INTERVIEW

The longer view for financial markets

FTSE RUSSELL CONVENES

Indrani De, CFA, PRM

Head of Global Investment Research, FTSE Russell, LSEG

Interviewed by

Jamie MacDonald, ex-portfolio manager, Point 72

Jamie: Let's start in the US. Let's start with the fact that we just had the debt ceiling raised. I'm not sure the exact number. I think the fiscal gap now is around 7% or so, and yet the dollar remains relatively strong. I think if it wasn't the world reserve currency, the dollar would probably be a lot weaker, but we still have this fiscal gap that needs to get solved somehow, and we also have this, you know, presidential election next year. So what do you think is going to happen here in the US in terms of resolving the debt problem, and what do you think happens to the dollar?

Indrani: That is such an interesting question. is a very nuanced question. It's not a unidirectional good or bad. So see, the repeated debt ceilings and I would say this is a repeat. 2011 was really bad this time. It got really bad. You saw the credit spreads, sovereign credit spreads, on the US really ballooned out. So while it got resolved this time, it does make the markets more jittery. Each time it happens, it's a cumulative effect. And that is certainly not good for the reserve currency because reserve currency depends on global confidence, it depends on the soft power of the rest of the world looking at the US. So certainly, it's not a good thing in that perspective, and it is true that our debt to GDP is on the higher end. It certainly crossed a hundred percent, it's about 130%. So it is getting on the higher end. The two counterpoints that I would make to that is while it is certainly true that the US has lost its share of the reserves globally in the last 20 odd years, it's got dropped from about 70% to 60%, but 60% is still a very high number. And the other fact we should look at is how much of the global trade is conducted in dollar. Like, let's say US is about 10% of the global trade, but more than 50% of the global trade is settled in dollar. So I think those are indicators that we should be looking at, and certainly post Ukraine conflict, the de-globalisation has picked up a little more trend. Traditionally, commodities are always priced in dollar, which is why you see a very strong negative correlation between dollar and commodities historically. That has weakened somewhat in the last two odd years, and that very weakening of that correlation tells me that a lot more of the commodities, particularly energy trade, is happening outside the dollar world so to say. So these are some long-term headwinds.

> On the other hand, as Warren Buffet says, "Don't bet against the United States” for the simple reason that it's very technologically agile, and, you know, we just might be on the cusp of the next technological boom.

On the other hand, as Warren Buffet says, "Don't bet against the United States” for the simple reason that it's very technologically agile, and, you know, we just might be on the cusp of the next technological boom. Just like the 1990s internet usage led to a productivity boom for some time, we just might be on the cusp of an AI led boom. And if that happens, then the US could again pick up its lead relative to the rest of the world. We'll of course have to see the consequences and the guardrails being put aside on this AI issue. But I think those are things to consider, which might work in favour of the US and the economy just again, booms and, you know, this debt to GDP ratio becomes less relevant. And last I'll point out, I mean, there are countries like Japan where the debt to GDP is far higher than the US, but you haven't noticed distinct loss of confidence in Japan. If anything, Japanese equities have really been doing well because of the structural reforms that they have gotten. I would say this is a very nuanced issues. There are certainly some headwinds, but there are lots of tailwinds too.

Jamie: So in some ways it seems like it's as simple as America is a great place for business, and therefore, it's a great place for technology to be. And in that respect, it's very difficult to ever bet against the US because technology is innovating so much here in the US.

Indrani: Yes, I mean we have certainly reached probably the limits of the last technology led boom. Like today in US equities, particularly the Russell 1000. Technology as an industry, the highest level 11 classification, it's almost one third. So certainly, it cannot grow in relation to the economy given where we are right now, unless a fresh boom comes in, which could either be AI, and I would also argue the Inflation Reduction Act with its emphasis on clean energy, or the CHIPS Act, bringing back lots into semiconductors. You know, pure technology that embeds into every part of the ecosystem, so to say. Because of these public sector investment, private investment has also actually gone up a lot in the last year, year and a half. The onshoring is certainly helping, so these are the kind of trends that can lead to the next economic growth boom, and then technology can grow alongside it, yes.

