Gerard Minack (Minack Advisors) – The End of Secular Stagnation

Tom Yeowart: Gerard, welcome to the podcast. Thank you very much for coming on.

Gerard Minack: You're welcome. Good to be here.

Tom Yeowart: I'd love to hear about your early career, and am I right in thinking you joined the industry on Black Monday in 1987?

Gerard Minack: Yes, that's right. I'd already spent five years in government and I joined an independent market forecasting group down here in Australia called Syntec. So first day on the job was the Monday. I was responsible for their quarterly economic and market forecasting publication. And the prior edition, the September '87 quarter edition had gone out blaring warnings about a possible market crash, which I didn't know at the time. Anyway, the next day of coming to work and people are saying, the index is down 25%. And I said, well, is that bad? And they said, no, it's very bad. I wasn't that market savvy. But I started to get phone calls. They'd ring up the switchboard and say, put me through to the person responsible for the quarterly forecasts. And they'd put me through to me and say, great call on the crash. Well done. So calling crashes ever since really.

Tom Yeowart: And did that experience prove formative in giving you a window into investor psychology straight off the bat?

Gerard Minack: I was probably a little too green. But I certainly took it to heart that, even though this publication had forecast it, to most people it was a huge surprise. And then to see the massive sentiment swings, because in the immediate aftermath of what happened in '87, there were all these calls, that, well, this is as bad as 1929, we are heading to another Great Depression, and that was a commonly stated view. Now we easily dodged that bullet, which shows that markets can forecast some things, but sometimes their forecast can be bad. But no, it was a very unusual baptism into financial markets. But from there, I went on to join BZW/Barclays with the rather grandiose title of Global Future Strategist. So I was opining on, typically short rate futures, long rate futures, around the world. Having gone from a very fundamental based job doing five year economic and market forecasts that whipsawed me to the cowboy end of the market. Once again, my first day on the job, I sat next to this gruff guy. He said, well, what do you think about tens? I said, well, look PJ, in big picture terms... And he just sort of shoved me in the shoulder and he said, mate, big pictures are for hanging on the wall, what do you think? Let's narrow it down. So I still rather talk about big pictures, but anyway, they are for hanging on the wall also.

Tom Yeowart: And then were you at ABN Amro and then Morgan Stanley?

Gerard Minack: Correct. So as I like to say, I didn't leave Barclays. Barclays left me. Barclays sold BZW globally to Credit Suisse, but in Australia, BZW and Credit Suisse were two of the biggest standalone investment banks, and it just would've been an absolute bloodbath. So we were sold as a one-off deal to ABN Amro in Australia. All through this, and it really started back in my very first job in '87, I'd been writing a global daily note, and I kept that up at Barclays and at ABN, even though my business card said I was the Aussie economist and strategist. And then got a job offer from Morgan Stanley and my only real concern was that I could keep that up and they said yes. Keep it up because we don't have house views. People can write about whatever they want. You are being hired as the Aussie strategist, so please do write a little bit about Australia.

And the global stuff was successful enough that they pretty quickly made me the global developed market strategist. So after Barton Biggs left, who was global strategist, they never replaced Barton. Barton was irreplaceable. So they didn't have a global equity strategist. They had myself doing developed markets and Jon Garner, who's still there, doing emerging markets. And then the last job I had, which was jack of all, master of none was as Global Cross Asset Strategist, but by then you know, I really enjoyed my time at Morgan Stanley, but I went along to the boss and said, look, I really would like to increase my PB ratio, which is the ratio of how much I get paid relative to how much bullshit I've got to put up with. So I'd like to leave big investment banks and they were kind enough to understand that. And then, almost 10 years ago, launched Minack Advisors.

Even when I was at Morgan Stanley, I always used to write the down under daily. It was always two pages. So in that sense, in terms of what I wrote and the way I did it, nothing changed. But what do I do with the rest of my time? Well, I'm either reading or data crunching or talking to clients, and this is crucial because here I am, I'm sitting down here in Sydney. Through the pandemic, I gave up my city office because I couldn't use it. So I'm now in my home office. How do I know what's going on? How do I know what investors want to talk about? Well, it's the relentless contact I have with people. That constant back and forth keeps you honest and generates ideas. And I'm not shameless to say that, most of my good ideas comes from clients. If I've got enough smart people I'm talking to, some of it has to rub off on me.

