Opportunities in a difficult macro-outlook

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Interviewed by

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Jamie: Elizabeth, thank you very much for joining us for this conversation. It's great to have you here.

Elizabeth: It's great to be here. Thanks for having me.

Jamie: Let me start with your job that you were just telling me about as it's a little nuanced. I wonder if you could go into a bit more detail about your exact role at Goldman.

Elizabeth: Sure. So, it is a new role for Goldman Sachs, I believe. I have spent my career as an institutional allocator. Before then I was in private markets. But I just spent four years in Hawaii as Chief Investment Officer there and two years at Maryland in a risk and hedge fund role.

One of the reasons I joined Goldman is that I've allocated capital. I've also been in private markets, so I can bridge the divide between what they're seeing and what our largest clients in the institutional space are seeing as well. And also help them with their asset allocation and these challenging sorts of environments we've been having over the last decade or so.

Jamie: Well, challenging environments are exactly what I'd like to talk about next. Some brilliant market investors, I was watching the interview with Stanley Druckenmiller recently who said, after 45 years, he feels that this year is the hardest year to have any insight into the macro-outlook. Is that something that you agree with?

Elizabeth: That's an interesting thing to say. I always think it's challenging. In hindsight it's always really interesting to know what the trends are. I wouldn't say this is the hardest year. I think there are the most opportunities. And so in arrears we'll probably look back and say we missed something that we could have capitalised on. It's almost like the post-credit crisis when you're interviewing managers these days and saying, "Well, did you take advantage of traps?" And they said, "No. But we did this other thing." And you're like, "Well, why didn't you see that?" But at the time, it's not always immediately obvious.

So, I think there's a lot of opportunities. What is challenging in the macro picture are the diverging central bank policies we're probably going to see and how countries are going to start differentiating, because they've been in lockstep for a little bit of time post COVID. So going forward, it should be a little more challenging to figure out the picture. At the same time, that means there's different things happening in different places instead of this decade of just up and up and up. So, I think it means there's more asset allocation choices that can be made, which hopefully leads to better alpha and better opportunities.

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Jamie: Well, that's interesting what you just said about central banks because I agree with you. I mean almost ever since the financial crisis, there's been a general easing of lower rates and then obviously a rate hike cycle which we’ve just experienced. So, when you look at the U.S., what’s your sense about the inflation outlook? Do you feel that the Fed is going to stay around this level for a while? Do you see that there’s further hikes to come even?

Or do you see the bond markets telling us that we've got easing to come? It feels like equities and bonds are telling us different stories. Equities are saying we're going to keep rates here or maybe even go higher, and bonds are telling us that rates are coming down. So where do you sit?

Elizabeth: It's challenging when folks say that equities and bonds are telling these different stories because there are so many variables that could explain. and it isn't simple.

Jamie: It's not as simple as that.

Elizabeth: It's never that simple, right? It's really easy to say X, Y, Z is the one reason, so inflation is the one reason why things are behaving this way, but really things have changed so much in the last 20 years - the advent of quantitative trading, the change in rates, where bond yields have gone and so on. There's a lot going on in the macro picture that makes it really difficult to pin any one thing.

I would say it really depends how the rest of the year plays out. There's a lot of things that could happen. We just had a major election, but we've got a couple more that are coming up in the next year or so. So those could always impact things. I think a couple of years ago, could we have predicted Ukraine, Russia? maybe, but not in the way that it spelled out. We'll have to look at the oil and gas picture, the dollar picture.

In terms of whether or not we're going to get additional hikes, I think part of that depends on what happens in the credit picture. Much of last 2022, we already saw tightening in credit lending standards. I think there was something like 85% of reporting, small banks were already starting to tighten their lending, right? So, we'll have to see a year out from that, what's happening post the January and February issues. I guess more February, March in the banking sector – so that's one thing that could affect it.

Also, one or two data points as you know in employment or prices do not a story make, we still have additional numbers we need to see in the labour picture. And I was thinking this morning, if I had to pin the entire future on one piece of information, like as you know as a former CIO, you look at tons and tons of data. If I just wanted to look at one number for the rest of the next three years, I think I'd want to see labour statistics. I think they're more important now than ever, and I think that's gonna have a lot to do with where we see the Fed.

