Episode 79

FireSide: 5 Challenges and 5 Opportunities

We identify the five key challenges facing investors in 2024 and the five opportunities that may provide income, growth and diversification.

Lara Rhame (00:04):

Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist here. And today, Andrew Korz and I are eager to talk about a piece we wrote to kick off the year, our 2024 Market Outlook. It's a chartbook that looks at five challenges and five opportunities in markets.

Andrew Korz (00:35):

Hey, it's great to be here, Lara.

Lara Rhame (00:37):

Let's jump in because this is one where I'm not interviewing you and you're not interviewing me—we wrote it together. So, let's take a step back. Why did we write this?

Andrew Korz (00:47):

That's a good question. Why do we write anything? No, I think there's two reasons. I think number one, it's a new year and people put out new outlooks in a new year. There's nothing particularly different between December 29 and January 3, but I think it does give us an opportunity to reset, rethink where we are, look at markets and reassess.

Lara Rhame (01:08):

And let's think where we were this time last year. Pervasive concerns of recession were dominant in January 2023, right, a year ago. And we're recording this on February 2 (though it still feels like January to me—I'm still getting my head in the game).

So, a year ago, I think we had this world where the Fed had raised rates significantly.

All we heard from a lot of our advisors and investors was, "I can get 5% in cash. Given that there's all this concern about the economy that makes all the sense in the world." That was the most that cash was yielding for two decades, right? After 15 years of cash yielding virtually zero. And I think that was such a good—made a lot of sense when to sit on the sidelines.

But by the end of the year, what did we see? That with the economy solid and the growth outlook very positive there's a huge opportunity to sitting on the sidelines and, you know, we have a lot of cash on the sidelines today. That's where we start the year. This opportunity set has really changed from where it was a year ago.

Andrew Korz (02:20):

And I think if we zoom out even further, I think the other reason to sort of write this was just an acknowledgement that this isn't a bad thing. There are certainly challenges in the market, but you look around and there are just so many more things to do today than there were call it four or five, six years ago. Most of the 2010s really. And I think that's the exciting thing is that despite some of these challenges that we're going to go through in terms of portfolio construction, there are lots of areas of the market that are just much more interesting today than they were five years ago.

Lara Rhame (02:53):

I love the way you're saying that because I feel like we say challenges and it makes it sound really negative. The reality is a lot of our challenges, and we have five to go through this, things are looking kind of expensive or very expensive. That's not in and of itself a negative thing. They may be expensive for a reason, but how do you enter a market, deploy cash, bring cash off the sidelines? And that I think is how I frame challenges in my mind. Not necessarily it's negative. And I love you saying that opportunities based on the fact that there has been a really seismic shift in markets and in opportunities.

Andrew Korz (03:27):

Well, I mean rates at five and a half on the short end, the number of opportunities that has catalyzed throughout fixed income and even other parts of the market has been enormous.

Lara Rhame (03:37):

Yeah. Alright, we're going to dive in here. Let challenge number one, equities are expensive. Why is that a problem? They've been expensive. We started out last year saying they're expensive.

Andrew Korz (03:46):

Why is that a problem? Yeah. Why is it a problem that every meal I go to costs over a hundred dollars now, right? Yeah. It raises the bar for how good that meal has to be for me to feel justified in spending that money, right?

Lara Rhame (03:58):

I'm just looking for an invitation to the meals.

Andrew Korz (04:02):

Maybe you can pay for it next time, but no, but to set the stage, the s and p 500 sitting here today, it's got a 20 handle in terms of the four P ratio that is remarkably high from a historical standpoint, easily in the top decile of history. And of course a lot of what's gone on a

Lara Rhame (04:19):

Long history,

Andrew Korz (04:20):

A long history, and of course a lot of what's gone on is the magnificent seven and the remarkable run they've had, their PE ratio as a group is getting somewhere around 30. But even you look at the rest of the market, excluding those seven companies, it's still 18.2 times forward earnings,

Lara Rhame (04:36):

Not a screaming buy.

Andrew Korz (04:37):

I mean that's still the top quintile of history. And as we show in our chart book that has historically pretended pretty bad forward returns. I shouldn't say bad, modest forward

Lara Rhame (04:46):

Returns. It's not that it can't go up from here, it's just that forward returns are underwhelming. Yeah.

