

Episode 37

FireSide LIVE: Midyear macro review

FireSide takes the stage! Chief U.S. Economist Lara Rhame and Investment Research Director Kara O'Halloran recap 2022 so far + what could lie ahead.

[00:00:05] Kara O'Halloran:

Welcome back. Welcome to the first ever live show of the FireSide podcast.

[00:00:11] Lara Rhame:

Yes!

[00:00:12] Kara O'Halloran:

We're doing it. We're doing it. My name is Kara O'Halloran I'm a director on the investment research team here at FS Investments. And I am sitting in a room with almost all of my colleagues. We are all gathered in Philadelphia for our midyear sales meetings, and we figured why not just do this thing live?

[00:00:29] Lara Rhame:

Yes.

[00:00:29] Kara O'Halloran:

I am joined. You just heard the voice of the one and only Lara Rhame. Who's joining me on stage, our chief U.S. economist. Lara, thanks for doing this.

[00:00:29] Lara Rhame:

It's so exciting.

[00:00:31] Kara O'Halloran:

I can't say that I had host-a-live-podcast on my career bingo card. Here we are. Um, this is going to work exactly like it usually does. We're just doing it with 150 or so of our closest colleagues. Um, and we've given them all pretzels and beer and they've agreed to not heckle us too much. Um, but it's, it's a really exciting time to be at FS. We just celebrated the firm's 15-year anniversary. We've spent a lot of time this week talking about where we've come as a firm and where we're going. Along that line, I really want to spend some time doing the same thing tonight, but markets edition. Sound good, Lara?

[00:01:13] Lara Rhame:

Let's do it.

[00:01:13] Kara O'Halloran:

All right. So 2022 has been a kind of a doozy. We're halfway through.

[00:01:17] Kara O'Halloran:

So I want to, I think daily, we're all just kind of heads down trying to make sense of this. Just unrelenting volatility that we're seeing. So I wanna...

[00:01:28] Lara Rhame:

it's been a ride, 2022, so far.

[00:01:29] Kara O'Halloran:

I really just, I wanna take a step back. We all need to take a deep breath. Um, at the most macro level I wanna talk about what's changed this year.

[00:01:37] Kara O'Halloran:

What hasn't, what we think is going to be center stage for the rest of the year and how to invest through all of it. The most important thing. Right? So kind of a tall order in our, uh, 15 minutes, but I think we can do it. We got this. All right. Let's dive in. inflation has been the topic of conversation for the last 12, 15 months.

[00:01:56] Kara O'Halloran:

I mean, we've talked about it on this podcast at our desks, at our dinner tables. It's I feel like it's literally all I've talked about for a year. I'm a really fun party guest right now.[00:02:05] and we've talked about. The fed and their hiking cycle to combat this decade's high inflation that we're facing, but it feels like the narrative is starting to shift a little bit right? Now we're starting to talk about, okay, what is the ultimate impact of these rising prices of this fed tightening cycle?

[00:02:22] Kara O'Halloran:

What is the impact going to be on our economic growth? The fed seems pretty convinced that they can engineer this softish landing markets seem pretty unconvinced. So I wanna start with the really big question of the moment, Lara. Sitting here June 14th, 2022. How concerned are you about a recession?

[00:02:41] Lara Rhame:

The R word, you just went straight there, didn't you? Yeah. All right. I think it's really important to not rush, to get too negative about the us economy. Uh, right now we have strong momentum and over the last. Two years, two and a half years, we have shown been a really a global leader in resilience.

[00:03:03] Lara Rhame:

Um, and we have an [00:03:05] unemployment rate of three and a half percent. So there's a lot going for growth right now. And in 2022, my GDP forecast is still two and a half to 3%. That is strong and is still, as strong as really that pre pandemic growth rate, where we saw our economy looking pretty healthy.

[00:03:23] Lara Rhame:

Now. We would be remiss. And I think all of us need to really just have our eyes wide open to the fact that as the fed raises rates and especially in an aggressive rate hike cycle, the historic pattern is they finish raising rates. And on average, a year later, we start a recession that is really pretty scary.

