Election uncertainties, AI impact and green transition challenges

At the end of last year, Tell Media Group, in cooperation with **Blackrock**, **DWS** and **Schroders** invited Swedish institutional investors to discuss asset allocation challenges and the outlook for 2024.

By: Niklas Tell Photo: Christer Salling

The discussion started with Niklas Tell asking the investors about the biggest surprises over the past year and what their expectations were going into 2023.

JAKOB CARLSSON: ” I was here for this discussion last year as well and then I was optimistic about risky assets but pessimistic about the economy. What has surprised me this year has been the dominance of the big seven and their huge impact on markets. Another surprise has of course been the volatility of interest rates this year, with 10-year rates declining 100 basis points at the end of the year after a period where they had increased by some 100 basis points.”

MAGDALENA HÖGBERG: “Last year, I was pessimistic and expected the lag of the tightening to make its way through the economy and we haven't really seen that to the extent that I expected. I agree with Jakob on the AI rally and the resulting increased concentration of equity markets has been dramatic.”

MARIA QUNDOS: “I agree with what's been said already. Going into this year, I was also surprised about how eager everyone was regarding China re-opening because I was afraid that would kick off a new wave of inflation but we didn't see that.”

FABIAN BECHER: “Another surprise was how quickly markets digested the problems in the US regional banks and also of course the speed of central banks actions.”

TARA JAMESON: “For me, 2023 was the year of the latent recession that didn't happen. I also think we've been surprised about how resilient the households and the corporate sector have been and I think we all underestimated how big and long-lasting some of the impacts from the pandemic were. I do believe that the pandemic is a big reason for why the households and the corporate sector managed so well last year.”

KARIM CHEDID: “Just to follow up with two observations on China. First the fact that the re-opening turned out to be deflationary rather than inflationary because it helped ease some of the supply-chain constraints. The pace of that was surprising to me. More broadly, I was surprised by the amount of money that went into duration exposures. And perhaps it was too much too soon.”

NIKLAS TELL: IN WHICH AREA HAS YOUR EXPECTATIONS SHIFTED THE MOST IF YOU COMPARE YOUR OUTLOOK FOR 2024 COMPARED TO YOUR OUTLOOK FOR 2023?

TARA JAMESON: “I think that must be the rate cycle. Last year, we were staring down the barrel of further rate hikes. Now we're talking about when central banks will start to cut rates. That has a huge impact on asset prices. Compared to last year, we also expect much more divergence across the world as to when different central banks will start to cut rates. We will have different macro-economic paths and it will also make a difference where the inflation came from in the first place.”

FABIAN BECHER: “I actually don't see a big divergence but rather a fairly similar picture in the US and in Europe right now. We expect less than 1 per cent growth in 2024 for both the US and Europe, while inflation is coming down and central banks are starting their loosening cycle. The difference is that the US has surprised to the upside over the past months, which led markets to price in an almost perfect soft landing. We stay a bit more cautious as after all the labour market and leading indicators are still sending mixed signals with risks both to the up- and the downside. Given current valuations, especially for the tech sector, there's little room for disappointments. And let's not forget the elections in the US, where a sweep victory of either Democrats or Republicans would certainly have a market impact.”

TARA JAMESON: “But I do think we have very different sources of inflation. In the US, it's very much coming from the labour market and in Europe, it's energy based. The growth picture is also much weaker in Europe. We therefore think that ECB will cut first, so we will have a larger but shorter rate cycle in Europe and it will be a more drawn out cycle in the US.”

KARIM CHEDID: “Historically, the ECB doesn't start before the Fed and I struggle to see why they would start this time. I do agree, however, that when they start cutting, they make bigger cuts.”

JAKOB CARLSSON: ”Also, I think we need to consider that geopolitical risk is higher today compared to a year ago. Investors will need to keep some buffers and that could hold back returns.”

NIKLAS TELL: WHEN WE TALK ABOUT GEOPOLITICAL RISK, WOULD YOU SAY THAT'S MAINLY RUSSIA/UKRAINE AND CHINA/TAIWAN OR IS IT ELECTIONS IN THE US AND ELSEWHERE?

