40:02):
Well, so bullish earnings, big basis trades on government bonds. It's about a quarter of a century since we last saw something exciting happen as a result of those types of trades.

(40:12):
I guess we'll find out what happens in the next three months, and we'll look forward to getting some of you back with us in three months time.

(40:21):
Hopefully, having our listeners rejoin us then, and we can review what's played out over the fourth quarter. Thank you, everyone.

Adam Bass (40:28):
That's all for this week. A big thank you from Joe and me to Ashley, Thomas, Anil, Jim and Hitendra, and to all of you for listening. You'll find more resources to help put this quarter in focus, using the links at the bottom of the episode page at MSCI.com.

(40:49):
Next up on the program, we dig deeper into the real estate story that Jim Costello introduced, specifically on the topic of lending. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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