Sebastian Lyon: Gerard, macro has very much added value for us at Troy, over the years. I know many investors are rather sceptical of the noise of the big picture. But there are times when actually it really is very important in defining what's going on in markets, and frankly you ignore it at your peril. I think this is one such time. You have changed your view very materially over the last two years. You've moved from being a secular stagnationist, which it would be helpful for you to explain what that is, but also the very material implications of what that change means to investors from the last decade to the decade that we're looking at now.

Gerard Minack: Yeah, Sebastian, I was a card carrying secular stagnationist for two decades. Larry Summers popularised the term only 10 years ago. But before that, I was telling everybody that the world was turning Japanese, which is the same story. And through the pandemic, I resigned my membership. I argued that the pandemic would be the catalyst for some changes that meant the curtain would come down on secular stagnation. Now, what is secular stagnation? Well first and foremost, let's describe it in economic terms. It's a problem I think where planned investment falls short of planned saving. If you start off with a disparity with planned saving above planned CapEx, something has to adjust to bring them back into balance. And what commonly adjusts is that interest rates fall. Interest rates falling encourage higher investment, and to some extent at the margin can discourage saving. And that gets to the nub of why secular stagnation mattered to investors, because it explained this secular decline in interest rates, which was the single most important financial feature of a world that was secularly stagnating.

For four decades, if you're looking at the US 10 year treasury yield, the cycle peak, each cycle, was lower than the prior cycle peak. And the cycle trough was lower than the prior cycle trough. So there was ups and downs for four decades, but it was a story of lower lows, lower highs, and that's the secular trend. That was unsurprisingly matched by the decline in the neutral policy rate. Every cycle peak in the Fed fund rate, adjusted for inflation, since 1980, has been lower than the prior peak. This is all up until the pandemic. So that declining rate story was hugely important for investors in a very direct sense. Long end sovereign bond yields have given you equity like returns in the four decades to 2020. The second hallmark of secularly stagnating economies is that you tend to see equities respond positively to growth news, because equity investors in a low growth, low rate environment, become concerned that there's not going to be the growth around to generate earnings.

On the other hand, bond markets always hate macro strength, so they tend to sell off. In other words, what you see in a world that's secularly stagnating is inverse correlation between equities and bonds. When equity prices go up, bond prices tend to go down and vice versa. Now, that also is tremendously advantageous for asset owners. It means that bonds are really effective insurance for equity risk because whenever equities go down, bond prices will go up. Now what made this even better was this was an insurance device that paid you. I assume it's the same with you as here. If I want to insure my car, I've got to pay the insurer something. Here it was though that if I want to insure my equity risk, bonds paid you. And that made for, particularly if you look at a conventional 60:40 equity/bond portfolio, it meant you were getting good returns with low vol. I mean, that's investment nirvana.

The third thing that happened through this trend decline in rates is it made being levered in an investment sense, normally quite pleasurable. So you could juice up your returns by deploying leverage in investment structures. Now we've probably all done that personally because we've probably all bought a house with a mortgage and that's leveraging up a real asset. But the really big change wasn't in what households did or even non-financial corporates, the huge licks of leverage in the system are within the investment community themselves.

That leverage did occasionally cause moments of pain. The GFC is a great example, but when you've got a secular declining rate structure, the ratio of pleasure to pain, being levered, is quite high. And we build up this massive leverage. Now all these trends potentially change if the curtain's coming down on secular stagnation. And, for me, it was symbolically important that when the 10 year treasury yield in the States broke through 3.5% a couple of months ago, that was the first time since the late 1970s that the cycle peak in a 10 year yield surpassed the prior cycle peak. It's a little bit too early to have really firm predictions, but I doubt very much that we're going to see in the next recession, 10 year yields go back to the 50 basis point low that we saw in September quarter 2020. So after four decades of lower lows, lower highs, we're going to mark out the first cycle where we've made a higher high, then a higher low. And I think we go on to make a new higher high in the next cycle after. And voila, the secular trend has changed.

Tom Yeowart: Gerard, can you touch upon the implications of such a change?