Jamie: I wanted to ask you a little bit about China. Coming into this year, I think a lot of us, including myself we're expecting China to open up with a huge amount of demand for commodities for example, and that really hasn't happened and I'm wondering if you would like to just comment on that, and did you expect commodity prices to be higher than where we are, and is this China reopening much slower very deflationary, and could it actually be inflationary in the future? How do you feel about it?

Indrani: To answer this question, I would say look at the importance of what happens through a business cycle and what happens structurally. I think most of the time, because markets we are like constantly deep in the weeds, we overestimate the cyclical and underestimate the structural. So China, coming out of the COVID closing, there was a lot of expectation that China is really going to boom, and alongside that the commodities, and it'll pull up other parts of the world that are very export-oriented. While certainly the growth has picked up, it has not met the expectations. I would argue because China has reached a point when its structural problems need a cure, so to say. So in its last decade, two decade, China has been riding on the investment led, infrastructure led, export led growth. In the world that we are in now, much lower growth in many other parts of the world, China really needs to increase its consumption as a part of the GDP to have a sustained high growth period. And similarly, the demographics. I mean, China has started aging distinctly with a drop in population, and certainly drop in the working age population. Demographics which usually become a headwind when countries are far more developed, is hitting China at a far earlier point in its economic cycle growth, this is something to definitely consider in mind. And on the commodities front, I would like to say, you know, this commodities versus equities, they tend to play out in very long cycles. Typically, you'll see they play out about 10 years. We had a long period of commodity under performance, relative to equities, which has actually turned around the corner. So as an asset class, commodities will probably do better relative to equities than they have done in the last 10 odd years.

Jamie: Interesting, that's very interesting. Thank you, Indrani. Turning back to the US, I'm interested on your thoughts on the labour market. It's been very resilient. In fact, you know, when you have a rate hike cycle as fast as we had over the past 12 months, I think many would've expected us to be in a recession right now. Where do you stand on whether the US will go into recession, and where you think the labour market goes from here?

Indrani: Well, I mean we have been expecting a recession for quite some time, simply based on the inversion of the yield curve, which most people see as one of the most accurate predictors of a recession coming or not. While the yield curve, depending on whether you see 10 minus two years, or 10 minus three months, they pretty much inverted last summer last fall. Going by the timing of, you know, when they invert and a recession sets in. We are probably looking at the end of 2024. Something like that, or maybe early 2024. But there are a couple of things that have again changed.

After this COVID disruption, so many people retired. Labour supply I think really got changed. So how much impact wage inflation will have on inflation, and rates increase, and subsequent impact on recession, it may well be different in this cycle than it has been in the past. And I would again argue you'll see that in, you know, how technology is playing out, we had a very long period where higher paid employees they were having a different impact than lower wage, and now you are actually seeing a lot of growth in the lower wage percentage of the economy, which I would argue is a good thing. So I don't think the traditional yield curve inversion will have the exact same impact this time round because the quantitative easing over the last 10 years has distorted those signals a little bit.

I think labour force, because it's starting to reduce in the US, the linkage between wage inflation, inflation and rates is different than in the past. I do think there'll be other components like compression in corporate margins that will have an impact on the inflation coming down. Rents in real time have actually started coming down in the last few months, and that'll flow through into the inflation numbers. So I do think the inflation numbers that currently we are looking at, about four and a half, five depending on which measure you're looking at, could come down to about three percentage points fairly fast. Whether it'll come down to two percentage points is another story, but then we have to remember that the two percentage points target it's a fairly new last couple of years, and there's nothing very sacrosanct about two percentage points per se. So as long as the reduction in inflation continues and it comes to about three percentage points, chances are we are at pretty much at the end of the rate hike cycle, and we'll just have to see how it plays out over the last six to nine months. But the US is a consumption led economy, so if labour force is doing well, then we have reasons to be optimistic about a soft planning.

