HSBC Private Banking

Video Transcript

What you need to know about stagflation

Jonathan
In this our latest video we're going to cover stagflation.
I'm Jonathan Sparks. I'm the CIO for the UK Private Bank and wealth and I'm joined by Emma Cory, who is the Alternative Specialist for Private Banking.

What is stagflation?

Jonathan
Stagflation has actually been one that's quite difficult to define. But put simply I think it's a period of stagnant growth usually with increasing unemployment alongside inflation. So it's quite an unusual mix because you have a kind of slowing economy usually but also you have inflation and this inflation is usually brought about by a supply shock. That will then lead to a kind of cycle of higher inflation expectations, which then lead to people putting up prices and people asking for higher wages, that kind of wage price spiral.

How is real estate affected?

Emma
So for real estate, not just residential but on the commercial side, essentially you always have a downside cushion, which is really the replacement cost. The cost of building assets has increased not just from the labor cost but also from the raw materials, so you've even seen recently actually on sort of the warehouses side, which are essentially sheds that are very cheap to construct, the price has been astronomically rising over the last few years.

Has real estate been exposed to price rises?

Emma
Yes, in particular with real estate, a lot of the rental increases usually have inflation linkers. However, real estate as an asset class at the moment, what is quite different is

it's still recovering from Covid-19. So we're only really starting to see transaction volumes increase this year, only started seeing that recover, but again, it really depends country by country. So going forward, it's very much a case of not just looking at the macro factors but very much micro levels. So what are the local supply and demand dynamics and making sure you partner with a manager who really has experience in these areas and allocates to liquid markets where the local dynamics are attractive.

Jonathan
Yeah, and that kind of helps as well when you've got some interest rate rises if you make sure that you've got a good manager fitting into these dynamics. It's less of a concern perhaps you've got these kind of higher borrowing costs, but it's important isn't it with a lot of real assets, is when interest rates rise, you might not get this kind of immediate rise with them, with inflation. There's often a lot of volatility around that because it changes some of the funding costs, but the key thing really is that over time a real asset should give you some of that protection from inflations. So if we go back to previous examples, you can see that real assets, yes, they might not knock it out the park but they are giving you that protection aren't they against inflation?

Emma
Yes, that's very true because by alternatives what we really mean is non-public equity, non-public debt, nor cash investments or really those investments that returns are driven by different types of risks so illiquidity, complexity, very active management and they tend to also be less volatile. And while this is very prevalent today, alternative investments, that certainly wasn't the case in the 70s and 80s. Private Equity in particular as an industry was only really forming more in the 80s and 90s and that consisted very much of these mega cap leveraged buyouts and likewise on the hedge fund side, the industry is certainly not the same structure and size as it is today.

Jonathan
Yeah, so more opportunities. I mean I think of what's happening in kind of volatility, that as a kind of tradable asset almost, it's just completely exploded. It just really wasn't something that you could do back then and then in the kind of more vanilla, normal kind of asset classes such as equity and fixed income, of course, they were around but you've got kind of more to investing in terms of sort of inflation link bonds that gives you kind of another opportunity set as well so you can get that kind of inflation protection there. But also we have a bit of, kind of understanding of what worked and what didn't so in the 70s, you know commodities is a key example of a sector that worked really well that this

time has been one of the best performing areas. You've got that big surge in commodity prices obviously around the war in Ukraine has really exacerbated that but you also had kind of what is known as kind of value stocks as well which tend to perform and the reason why is because you've got rates going up that's because they're having to adapt to this inflation and so the investor is kind of wants in that higher rate environment. They want those kind of near-term cash flows. And if you look at what was happening leading up actually to this period we're in, where you can almost call it a secular stagnation, you saw a big outperformance of growth. So this kind of opportunity now for some of those more value stocks perhaps in some cases a little bit more cash flow generative, maybe in some cases pay dividends like getting your money kind of now rather than kicking it down the road in the kind of growth stocks. They're coming back into favor more now.

