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Notes from the Road...or the Boarding Gate

This short note draws out common themes from our recent conversations and meetings with clients across the US, Canada, Europe and the Middle East. The questions we were asked ranged from monetary policy and inflation to strategic asset allocation, the impact of artificial intelligence and market liquidity.

There was almost no pushback to our suggestion that equilibrium inflation will be higher, but that does not mean investors have changed their strategic asset allocation to reflect this. There was a general view that allocations to private assets are going up, especially private debt, though there were also questions on the system-wide impact of this development on liquidity and the cycle. We found no consensus at all on the tactical outlook, which many investors have found especially hard to navigate.

Inigo Fraser Jenkins
Co-Head—Institutional Solutions

Alla Harmsworth
Co-Head—Institutional Solutions and Head of Alphalytics

Additional Contributors: Robertas Stancikas, Harjaspreet Mand and Maureen Hughes

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When traveling to meet with clients, it's striking how often common topics surface. This could, of course, suggest that we are all in one giant echo chamber, but it does seem to reflect shared concerns. Below, we summarize themes that emerged in recent meetings across the US, Canada, Europe and the Middle East. They run the full gamut from strategic to tactical and from macroeconomic to portfolio construction.

Higher Equilibrium Inflation: Strategic Allocation Changes Are Yet to Come

The principal macro concern for CIOs and asset allocators has been inflation—not necessarily the cyclical inflation central banks have focused on, but the possibility that equilibrium inflation will settle at a higher level over the next decade. Our case for a higher rate is rooted in the observation that a shrinking working-age population, deglobalization and greater attention to wage dispersion implied by the "S" in ESG will act in concert, pointing to a higher path for wages. We also suggest that the cost of the energy transition is inflationary. This suggests forces acting on inflation that were not present for much of the past 20 years, when the combined effects of demographic change and globalization grew the effective labor pool.

Some clients have asked: Can deglobalization actually happen, given the huge cost to corporations from undoing established supply chains? Our answer is that one should expect governments to have a greater role in supply chains moving forward. Also, part of the thesis for regime change is that firms will likely lose power to governments. One could also draw the somewhat depressing parallel with 1913, when people said the world was too interconnected to see a reversal of that earlier stage of globalization.

Overall, we had little pushback on our call for higher strategic equilibrium inflation. If anything, the view we heard in some meetings was that our 3% equilibrium forecast was "not that high." However, when we asked clients if they've actually changed their strategic asset allocation as a result, the answer was mainly "no." The difficulty is that 10-year inflation break-even rates indicate a muted long-term inflation outlook, and a large allocation change is a big call to make. So, we generally think that this change is yet to come.

Investors were very interested in the pros and cons of different inflation-hedging assets in portfolios. Inevitably, we were asked many times about Treasury Inflation Protected Securities (TIPS) and how attractive they look now compared with a year ago (and recently, there has been the first net inflow into inflation-protected assets in a year), though insurance investors noted that TIPS were a relatively poor hedge for claims inflation versus the Consumer Price Index. There was agreement that equities could act as a real asset in all but very-high inflation environments, and that there is a need for a range of other private real assets.

One client pithily summarized this by asking: How can an investor buy into an increased wage share of GDP? This is the key challenge, as it is owners of capital who have relatively benefitted in recent decades, and it is that advantage that now looks to be weakening.

Artificial Intelligence: Lively Debate but Little Allocation Impact

When we outline a future of higher inflation, lower real growth and a rebalancing of power from corporations back to labor and governments, someone invariably interjects: "But what about artificial intelligence (AI)?" It is a fair question, and a frequent topic in strategic client conversations of the past three months. Could AI's emergence be a counteracting force to all these trends? There is a potential for it to boost growth, be deflationary and also—in a narrative currently being driven by firms—help reassert corporate power.

We don't think it would be too flippant to point out that no one really has a clue about the macro impact of AI a decade from now. We have heard some liken it to the steam engine and a boost to growth, but we also hear worries about the distributional effects of a technology that may destroy jobs while making a small cohort of people very wealthy. We will explore AI in a forthcoming note, but while it spurred lively debate, AI seems to have had no effect on the asset-allocation intentions of investors we speak to.

Strategic Allocations to Private Assets Should Rise

Conversations about strategic asset allocation have been dominated by the question of what weight to put on private assets. There is general agreement that the allocation is rising, though some investors face liquidity constraints (see our comment in the liquidity section below).

The need to look beyond public markets for return streams and diversification sources is well recognized. In this vein, investors asked lots of methodological questions about how to form capital market assumptions for private assets—and whether this approach needed to change. We heard a fair degree of skepticism about the ability of private equity—in aggregate—to deliver high net-of-fee returns, and we generally agree; there was much more interest in private debt. Some clients expressed concern that the illiquidity premium might have been eroded, but the ability to observe the yield on private versus public debt makes it easier for some to invest in private debt than in private equity.

The diversification potential of private assets was seen as a key attraction, with many noting that not marking assets to market isn't diversification in any real sense; instead, the focus should be on finding return streams not available in public markets.

