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THE IMPORTANCE OF AGILITY IN NAVIGATING UNCHARTED WATERS

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ABOUT PGIM WADHWANI

PGIM Wadhwani LLP was founded in October 2002 as Wadhwani Asset Management by Dr. Sushil Wadhwani, CBE. Investment operations commenced in January 2003. PGIM Wadhwani is a London based asset management company, authorized and regulated by the Financial Conduct Authority (FCA) (219900), which specializes in systematic/quantitative macro investing.

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Agility seems to be of paramount importance given the current quickly changing economic environment. ***Dr. Sushil Wadhwani, CBE, Chief Investment Officer for PGIM Wadhwani LLP****, shares his expert views on the biggest risks to the market and the benefits of allocating to a global macro manager.*

I. How do your views on medium-term inflation risks impact your forecast for different asset class returns?

I think the answer to that question depends on the inflation scenario that each investor thinks is the most plausible. From our point of view, there are three scenarios that are relevant.

The first scenario is one where the rise in inflation turns out to be entirely temporary and inflation just subsides without any policy action being needed. The big output gap we have, globally, becomes important, and inflation just automatically comes down by itself. And in that scenario—the Goldilocks scenario—obviously, equities and bonds are likely to do well.

There's scenario two where inflation persists into 2022 and 2023, and central banks remain patient. They may remain patient because of implicit government pressure, but they may also remain patient because they've announced they're going to be behind the curve. Now, that scenario, where inflation expectations rise and get embedded, could actually be quite subversive of both bonds and equities, because clearly with higher inflation expectations, other things being equal, bond yields will go up. If higher inflation expectations lead to higher nominal bond yields, you may get a higher earnings yield, i.e., a lower price/earnings ratio, so you could get multiple contractions in the equity market as inflation goes up. That means equities and bonds fall together. So, this is a scenario where inflation expectations are dislodged.

Scenario three is, as former Federal Reserve Chair Janet Yellen has told us, that the US won't allow inflation expectations to be dislodged because if the Fed thinks they're about to be dislodged, it will respond forcefully and promptly. In this third scenario, there is inflationary pressure in the economy, but the central bank then responds aggressively. Now, at the beginning of this year, the markets weren't expecting a rate hike until well into 2023. Now those expectations have been brought forward into early 2023. But I would say on the Janet Yellen scenario, the Fed may end up having to hike in late 2022.

It may be that if we see building inflationary pressure, the Fed may well respond, especially if inflation has a three handle through 2022, which is not at all implausible. If the Fed suddenly starts tightening at the end of 2022, you've got to believe that both equities and bonds will go down meaningfully.

We have to choose between these scenarios and that, to some extent, is what all the modeling work we do attempts to accomplish. But it is clear that what happened in February this year is that the markets went from believing my first scenario was a 90% plus probability to thinking that maybe scenarios two and three had meaningful probability, and that scenario one wasn't a done deal. And that's why I would say that the yield curve steepened and real rates rose.

2. In your opinion, which scenario is most likely to materialize?

In our view, both growth and inflation are likely to surprise the consensus on the upside during 2021, in part because there is a behavioral tendency for forecasters to underestimate the impact of special factors like pent-up demand when preparing their numbers. If these surprises do eventuate, we feel there will be a tendency for the markets to assign a higher probability to either scenario two or three materializing. Since neither scenario is good for a traditional 60/40 portfolio, our best guess is that investors should seek diversification. Once we get into 2022, if inflation fails to come down sufficiently, I suspect that the Federal Reserve will "do the right thing" and, in that sense, scenario three is more likely than the second scenario within which inflation becomes embedded within the system. Of course, were the Fed to turn aggressive in the second half of 2022, then equities, bonds, gold and inflation-linkers would all fall together.

3. Given your views on inflation, interest rates and bond yields, what are your views on the role of fixed income in a multi-asset class portfolio?

In terms of sovereign fixed income in the G7 or G10 countries, we believe allocations to this area are offering a significant amount of risk with very little return potential. Historically, it's been great having sovereign fixed income exposure from the developed world, because it's tended to help you when equities go down. In the current low interest rate environment, fixed income is likely to do very little for you in a deflation scenario, and then, of course, in an inflation scenario, they're very risky. As we saw in March 2020, in places where you are already near the tactical lower bound for interest rates, the degree of defense offered by sovereign bonds in those countries is incredibly limited.

Therefore, given the uncertainty around inflation combined with little diversification benefits and minimal expected return for fixed income, the key decision is finding substitutes for your fixed income allocation. All our research has been oriented towards ensuring that within our own portfolios, where historically we relied on sovereign fixed income exposure, we diversify in other ways. We have, for example, traded safe-haven currencies and have consistently had some allocation to them. The ability to go short equities as well as commodities is also key to providing a diversification benefit.

I think speaking more broadly, investors are coming around to the view that they're going to have to replace their sovereign fixed income exposure with some sort of liquid alternatives strategy which would provide downside protection when equities retreat.

