Five Questions

Episode Nine | Reflections on Market Turmoil

Pete: Hi, my name is Pete Mann, and I'm the President and CEO of Grayhawk Wealth. Welcome to the second season of our podcast, Five Questions, which will see one partner at Grayhawk paired up with another to touch upon relevant topics as they relate to the economy, investments and generally what's going on in the world as we see it. And sometimes we'll invite special guests to join us so you can also hear their views. With me today is Greg Gipson, Grayhawk's Chief Investment Officer. Who's responsible for shaping our investment philosophy and portfolio strategy. Hey, Greg, how are you doing?

Greg: All right, Pete, it's mid-June. Kids are going to be out of class soon and markets are not behaving nicely

Pete: No, they sure are not. And, you know, I think having both been in this industry, for an excess of 25 years, we've seen a lot of cycles and we've seen a lot of environments that have really brought to bear how people need to be more rational during periods of uncertainty. But I thought maybe one of the things we could do as it is our last podcast of season two is we could talk a little bit about what we would call the five biggies. What are the five most important issues that the world is facing today? And maybe we can sort of break down the most important ones and just have a great conversation about it. But I know you and I have spoken about this before. We would see the five biggest issues in the market today is obviously inflation. It has quickly gotten out of hand. There's a grave concern as to how it can be managed because it's been so long since it's been present in the world and in markets. Obviously, the war and what that's doing to disintermediate the transportation of goods, the flow of services, the needs for food. Obviously, trade barriers for the better part of 50 years. We had declining trade barriers globally that were very, very positive to an economic cycle that became quite virtuous and long lasting. Today, those barriers are reemerging; obviously, interest rates being correlated to all of these things. For the first time in some period of time, we see a material rise in interest rates which have caused a very, very dramatic change in the borrowing capacity and ability for both individuals and businesses. And then maybe the most challenging thing because this is something that the world hasn't seen, is something called quantitative tightening and quantitative tightening is effectively the extraction of liquidity by central banks globally at the same time that markets are also going down and typically it is the inverse of that when people are concerned, when markets get worried. Central banks have a tendency to deploy liquidity into the system. So those are the five biggies. Why don't we start at the top of the house and take me through, you know, how we're thinking about things right now?

Greg: Well, I believe that since this is our final episode, of season two, I may pepper through a few quotes as we move forward. So maybe we'll start with the first one that everyone has heard, which is history does not repeat itself, but it often rhymes. And so, when I think about the five points that you outlined, I really look at you know, what are the common themes that are going on currently versus historically? And then how are they different from a thematic perspective? You know, there's really four main points of commonality. First, there are pockets of conflict around the world. There are always pockets of conflict throughout time. Number two, the interconnectedness around the world, both from a geopolitical perspective, but also an economic perspective. The third one is the jockeying of global superpower to ensure that they stay relevant in the global context. And for maybe my favorite, don't fight the Fed. The differences that we see perhaps relative to history are, one, these pockets of conflict around the world are now expanding geographically, impacting more countries and perhaps more importantly, impacting developed markets and global superpowers. As you pointed out, another difference, one that perhaps very few in financial services have experienced is that rapid rise in interest rates, that rapid rise of the cost of borrowing. So, in a in a historical context, just you know, if you look back to the great financial crisis in 2008, you know, the U.S. ten-year yield fell to 2% and then doubled to about 4%. In context, what we've seen is the ten-year U.S. yield has increased almost seven-fold from the depths of COVID and has increased over two times this year alone.

Pete: Yeah, it's incredible.

Greg: And the third point that maybe covers a few of the issues you outlined would be the uptick in nationalism or isolationism and really a slowing down of the globalization theme that we've seen over the past century.

Pete: Well, that's really helpful, Greg, and it certainly sets the framework that we were talking about. If I were to come back to you and say of those five biggies, how would you prioritize the concerns and maybe talk a little bit about the interconnectivity associated with them.