Jamie: So, unemployment's ticked up, where are we now? 3.7, 3.8%? Is there a magic number at which point the Fed can kindly take a victory lap and say it's done its job to really have an effect on inflation. Let me ask you a quick second point to that question, because I don't think I'm anywhere near as much of an expert as you are. But when it comes to U.S. monetary policy, is there any argument to say that what the Fed does is having less of an effect now than it has previously? And that could be a culmination of so much fiscal stimulus that there's just so much washing around that it doesn't have as much as a leveraged effect.

And secondly, so many of the products which they aim to affect don't affect them because 90 to 95% of the mortgages in the US are fixed. So there's obviously very little effect right now. I mean, we'll see when that runs off. If you could talk a little bit to those two things?

Elizabeth: So that's an interesting question on whether or not the Fed impact is as large. I think back to your earlier point on distortions in the equity and bond markets, central bank action does distort some of the volatility we see there and some of the pricing, some of the curves pricing that we see. Sometimes when it doesn't make sense, it might have to do with stimulus, right ?

In terms of whether or not they have an effect. I mean, I think the Fed is a much different animal than it was 20 years ago. And I think first of all, you and I are probably too young to really know what they were saying 30, 40 years ago in person anecdotally, but they certainly have this 'we all have to move in lockstep' type of mentality now where they're all coming out and trying to show support. So, it's definitely a different animal.

I'm excited to one day read the autobiography of the Fed and see what's really happening there. And I think listening to former Fed Governors, we get to hear a lot more interesting things about what's actually going on. Whether or not it has an effect. Again, I think it goes back to there being a lot of variables and I think this inflation scenario was really challenging – so no two inflationary scenarios have ever been the same.

Go back to the 1920s, in the US, you can find multiple different causes that are driving inflationary scenarios, and you've got rates in equities in different places. So everyone can say, this time is different, but this time really was different. It's a unique situation. The Fed started hiking when we were already about at an 8% inflation rate, the solution was not immediately obvious.

Again, in hindsight, we can say, wow, at 8% they started hiking. But obviously they're paying attention to that - we were seeing things that were really challenging in this market environment. I don't know if it's fair to say that they can't change things. I think that this dynamic is really tough, especially coming out of post COVID and how much inflation was disrupted on a world order, and globally.

And so they're not just managing how they're playing in this game, but they have to manage all the players on the field or think about how they're all maneuvering as well. And with the advent of AI and that technology and the internet and social media... 20 years ago when a hedge fund would say, we really know what we're doing because we have a key insight into this central banker or we're really tight with this person. I think those are harder to believe stories now because the world's gotten smaller in some respects, right?

Jamie: Yes.

Elizabeth: So I think there's just a lot of variables that come into play on that. It's just a very different environment.

Jamie: When it comes to commercial real estate, there's some talk in the market that this is a possible shoe to drop.

It feels like a lot of these loans are going to roll off very slowly. I read in a newspaper today that there are some banks who are trying to offload these loans even at a discount and take their losses now.

Now, part of me thinks, oh great, some of these smaller banks are being prepared. And then part of me thinks, well, hang on a second, maybe they can see something that we can't yet and they're just trying to get them off their books at 90 cents in the dollar or something. Do you have a particularly strong view on where we stand on commercial real estate and how much of an impact it could have?

Elizabeth: If I had to make one strong view, I would say when everyone's fleeing an asset class or everyone says it's not a great place to be, wait two years and it'll probably start to look more interesting because the capital flooded out. It's like watching the tides and you might want to be there. I think eventually it'll become a good place to search for Alpha because there'll be a drain of capital.

I think it probably offers new opportunities to investors who can step in and fill the hole just like that happened in private credit and private equity years ago. So, hedge funds, private investors, those sorts of things. I think it's really easy to point to commercial real estate right now and say there's a bad actor. There's something we want to avoid. But that's overly simplistic. There's probably pockets of opportunity, maybe not right this second, but down the road.

Jamie: I can't quite work it out, because I mean, I watch these new shows like you do, and they keep telling me that there are so many cities across America where offices in the middle are just completely empty. Maybe that's just one of those times where the media is just maybe exaggerating a story and that we're ingesting that media and then it starts to become a reality. So do we all need to be a little bit careful about how we ingest this media?

Elizabeth: Well, I mean in parts, I don't think they're wrong. Downtown Manhattan feels very different to me than it did 15 years ago. San Francisco feels very different to me than it did five years ago. This work from home phenomenon has legs. I think potentially, and this is not a Goldman view, its my view, may have changed the future of work forever. But there's always something else that comes on and changes another part of it.