Gerard Minack: The outlook for bond yields is obviously we go from a tailwind of falling yields to a headwind of rising yields. We have also seen a breakdown in that second hallmark of secular stagnation. We now have equity and bond markets that are positively correlated. That is, the price direction of the two big asset classes move together. And hasn't that absolutely been the story of 2022? We've seen massive losses across all major asset classes. And it's worth noting that if you look at the Bloomberg Long Bond Index, which was launched by Barclays back in 1973. Up until this year that had never experienced a bear market i.e. a 20%+ drawdown. Where is it now? It's lost over 40%. So the Bloomberg Long Bond Index has had its first ever bear market. It has had a worse year than the NASDAQ and the NASDAQ hasn't had a terrific year. So that's the power of positive correlation that we've had broad based losses. That has completely changed the dynamic for asset allocators.

The third factor is the leverage point. Now you have just had over there in London, a front row seat on what leverage problems can cause amongst the defined benefit pension funds. And that style of leverage is everywhere in the system. I'm not saying it's going to be systemic like ' 08 was, but it just illustrates the point that if rates start trending up there will be more painful episodes for levered investors. So the pleasure pain ratio is going to tip in a way that's not good. I'm not saying we automatically get rid of all leverage, but the optimal amount of leverage in most investment structures is going to fall in coming years as rates trend up. It's as simple as that.

Tom Yeowart: There's obviously a lot in what you've just said, but just to go back, you were clearly forecasting higher highs in rates last year, and I imagine most people were quite sceptical at the time. They're now confronted with the reality of higher rates. But do you think there's still a degree of complacency? The fact that a lot of investors have become used to policy responses being quite rapid, and it seems like everybody is hanging their hat on a potential Fed pivot and a quick coming down from higher rates to lower rates. But what do you think the risks are of just a slower grind?

Gerard Minack: Yes, most people have been surprised how high rates have gone this year. They're not taking that as a sign that the structural change that I'm talking about is really underway. Most of the people I talk to just go, I bungled the cycle, I'm still sceptical though about your secular change, Gerard. And there's a degree of institutional inertia there that means that for many people, I'm getting the sense, once we get through this nasty bout of inflation, that we all go back to a world that looks quite like the pre-pandemic world we had. So people aren't buying the structural story on average. Some are, but most of them aren't.

I'm now taking to describing this as equity investors going through the seven stages of grief. And for many, they still haven't got out of denial. The whole year has been a year where equity investors in particular have been looking for excuses for the equity market. So the very first excuse that was prevalent right through last year was obviously inflation's transitory. So we don't need much of a rate response. Then the fall-back position was well we don't need rates to go very high because it's a fragile economy. That hasn't proven to be the case. Then it was well we know that the Fed always blinks when there's financial market distress. Well, that didn't happen either. And that reflected a fundamental misunderstanding of how the Fed had operated post GFC versus how they're operating now. We don't need stimulus, we've got too much stimulus and therefore we want reverse wealth effects. Getting weakness in asset prices is a feature of the current programme, not a bug. So people were always wrong to look for the fed to come to their rescue as they had ostensibly for a decade.

Now the view is, well, look we are not in recession yet, but surely recession's priced. And my view is no. I mean, the first half was all about a derating story as real yields and inflation went up. You can't tell me that this was a market pricing in a cyclical down swing when in the first big leg down to the middle of June, the four best performing sectors were energy, materials, financials, industrials, the four most cyclical sectors in the market. Equities don't normally bottom until the downgrade cycle is virtually over. In the GFC, the index troughed two months before the earnings downgrade stopped. Now, this is where people will say, hold on, this is the most forecast recession in history. And my response is, well, I tell you what, the sell-side hasn't got the memo. S&P500 consensus EPS numbers are down around 2% from their all-time highs. That may not matter if we started to see companies miss their numbers and the market shrugged its shoulders, but guess what happened last week when Meta came out and had a downgrade. The market didn't shrug its shoulders, the market puked. So there's no sign in the day to day price action that earnings disappointments are in the price.

Sebastian Lyon: Gerard, what would a normal recession look like in terms of EPS downgrades? The pandemic was so short that almost by the time we saw the downgrades you were seeing upgrades again, financial crisis was somewhat longer. But actually we haven't really seen a normal recession for probably a couple of decades.

Gerard Minack: You're right Sebastian. One of the interesting things, and this is the final sort of pushback I get, which is, well, if we just have a gentle recession and we've got higher inflation, perhaps there won't be many earnings downgrades. Now what history shows is even in the seventies you absolutely had EPS downgrades. There has never been a recession without EPS downgrades in the post-war period. But what's really interesting is over the last three decades US S&P500 earnings seem to have become more sensitive to macro downturns. And my sense is this is because corporate America has become both more operationally leveraged and financially leveraged.