Greg: As we spoke in one of our prior podcasts about supply and demand. You know, we're really in this environment of continued demand and decreased supply. The causes of those phenomenon are what we outlined, global conflicts increasingly impacting the cost of people's everyday lives, how they get around, how they feed their family. Trade barriers breaking down of global supply chains again impacting supply. Quantitative tightening, decreasing supply, and so we're in this environment where it seems very complex, but it's almost very simple. There's an imbalance of supply and demand that has led to an increase in pricing, hence inflation. You have the Fed and central banks around the world raising interest rates. Quantitative tightening, so to speak. All of those are designed to reduce demand. The real challenge that the global economy faces is on the supply side and fixing that supply side, reducing trade barriers, improving global supply chains, increasing food, productive All of those take a much longer time. And so central banks are focused more as they should, as their focus is on curtailing demand, because that is the short-term fix. But the world has a long-term problem on the supply side.

Pete: So, in many ways, as we talked about earlier, the correlative effect associated with all of these issues are creating this notion of a vicious cycle rather than a virtuous one. As all these things change, one can feed on the other, which feeds on the other, which feeds on the other. And oftentimes, obviously, for investors that can feel almost insurmountable. But of course, we know that isn't the case. I mean, one of my favorite anecdotes that I love to share with people is that between 1966 and 1981 the Dow went up one point. Now there were lots of times when it was up 20 and there were lots of times that it was down 20. But over that 15-year period, the Dow went up at exactly one point and Warren Buffett compounded it north of 30% a year. So really with that as a backdrop, there are opportunities. So why don't we talk a little bit about where we are sourcing, where we are finding opportunities around the world. Because that really goes to the heart of how you manage these cycles. This is a materially different circumstance than most in this industry have ever seen. And so why don't we dig in a little bit on some of the things that that we're optimistic about in terms of capital deployment?

Greg: It's interesting. I think as a first principle, you always want to separate the signal from the noise or the froth from the undercurrent and optimism is often a relative sensation. So, one may be happy to find the loonie on the ground, they are likely more happy to find $100 bill on the ground. And in that context, we're always looking for unique opportunities that arise during periods of stress in capital markets. But when we do so, we always want to be prudent So here's a great quote for you walk before you run. But when you run, run like you don't want to be the slowest person in a race against a bear. So, I think when you think of opportunities in the market, when we look over the past couple of years, you know, there's been a lot of different anecdotes and stories about growth versus value. But when you look at really what has worked over the long term, and why we believe any investor should believe in capital markets is that growth and innovation are a long-term trend.

In the short term, though, there can be periods of dislocation. And really what we've seen in the past two years coming out of COVID, it was what everybody talked about. We like our acronyms, WFH, work from home, that area of the market, it was speculative growth and that those companies did extraordinarily well in 2020, even into 2021 what we saw in late 2021 was the so-called reopening trade. And so that reopening trade really focused on areas of the market that people would refer to, such as quality and value. In the first quarter of 2022 I would call it by which you need right staples, defensives, energy, food which is classically defined as value. What we've seen over the last few months is that value or buy what you need is continued to do well on a relative basis and aspects of growth perhaps more profitable growth or quality has continued to do well over the past few months. As far as specific opportunities you know, it's, it's interesting. There's always opportunities. There's always separating the wheat from the chaff. Commodities are certainly one that is of interest and perhaps the area of commodities that is particularly compelling is in food. And I've spoken about this before, speak about that a lot with clients. And food is the biggest challenge that I think the world faces in the commodity perspective.

