Ep44: Candid Conversation with Alex Dryden, Global Market Strategist, at JP Morgan

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PATTI BRENNAN: Hi, everyone. Welcome to the "Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives. Hey, everybody, let's face it. This is a strange time right now.

We're all feeling this ambiguous grief. We're stuck in our homes, separated from others, and trying to fill the emptiness with things that give our lives meaning and joy. Before we even start, as you do, I just want to say thank you for including me in your day. I hope that you find that our time together gives you some practical understanding of what's happening, and more importantly, some hope.

I have to tell you, I am really, really excited to have our special guest today. He is Alex Dryden, global market strategist at J.P. Morgan. He's a frequent contributor on CNBC, and Bloomberg, and everything else in between. Alex holds degrees in international business, finance, and economics from the University of Manchester. Alex, welcome to the show.

ALEX DRYDEN: Thank you very much for having me, Patti.

PATTI: Now, here's a deal, Alex. Before we get into the meat of this, many of my listeners already know this, but I want you to know that in my previous life, I used to be a nurse. I was an intensive care nurse. I want you to know Alex, the only reason I'm bringing that up is that I spent a semester in Manchester, England learning midwifery.

Now, I would imagine that it's probably changed a lot since then. I would never trade that opportunity to learn about the healthcare system over there, socialized medicine, and how care is, or at least I should say was delivered back then.

ALEX: I imagine it's changed a little bit since then.

PATTI: Just a bit. By the way, where are you right now? I think that you're based in America. Where are you calling in from right now?

ALEX: You're right. I'm normally based in New York, but I was over in Europe for vacation when the travel ban came into effect. My visa gets me out of the United States but doesn't get me back in. I'm currently camped out in London, waiting for the travel ban and the virus to disappear. Could be a while.

PATTI: Wow. Is your family with you?

ALEX: Yeah. They're over here as well.

PATTI: That's good.

ALEX: There's definitely worse places to be quarantine than London, UK.

PATTI: That's terrific. Good for you. That's terrific. Let's talk a little bit about what's going on. Really, I want to pick your brain in terms of what we should be thinking of in terms of our portfolios.

Alex, diversified investors have been waiting a full decade for interest rates to rise, small caps to outperform large caps, and international stocks outperform the US. Especially now, is there an argument to be made that none of these things are going to happen anytime soon? What do you think?

ALEX: Good question. I think it's a great place to start the broader discussion. Let's maybe unpick some of those different areas. Firstly, with interest rates, I think investors need to get themselves into the mindset that we are certainly in a lower, even longer environment. If we go back a few years, the Federal Reserve were gradually moving rates higher.

We started to approach a level where interest rates in the United States at least, were starting to look a little bit higher than they had done post the financial crisis. That's immediately been reversed as the virus has hit. The Federal Reserve have cut rates dramatically. Then they've also flooded the market with additional monetary policy support that has driven rates even lower.

We're probably going to be living with the effects of this monetary policy response to the coronavirus for some time to come. I think investors need to get used to having lower for longer when it comes to interest rates.

You also talked a little bit about the small caps and their tendency to outperform large. I think that again will be a common part of the next expansion, is looking for better growth opportunities in some of those small-cap names, I definitely think that will be part of the growth picture.

Finally, talking a little bit about where geographically should investors be looking. For much of the last cycle, the United States market completely outperformed much of the international environment. It's important that clients understand why that dynamic was in place. For much of the last 12 years, we've seen the dollar rising versus many currencies around the world.

Whilst that's great for any Americans traveling overseas, it's a little bit challenging when you're putting your money to work in a foreign currency, to have the dollar rising like that. Now, we actually think that over the next few years, the dollar will begin to weaken.

As the dollar goes from being your foe to being your friend, as an investor, we're actually starting to think that maybe international equities will do a little bit better. We've got to be careful. Not all international markets were born equal. One area in particular that we think will outperform and do much better is emerging markets, particularly in the Asia-Pacific region.

They have some really favorable demographics, a really powerful emerging consumer. As the dollar changes direction, we think they could do really well. I definitely don't think that these trends that have been in place for a while, not all of them are going to stay put over the next few years.

PATTI: I'm curious. What do you think would make the dollar weaken? Is it because of the amount of stimulus the Federal Reserve has put into the system? What's the dynamic that goes on to make that occur?