4. What are the key advantages of investing in a global macro strategy given the current market conditions?

We believe the single biggest impact of the pandemic on markets that could turn out to have the most profound consequences are the impact on macro policy, because the way policymakers are talking about it is so different from the so-called Washington Consensus over the last 20 years. Views on fiscal policy have changed globally and everyone is talking about higher budget deficits because it's more affordable now with interest rates being so low.

Both developed countries, like the US, and several emerging markets (EM) countries have taken the view that their already substantial budget deficit can grow even more. I think in 10 years' time, we'll have seen a big regime shift. This has profound potential implications for wealth preservation, and I believe, to be able to protect one's wealth and hedge against this profound policy change, one way is to allocate a portion of your portfolio to a global macro manager because they're best positioned to respond to this policy change.

A couple of other advantages which go with a global macro strategy are that if it turns out that we don't have inflation, then global macro managers are likely to flip their positions very quickly and therefore, you don't psychologically get locked into a particular hedge. Essentially, if you are worried about a change in policy regime, you have two choices.

One choice is to add things like long-only exposure to commodities and inflation-linkers to your portfolio. These positions will work in some, but not all scenarios. If inflation becomes persistent and the central banks don't react, you should benefit from these trades. But if the central banks react and get aggressive, you definitely don't want to be in either commodities or inflation-linkers.

The second choice is you allocate to an agile global macro manager, which I believe on average will serve you well through what's likely to be an incredibly challenging period for wealth preservation – wealth preservation in real terms, I hasten to add.

5. What other risks are global investors facing?

Aside from inflation, of course, there are always significant downside risks to the global economy – they reside in the known unknowns and the unknown unknowns.

If I look at the known unknowns in terms of the global economy, at least two come to mind. The first is virus mutations. We know that even though the US, the UK and a few other countries have done a good job in rolling out vaccines, it's going remarkably slowly in the rest of the world. Obviously, the longer you allow the virus to, essentially, thrive in some countries, the greater the statistical chance of mutations and therefore, the greater the chance that you may get a mutation that the vaccines may not be effective against. Some health experts say that the statistical chance of there being a mutation which none of the current vaccines can cope with is not small. This combined with very slow vaccine rollouts in places like Africa, for example, could stir up trouble. So, if vaccines stop working on mutations, I believe this is a live risk, and in terms of markets, we're looking for very, very big moves.

The second risk is some sort of incident around Taiwan with the current Chinese administration. Having essentially achieved their agenda in Hong Kong, they're now going to look for the next item on their agenda and Taiwan seems highly plausible in my opinion. The rhetoric around this is ratcheting up, therefore I consider it a known unknown.

6. Where are you finding the most opportunity?

If I stick to my central scenario, which is one where our vaccines cope with mutations and a Taiwan-China incident doesn't happen, then bond yields are still extremely low in terms of economic fundamentals and have some catching up to do. Currently our models are suggesting upside risks to growth in many, many countries.

In a world that continues to normalize – and by normal, I mean somewhere in between where we were pre-pandemic and where we've been recently – there are opportunities both at the long side and the short side. In essence that's how we're positioned – for a normalization trade. For example, there's plenty of opportunity in energy as well as plenty of opportunity in several emerging market currencies. In the commodities space, you could argue that gold went too high, and it may continue to give back as bond yields go up and as the world becomes less risky.

Having said that, we are agile in all of our strategies, and if it looked like one of the risks I mentioned above might begin to materialize, we would then head for the hills in terms of these positions and aggressively re-allocate accordingly.

7. Given the three scenarios for inflation and the probabilities of each one, how do the signals in the management of PGIM Wadhwani's strategies incorporate that information in terms of portfolio positioning?

By the middle of January 2021, it became clear that the ambitions of the new administration in terms of stimulus and fiscal policy were significant. In terms of the modeling we do, our models began to suggest that the markets were meaningfully underestimating scenarios two and three by putting all the weight on scenario one. Therefore, early in the year we positioned our portfolio for a meaningful yield curve steepening and a sell-off in fixed income.

In terms of equity positioning we started the year reasonably optimistic in terms of our overall portfolio equity beta. We positioned the portfolio to remain agile depending on how much tightening was experienced in the markets. We maintained this positioning through February, and the portfolio benefited from market moves. Then as real rates continued to increase, we responded by bringing our equity positioning down, with a meaningful reduction in overall equity exposure by the end of February. As the portfolio benefited from quick market moves during February, we've taken profits on many of our positions.

Having said that, the portfolio is still positioned for a yield curve steepener, however to a lesser extent. For example, in Europe, we are long Bobls and Schatz but we are short the Euro-Bund future and the ultra-long in Germany.

We remain wedded to the view that the yield curve is likely to steepen through this year, because at the moment the main shoe that's dropped in terms of fiscal policy, is the US, and we expect it to happen elsewhere. It happened recently in the UK and we think it's going to happen in many other places too.

Our remaining equity positioning is largely cyclical. We are either in equity markets that are commodity sensitive like Canada and Australia, or we are in Japan, which tends to do well during a global upswing. Likewise, our currency positioning has been very oriented towards commodity sensitive currencies – our two longest positions at the beginning of March were the Canadian dollar and the Australian dollar.

PURSUIT OF OUTPERFORMANCE

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