And that means that even though, for example, the early nineties recession, was quite a mild recession. Even milder was the 2000 downturn. You actually saw quite substantial, as in 20%+ drawdowns in EPS. So I, at this distance, don't expect it to be a very severe recession next year, but I would still expect at least a 20% EPS drawdown. And of course if you look at consensus forecasts, and I tend to look at the moment at the earnings forecast ex-energy, they're still looking for 10% up next year. There's been downgrades to this year's numbers, but no downgrades to the growth rate expected next year. So relative to what people are expecting, up 10, I could easily see a down 20. And in that sense, I think this is going to be a two part bear market. We've seen the first part, which is a derating affair. It's actually been a more savage sell off this half than I thought. But the starting point valuation was either the highest or second highest of all time. And that ran into the fastest or second fastest hiking cycle of all time. So a pretty big balloon bumped into a pretty big prick. So no wonder it lost air. But what that hasn't allowed for is the prospect of serious earnings downgrades. And that'll be the second part of the bear market.

There may well be more bear market rallies in between. It is normal for equities to rally after the last fed rate hike. So you could absolutely see some sort of bear market rally there, but once the Fed has finished tightening, how you treat the subsequent rally depends on one thing and one thing only, whether you have a recession. If you're heading to recession, then the onset of Fed easing is an absolutely terrific sell signal. If it's a soft landing, then any Fed easing just simply turbocharges a rally that's already underway, as we saw most recent soft landing being in 1995.

I'm in the recession camp, so that would mean that any rally that accompanies the end of Fed tightening is simply to be treated as a get out of jail free card. Your best last opportunity to lighten up on your equity risk before we have another big leg down.

Sebastian Lyon: And Gerard, would it be the bottom of the rate cycle where you would actually see equities beginning to perform rather than the top?

Gerard Minack: Sometimes rates continue to fall even as equities have started to rally. Equities are always on the lookout for growth and history shows that equities normally trough four or five months before the end of a recession. The indicator to watch is the downgrade cycle because normally they're very close to each other. So once you get a sense that the pace of downgrades is inflecting, that's a sign that you're getting towards the end of the selloff.

Bonds on the other hand can continue to rally, i.e. fall in yield for longer, and that's partly because, and this is going to matter in this next cycle, the most lagging indicator in the economic universe is inflation. If you look at the 12 month change in core CPI, so whether the core inflation rate is above or below year earlier levels, that doesn't normally start to decline until the recession's over. In fact it's highly correlated to the change in unemployment. Now, unemployment itself is a lagging indicator, but unemployment actually leads inflation by nine months. In other words, it's only nine months after you see a rise in unemployment that you'll get a decline in core inflation.

Now, I don't think the Fed will wait or needs to wait for core inflation to start falling before it can justify cutting rates. If it waits for core inflation to be falling before it eases, then it will have created a deep downturn because it means that it has let unemployment rise a long way before it has eased. What it needs to be able to point to though, is clear evidence that the labour market's weakening. My sense is that the Fed will turn quite quickly. We've all become used to talking about Fed pivots. I think of the pivot as the time between the last Fed hike and the first Fed cut. So the time between the Fed doing a complete 180 degree turn.

Now the last three pivots, the last three gaps between the last hike and the first cut were the three longest in history. The longest in history was around '06. The Fed stopped tightening in '06. It didn't start cutting, but boy, when it started cutting, it started cutting, until the GFC really blew up in the second half of '08. It was a 15-16 month pivot. The reason I mention this timeline is I think we need to remember that the average pivot since the mid-fifties is three months. So historically it's only a three month gap between the last Fed hike and the first cut. And the Fed may not be that fast, but I think it's going to be closer to a three month pivot than a 15 month pivot, because I sense once the Fed is clear that the labour market is weakening enough so that unemployment's going to rise, it can say, well, we've done our job. And it can be fairly confident that that rise in unemployment will, after a lag, lead to falling inflation.

So I at long last, don't have a big fight with short rate markets. They're pricing a peak of 5%, it could be a little higher, could be a little lower, but given that the rate market was pricing a peak of 1.5% at the end of the year, that's such a huge move I'm not going to quibble about the last 25 bps. And then it's pricing the start of Fed easing late next year, and that also seems reasonable to me. I've pencilled in the start of a recession in the June quarter. Completely plausible for the Fed to be easing through the second half of the year.