[00:03:46] Lara Rhame:

And the chances of a recession in 2024 have gone up significantly. You know, the fed talks about their hope of being able to engineer a soft landing, but hope is not a strategy, right? It should not be our strategy. And certainly I think when we're out there, um, [00:04:05] meeting with investors and all of our clients who help investors, um, this is the uncertainty that is just really, causing so much volatility for markets.

[00:04:18] Lara Rhame:

That is it. That is the shadow that is cast over markets over valuations. So for as solid as growth is right now and a recession is not in our forecast. and we do not have a three year forecast, Mike Kelly and Troy and I are smart enough to know that we don't have any particular insight into the economy that far down the road. But, that is really the shadow that is happening and it's not going to dissipate next quarter. It's not gonna dissipate. Even by the beginning of 2023,

we can expect to face economic uncertainty for some time given how aggressive the fed is being.

[00:04:55] Kara O'Halloran:

And. Speaking of that uncertainty and market reactions. Um, we do have to talk about inflation.

[00:05:01] Lara Rhame:

Yeah. It's just another area of uncertainty. We just got the may CPI print [00:05:05] last Friday. and it showed that inflation had accelerated once again, after we had all hoped that it had peaked, in April, and we saw really violent market reactions.

[00:05:13] Kara O'Halloran:

Stocks were down really sharply Friday and, and yesterday. Rates are up across the curve. I think the tens at the highest level, since 2011 now. Um, so we just got your thoughts on growth and we talk about how this is kind of a pendulum swinging between the conversation between growth and inflation.

[00:05:28] Kara O'Halloran:

So how does this environment of sustained elevated inflation, um, factor into all of this?

[00:05:34] Lara Rhame:

Well, inflation is at the epicenter of the economic uncertainty, the policy uncertainty, and this market volatility. And when I think about 2022, Madison Murphy. I dunno where she is. Madison was the, one who thought of this, phrase, but the 2022 outlook is really a peak without descent.

[00:05:55] Lara Rhame:

That's what we wrote about for our Q2 outlook. And, you know, we expect inflation to peak in the second quarter, core inflation may have already peaked, you know, we're talking about [00:06:05] year on year base effects, just that math. but. This does not mean we're going right back to 2%. That is so critical to understand my, 2022 inflation forecast is 5%.

[00:06:17] Lara Rhame:

Brian Cho is putting it around 6%. either way you are talking about high inflation, which erodes investments, erodes wage gains, erodes savings. You know, this is so critical. Inflation skipped a generation. Think about that, right? This is 25 years of low stably, low inflation. when we talk to investors that are 50, that are 60, they may remember inflation as kids or young adults, but they haven't invested through it.

[00:06:47] Lara Rhame:

And if they remember the economic inflation from the 1980s back then the tenure treasury was at 13%. So the investing reality is completely different. And when you frame it like that, I think this idea that, oh, [00:07:05] we've tweaked our portfolios around the edges to kind of manage through this transitory inflation.

[00:07:10] Lara Rhame:

You need to be really ripping it apart and rethinking how you're going to deal with inflation. That's probably going to, remain persistently high for the near future for the next several years.

[00:07:22] Kara O'Halloran:

Yeah. And I wanna get to the kind of longer term impacts and portfolio construction impacts, but I wanna talk really, really short term right now.

[00:07:30] Kara O'Halloran:

And this is a really macro driven environment. and we are all living day in and day out with all that really acute volatility. do you see any catalysts that can snap us out of this pervasive pessimism that we're seeing?

[00:07:42] Lara Rhame:

You know, there, there are certainly catalysts. but I think the problem is it's hard to see all of that. Resolving in the near future. I think, the top three on my list are, the fed, um, really hitting peak hawkishness and we have not seen that yet. Right. We've had markets now price in 75 basis points for tomorrow's [00:08:05] rate hike. They now expect a terminal fed funds rate of 4%. It, the, that pendulum keeps swing.