ALEX: You're completely correct looking at the central bank. What we've seen happen over the last 10 years has been that the US economy has been growing quite quickly, especially relative to their peers overseas. Much faster than growth than we've seen in, say, Europe, the UK or many other developed markets.

When you're the only game in town from a growth perspective, what that means is that your currency becomes more valuable. As it enhanced further, as the Federal Reserve have been the only central bank for the last few years that have really been able to get on and raise interest rates. What that does is it attracts capital into the United State and people start to purchase the US dollar.

The reason being is that if the Federal Reserve are the ones raising rate, that's quite attractive for overseas investors and savers. If you go to somewhere like Europe or Japan, many of those central banks have close to zero or even negative interest rates. That's really damaging if you're a long term saver.

What a lot of European and Japanese investors have been doing has been moving into the United States, looking for a better rate to savings. That has pushed up the value of the dollar for the last few years, but in recent weeks, we've seen that relationship completely reverse because the Federal Reserve have taken rates all the way back down to zero.

What that will likely mean is that international investors who are currently camped out in the United States are probably going to say, "Well, actually, maybe it's easier for me to go home because the benefits of me holding US-based assets isn't quite as useful as what it used to be."

As they start to sell US Dollars and go back to where they came from, that should start to weaken the dollar gradually over the next few years. We do think that's definitely a trend that will play out over the coming years ahead.

PATTI: That is so interesting. It does. It makes so much sense, Alex. It really does make a good case for including the international equities and even international bonds in a diversified portfolio. Nobody knows what's going to happen in the future, but we've got to take all of that into consideration and not necessarily rely on the last decade in terms of making decisions going forward.

With that in mind, what are your thoughts about index funds versus active management? Most of the index funds, for those of you who are listening, really focus on how big a company is. That's called market cap weighted, versus active management where you have a money manager that is actually doing the stock picking.

Yet, when we look historically, again, the average fund manager hasn't outperformed their index. Well, I'll give you my thoughts after you answer, Alex. Just on the face of things, how can active management compete with the effect of large companies just getting larger?

ALEX: Good question. Let's just take a step back and consider active versus passive. The financial industry as a whole tends to divide themselves into two camps. They're either all in on passive or they're all in on active. We need to acknowledge it. There's a time and a place for active management, and then there's a time and a place for passive.

During, for example, boom years where the market is moving up quite considerably, that's a great time for passive management in many different asset classes. We need to acknowledge not every asset class is amazingly useful when deploying active management. Sometimes, there's a time to be passive. Sometimes, there's a time to be active.

For example, in the US markets when things are looking good, then passive can tend to outperform, and the low fee are attractive. During periods of volatility, here is when there is dislocations in the market, such as what we're experiencing at the moment. Having an experienced manager at the helm who can make sophisticated decisions, that can be helpful for managing the risk within the portfolio.

That's when I tend to think about active, at least within the United States. Now, don't get me wrong, as we start to venture away from the US equity market, I tend to favor active over passive. The reason being is that, as you go into the international markets, the benchmarks that you're attaching yourself to and what you're actually getting exposure to in your portfolios isn't always amazingly great opportunities.

For example, in somewhere like Europe, some of the biggest sectors, it's the banking sector. Now, we don't really worry about the European banking sector like we did back in, say, 2012 and 2013, during the Eurozone Debt Crisis. It's not the most profitable or exciting opportunity within the European market.

Therefore, we want to think that maybe that's a good space to deploy some active management. The same is true within emerging markets as well. Again, the benchmarks aren't amazingly constructive, and therefore active managers can dig around and find the best opportunities within the EM universe that may not have huge amounts of waiting within a passive benchmark.

That story becomes even more true if we step away from equity and into fixed income. That is really an opportunity where active managers can use some opportunity in their stance to be able to jump in and out of the most exciting names within the fixed income world. For me, when it comes to this active versus passive discussion, there's a time and a place for both.

Investors need to be cautious during this risky, volatile period about just going along with the ride for passive management. For me, think about it carefully. Think about the opportunities for the long term, try and work out what suits you in your risk portfolios.

PATTI: Alex, I couldn't agree with you more. I didn't want to tell you what I thought, but especially right now, as we look at some of the managers and some of the things that you guys are doing, it's been really impressive. I think about also like the small cap area we talked about before.

A lot of people don't realize that the Russell, the index for small cap stocks, even before all of this happened, 40 percent of the Russell Index, they had negative earnings. If you're buying the index, you're also buying companies that aren't making any money.

