Navigating Uncertain Waters: Preparing for a Post-Pandemic World

Manager Webinar with Canterbury Consulting and Franklin Templeton

On June 30, 2020, Dr. Michael Hasenstab, Chief Investment Officer, Templeton Global Macro, provided his view on what to expect post-crisis. Considering the potential paths ahead, he sees a gradual reopening and recovery as the most likely scenario, but it won't come without its economic challenges.

During the call, we addressed key risks the world will face once we emerge from the downturn, extraordinary policy responses from central banks and governments around the globe, challenges with massive increases in debt-to-GDP ratios and deepening fiscal deficits, global challenges pre-crisis that may add complexity to the economic recovery, and investment implications in this altered macroeconomic landscape. The following notes summarize the comments made by Dr. Hasenstab and do not necessarily reflect the views of Canterbury Consulting.

Challenges in the Current Landscape

- The current economic and political landscape poses challenges to portfolio construction, and the low interest rate environment only adds to those challenges.
- Optimism towards re-opening the economy during summer was high, but that attitude now seems to be faltering as the number of virus cases have risen.
- There is reason for concern as solvency issues are likely to rise going into the fall and winter seasons.
  - The Fed is able to support the financial markets by providing liquidity, but it won't be able to prevent insolvency.
- The team believes the base case unemployment rate will hover around 15% and will remain sticky.
  - High unemployment is likely to lead to a high savings rate, which will create further demand destruction in the current economic landscape.
  - As the economy is built on consumer consumption, having a high unemployment and savings rate is likely to create solvency issues later this year.
- Political division across the U.S. and in other parts of the world is increasing and is stemming from growing income inequality, racial equality, and urban/rural gaps.
- Political policies are only going to be more extreme due to the looming presidential election, which will make it more difficult to solve social and economic issues.
- In the current environment, the federal government believes printing unlimited money to fund large stimulus packages and support financial markets is the solution, but historically, this has not led to great outcomes.
- The U.S. and China had a good relationship for over 40 years. That has not been the case over the last 5-7 years.
  - Friction between the U.S. and China is only the "tip of the iceberg."

Navigating Uncertain Waters

- Due to political polarization, fractured country relationships, and solvency issues, the team is taking a defensive positioning, which they consider as Phase 1.
- The team is focusing more on currencies as the primary tool to provide alpha given the low interest rate environment.
    - Currencies provide additional diversification benefits and have the ability to provide returns that are differentiated versus interest rate instruments.
- The current portfolio is meant to be one building block of differentiated return streams in a larger diversified fixed income portfolio.
- In order to play offense, you need to play defense. Templeton will implement Phase 2 of their plan once the global economy enters into a recovery.
- The team's current playbook is similar to that of the Great Financial Crisis (GFC).
- The portfolio is positioned to be more liquid in order to take advantage of dislocations that may arise in the future.

What characteristics are being assessed when determining a 3–5 year recovery outlook within a specific country?

- Political cohesion, social issues, and other ESG risks are key characteristics the team takes into account when analyzing a country.
- The team also takes into account fiscal prudence of a country and monitors the behavior of its central bank to make sure monetary policy measures are appropriate for the region.
- The amount of external debt is another measure the team considers, as currency depreciation can create solvency issues for a country if its debts are primarily denominated in external currency.

What is the end game for modern monetary policy (MMT)?

- MMT was not popularly accepted toward the beginning of the year, but the pandemic has now made MMT the center of attention.
- Demand destruction due to shutting down the economy has been very large, making inflation risk low in the near term but poses a significant threat in the coming years if MMT continues at its current pace.
- Exposure to low interest rate securities is a large risk given the lack of yield and the sensitivity to potential inflation and future monetary easing.

What are the team’s thoughts on global central banks creating a moral hazard in the markets?

- The central banks' policy responses were great and it fixed the problem well, but the problem is that they fixed it too well.
- There are many investors that believe they can take on risk because they know the central bank can bail them out.
- The moral hazard problem is the reason the team isn't purchasing much in credit sectors.

What are your general opinions on fiscal policy responses?

- It was necessary to spend large amounts of money due to the unprecedented economic hardships.
- Fiscal policy response didn't stimulate demand and didn't provide jobs.
- Fiscal policy only provided a short term life line and will present problems once it expires.
- New rounds of fiscal policy will likely be more politicized than the first round.

To what extent is the U.S. following in Japan's footsteps?

- Japan has never embarked on money printing and never implemented helicopter money.
- Japan's central bank is generally conservative and has negative sentiment towards printing money.
- It's not very meaningful to compare the U.S. and Japan together due to demographic differences and different approaches to central bank policy.
- Japan and the U.S. are on opposite sides of the spectrum while the European Union is somewhere in the middle in terms of comparability.
- The biggest difference between the U.S. and Japan is that Japan has a large current account surplus.
- Printing money might actually help Japan defeat the deflation problem they are having.

What are the investment implications from the upcoming presidential election?

- Economic policies are becoming more extreme and there seems to be no thought between right and wrong.
- The ability to compromise and come to solutions between the liberal and conservative parties is very low.
- The inability to compromise will only lead to financial risks that are not yet priced in the market.

How do you rationalize between the real economy and the financial markets?

- The massive liquidity injection has caused the real economy and the financial markets to split from each other.
- There will be a harsh "snap back" of the real economy and the financial markets, which is a large risk investors need to think about.
- The market can be on its own path for a while, but when it starts reflecting the macro fundamentals, there will be a significant correction.

Has the pain of the shutdown been enough for policy makers to re-open the economy?

- The economic shutdown created mental and physical hardships for people that were not originally accounted for.
- Policy makers debate back and forth when it comes to agreeing on another shutdown, which creates more uncertainties and more risks.

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Michael Hasenstab, Ph.D., is executive vice president and chief investment officer for Templeton Global Macro, which conducts in-depth global macroeconomic analysis covering thematic topics, regional and country analysis, and interest rate, currency and sovereign credit market outlooks. Templeton Global Macro offers global, unconstrained investment strategies through a variety of investment vehicles ranging from retail mutual funds to unregistered, privately offered hedge funds. Dr. Hasenstab is a portfolio manager for a number of funds, including Templeton Global Bond Fund and Templeton Global Total Return Fund.

About Canterbury

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