Emma
But we are still overweight alternatives as an asset class because as you say they are less correlated to these traditional asset classes, which we probably are going to see some signs of stress or more volatility in the near term and also with alternatives, it's very much the returns are driven by that more active management. So as always we're really focused on selecting the best managers.

Jonathan
Yeah active management, it's a very important one, isn't it? Because there were periods, wasn't there, after quantitative easing where it kind of didn't really matter. Or at least it felt like it didn't matter too much what you brought because it was all about those rates coming down. Now we're in a period actually where we've got kind of higher rates and so there's sort of greater opportunity set isn't there, for a kind of active manager.

<u>What does the future hold for Private Equity performance?</u>

Emma
So in terms of performance so far this year, alternatives have provided valuable diversification benefits and downside resilience. For example in Private Equity performance, which reports quarterly with at least a three month lag. We're only starting to see Q1 or 31st of March valuations come through and in fact while public equities have declined during the period, Private Equity is actually seeing marginal gains, but on a forward-looking basis, we probably do expect the Q2 or 30th of June valuations to not be so resilient. We think then that's when Private Equity managers will

be focusing on the impacts of the rising interest rates, how's that impacting their leverage, leverage at the underlying company levels and the operational impact it has on their underlying companies.

How are hedge funds performing?

Emma
It's even hedge funds as well this year, hedge funds can invest across all asset classes. They can be on the long side, so benefit from rising prices, but also on the short side and can benefit when there is a decline in prices. So, so far this year, we allocate through very diversified portfolios of high conviction managers. These have performed very well, in particular given the multi strategy or macro managers who really benefited from this volatility and in particular the rising commodity prices.

Looking ahead

Jonathan
So I think you know, when we look ahead it is going to be an extremely, kind of interesting year next year from that perspective, isn't it? Because ultimately, if things go in line with our view we should start to get an easing of that inflation as well. And that's really being the big story and then perhaps next year you'll start as well, then maybe probably going to be more rate hikes, but actually some of those rate hikes will start to taper off as well. And so we won't have quite an aggressive central bank policy, and who knows, if the economy is actually weaker than they expected, they may actually be looking at ways that they can stimulate the economy again, but we're some distance off that given where inflation is at the moment.

Emma
The fact that hedge funds can allocate across all asset classes and particularly macro managers trade around these interest rates. It creates a really interesting opportunity set for hedge fund managers and furthermore as hedge funds the returns tend to be very much driven by the active management rather than necessarily the underlying sort of beta or market sort of returns. We think it's particularly valuable to have in a diversified portfolio at this point in time.

Key takeaways

Jonathan
I think if we are going to boil this down then into some of the key points. I think the first one, I think perhaps the most important one I think, is to make sure that you stay invested. If you're not invested then there's the potential that you keep getting inflation. So in real terms your cash rates are going to be lowered in inflation and so you're making a real loss there. So I think it's really important to stay invested. It's very difficult to get an asset class that is going to kind of completely perfectly go up in line with inflation and give you that hedge. But over time, that is the best place to be because an overall portfolio should be able to keep track of inflation because they provide you those real returns.

Emma
And also importantly is that diversification as you say across different types of risks, different types of asset classes and even within those so again across hedge funds, diversifying across strategies, managers, and particularly with Private Equity diversifying by vintage. So keeping to your Private Equity commitment programme, commit every year to make sure not only your capital calls match distributions over time, but you really do stay invested, so you're exposed to that active portfolio management that really drives returns.

Jonathan
Yes. So that's the key second one, isn't it that diversification and I'll add one more and I think it's to just be perhaps a little bit more creative, think about different asset classes or such as alternatives that perhaps you wouldn't have otherwise thought about because in this environment they can give you that little bit more resilience. And actually there's some interesting ways to actually enhance returns in there as well because we've got that volatility. So definitely taking a little bit more creative, trying something a bit more, bit different that perhaps in previous markets that was seen as too unusual or too complex. I think it's a good time to kind of revisit those asset classes now.