JAKOB CARLSSON: ” For me, it's more about elections. It's very special what we see in the US with two candidates with very weak profiles. It could easily drive uncertainty around debt financing or capacity of backing Ukraine and that's a global risk.”

NIKLAS TELL: WHAT DO YOU SEE AS THE BIGGEST DILEMMAS FOR INVESTORS RIGHT NOW?

TARA JAMESON: “My personal view is that there are some very strong structural forces at play right now and we talk about the three Ds: demographics, de-globalisation and de-carbonisation. They are all inflationary and it means we have a deterioration in the growth/inflation trade-off and that puts central banks in a difficult position. They have some hard choices to make.”

PARTICIPANTS

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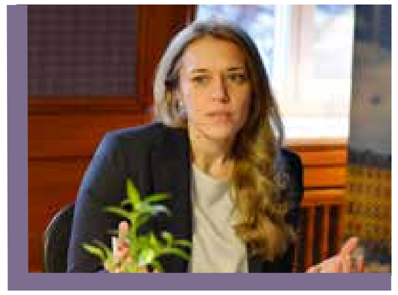
MARIA QUNDOS
Head of asset allocation at Skandia. She joined Skandia in 2020 from Nordea where she spent more than 18 years. During her time at Nordea, she spent close to 15 years as a portfolio manager but also worked as an analyst for tactical asset allocation prior to that.



MAGDALENA HÖGBERG
Head of strategic allocation and quantitative analysis at AP4. She took on her current role in 2021, having joined AP4 as a quantitative analyst covering asset allocation in 2013. Prior to joining AP4, she was a consultant at VPD Financial Software Consulting.

MARIA QUNDOS: “We all sound very pessimistic right now but to me, I think we’re actually in a much better position when we talk about a diversified portfolio. The fixed income side is finally producing returns and that’s a good thing. Yields going up has been painful but it was good and it was needed. From a portfolio perspective, we’re in a much better position right now.”

KARIM CHEDID: “I think that a key message as we enter 2024 is the fact that there’s a lot of cash sitting in money market funds. Geopolitical risk may hold back returns because cash is still attractive in terms of the rate that you’re getting. But rates are falling and there’s a performance drag if you sit on cash and that risk is real. I’m not saying that we’re going back to the QE era of asset reflation and that everything will rally but there are investment opportunities and the opportunity cost of staying in cash will be painful. That’s very different compared to a year ago.”

MAGDALENA HÖGBERG: “I do agree that the change in yield levels has the potential to restore more diversification benefits in the fixed income allocation. Going back to your point, Tara, that the current environment is more inflationary – I think we need to think about that from a long-term perspective and ask ourselves what that means for what a neutral rate will be in the next decade. Will AI drive productivity gains and will the geopolitical tensions drive inflationary spending on war infrastructure? Figuring out and navigating those types of long-term strategical changes to the macro environment is key for us. Related to that is also how you think about your strategic allocation to alternatives. How will a higher discount rate for longer affect your allocation to infrastructure, real assets and private equity? In the long term, you might view an allocation to private equity as beneficial because you access another type of equity premia but in the shorter term, valuations can be challenging.”

NIKLAS TELL: WHAT HAVE BEEN SOME OF THE MAIN CHANGES TO YOUR PORTFOLIOS IN 2023?

MAGDALENA HÖGBERG: “I would highlight two changes. The first is that we’ve strategically added duration to the portfolio as we see interest rate levels now at more motivated levels. We’ve also added more capacity and capability in order to be more dynamic in our asset allocation and to benefit from the increased volatility in the market.”

MARIA QUNDOS: “We’ve also added duration and we’ve also added a bit of Swedish krona. Up until recently, it has been very undervalued and I still think it is. I also think that Swedish investors need to consider their global exposure because as a Swedish investor, we’ve been spoilt with nice returns and a cushion in the Swedish krona. It’s time to wake up and realise that we will not have that same cushion going forward.”

JAKOB CARLSSON: ”It’s the same for us in terms of duration. Duration matching is a very important lever for us and we started this year with a duration gap and now we’ve closed that. Another interesting area for discussion is, of course, emerging markets. We reduced our exposure to zero a while back and that was a financial-based decision but with ESG mapped into the analysis.”