So, you have global climate change impacting crop cycles. You have conflict in Ukraine invasion of Ukraine, which has curtailed the breadbasket. And that is a challenge for families, a challenge for individuals, because as I've said before, you can perhaps choose not to drive your car, but it's much more challenging to choose how you feed your family in the broad commodity space, we still believe that food inflation will persist. We think in areas like energy and metals, they'll be continued support in price but there is some impact from the expectations of global growth and in particular the reopening of economies and maybe the one that stands out the most is how China will reopen from their zero Covid policy. Other areas that are interesting, I know Pete, you had mentioned the other day biotech. So, I think biotech, any area of the market that is looking to improve the health of the individual has a long-term runway. And biotech specifically has been quite volatile of late, and it's really been trading more in that speculative growth range. So, if you look at a broad-based biotech index right now, it's you know, it's effectively trading where it was seven years ago. And so, this, I think, is actually an interesting opportunity. I think it's been caught up in the current market environment where, you know, the attitude is sell what you have. And so, 2022 I did say it's buy what you need. But of course, you can't buy something without having the money. So, sell what you have and what generally investors have been exposed to, certainly for the last decade plus has been growth in perhaps that speculative growth area of the market. From a geographic perspective, I think that there are certain forces that impact everyone globally. So, inflation is going to impact countries around the globe. Developed markets probably would likely fare better because inflation is generally less of an impact than on emerging markets. Big emerging markets are going to continue to be challenged by a strong U.S. dollar slowness in the rollout of vaccinations against COVID and a potential slowdown in globalization.

European markets have the overhang of inflation, but also the overhang of working towards energy independence and having an aggressive superpower at their doorstep. U.S. market has been the darling of the last 14 years. It's, you know, for the past seven years, you know, every year someone will say, this is the year the U.S. will underperform, and it never comes to fruition, perhaps until this year. So, we're six months in and the U.S. markets are underperforming European markets and Asian markets. On a relative basis, and again, China does have a large impact on this the Asia Pacific region is quite attractive, certainly relative to European counterpart and our homegrown Canadian market. Is certainly of interest as well. You know, we have the challenges of inflation that every country has. We have the challenges of a tight labor market, same as many other countries. But our exposure to commodity markets certainly has been a beneficial aspect of being exposed to Canadian equities this year.

Pete: And maybe, you know, just as a follow on, if we can find some political realm that allows us to think or be more contemplative around the idea that energy doesn't just serve our needs, but the needs of the world, there's probably an opportunity for us to have a much more meaningful voice and say in the world. And, you know, you and I have talked about this many times, but the fact that there has been so much withdrawal of global capital from Canada over the last five to eight years, largely because the commodity cycle was so out of favor, to see some of that money come back in could have a meaningful impact, not just on the commodity cycle, but valuations in the underlying economy of Canada overall.

Greg: Yes, I think that over the last seven years, investors have typically rented commodity exposure and they typically would rent that through the use of a passive vehicle like an ETF. That is, for all intents and purposes, likely listed in the U.S. And I think that energy policy and we don't want to diverge too much from the content of what we want to focus on, but it is quite interesting the amount of rhetoric around windfall profits, taxing of windfall profits, for global energy companies. But when you think about why are they doing well, it goes back to supply and demand. Yeah, exactly. So, government regulation, if you curtailed the ability to manufacture and supply energy, that necessarily impacts the price. So, to then tax those profits due to the activity of your government, is quite tenuous.

Pete: I think tenuous is the perfect word. It doesn't it's apolitical. I completely agree with you. And, you know, I think maybe just I mean, we did not subsidize windfall losses when commodities were low. And so why on earth are we taxing windfall profits OK, great. So, listen, we've talked a lot about the challenges. We've talked about some of the opportunities. I think maybe with all of your experience, maybe one of the most important things that we can really bring to bear on this podcast today is the idea of how it is that you adjust or nuance a portfolio under regime change. A lot of managers, as we talked about before, have never really been in any other market but a raging bull market with a lot of global stimulus sitting underneath them and rates near zero. So, growth has obviously been the preponderance of return. And where most capital has found itself in the unwind of that and the experience that is required to think about it from another lens, maybe you can take us through how you think about a regime change.