Andrew Korz (04:51):

Have I ever had an expensive dinner that I've been pleased with? Yes, stocks can go up from here still, but the bar is just much higher. So you think about where the market's gone. You've had the AI narrative, you've had the tech cost cuts, you've had even ozempic and what that's done to some of the healthcare companies. You have rates coming down to Q4. So many good things have happened that as we sit here today, again, could stocks go up this year? Yes, they could. But if we're thinking about portfolio construction over a multi-year horizon, I consider the expensiveness of stocks to be probably the biggest challenge going forward.

Lara Rhame (05:26):

And so I'm just going to push you right into the opportunity. Where do you find value? What I keep hearing, and I think that'll be a recurring theme, but where's the value?

Andrew Korz (05:36):

And if you're just kind of thinking about the pure growth side of your portfolio, stocks are expensive sort of everywhere. But if you take it into the private equity space, there's kind of a unique opportunity here where you had massive private equity fundraising in 21 and 22 m and a activity was gangbusters. The second half of 22 as the fed raised activity fell off a cliff. Investors weren't getting nearly the cash distributions they were expecting from their private equity vehicles. What does that mean? A lot of 'em were over allocated and had to ultimately sell some of their shares into the market to gain liquidity. That really in turn gives secondary investors a chance to come in, buy assets at discounts. The second thing that we look at, if we look outside sort of the pure equity part of the market is the yields you can get in the fixed income market and parts of credit, private credit, public credit are eight to 12%. What's the average historical return on stocks? It's 10% again.

Lara Rhame (06:28):

And how high after decades where yields were really suppressed for a variety of reasons that we're not going to go in on this podcast.

Andrew Korz (06:40):

Remember the Tina mantra? There is no alternative. There is certainly an alternative today and you can get equity like returns the market. There's your opportunity.

Lara Rhame (06:48):

Love it. Yeah. Let's talk about another challenge. And this one may take a little more of an introduction because I want to talk about the fact that the correlation between traditional stocks and bonds is now at multi-decade highs. And what this means, because this doesn't just impact traditional investing, we've all gotten used to this comfortable portfolio behavior that is coming from sort of two places. One, when equities rise, fixed income falls. And then I think the other one that is less well appreciated, it's the fact that bonds have been very low volatility and that's a feature of quantitative easing zero interest rates, a lot of other factors, low volatility in inflation that has just erupted spectacularly into higher bond volatility and this positive correlation. And I think diversification, I often refer to it as the unsexy part of sort of investing. We don't think about it naturally.

(07:55):

Part of that is because we've grown complacent in this well diversified behavior. And I think the second is because we all missed because the returns were higher last year, we kind of missed the fact that bond volatility is now so much higher than it has been for decades. I think this to me is a challenge that takes a little bit of explanation. I think it is very real. And I think if we get a year where returns more broadly are maybe not so spectacular as they were last year are going to really surface. And I think the solution that you and I both talked about, we pulled directly from the multi-strategy chart book that our team co-authored with Beth Ann Byrne at the end of last year. But I think it's important to understand why this is so critical. What's the opportunity?

Andrew Korz (08:49):

Yeah. So to your point, I think those were the two pillars of portfolio construction over the past two decades where the low volatility of bonds and the negative correlation between stocks and bonds and what you didn't really need much from your bond portfolio because stocks were going up 12 to 15% a year. If rv, it was the ballast. If our view is that that's not going to be the case going forward, you might need more out of the non-stock party of your portfolio and it's gotten a lot more volatile. The correlation between stocks and bonds is above 0.7 over the past two years. That's incredible. That is remarkable. And they're both sort of exposed to the same risk, which is rates and the Fed, the fed having to balance both sides of their mandate. So one opportunity that we do see that you kind of tease there, number one, you can just go shorter duration, you can find assets that are floating rate.