FABIAN BECHER: “We’ve also increased our exposure to fixed income significantly and we now have a buffer going into 2024. Also, we’ve reduced our exposure to alternatives as we prefer fixed income as the main source of income. As we saw in 2023, there’s also no way around equities if you want to hedge against inflation or participate in economic upside ‘risk’. And as the AI-driven rally in the tech sector has shown, if you want exposure to innovation, you need equities.”

NIKLAS TELL: LAST YEAR, RISING INTEREST RATE LED TO SOME PROBLEMS IN THE MARKET, WITH EXAMPLES SUCH AS REGIONAL BANKS IN THE US AND OFFSHORE WIND. WOULD YOU SAY THAT WE’VE GONE THROUGH THE CORRECTION PHASE IN MARKETS OR ARE WE STILL WAITING FOR MORE PRICES TO ADJUST, ESPECIALLY IN LESS LIQUID AREAS SUCH AS REAL ESTATE?

JAKOB CARLSSON: ” Remember, in real estate and in private equity we’ve had significant corrections of valuations gaps in 2023 with valuations of illiquids down some 0 to 5 per cent while liquid listed assets increased by some 10 to 15 per cent. However, I would guess there’s further to go.”

MAGDALENA HÖGBERG: “There has been this aggressive push into core assets, many of them are low yielding businesses, and we need to understand that even if interest rates fall from these levels, they will probably not fall to zero. So some of these businesses will probably face higher interest rate costs compared to the last regime and that will likely cause problems for some business models.”

KARIM CHEDID: “I don’t think we’ve seen the full impact yet because there’s always a lag. The real economy in the US has done better than expected, mostly thanks to the US consumer and they’ve done well thanks to spending savings. Going forward, however, they will need to fund spending through credit, so we’re likely to see a weaker economy going forward. In public equities, we see an increased dispersion in corporate earnings and that’s likely to continue. In private markets, we’ve seen the impact through a lower deal activity.”

NIKLAS TELL: KARIM, YOU MENTIONED DISPERSION BETWEEN COMPANIES BUT I ASSUME WE’RE SEEING DISPERSION BETWEEN DIFFERENT REGIONS AS WELL?

TARA JAMESON: “In equities, I would say the US market is getting difficult because the S&P 500 is so dominated by the magnificent seven. And they are difficult to call because they’re benefitting from some very strong structural trends. However, once you strip out the magnificent seven, equity markets have actually not done that well, so in 2024 it might be time to look outside those top performers. Japan would be one example. The market has struggled due to the strong yen but there are exciting things happening under the hood. It’s also the one economy where inflation is actually a good thing.”

FABIAN BECHER: “I agree that we need to be careful when it comes to the US but as of now, investors stick to winners and it’s become a self-feeding process. I think that the actions from the Fed, if and how much they will be able to cut interest rates, will be key for the future direction of the magnificent seven. Elsewhere, we do like Europe and especially small- and mid-caps and I also agree with Tara on Japan. Finally, while it’s difficult to time, it could be worth looking at direct real estate as we’re moving into a rate-cutting cycle.”

NIKLAS TELL: WHAT ABOUT THE GENERAL MACRO PICTURE? THERE’S BEEN TALK ABOUT A RECESSION IN THE US FOR A LONG TIME NOW BUT IT NEVER SEEMS TO HAPPENS.

JAKOB CARLSSON: ” Coming back to your question on markets first. The US markets are so dominant, I would actually say you take a risk not being in the US. Looking forward, we should probably look outside of the magnificent seven, where we hopefully will see the AI-profits to spread out in the economy to other companies. Looking at the US economy, there are some uncertainties with the election at the end of 2024 but it’s still a strong economy.”

JAKOB CARLSSON
CEO of Länsförsäkringar Liv. He took on his current role in 2019 and spent nine years as CFO of the pension company prior to that. Before joining Länsförsäkringar in 2007, he was head of group control at SPP and Handelsbanken Liv.

