Investment
INSIGHTS

IN THE POST-COVID RECOVERY, WATCH OUT FOR POTENTIAL RISKS

BIAGIO MANIERI, PH.D., CFA
Managing Director
Chief Multi-Asset Class Strategist
PFM Asset Management

With the resurgence of global economic activity as the COVID-19 lockdowns ease, institutional investors are looking at accelerating corporate profit growth and accommodative monetary policies as strong tailwinds for overall investment performance. Yet these developments also bring inflationary pressures at a time of high fiscal spending. In addition, debt levels are high and rising, and we may be at the beginning of a new era in foreign policy. Pensions & Investments spoke with Biagio Manieri, Ph.D., CFA, managing director and chief multi-asset class strategist at PFM Asset Management, to sort through the current macroeconomic and market risks that asset owners need to understand in order to better position their investment portfolios and avoid a potentially bumpy ride.

We believe that investors need to be cautious, despite the recent run-up in global markets, and continuously evaluate long-term impacts of current policies.

Pensions & Investments: As the world slowly gets back to normal, can investors start to relax with the expectation of smooth sailing from here?

BIAGIO MANIERI: We wish that were the case. Investors face a number of risks. Many are risks that they have not had to think about for a long time, such as inflation. The last time investors needed to seriously fret about inflation was in the mid-1960s and 1970s. Since the early 1990s, investors have not had to materially worry about inflation, nor ponder its impact on portfolio performance.

Taking this a step further, many investors who included inflation-related hedging investments in their portfolios over the past decade did not see much of a financial benefit and, in some cases, paid a price in lower investment performance. Today, however, a number of factors may push inflation higher, including the Federal Reserve's new inflation-targeting framework, significant fiscal and deficit spending combined with easy monetary policy, and other factors.

P&I: What about the Federal Reserve's position that any higher inflation will be transitory?

MANIERI: Federal Reserve Chairman [Jerome] Powell and others have argued that higher inflation is transitory and that [the Fed has] the tools to deal with it. In effect, the Fed is saying "trust us." If one considers short-term versus long-term inflation expectations, investors are indeed placing a lot of faith in the Fed. That said, investors would be well served to keep a careful eye on early indicators of inflation and be ready to act should it prove to be more than transitory.

P&I: In addition to possible higher inflation, what are other areas of concern for investors?

MANIERI: One topic that has received a great deal of attention is the diminishing prospect for higher future investment returns. Because low interest rates are hampering fixed-income returns and have led to elevated equity valuations, many investors are concluding that future returns are likely to be lower.

In addition, there are demographic trends — aging population, slower population growth. We think that most investors understand that. But investors may not be fully accounting for the impact of rising debt and continuing low productivity.

A number of studies have linked debt levels and future economic growth. One study by the International Monetary Fund found that higher debt levels lead to lower future economic growth. It also showed a nonlinear relationship between debt and future economic growth, meaning that as debt increases, it has a proportionally greater impact on reducing future growth.

It is also important to note that the Congressional Budget Office [in the U.S.] estimates that debt held by the public will reach approximately 200% of gross domestic product by 2050. As a reference, it stood at about 100% of GDP during the World War II era.

P&I: Why should investors care about high debt levels and its impact on productivity?

MANIERI: Modern Monetary Theory makes the case that debt levels and deficit spending do not matter. However, this is not what the data show. High debt levels are also tied to another risk factor: slowing productivity. In our view, slowing productivity is more important than demographics, because productivity is what drives our improving standard of living.

Over the past decade, productivity has slowed to about half of its longer-term average, and the CBO estimates that productivity will continue to slow. There is a relationship between rising debt levels and slowing productivity. Rising debt levels and lower national savings are taking place within a backdrop of slowing domestic investments and rising entitlement spending. We are saving less and not investing for the future and we are borrowing to fund higher current consumption.

Why should investors care? Productivity is one of the major factors driving real economic growth over the longer term, which drives corporate profit growth and which, in turn, drives stock price appreciation. In short, we believe that lower productivity could result in lower equity returns over time.

P&I: How should investors interpret the Biden Administration's far-reaching spending programs?

MANIERI: In some respects, there are similarities between the current administration and the previous one. From different ends of the political spectrum, both adopted a 'populist' approach to the relationship between state and civil society. That's to be expected as the political pendulum swings back and forth. Just as the excesses of the 1960s and 1970s led to the election of Ronald Reagan, followed by Bill Clinton proclaiming that the "era of big government is over," the perception of income and wealth inequality today has led President Joe Biden to proclaim the end of the end of big government.

It remains to be seen what impact these far-reaching programs will have.

Some of the proposals would significantly strengthen the power and influence of the state over the economy and civil society. As the U.S. moves forward on this path, investors would be wise to keep the historical case of Germany in mind. From the late 1990s to 2005, Germany was referred to as the "sick man of Europe" [because of unemployment and poor economic growth]. However, in the years that followed, it improved its economic performance by liberalizing some of the rigidities of its economy and labor markets.

P&I: Can investors hope for improved U.S.-China relations under the Biden Administration?

MANIERI: There are some areas where the two nations have common interests, and we expect cooperation in those areas, such as climate change and terrorism. But it has been our position for some time that U.S.-China relations are likely be strained regardless of who occupies the White House.

When China was admitted into the World Trade Organization, the expectation was that China would begin to relax some of its internal controls while simultaneously working to improve its international relations. However, as we have seen in the South China Sea and other regions, China is actually adopting a more muscular foreign policy while tightening internal controls. Based upon these developments, we expect increased competition in U.S.-China relations.

P&I: Do you expect substantive changes to U.S. foreign policy with our allies?

MANIERI: With respect to allies, no doubt President Biden's style is different than President Trump's. The question is, How much will policy change in substance? Again, we expect cooperation in areas of mutual interest. But we also expect areas where the U.S. and its allies will see increased competition in the future.

On the issue of economic and trade relations, while we are unlikely to see inconsistent tariff proposals, President Biden has announced that 'Buy American' laws will be pursued more forcefully. This has an impact on our allies and trading partners. Nevertheless, we may be at the beginning of a return to a more multipolar world, where the U.S., China and Europe cooperate in some areas while competing in others.

P&I: Any final or parting thoughts?

MANIERI: We believe that investors need to be cautious, despite the recent run-up in global markets, and continuously evaluate long-term impacts of current policies. A thoughtful asset allocation, combined with diligent oversight [in order] to make tactical shifts when opportunities arise, is vital for investors to stay nimble in a changing world. ■

sponsored by: pfm

www.pionline.com/PFM_risk21