[00:08:11] Lara Rhame:

The second catalyst, I think is some, really positive news on the global growth front, uh, that would be China, really sort of finally really doing a major policy shift to increased growth. European growth continues to be revised lower. All of this is slowing, the global flywheel of growth.

[00:08:31] Lara Rhame:

And then finally some resolution for Russia. Um, the Ukraine conflict, which didn't, you know, it, it hit the energy commodity complex, but it's also hit the food commodities complex so badly. So, it would have to be some combination of those three things.

[00:08:47] Lara Rhame:

And the reality is that true resolution for any of those is highly unlikely this year. Scott Sullivan today, talked about how we may, you know, soon be kind of finding a market bottom. I think the question is you muddle along there for some time, what's the catalyst for us to [00:09:05] really move higher. And that could really, take quarters to resolve.

[00:09:09] Lara Rhame:

We we're gonna be in this volatility and uncertainty for some time

[00:09:12] Kara O'Halloran:

and I wanna pile onto that because, I think there's a sentiment out there. That's like, oh, the pain has already been felt, right. Equities are down 20%. They have to go up from here. Um, it's not too late to position portfolios because.

[00:09:24] Kara O'Halloran:

Those catalysts that you just mentioned, they're not happening tomorrow. Likely, you know, it's...

[00:09:28] Lara Rhame:

we've gotten head fakes...

[00:09:29] Kara O'Halloran:

we could be in a lot more pain...

[00:09:30] Lara Rhame:

...in fact that they're resolved and they're not, so.

[00:09:32] Kara O'Halloran:

Yeah, exactly. okay. So I do wanna talk longer term now. I think the phrase getting back to normal is one that everyone in this room has probably used ad nauseam for the last three years after the pandemic just completely upended all of our lives.

[00:09:45] Kara O'Halloran:

I mean, I was definitely just using it when I wanted to go out to dinner again. But, um, you know, I think it's, it's, it's one. None of the challenges that we're facing right now are normal though. And I think it's a little naive to, for all of us to think, oh, okay. Covies gonna just completely go away. The Fed's gonna hike interest rates a couple of times, and inflation's gonna go back to 2%.

[00:10:03] Kara O'Halloran:
and the world's gonna look exactly [00:10:05] like it did three years ago. I just, you know, I don't think any of us think that that's. Going to happen. So I think we're all kind of figuring out what our new normal looks like. Um, and so Lara, you know, when it comes to the economy, what do you think our new normal looks like?

[00:10:20] Lara Rhame:
Yeah, this is, I, I think what you touched on to me is just really at the core. Of my longer term outlook. I am a huge believer that we have ended a multi decade phase of low macro volatility, longer, slower growth cycles. And really what we saw is a golden era of traditional asset performance and you know, this morning, it was interesting cuz we heard from Ryan Caldwell at Chiron talk about the fact that China entering the WTO was a transformative event in investing. And I would agree with that because right now [00:11:05] the shift that we've seen away from globalization, the explosion of inflation, all of that has really brought this great moderation to an end. we just published a paper on this.

[00:11:16] Lara Rhame:
With Andrew Korz and with Brian Cho, and you know, don't take my word for it. Ask the astrophysicist, you know, that's what I like to fall back on so that would be Brian Cho of our trio,

[00:11:28] Kara O'Halloran:
Not Andrew Korz?

[00:11:28] Lara Rhame:
Not Andrew Korz, but you know, it's hard to tell the difference when you talk to the both of them. um, and you know, the implications of this.

[00:11:37] Lara Rhame:
We feel it right now in the business cycle. Right. It feels like someone still has their finger on the fast forward button, on the VCR, because we had the sharpest and the shortest recovery in the, from the bear market to, recovery in 2020. Right. We had, uh, the shortest and deepest recession that we've ever experienced.

[00:11:55] Lara Rhame:
We are talking about an aggressive fed rate hike cycle only two years into the expansion and if you think about a potentially higher [00:12:05] probability of a recession in 2024, that would give us a four year expansion. That's the shortest since the 1970s. So that's it. This is what we're experiencing. And here's the connection to investments, right?