TARA JAMESON
Multi-asset fund manager at Schroders. She joined the asset manager in 2014 from Cambridge University and is based in London. She manages assets on behalf of UK pension & wealth management clients and is co-manager for the Schroder Global Multi-Asset Portfolios. She is also head of the credit research group within multi-asset investments at Schroders.

FABIAN BECHER: “For investments in the US, has that been an active or passive exposure?”

JAKOB CARLSSON: ” We’ve invested with the index and that has been very profitable for us so far, so I would guess we will stick to that base. However, going forward we’re developing other models as well to capture global trends like AI, climate change and demographics.”

MAGDALENA HÖGBERG: “I think you’re right. The weight of the big seven in indices means that you don’t have the same diversification benefits today. We’re looking at equal-weighted allocations and also small caps in order to get a better diversification from US equities.”

JAKOB CARLSSON: ” As long-term investors, I also think we cannot separate the economy from the geopolitical developments. The US has been the leader, also on the military side, but the question is if they can afford to protect both their own interests and Europe going forward. What will happen with their support to Ukraine, for example. If the US withdraws, then Europe will have to step in and the response from Europe – to heavily increase support spendings or back out – will have a big effect on the global economy and markets as well.”

NIKLAS TELL: LOOKING INTO 2024, WHICH PARTS OF YOUR PORTFOLIOS ARE YOU MOST CONCERNED ABOUT TODAY?

MARIA QUNDOS: “I think the main things to look out for would be on the private side and the more illiquid exposures. I’m not worried about our real estate exposures but that’s an area where you don’t know how pressured other investors are. It could be that we haven’t seen the worst yet and that could cause volatility in the shorter term. It’s the same with private equity. Again, I’m not worried about our exposures but how are other investors coping?”

JAKOB CARLSSON: ”I agree with you, Maria, that we will probably see some additional valuation adjustments when it comes to real estate and private equity.”

MARIA QUNDOS: “Another thing that I’m thinking a lot about is our exposure to emerging markets. We still have emerging markets and that has not performed for us. The question is how you can capture the growth in emerging markets. Maybe it’s not the best route to get that via public equities. Maybe it’s through currencies or something else.”

NIKLAS TELL: WE HOSTED A CHINA ROUNDTABLE LAST SUMMER WHERE SOME INVESTORS SAID THAT IT WILL BE A STRATEGIC DECISION TO BE INVESTED OR NOT. THE ARGUMENT WAS THAT CHINA IS INVESTABLE TODAY BUT IT COULD BE THAT IT’S NOT INVESTABLE IN 10 YEARS, WHICH IS A KEY QUESTION TO ANSWER FOR A LONG-TERM INVESTOR.

MARIA QUNDOS: “I think everyone is thinking along those lines. If you argue for investing in China today, it’s all about valuations. But the strategic consideration is something on everyone’s agenda.”

TARA JAMESON: “I find it hard to get excited about China apart from the valuations. Structural forces and demographics are working against China. Also, the housing sector is sitting on a lot of debt that needs to be sorted out.”

KARIM CHEDID: “On the flip side, I would say that India is one of few countries benefitting from demographical changes. We saw the inclusion of India into bond indices this year and ETF investors are interested. The equity market is not as cheap, however. It’s above the average of emerging markets.”

NIKLAS TELL: WE’VE TOUCHED ON SOME OF THE CHALLENGES GOING INTO 2024. WHAT ARE YOU THE MOST OPTIMISTIC ABOUT?

MAGDALENA HÖGBERG: “I’m optimistic about all strategies that benefits from dispersion and equity long/short is one example. I also think that there will be a lot of things happening in markets for a lot of different reasons and that will create volatility. Coupled with the higher interest rate levels, this is exciting from an asset allocation point of view because of the larger opportunity set.”

KARIM CHEDID: “Japan is the one area in developed equities where we’re overweight. We might see some weakness in H1 if Japan raises rates when everyone else is cutting but I would buy into that weakness. There’s real change happening in Japan right now in terms of stock market reform and increase in domestic ownership.”

FABIAN BECHER: “We like Japan as well and we like Europe over the US. Our sweet spot would be European small- and mid-caps. Compared to big caps, their valuation is really cheap at the moment.”