(09:32):

That's certainly one way you could go. But again, I think the operative point on the correlation side is that this environment is showing us, again, stocks and bonds are heavily exposed to some of the same risk from the Fed from rates. And what does that tell us? There are opportunities to go outside and get exposure to different elements of risk, whether it's in commodities, whether it's in currencies, whether it's in rates abroad, there's lots of other risks that you can get exposure to that you may not want to have naked exposure to those risks, which is why we think the right wrapper for this type of diversification is some sort of multi-strategy approach where you take all these different areas that look attractive and have risk premia and you bundle them together. And what you get if you do it right is that you get basically a situation where you can minimize volatility through diversification within that multi-strategy sort of wrapper. It is the old adage that returns some and risks don't. Right? So we think you need to look outside of stocks and bonds to get that diversification because frankly again, they're exposed to the same risks in a way we haven't seen in a long time.

Lara Rhame (10:43):

Yeah, I think that's really critical that you can find the ballast elsewhere. You can replace what fixed income used to offer your portfolio through multi-strategy solutions. Absolutely. Okay. I want to dive into one of my favorite challenges. And I love the way that we wrote this up, which was like, what's the challenge? The credit spreads aren't wide. I think you know me, I'm not supposed to have a favorite child, but high yield and the credit market is really one of my favorite places in the market to look for return. It has been for decades. But I think something that we have seen, and it's a conversation that I have all the time, is that it doesn't, again, it's this theme. It doesn't seem to be a screaming by credit spreads aren't wide right now. And I think we have gotten used to this boom bust in credit where you wait for a credit cycle to happen.

(11:44):

You wait for spreads to blow out, you rush in and you just harvest this beautiful recovery and yield that gives you these outsized returns. But I think that thinking and waiting for that has really caused an unforced error in 2023, high yield return, 13.5% last year. That really is an incredible return. And looking forward now, the outlook for my outlook for the economy is slower than last year, but not to your point pessimistic. If we see growth of one and a half to 2% in 2024, that is absolutely a solid pace of economic growth. That's

Andrew Korz (12:26):

Fine for credit.

Lara Rhame (12:28):

Absolutely. And I think there's been some attention default rates have picked up. Again, it's this idea that they were really suppressed during the pandemic by so much of the monetary policy response to that event. They're really just within historic norms and a lot of the metrics that we track on corporate health look fine right now. And so to me, when I look ahead and I think about this idea like, oh, we have to wait for credit spreads. That really only works when core interest rates, benchmark rates are zero and that spread only reflects credit in this higher return world, there is a huge opportunity in credit.

Andrew Korz (13:13):

People are just so not used to the starting yield being an acceptable level of return for an asset, right? You think about the 2010s, the majority of credit yields were made up by spread. So what happened to spreads dictated what happened to the asset class, right? Today rates are not just not zero, they're pretty high. So you have this starting yield in a lot of these asset classes that is really attractive. And if we go through 2024 and high yield spreads and leverage loan spreads just kind of meander along, you're going to get yourself close to a 10% return. And that is, I think a lot of people would certainly accept that given again what we're expecting in the stock

Lara Rhame (13:55):

Market. And you compare that to cash, I think again, this happened last year. 5% felt like all the return on the world. We were used to a world of zero. But remember inflation's at 4%. It hasn't come down yet. And we can debate the expectations there, but nominal yields really matter. And when you're dealing with inflation that is still a little higher, maybe uncomfortably higher, you need to really harvest as much yield as you can. And in a world where we really have a pretty solid economic forecast, credit's going to do great.

Andrew Korz (14:31):

And to your last point on cash, that's

Lara Rhame (14:33):

Not a guarantee. Hopefully it'll do great. I think given the fundamentals where they are today

Andrew Korz (14:39):

May have the opportunity

Lara Rhame (14:40):

To do great. Yes.

Andrew Korz (14:42):

No, I think to your point on cash, and we have a chart in this chart book that shows if you just take the market's forecast of the fed, which we do have a bit of uncertainty around, and you take the consensus around inflation, real returns on cash have probably peaked. There's very little upside to real returns on cash going forward. So look, if you're okay with one to 2% real returns on cash, great. But if you're the vast majority of investors who can't accept that type of real return, there's a ton of opportunity in other parts of the market that are built on top of that elevated starting yield.