And I think it'll be early in the New Year that we will get a decent response from the consumer. They'll get through to Christmas, get through to January, come back to work in the New Year and go, gosh rates are up even more. My house price is even down more. My real wage is going back to front. Let's tighten the belt. We're already seeing your more interest rate sensitive sectors, fraying at the edges, most obviously housing in the US, but the service sector remains robust. It's when the consumer pulls back spending on services that the labour market starts to crack. And if all that starts to become apparent in the March quarter, it seems plausible to me that you'll be in a recession by the June quarter.

Tom Yeowart: Just taking a step back, it sounds like your belief in the base case being a recession next year is based on core inflation being persistently higher than I guess many expect. Is that the case?

Gerard Minack: Yes. It's the difficulty of what the Fed needs to achieve is the key reason, and let me spell out what that difficulty is. We've obviously seen some supply side shocks that have lifted goods prices and obviously the war in Ukraine, food and energy prices. But the core of America's inflation problem is its service sector, and I define that broadly to include housing rents, housing costs. If goods sector inflation went to zero tomorrow, the US core CPI would still be running at 5%. In other words, the service sector is driving a 5% core inflation rate.

What drives service sector inflation? Overwhelmingly the single biggest influence is wage growth. And so put bluntly, wage growth in America today is running at levels incompatible with the Fed inflation target. So the task ahead of the Fed is to loosen the labour market enough to get wage growth down to levels compatible with its inflation target. How much loosening is required? Well, if you look at the relationship between unemployment and wage growth, i.e. a Phillips curve, what that's now suggesting is that the Fed needs to lift the unemployment rate by at least a percent to get wage growth down to levels that are consistent with its inflation target.

Now, the punchline to that story is that there's never been an increase in US unemployment of more than half a percent not associated with recession. In other words, the task ahead of the Fed is to achieve something that has never been achieved before: to get the unemployment rate up by a percent without causing a recession. It's not mathematically impossible, but the probability I attach to that scenario very, very slim. I think you just have to make a recession your investment base case.

Tom Yeowart: Gerard, turning back to equity markets. Clearly you think we are experiencing a paradigm shift. How does that inform your view of what companies, businesses, and industries will be the winners over the next decade versus the companies that have done incredibly well over the last decade?

Gerard Minack: Great question. For me there are three big changes. The first is policy makers have rediscovered the joys of fiscal policy and fiscal works. Secondly, Central Bank best practice has changed. They no longer have a singular focus on inflation. They have one eye on the labour market. But the third reason, is I can see a number of secular drivers of investment kicking in.

Now I go back to my very opening comment. Secular stagnation is a problem where planned saving exceeds planned CapEx. If you look at the actual data, the big change in most developed economies over the last three decades has not been an increase in saving. It's been a decline in CapEx. So if I can persuade you that CapEx is going to pick up, I've persuaded you that secular stagnation is going to weaken.

So I can see five reasons why CapEx is going to rise. First, policy makers and investors will want to make the developed world economies more resilient because for three decades, we optimized developed economies for financial return, but that created very fragile economies. And the GFC highlighted the fragility of the financial sector. The pandemic highlighted the fragility of the non-financial sector. And I think Mr. Putin and Xi are highlighting geopolitical risks. So what's the response going to be? Some onshoring of crucial productive capacity. Some friend-shoring or diversification of supply of others. And as things as simple as going from just-in-time to just-in-case inventories. So it's all going to require more stuff. The second thing pointing to higher CapEx is just simply higher defence spending. The peace dividend that we all reaped after the Cold War ended has now become a rights issue. The third factor, spending on climate mitigation. And this is potentially a huge, huge spending requirement over the next two or three decades. Fourth factor, more spending on public infrastructure.

The fifth and final thing pointing to higher CapEx is the prospect of stronger wage growth. Now, in most developed economies, we've seen literally a collapse in business CapEx over the last two or three decades. There are a few reasons for that, but I think one reason is that wage growth was quite anaemic. And why does that matter? Well, if you are the corporate sector, considering the payoff to undertaking some labour replacing CapEx, that payoff is going to be a function of wage growth or expected wage growth. And if wage growth is low, that's going blunt the incentive to undertake that sort of CapEx. And I think wage growth is going to be higher on average, and that means more labour replacing CapEx. So, I think it's going to be a great time to be making stuff because most of the CapEx I just alluded to is not a computer coder coming up with the next TikTok. It's all tangible stuff. And I talk a lot about the so-called high beta goods producers, which is an amalgam of materials, resources, and industrials.