Greg: When we talk about regime changes. You know, I always go back to ships and water and laminar flow and regime changes really are a shifting of the undercurrents of a market. Now, from an investment perspective, it's always important to remember that you can be right at the wrong time at the right time. And even a broken clock is right twice a day. When looking at what the undercurrent or the drivers of market returns are, it's extremely important to remember that nobody gets the timing right if they do, sheer luck. So, when you focus on markets and changes in regimes, what you really want to make sure is that those changes are more structurally than temporary. And think of it again as a big moving ship going from where you are to where you want to be. You know the direction you want to head. You know the end points but during that trip, you may have to adjust your sails. You may have to do slight course corrections to avoid choppy seas but what you don't want to do is overcorrect. So, when looking at regimes in markets, it's always important. And there's some amazing work that my team did in the former life around regime changes, identifying regime changes using fancy words like cumulative probability distribution. So, you always want to make sure that these changes are more structural and more long term and not a blip in the signal or a temporal change.

Pete: So that's great. Greg, you know, if we get really to the heart of it, I know one of the things that you're very process driven guy, how you think about the world, how you manage your team is also very process driven thing maybe talk a little bit about some of the constructive processes that you look at and you build around the opportunities that arise from a regime change.

Greg: When managing a portfolio. It really is risk management, understanding sources of risk, balancing that against the opportunity for return. Through market cycles, through market regimes, the reward that one is able to attain relative to the risk will change. So having a process by which you're able to consistently and persistently measure that risk relative to return is foundational to investing. How you implement that decision, whether you buy growth, whether you buy value, whether you buy distressed credit, sub-Saharan African debt, irrelevant on the implementation side, what's important is that consistent approach to the allocation of risk and the consistent approach to constructing a portfolio that meets your long-term objectives.

Pete: So, one of the things that you often touch on is this idea of broadening the range of outcomes. And of course, there is no certainty as to where the world is evolving to. I think that's a big part of why we're dealing and facing so much volatility in the short run today. Can you talk a little bit about how then you think about the portfolio from the construct of a broader range of outcomes than has been the case in the most recent cycle or regime?

Greg: So, in an environment where the outcomes are quite broad it's always important to be able to have access to a number of different levers to pull a number of different sales to hoist to ensure that the portfolio or investments are moving in the right direction. The world is not binary, investments are not binary. If it was easy, then you could simply at different times of the market by Apple or by JP Morgan. Very simple. In the current environment where market fractures exist and perpetrate throughout the entire system, you know, it's this concept of fragility and in markets that are highly fragile, it's important to be able to access and leverage a broad range of investment solutions to help smooth the waters.

Pete: So, Greg, if I take it right to the portfolio why don't we try and lay one as a final thing? Why don't we lay one or two things that we're doing specifically right now?

Greg: When I look at the major changes that we have made to our strategy this year, really a focus of commodities and inflation. Within equities or within public market equities, and we've generally been more biased towards that buy what you need a value-oriented area of the market. We've also reduced our equity exposure and replace that with direct commodity exposure because we believe that the impact is greater in the price of the commodity than in the equity market.

Pete: Yeah.

Greg: On inflation, it perpetrates through a number of different markets. So, it impacts our hedge fund portfolio where we have exposure to commodity trading advisors to strategies. It impacts how we're positioned in public market fixed income. So, we have less exposure, less sensitivity to that change in interest rates. It also impacts from an innovation perspective, the type of solutions that we bring to families. And in this specific case, it's the creation of a private credit portfolio which offers that diversified exposure partnership with world class managers to provide a reduction in the volatility of pricing, but also the potential for higher return or higher income than what one can attain in public markets out of periods of distress. There's always opportunities. One of the areas that we find quite compelling is in distressed credit, particularly really distressed credit focused in European markets where we made an investment in strategy earlier this year. We also see the opportunity as we've mentioned, in the management of risk. So how does one reduce the overall variability or volatility of a portfolio? We believe one of the most compelling opportunities in these types of markets is in hedge funds, but in particular market neutral hedge funds. So those types of strategies that are less dependent on the direction of markets up or down and look to capitalize on inefficiencies within markets. And when I look at the types of managers types of strategies that we're investing in, in that area, most if not all have had positive returns year to date in 2022.