JAKOB CARLSSON: ”I would say developed market equities and why not Sweden?”

TARA JAMESON: “I think in 2024, we need to be contrarian and look at laggards. Japan is certainly one area and I agree on small- and mid-caps as well.”

MAGDALENA HÖGBERG: “Even though I think 2024 will be volatile, I think the valuation case for small caps is valid. In Japan, I would prefer the currency over equities right now.”

NIKLAS TELL: WHAT DO YOU SEE AS SOME OF THE KEY CHALLENGES AND PRIORITIES IN 2024 FOR AN INSTITUTIONAL INVESTOR WHEN IT COMES TO ESG?

MARIA QUNDOS: “When it comes to ESG, it’s of course not enough to look at only one year – it’s a long-term process. That said, we of course focus a lot on the green transition and the climate challenge and that will continue to be high on the agenda in 2024.”

NIKLAS TELL: HOW MUCH OF A CHALLENGE WOULD YOU SAY IT IS TO ALIGN THE WORK ON THE GREEN TRANSITION, WHICH IS A VERY LONG-TERM PROCESS, WITH YOUR ASSET ALLOCATION WHERE YOU ALSO NEED TO PROVIDE RETURNS IN THE SHORTER TERM?

MARIA QUNDOS: “That’s what has been in focus over the last couple of years now. It’s our job to provide returns to our clients and we can’t make ESG adjustments that reduces the long-term returns. It’s a balance and as we’ve seen that a screened ESG index will perform better than the broad index in some years but in other years, it will perform much worse. On a separate note, we would like to do more infrastructure investments in Sweden but regulation is not stable enough for us to engage so most of our infrastructure investments are abroad.”

JAKOB CARLSSON: ”I agree with you Maria on that but I would like to add two more things. The first is science-based targets. Focusing on companies that have that in place we think will enhance returns and help the planet. The second would be opportunities in carbon capture. Regarding your comment that you can’t sacrifice returns – we actually asked out clients if they were willing to accept lower returns if we would go ‘all in’ on ESG. Some 35 per cent said no and since

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FABIAN BECHER
Head of CIO Office at DWS. He joined DWS in 2014 and prior to his current role, he was co-head of the CIO Office after working as research analyst in the same department. Before joining DWS, he worked at Deutsche Bank Wealth Management and served as DPM specialists and investment officer.

we must take care of all our policyholders, we need to keep an eye on returns as well when working on developing our ESG policies."

TARA JAMESON: "You can, of course, create a net-zero portfolio today but then you would reduce your investment universe by some 80 to 90 per cent and then you need to question the investment integrity of that portfolio. I think the preferred solution is to focus on engagement rather than exclusions."

KARIM CHEDID: "I also think that you need to not only focus on helping 'brown' activities to become 'greener' but you also need to focus on the green economy itself as it's very resource intensive. I would therefore agree that the way forward is engagement and not exclusions."

FABIAN BECHER: "Over the next couple of years, I think it will be important to focus on the transition planning and transition investing. We need to move away from these big announcements and focus more on the near-term plans of companies. Carbon intensive sectors are key to the climate transition and here, investors have an important role to play to push them in the right direction. It would be wrong to exclude them from the portfolio. Another interesting and important area is biodiversity and here we see companies preparing to disclose nature-related data and that will mean they have to dive much deeper into their supply chains."

NIKLAS TELL: HOW MUCH OF A CHALLENGE IS IT TO STRUCTURE A PORTFOLIO THAT HELPS TO SOLVE THE PROBLEMS OF THE WORLD RATHER THAN JUST STRUCTURE A PORTFOLIO THAT SOLVES THE CO2 PROBLEM OF THE PORTFOLIO?

MAGDALENA HÖGBERG: "I think it's important to recognise that it doesn't help all that much that you have a net-zero portfolio if you're not impacting the global CO2 output at the same time. During a transition period, we might still need some fossil fuel but we also need to invest heavily into alternative solutions that help the transition. However, with interest rates being higher and due to increased costs from supply chain problems etc, some of these projects are struggling from a financial standpoint. We therefore need governments and regulation to step in – perhaps through subsidies – to drive things forward."