Lara Rhame (15:17):

Yeah. Alright. I want to talk about one of the other challenges that doesn't necessarily feel like a challenge on the surface. And that is the fact that US growth continues to really outshine the rest of the developed world and the fact that US valuations are so much higher than the rest of the world. And I'll say that we're coming off of now several years where this has been the starting point in January and I've seen a lot of allocators say, oh, well let's just buy Europe or China is cheap, let's look outside of the US because the valuation differential is so significant. And I think you've always I given good counsel, which is just because cheap isn't a catalyst to buy it. And I think that is something that we've spent a lot of time talking about. There will be a time to look globally for better returns, but I think today you may very well be in a situation where the US remains the best place to harvest growth.

(16:29):

And before, I think, because I'm eager to hear your thoughts vis-a-vis these big global tech companies. But I had another question that I get a lot is, Lara, our global geopolitical concerns being priced into markets today. My answer would be no. That if you are concerned about geopolitics looking to the us, there's a reason why it continues to feel like a safe haven. Energy independence, food independence. And I'm going to cue you up, Andrew, to give some color on when publicly traded stocks are so expensive, how do you drill deeper into the US economy to harvest other growth? And is there growth there to be gained?

Andrew Korz (17:18):

Yeah, I mean you certainly tell me that there's growth there to be gained given our expectation for the economy this year. Look, I think you look at the magnificent seven, I think we've all been worn out to the point where nobody's going to call for them to B off a cliff imminently.

Lara Rhame (17:32):

No, they're good companies.

Andrew Korz (17:33):

These are incredible companies. Now to your point on geopolitics, these are the stocks that are heavily exposed to those types of risks. You think about Apple and their issues that they're having in China. You think about Nvidia and the fact that all their chips are made in TSMC in Taiwan.

Lara Rhame (17:49):

I think that's a good point. The US equity market, arguably the s and p 500 is a global index to some

Andrew Korz (17:55):

Degree. And I think that's the key point is that the US economy is incredibly closed relative to the rest of the world. The US market is not. So when we're thinking about that dichotomy, it's like how do you navigate that? And I think the answer is the US middle market is if you just kind of take a proxy like US small cap stocks, more than 80% of the revenue comes from the us. Look at the s and p 500. It's less than 60% comes from the us. Yeah. So you think about smaller mid-size US companies, a lot of which are private. And how do you access that? There's the ability to, as I mentioned earlier, the private equity space. We see a lot of opportunity, especially in the secondaries private credit, whether it's on the commercial real estate side, whether it's on the corporate side, you can get really attractive yields there. And most importantly, the fundamentals of those companies are rock solid for the most part given their exposure to just the US domestic economy.

Lara Rhame (18:52):

Awesome. Alright. Well what I'm hearing is while the title is five challenges, there's a lot of opportunity. This isn't a pessimistic. And I think after coming off of a year where there were just overshadowing clouds of concern, I think today I want to be cautious about being too rosy. The year is going to bring a lot of unexpected outcomes, prepare for the unexpected, but it's not a pessimistic outlook. And there is so much opportunity out there. The exciting thing is this opportunity we haven't had in decades, maybe new markets that we really haven't, like private equity secondaries, like this rich middle market lending opportunity that we haven't seen in a long time.

Andrew Korz (19:39):

No, I totally agree. And it is fun for people in research and people who are allocating because before it's like I hope stocks go up. I don't really have any other options. And now there's so much out there to look at and weigh and talk about risk return and it's a lot, it's more fun world to analyze and I think it's a better world for investors ultimately.

Lara Rhame (19:58):

Alright, what do you say? We refresh this piece over the summer and come back and do this again?

Andrew Korz (20:01):

Let's do it. And I vow that if we are right about everything, we'll talk about how right we were. And if we're not, we'll just kind of gss over it.

Lara Rhame (20:09):

I don't know. I like to do scorecard and keep track, but

Andrew Korz (20:12):

You're the honest one here. All

Lara Rhame (20:14):

Right. Thanks, Andrew. All right, thanks. This was great.

Lara Rhame (Credits) (20:18):

This episode is recorded at the FS Investments headquarters in Philadelphia's historic Navy art. It was produced by the investment research team. It was edited and engineered by Erin Sherman. Special thanks to show coordinator Ellie Zang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.