Pete: Yeah, it's been very notable. I agree with you, and I think that this is the part that people always forget is that you talk about this a lot, the design of the strategy is embedded in the nature that it works with some level of lower volatility and more consistency. But that means to that you are foregoing the outsized return on the right-hand side of the distribution curve to not participate in the left-hand side of the distribution curve. And I think that's the piece that becomes so paramount in the portfolio and allows you to build on some of the pieces of risk or overshoot, if you will, within a portfolio overall. So, it's been fascinating to see that active management with the right construct in the environment in which we live today has actually done quite well this year. OK, Greg, we are at the final question of our final episode of season two and one of the things that I know we talked about at the end of season one is obviously what are your plans for the summer, number one? And number two, I'm always fascinated to hear because as the weather changes and kids are out of school and how does your day change in terms of the same output of work that obviously is required at any other month in the year, but how does your day change relative to the rest of the year?

Greg: Well, Pete, I I'd love to have a fantastical answer to your question to cap off the final episode of season to but, you know, one of the one of the best things, one of the best pieces of advice maybe that you can think of is, you know, always know yourself. And in that vein, I will tell you that I lead a very boring life. Time of year, time of day, doesn't matter to me. As you know, I'm a huge proponent of outdoor walks. I have dragged feet along with me for, you know, four- and five-mile walks at a time. And I try and do that rain or shine, snow or sun. I will tell you that July and August are a lot more fun walking outdoors than it is in January and February. But I think there is a psychological impact. Nicer weather just makes one feel more relaxed. And I think that the summer months, although as busy, if not busier at times than the winter months, certainly in the world that we live in, it's certainly a bit more relaxing. No need to get the kids to bed on time. No need to get the kids up in the morning. No need to fill out the endless daily questionnaires on COVID testing. So, I do look forward to maybe enjoying my morning coffee without answering yes and no to a 30 question.

Pete: Yeah, yeah.

Greg: So hopefully at this point in the conversation, I didn't put people to sleep because Pete, I think that you have a much more exciting life than I do.

Pete: Well, I'm, I'm going to crush that that thought almost instantaneously because like you, I'm a creature of habit. I'm super, I'm super focused on getting tasks completed. I will say, though, that I think for me and certainly for my family, I'm from the East Coast originally, and so to have a chance to spend some time back home is really great. There is this old adage in markets which many of you will be familiar with, which is this thing sell in May and go away. And for the longest period of time, it was something that proved positive. You know, essentially relax, take the summer off. And the fact is, is that my make up for those that know me know that that doesn't work for me at all. And the reality is, is that this period of time that we're in right now and you and I, Greg, talk about it far too often is where opportunity lies. And that actually excites me greatly. And so, the idea that we are entering this period of dislocation at the same time when weather is better and opportunities are arising is really what gives me great pleasure and excitement and, you know, my kids, my wife certainly get very sick and tired of hearing about it. But the fact is, I know my partners do. I am a big believer in the constant learning and reading and development that come from all of these pieces. And, you know, being able to think about those things through a lens that enables I think, a clearer train of thought is a really positive thing. And to also have that correlate highly with great opportunity is just a spectacular summer for me.

So, where most people get very nervous about these things, I am very, very optimistic. Well, that's it for the ninth and final episode of season two of Five Questions, I'm Pete Mann, President, and Co-Chief Executive Officer of Grayhawk on behalf of my partner, Greg Gipson, our Chief Investment Officer. We want to thank you very much for listening this season. We'll be back in the fall with season three. We wish you a restful summer and hope you find some time to enjoy the past episodes of Five Questions. This podcast is for informational purposes only. It is not meant to be relied upon for investment or tax advice. It is the opinions of those on the podcast and does not necessarily reflect the opinions of great hot wealth.

If you'd like to offer any feedback or pose a question for inclusion on the podcast, please reach out to our Chief Experience Officer, Alison Comeau, at acomeau@grayhawkwealth.com. Thanks very much and we'll see you next season.