JAKOB CARLSSON: " One important factor in these discussions is also what the price of emissions will be. If you would know for certain that price of emissions will increase to fair value including cost of long-term environmental effects, you would also know which investments would be profitable and which would not. Then investments would flow. This is an important message to politicians because as investors, we would like the probability to be very close to 100 per cent."

FABIAN BECHER: "Another important aspect to take into consideration is the fact that we will have a lot of elections in 2024 and the outcome of these elections will also have an impact on sustainability. We've seen the election in Poland where we might get a government that supports the transition but we've also seen the opposite where people vote against it due to concerns over the cost of living for example. And we, of course, have the election in the US, which will have a big impact depending on the outcome."

NIKLAS TELL: ARE THERE ANY THOUGHTS ON THE RECENT COP28 MEETING?

JAKOB CARLSSON: "I think the positive thing was that it wasn't the disaster that we feared it could be."

NIKLAS TELL: WE TOUCHED ON AI EARLIER BUT I WOULD LIKE TO HEAR MORE ABOUT YOUR THOUGHTS AS INVESTORS. IS THE BIGGEST IMPACT ON A COMPANY LEVEL WHERE SOME ARE CURRENTLY BENEFITTING MORE THAN OTHERS OR ARE THERE OTHER ASPECTS THAT YOU NEED TO TAKE INTO ACCOUNT?

TARA JAMESON: "I think there's potentially a big impact on the macro environment and on the growth/inflation trade off that we talked about. In the US, the labour market has been the driving force behind the inflation and one solution to get wage growth down without slowing the economy is through improved productivity. AI has huge scope for that. The question is how quickly it happens."

KARIM CHEDID: "One of the sectors that comes to mind where AI could help to overcome the labour shortage is health care. For example, in 2022 a third of all surgeries in the US were assisted by robots. Also, the dispersion that we talked about earlier, and where AI was been an important driver in 2023, will appear both within sectors as well as between different sectors."

FABIAN BECHER: "I think it will take time until we see the long-term winners of AI. It's similar to the internet boom in the 1990s where the initial beneficiaries were the enablers but the long-term winners have been companies using it. I think it will be a similar development with AI where we're now seeing enablers benefitting hugely. Maybe the long-term winners have not yet been founded."

JAKOB CARLSSON: "Every time in history where we've had rate hikes and such an inverted yield curve as we have today, there has been a recession. Maybe the benefits from AI means it will be different this time. We can at least hope for that."

NIKLAS TELL: IF WE LOOK BROADLY INTO 2024, WHAT ARE SOME OF THE KEY FACTORS THAT POINTS TO IT BECOMING A FAIRLY GOOD YEAR?

MARIA QUNDOS: "I think there are reasons to be somewhat optimistic. If you have a balanced portfolio, there's a higher probability today for bonds and equities showing a negative correlation and that's positive."

MAGDALENA HÖGBERG: "I think one reason to be positive is the resilience we've seen from households and the corporate sector. Also, we've talked about a potential recession for a long time now, so hopefully if it comes both households and companies will be prepared. I'm, however, not as optimistic on the equity market. A lot of positives have already been priced in and markets are also expecting aggressive rate cuts that might not materialise. On the negative side, you of course have geopolitical events and a potential recession."

JAKOB CARLSSON: " I'm moderately optimistic. Not as optimistic as last year because I think markets have been too quick to price in good news. If interest rates are cut as quickly as the markets expect, then it will be because of a dramatic slowdown in the economy and that's not good news. I can hardly see a simultaneously strong economy and dramatic rate cuts."

NIKLAS TELL: ARE THERE QUESTIONS AND THEMES RELATED TO MARKETS OR ASSET ALLOCATION THAT WE ARE NOT DISCUSSING ENOUGH?

TARA JAMESON: "I think we need to consider the level of debt that governments sit on today. There's a risk there and I think it's something that investors will focus more on going forward. It will be another reason for divergence in yields between countries that have been more conservative and those that have not."

"Another important aspect to take into consideration is the fact that we will have a lot of elections in 2024 and the outcome of these elections will also have an impact on sustainability"

– Fabian Becher, DWS