Jamie: It sounds like you think the Fed does have a plan, like it's got an idea of what it wants to do, or do you think that actually it's going to be more data led and will pause the rate hiking cycle, and then see what the data tells us and then move? Or do you think that the Fed has got a plan now to basically pause its rate hiking cycle, and start the easing?

Indrani: Given that I know about the Fed only as much as they make statements in the public markets, obviously the recent statements by a Fed chairperson has indicated that they are close to at least a pause for the simple reason that it's not just that the absolute amount of the rate hikes have been so high, the pace has been so high. And since economic theory traditionally says that the effects play out over 12 to 18 months, we still have to give it time to play through the system so that we don't enter the downside scenario of too much too soon. So I think that's one reason that the Fed might go into more of a pause. Let the effects of what has already happened show itself in the system before they take a decision, and hence the data dependency. So which is why, you know the reasons we just talked about that if the rental inflation plays up in inflation numbers pretty soon, corporate margins playing into the inflation numbers pretty soon, then we have reasons to be optimistic that we are at the end or very close to the end of the rate hike cycle.

Jamie: Indrani, I wanted to ask about emerging markets. Do you think there's going to be more opportunity to invest there?

Indrani: So, you know, opportunity to invest I look at in two different ways. One is obviously the return, and also the risk adjusted return. Are you getting paid to take the risk? And the third is in a portfolio, where does it fit and where the correlation and the diversification impact is very strong? And again, are you talking about emerging markets from the equity perspective or the fixed income perspective? Because fixed income, this particular cycle, the rate tightening has shown us that emerging markets have really evolved. They are not the emerging markets of the 1990s where if the Fed hikes rates, they go into a stress period. Emerging market debt did very well because they have extended their duration, they're much more in local currency, their fiscal balance sheets are far stronger. So that's one point to remember. On the equity front, China plays a very predominant effect. China is about one third of EM equities. When you consider countries that are very dependent and linked to China together, they make up with China about 50% of the EM equities. So what happens in EM equities is very dependent on what happens to China, which we discussed. So that's why probably EM Equities are still not they haven't picked up their under performance relative to the developed markets for a very long time, even though emerging market debt has been doing well. But that brings me to the third part of portfolio construction, the diversification effect. And there we see, you know, people talk about de-globalisation now, but if you take a slightly longer view between 2000 and 2010, roughly that decade, the correlation between EM and DM about mid 85, 85% or so. In the next decade, 2010 to 2020, it dropped to about 74%. Now currently it's about low 60s, just about 60% correlation between DM and EM equities. My point being aside from the return in EM equities, the diversification benefit is very strong. So in that sense, it certainly has a role to play in a well diversified portfolio.

Jamie: That's a great point about diversification. So last thing, Indrani. You say you're an optimist. Are you generally quite positive in your outlook for markets from here?

Indrani: I do think so. I do think we could possibly be on the cusp not only of a technology in the sense of AI related revolution, but even on the pharmaceutical front, the new vaccines that came out, the mRNA technology, and there's lots that's happening in healthcare. And you have to remember that we are in a world where demographics, aging demographics, so anything on the healthcare front, it's very important. Anything on the technology front, very important. As long as the global economy grows, financial markets grow. That's a good thing. Any changes that happen between different industries, different countries, that dispersion makes for investment opportunities. But as long as the economic cycle goes in a positive direction, I think we're all headed in the right direction.

Jamie: Indrani, always so great chatting with you. Thanks for your time.

Indrani: Thanks, Jamie. Always great to have a discussion with you. Thank you.

ABOUT FTSE RUSSELL

FTSE Russell is a leading global provider of index and benchmark solutions, spanning diverse asset classes and investment objectives. As a trusted investment partner we help investors make better-informed investment decisions, manage risk, and seize opportunities.

Market participants look to us for our expertise in developing and managing global index solutions across asset classes. Asset owners, asset managers, ETF providers and investment banks choose FTSE Russell solutions to benchmark their investment performance and create investment funds, ETFs, structured products, and index-based derivatives. Our clients use our solutions for asset allocation, investment strategy analysis and risk management, and value us for our robust governance process and operational integrity.