So that's the good news. The bad news is what higher rates may mean for other parts of the market. Now, here I just have to point out that the relationship between equity valuations and rates is not straightforward. Most time when rates go to very low levels, equity markets suffer. Just look at Japan the last three decades. If low rates were the key to overvalued equity markets, Japan should be the most expensive market in the world. Normally the macro conditions that lead to very low rates make it difficult for corporates to earn money, and that's why they derate. But if you can earn money in a low growth environment, low rate environment, you will be rerated. Now, the big post - GFC story for global equities was that earnings went nowhere, with one honourable exception, the US. What set the US apart from the rest of the world wasn't the level of rates. It wasn't central bank QE, it was the ability of American corporates to grow earnings in a low growth, low rate environment. So American outperformance in the dozen years after the GFC was a combination of higher valuations and higher earnings.

If it didn't have the earnings go up, the valuations wouldn't have gone up. And every other market in the world illustrated that fact. The final thing to say is that ability of corporate America to grow earnings was actually quite narrowly based. The big platform companies were absolutely dominant. I focus on the sexy six as I call them. Microsoft, Apple, Amazon, Facebook, or Meta now, Netflix, and Alphabet. Now only six stocks, but their combined market cap at the end of last year was almost $10 trillion, which meant that they were worth more than every other equity market in the world, worth more than the investment grade bond market in the US. But if you do rerate in a low rate environment, you will derate in a rising rate environment. And that's exactly what they've done. So this story of a new era with stronger CapEx and higher rates is not a disaster for equities overall, but it's absolutely a story of leadership change and boiled down it's the leaders of the last cycle that are most vulnerable to derating as rates go up. And it's some of the laggards that look set to have a good decade because they're in the sectors where they make stuff. And that's combined with exceptional supply side discipline amongst a lot of these sectors at the moment.

Sebastian Lyon: Gerard, we're talking effectively about the deflating of a bubble in not just one asset class, but right across all asset classes. And one of the things that probably gets a lower profile because they're not listed securities is the huge boom that we've seen in private assets both in venture capital, but also in leveraged buyouts, et cetera. And I just wondered where you feel that comes in compared to what's been happening in the listed securities market, whether it be in fixed income or whether it be in equities.

Gerard Minack: Yeah, they've had a couple of advantages. I put that in quotes. The first is the vehicles have been able to take on more leverage than many publicly listed vehicles. And in a world where leverage is good, that was a good thing. And now we're seeing the second advantage, which is that they tend to mark to model, rather mark to market. Because you would surely believe that if anybody was honestly marking these sort of unlisted portfolios to their publicly listed comps they'd be seeing really big haircuts. So I think the fad for these alternatives, well, for people that really just bundle up stuff into leveraged vehicles is going to struggle.

So, we had at the end of last year, either the most expensive or second most expensive equity market of all time, married to arguably the most expensive bond market of all time. I mean, that's a diabolical starting point. To be fair, such has been the collapse in fixed income returns, we have restored some value, but it's still going to be meagre pickings for some time. And that means that people that really for a long time could cheaply harvest beta, particularly if they levered that up, and that was quite a good living, they're going to struggle. The beta's not going to be as plentiful and deploying the leverage isn't going to be as attractive. Now, I'm sure some of the private equity people do have a track record of generating alpha. So that's why I don't want to put the kibosh on that part of the market, even though I am cynical enough to think that some of the way they generated value was pretty artificial. But I mean, the point is everybody needs to find alpha. But it is difficult. It's going to be a harder world because harvesting levered beta is far easier than finding genuine alpha but those days are behind us.

Tom Yeowart: Just going back a step to what you were saying in terms of the change in equity market leadership and also noting something you said earlier about how the leaders of this year are also very cyclical industries and probably won't fare too well during a recession. So I guess you've got this dynamic where potentially some of the companies that do well over the next decade may suffer a relatively severe draw down if we do have a recession. So, is there anywhere to hide?