[00:12:17] Lara Rhame:
When do we get assets selling off together? When does diversification break down? It's when we get these big macro inflection points and if we're used to them happening only every 11 years. You dive into the mini cycle versus the macro cycle. But if the cycle is actually fluctuating that fast, like it did in the fifties, sixties, seventies, you're faced with this incredible correlation and this breakdown, we need to completely reconceptualize diversification in our portfolios. Like I don't mean to sound like I'm calling for some apocalyptic new era, right. I don't wanna get that extreme, but it's important to appreciate that this shift away from globalization is a decades long [00:13:05] process, just like China entering the WTO, created decades of a certain investment environment, the removal and walking, all of that back has an equivalent, aftershock. And that's what we continue to feel. It's it is a new, it is a, it is ripping up the old playbook.

[00:13:22] Kara O'Halloran:
Yeah. And you teed me right up there, Lara.

[00:13:24] Kara O'Halloran:

So there's a reason that we published a new research series this year literally called our playbook. So we've put...

[00:13:30] Lara Rhame:

Your brainchild by the way.

[00:13:31] Kara O'Halloran:

Yeah.

[00:13:31] Lara Rhame:

Inspired by.

[00:13:32] Kara O'Halloran:

Because exactly what you said, we really think that the old playbook needs to be completely thrown out or at least really revisited, right.

[00:13:38] Kara O'Halloran:

These fundamental relationships that we've built our portfolios on that worked really well for a lot of years. Are no longer working.

[00:13:44] Lara Rhame:

Yeah. We did the inflation playbook. We did the fed rate hike cycle playbook. Yeah. And you thought of the title for the one that's coming out in...

[00:13:50] Kara O'Halloran:

what to do, and it feels like your whole portfolio is correlated, which is, what it feels like right now.

[00:13:55] Kara O'Halloran:

Um, but yeah, these relationships are breaking down. Uh, if we think about on the equity side, it was really easy to buy us tech and by extension us indexes for the last [00:14:05] 15 years. And they worked really, really well. And. You talked like we still have strong nominal growth out there. We still have companies that can grow earnings, generate free cash flow.

[00:14:13] Kara O'Halloran:

It's just accessing them. You have to get really active. I think everyone in this room knows how, challenged the fixed income side is for those listening. We have talked, we've had three straight days of meetings, basically talking about how to solve the challenges, in fixed income. Um, but the relationship between the two, our research has shown us that with inflation higher than 2% stocks and bonds move together.

[00:14:34] Kara O'Halloran:

We just heard you talk about Lara, you don't see inflation going back to 2%...

[00:14:37] Lara Rhame:

that was the world...

[00:14:38] Kara O'Halloran:

...any time soon.

[00:14:39] Lara Rhame:

...had in the eighties and the nineties.

[00:14:40] Kara O'Halloran:

Exactly.

[00:14:40] Lara Rhame:

That what we have, that's the generation.

[00:14:43] Kara O'Halloran:
Yeah.

[00:14:43] Lara Rhame:
That's the generational difference in diversification?

[00:14:45] Kara O'Halloran:
Exactly. I mean, these are the sources of diversification that we relied on for the last 20 years.

[00:14:49] Kara O'Halloran:
So we really need those alternative sources. I mean, the list could go on and on, but if I think about the, the investing implication, it's that, the great moderation made a lot of us look like really good investors and really good allocators by buying indexes.

[00:15:02] Kara O'Halloran:
and so I think it's, we really just, there's going to [00:15:05] be more volatility more frequently. We just need to, to really reconsider our portfolios. But the good news is that the toolkit has expanded right. There are those products out there that can address these challenges that we're facing now and the ones that we think we will be facing in the future.

[00:15:20] Kara O'Halloran:
Um, and because he's not here to say it, I will have to say it the time for alts is now . Um, but I think. I think that's enough serious stuff. Um, feel good about that, Lara? Oh

[00:15:32] Lara Rhame:
yeah. I think we, I think we got it in under 15 minutes.

[00:15:35] Kara O'Halloran:
I think we we're. We, we did. Yea, alright, Lara thank you so much as always for joining us and going through all that.