While many clients agreed with our view that private-debt allocations should rise, the concern we heard was not so much about allocations in their own portfolios but about the potential impact on the system overall. Among the questions: Can borrowers afford current rates? Does the distribution of credit risk across private markets as opposed to banks make that risk harder to assess if the whole system is under stress? What will default and recovery rates look like if there is a negative turn in the cycle? Some investors suggested that the high cost of variable-rate credit could be a trigger for unemployment to finally rise if debt-service costs crowd out other expenses.

Questioning the Monetary Policy Regime

Beyond inquiries on topics with an immediate impact on asset allocation, our meetings have seen sustained questioning about the overall monetary regime—addressing the linked topics of central bank independence, ongoing dollar hegemony and potential debt monetization.

The underlying concern is the level of public debt to GDP across OECD countries and the balance of fiscal versus monetary support for economies after the pandemic. We share these concerns. Public debt/GDP is back up to the same level as at the end of WWII, implying that governments will be tempted to let inflation run above neutral as a means to reduce the real value of debt, but this implicitly curbs central bank independence.

The linked question of whether the dollar could retain its reserve-currency status came up in several meetings. There is a wish for some countries to de-dollarize, but clients expressed divergent views as to the extent to which de-dollarization is possible. Investors noted that most gold buying over the last year has been for geopolitical reasons, not as an inflation/monetization hedge. Our view is that while attempts to de-dollarize will continue, in practice it is very hard to do given the lack of alternatives and that other countries are unable to realistically step into the role of the US.

Liquidity Concern Isn't Going Away

For many types of investors, liquidity remains a huge issue. Some who raised it see liquidity as a macro risk; others view it as a very real constraint on the ability to change their asset allocations. It is very hard to generalize about the need for liquidity, because it is always investor-specific. However, the concerns rest on the view that central banks will continue their attempt to transition from quantitative easing to quantitative tightening (QT), even as investors have transitioned to less-liquid portfolios.

Another side of this topic is a fear that credit disintermediation will further reduce liquidity. We think taking more illiquidity risk in portfolios can make sense from a strategic asset allocation perspective—in the context of the need to find sources of real return and diversification. This implies that many investors may face a trade-off between inflation protection and liquidity. Several investors expressed surprise that removing liquidity via QT has had no discernible impact on the prices of risk assets.

Looking For an Excuse to Buy Emerging Markets

We found that many investors were, in effect, seeking an excuse to own emerging markets (EM) after an extended slump, with the view of a potential bounce-back. This perspective is mirrored in aggregate flow data, which shows a USD 6.3 billion inflow to EM equity funds so far in the third quarter. There was near-universal agreement that China should be split out from the rest of EM, given its size and that the forces driving performance are very different. Several investors expressed this point even more strongly, asserting that pan-EM benchmarks no longer made any sense.

We have been pointing out that while the case for a strategic overweight on China is debatable, a stronger case exists for the ability of active managers to generate idiosyncratic alpha in that country. Thus, China deserves an over-allocation from an alpha

perspective—a case met with broad agreement. A few investors asked about India's ability to play the role China did over the past decade, given India's still-expanding labor pool—unlike China's. There was a very low level of interest in frontier markets.

Tactical Allocation Has Been Vexatious

Our recent marketing trips have spurred many tactical questions from allocators and investors, even when the meeting focus was supposedly strategic. The tactical side has been a painful topic for many. Earlier in the year, the most common question we were asked was: How could the yield curve be so inverted yet equities moving higher? This environment led many investors, including us, to a tactically cautious stance which meant being on the sideline for the recent rally.

We found views to be very split. Some argued that the inverted yield curve and high headline rates for corporate and consumer borrowing would still lead to a recession, or a slowdown of some form. A few suggested there was still time for a recession in 2023. However, we also heard in several more recent meetings the view that any sign of a Fed pause would lead the market to another leg higher. There were consequently many more questions about our tactical metrics for sentiment and earnings growth than we normally field.

Inevitably there were many inquiries about whether a narrow market could continue or, put another way, about what would be needed for the outperformance of the combined growth/US trade to continue.

One tactical theme uniting clients we have spoken with is the attractiveness of short-duration instruments—both credit and government. This has been most apparent from ongoing flows into money-market funds, which have gathered further inflows of USD100 billion so far in the third quarter.

Asset-Allocation Methodology and a Change in Investment Regime

We have been encouraged by the number of investors who want a conversation with us not just about the directional implications of our allocation views but also about the methodology of *how* to form strategic-asset-allocation and capital-market assumptions (particularly for private assets).

We heard much agreement with our assertion that the investment regime had changed (or at least that there was a good chance of it), and that there must be a change in the way people invest. Examples of changes that surfaced were the idea that bonds might not diversify equity beta as effectively, that alpha deserves an explicit and higher allocation in strategic asset allocation, and that factors can play a bigger role in a world where most asset classes are fully valued.

Several meetings ended up covering the interaction of social-political choices with the strategic inflation view. Linked to this topic was concern about the ability to fund long-run savings and about the implications of long-term-care for an older population: What does it mean for the number of workers that would need to be diverted from other careers into the care sector? How will the entire thing be funded? What does it mean for our industry?

The bottom line from our recent activities was a series of meetings with clients who are reviewing the fundamental building blocks of strategic asset allocation and how to think about the combination of return streams in the presence of structurally higher inflation—but also a greater need for liquidity.

INVESTMENT RISKS TO CONSIDER

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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