Gerard Minack: Yeah, Tom, look there is absolutely a huge tension at the moment between my three quarter view and my three year view. Three year view, a lot of the equity stuff I like will go very badly on a three quarter view because as you rightly pointed out, they are cyclicals and if you have a down move, and we have spent, I mean, almost all this conversation focused on the US but my quick tour of the world for next year is a US recession, a European recession, a UK recession, Japan's a snafu, and China looks screwed. It's not a great cyclical outlook. But where do you hide? Well, the good thing is we are now starting to see opportunities in the one thing that's been really beaten up this year, which is safe sovereign bonds. I'm not saying we've hit the absolute yield peak. You might be able to finesse better entry levels. But if I'm right and we have a recession in the middle of next year, on a 12 month view, bonds will do very nicely. So imagine if you can pick up a 10 year US bond at 4.5%, in a recession it might go to 2.5%. Last time I looked, I think the duration's seven or eight years. So that would give a capital gain of 14-15%. You've picked up a 4% yield. So I'm going to round it up to a 20% total return.

I mean, it's the obvious thing to do. This gets back to a point that comes across in my client meetings, which is despite the fact that sentiment surveys are grim, despite the fact that we've had big drawdowns in equities, I think there's been unusually little fund flows, particularly at a very high level. People have got defensive and gone to cash. But you know, the typical move out of equities into bonds has been out of the frying pan into the fire trade in '22. So it's limited the movement. But next year, if bonds start to generate those sort of returns, then absolutely there's going to be high level asset allocation movement, I think, out of equities into fixed income. And that's ahead of us, I think.

Tom Yeowart: We haven't talked at all about credit markets. What are the risks of some sort of liquidity driven breakdown there?

Gerard Minack: I think they're real. I'm not saying that this will be a particularly nasty credit cycle in a fundamental sense and I don't think the non-financial sector is that levered, I mean it is levered, but it's not extraordinarily highly levered. I worry more about the operation of the credit market itself, and there's two things that concern me. The first is the lowering of credit ratings. The average rating on corporate bonds is now near all-time lows, which suggests that if you were to see even just a vanilla downgrade cycle, you would get an unusually large number of companies flipping from investment grade to junk. And of course, that causes mandate problems for a lot of investors that aren't allowed to own sub-investment grade.

The second thing is just the unprecedented inflows into credit the whole post-GFC cycle. We know why. Safe rates were driven down to zero. People perceive equities as risky. So you can see, once again I don't want to be too cynical, but mom and pop investor being offered a bond fund that is offering them high yield. All they hear is fixed income, high return, get me in. And of course, the result of that was $3 trillion of inflows into credit funds in the eight or nine years after the GFC. And not only did we see these unprecedented inflows, but a lot of that was via ETFs, which ostensibly offer daily liquidity. Now anybody who knows anything about credit markets knows that it's asymmetrical daily liquidity. If you want to buy, you can probably find someone who's going to sell. But it doesn't work the other way. So, I can see that this could be a very disrupted credit market if we get what I think you may see, which is a lot of fat arses heading for a thin exit. And so there could be some big price swings there.

Now the one thing I will say is, I think this cycle will see the normal sequencing in credit markets, which is to say you have a recession that gets you credit distress. The GFC was very unusual because it was the other way around. You got the credit distress that caused you the recession. But normally you've got to wait for the bad macro news to appear before you get the response from credit markets. To go back to one of our early discussion points, when people tell me that this is the most forecast recession of all time, my response is the recession is obvious everywhere except in financial markets. As I've already mentioned, the analysts haven't downgraded their numbers, credit spreads haven't blown out, default rates are quite well behaved and even volatility measures are relatively low considering the size of the losses. So, I keep on coming back to the point, I'm just not persuaded that much in financial markets have priced in a recession. And that includes credit markets.

Tom Yeowart: Turning to our closing question. What piece of advice would you give a young Gerrard Minack at the beginning of his career?

Gerard Minack: The funny thing is I would give him advice that I actually followed. Either I got lucky or I did have old head on young shoulders. But always do stuff you enjoy. Life's too short. And the funny thing about finance when I got into it in the eighties is, at least in Australia, it wasn't the sexy money making machine that it subsequently had the image of becoming. I didn't get into it for the money. I've never done anything for the money and I wouldn't because if you're doing something you don't like for the money, I spend more of my waking hours working than I do anything else. So, I enjoyed it back then. I still enjoy it now. So, my advice to a young Gerard would be, don't do it if you don't enjoy it. The good news is I've enjoyed it almost since day one.

Tom Yeowart: Great answer and thank you very much for your time.

Gerard Minack: You're welcome guys.