For over 35 years we have been at the forefront of driving change for the investor, always innovating to shape the next generation of benchmarks and investment solutions that open up new opportunities for the global investment community.

CONTACT US

To learn more, visit lseg.com/ftse-russell; email info@ftserussell.com; or call your regional Client Service team office:

EMEA +44 (0) 20 7866 1810

North America +1 877 503 6437

Asia-Pacific

Hong Kong +852 2164 3333

Tokyo +81 3 6441 1430

Sydney +61 (0) 2 7228 5659

Disclaimer

FTSE Russell® is a trading name of FTSE, Russell, FTSE Canada, FTSE FI, FTSE FI Europe, YB and BR. "FTSE®", "Russell®", "FTSE Russell®", "FTSE4Good®", "ICB®", "The Yield Book®", "Beyond Ratings®" and all other trademarks and service marks used herein (whether registered or unregistered) are trademarks and/or service marks owned or licensed by the applicable member of the LSE Group or their respective licensors and are owned, or used under licence, by FTSE, Russell, FTSE Canada, FTSE FI, FTSE FI Europe, YB or BR. FTSE International Limited is authorised and regulated by the Financial Conduct Authority as a benchmark administrator.

All information is provided for information purposes only. All information and data contained in this publication is obtained by the LSE Group, from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, such information and data is provided "as is" without warranty of any kind. No member of the LSE Group nor their respective directors, officers, employees, partners or licensors make any claim, prediction, warranty or representation whatsoever, expressly, or impliedly, either as to the accuracy, timeliness, completeness, merchantability of any information or of results to be obtained from the use of FTSE Russell products, including but not limited to indexes, data and analytics, or the fitness or suitability of the FTSE Russell products for any particular purpose to which they might be put. Any representation of historical data accessible through FTSE Russell products is provided for information purposes only and is not a reliable indicator of future performance.

No responsibility or liability can be accepted by any member of the LSE Group nor their respective directors, officers, employees, partners or licensors for (a) any loss or damage in whole or in part caused by, resulting from, or relating to any error (negligent or otherwise) or other circumstance involved in procuring, collecting, compiling, interpreting, analysing, editing, transcribing, transmitting, communicating, or delivering any such information or data or from use of this document or links to this document or (b) any direct, indirect, special, consequential or incidental damages whatsoever, even if any member of the LSE Group is advised in advance of the possibility of such damages, resulting from the use of, or inability to use, such information.

No member of the LSE Group nor their respective directors, officers, employees, partners or licensors provide investment advice and nothing in this document should be taken as constituting financial or investment advice. No member of the LSE Group nor their respective directors, officers, employees, partners or licensors make any representation regarding the advisability of investing in any asset or whether such investment creates any legal or compliance risks for the investor. A decision to invest in any such asset should not be made in reliance on any information herein. Indexes cannot be invested in directly. Inclusion of an asset in an index is not a recommendation to buy, sell or hold that asset nor confirmation that any particular investor may lawfully buy, sell or hold the asset or an index containing the asset. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

The information contained in this report should not be considered "research" as defined in recital 28 of the Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council ("MiFID II") and is provided for no fee.

Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only. Index returns shown may not represent the results of the actual trading of investable assets. Certain returns shown may reflect back-tested performance. All performance presented prior to the index inception date is back-tested performance.

Back-tested performance is not actual performance, but is hypothetical. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. However, back-tested data may reflect the application of the index methodology with the benefit of hindsight, and the historic calculations of an index may change from month to month based on revisions to the underlying economic data used in the calculation of the index.

This document may contain forward-looking assessments. These are based upon a number of assumptions concerning future conditions that ultimately may prove to be inaccurate. Such forward-looking assessments are subject to risks and uncertainties and may be affected by various factors that may cause actual results to differ materially. No member of the LSE Group nor their licensors assume any duty to and do not undertake to update forward-looking assessments.

FTSE RUSSELL

An LSEG Business