I don't know what that next step will be, but there's also repurposing that can be doneand imagination that can be done like before WeWork, who would've thought the coworking space would've been something that would've taken off so strongly? So there's gotta be opportunities. I think what is distressing, I was just in my hometown of Charlottesville, Virginia and there's a really large mall there.

It used to be the place to hang out on Friday nights when I was a tween, and I was driving by it on Friday night, and there were very few cars in the parking lot and that is a huge piece of real estate. So what do you do with that? I don't know. But the University of Virginia could theoretically one day be 100,000 students. Because they've also got Zoom classes and whatnot – so there's opportunities to expand into these places. Maybe it just looks different. And with AI, maybe there's jobs we don't even know about yet that could be going to these locations.

Jamie: Well, who knows? With AI maybe they just become college professors and we're all just getting our degrees online. Who knows? It's such a big question mark. You mentioned China just now. I was going to ask, me included, I think people expected the reopening of China, so to speak, to create quite a lot of demand for energy, oil, and that didn't really unfold.

Do you think the oil prices now, I mean actually we've got some use today out of the Middle East that there's going to be a cut in production, so the oil prices are doing a little better. But do you think that's something that people were positioned? Were a lot of people positioned for a pickup in energy prices going into 2023, and how do you see that playing out?

Elizabeth: Yes. I think so. I think part of that was the combination of equity and bond correlations were high coming out of COVID, and positive right. So institutional investors, retail investors, everyone was looking for some diversification in their portfolio other than cash. Because if you think about it this time a year ago is really when cash started to pay. It didn't before then, I mean literally, it hasn't been that long since we were at 0% rates. It's been amazing.

So where do you look for diversification? You can look to hedge funds, you can look to cash. Some investors are prohibited from investing in cash. Commodities you can look at. But a lot of institutional investors at least took commodities out of their portfolio a decade ago because it experienced some challenging returns. And it's a difficult asset class usually to hold.

And same with the retail markets. But you saw in COVID with all the supply chain disruptions, retail really was the first one saying, "I'm looking at copper, I'm looking at gold." And then really last year, or maybe one or two years post COVID, you started hearing the institutional investors like, "Okay, where can I reach for yield?"

I do think there was a lot of money being considered to be put into commodities last year. It may not have been direct. It might have been through a CTA strategy or something like that, but there was a lot more interest than I've heard in a really long time. So what happened this cycle is it China... One, I wish I was in China right now because I would love to see what it's like in this reopening. If you remember when we reopened, it was just completely amazing scenario.

Jamie: Optimism everywhere.

Elizabeth: Right. I'd love to be there, but I think this commodity story might be a little different. If you think about how expensive it is to hold ... literally the carrying cost of holding a commodity right now, and that's not just oil, it's metals as well.

Jamie: I never thought of that.

Elizabeth: You've got high cash rates, so you've got a high opportunity cost, and then you've got the actual cost of the physical commodity and storage. The only way really to get the price back up is to keep destocking and it'll happen. Commodities are at the same time the most challenging asset class to invest in, and also pretty predictable to some extent. All you've got to do is get the supply low enough that it'll pop and it'll become an investible asset class again. And in general, it's kind of how energy works.

Jamie: Final question on digital assets. Bit of a left field question, but I do remember a few years ago, admittedly when Bitcoin and Ethereum was so much higher, there was a lot of debate that on a long term view, that asset allocators were going to think seriously about allocating capital to some of these digital assets. Is anyone even having those conversations right now? Are cryptocurrencies even on the table as a possible asset class to invest in or are people just waiting till the volatility and those prices calm down?

Elizabeth: There are in fact public institutions, public pension funds that do invest in crypto. First of all, take a step back, almost all public institutions have exposure to crypto. They may not know it, but it's in your CTA portfolio, it's in your private equity book. There's some flavour of it in there. But there are some that make direct allocations, very, very small.

When folks push back and say, "Why hasn't the market gotten there in terms of digital assets and investing? Why are they so late? My response to that is in December, there were a handful of really large institutions that said, we're going into private equity for the first time. Private equity has been around longer than you and I have been around. And now institutions are just starting to allocate. So, it’s just a longer haul.

In terms of the rest of your question, is it the volatility? It's hard to dedicate scarce resources to an asset that's going to have to be such a small allocation with such a high volatility. It's just where do you maximize your time. It's the 80-20 rule right ?

Jamie: That makes perfect sense to me. Elizabeth, this has been a fascinating conversation. Thank you so much for taking the time to chat.

Elizabeth: Thank you so much for having me.

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