I've always believed that just because I, Patti Brennan, who stands 5'3" can't dunk a basketball, or that the average person can't dunk a basketball, it doesn't mean that anyone can't dunk a basketball. I do believe there are people out there with access to CEOs, balance sheets, and really have a better understanding of a particular company or an industry. That can add some value.

You talked about fixed income, because I agree 150 percent in terms of how to manage a fixed income portfolio. Getting back to what we were talking about as we first started, with interest rates this low, and with companies that are struggling, states and municipalities who are probably not going to be able to balance their budget, how should we think of bonds in a diversified portfolio?

ALEX: This is certainly a head-scratcher. It's one of the really big challenges, not just for the last few years, but it will be a big feature during the next expansion, especially now that many of the central banks around the world have cut rates even further. They've dragged down the yields of bonds.

Now, if you go back a couple of decades, government bonds really used to be this perfect asset class, where we could go to it not just for income and yield, but we could also go there to look for safety and diversification. It's this perfect mixture of the two.

What we've seen happen since the financial crisis, and the unorthodox policies that many central banks have adopted, what they've essentially done is broken the bond market in two. They've forced investors to choose. You can hold government bonds if you like, and that provides you with diversification benefits, but the yield is very, very low.

Therefore, it's unlikely to meet many clients' income needs. Therefore, they're forced to go elsewhere for income. We've now broken the bond market into two parts, income-orientated asset classes that come with higher risks, or safer, more secure government bonds, but they come with much lower yields. What are investors meant to do about this?

Again, what we need to think about is careful financial planning when it comes to managing this particular challenge. What we need to be able to do is hold part of our fixed income exposure in those secure assets that provide some diversification, some insurance against volatility elsewhere in our clients' portfolios on one hand.

Then we need to carefully go about finding income opportunities elsewhere. Now, using that balanced approach between the two, we can try and solve for this problem. Let's be clear, Patti, this isn't as easy as what it used to be. The central banks have really made it challenging.

I urge investors to seek out professional help in order to try and navigate this particularly challenging problem. It's only going to get worse during the next few years.

PATTI: Wow. Alex, you are singing my song on that one. It ultimately comes down to the financial planning and to see how all of the asset classes can work together in such a way so that the portfolio itself is congruent with the longer-term financial plan.

We can look at everything individually and micro-manage that, but to me, the most important thing is how is this group of asset classes, how is this portfolio serving the client and what the client wants to do and needs to do? It's really important, and I love the way that you broke the fixed income into the high-quality government debt, that money that is your plan B if everything else is plummeting.

You always have that place to go for emergencies or for cash flow. Whether it be from the income, I think that we all have to be realistic that, with interest rates this low, the income component is not probably going to cut it. How do we create cash flow, which is a word that's different than income? How do we create cash flow in a predictable and sustainable way?

I think the way you laid it out was brilliant, Alex. I love that, because we're not allocating or putting 40 percent of our portfolio into something that's not really going to do anything, but to maybe stage that part of the portfolio with the understanding that some of it is short-term, some of it's intermediate, and the rest of it's longer-term, rather than trying to predict.

Here's a question. Is there any part of the bond market that we really should be focusing on, that you think, wow? You are one of the best managers, with one of the best companies in the world, and the most respected, if I may say, as a financial planner who, to be perfectly honest with you, as independent planner, I can go anywhere, I can work with anyone and recommend anyone.

J.P. Morgan just continues to come forward with really thoughtful, great answers to the problems that we're trying to solve for our clients. In that fixed income area, what are you doing for your mom?

ALEX: Absolutely, and obviously we need to think about the risk tolerances of each individual client and what's appropriate. Right now, what I'm saying to clients is, now's the time to be thinking about quality within our fixed income portfolios. How I've been positioning it is that, bonds are like bubble wrap that you put into your portfolios. When do I use bubble wrap?

I use bubble wrap when I'm trying to send a gift back to my mom in the UK, and I want that gift to turn up in one piece at its intended destination. Just a bit of padding and protection in case it hits any turbulence on the flight over. The same is true with investors and their fixed income portfolios right now.

What I want to do is try and find areas with quality, that I can just put into the portfolio to provide padding and protection, not just to bonds, but for the entire client exposure, so that if we do hit any turbulence, we've got that protection in place. For us, what that looks like is having a little bit of things like municipal debt, in part, where we think it's appropriate.

Also, putting in some core US treasuries. Yes, it's low-yielding, but it does a good job of diversifying the portfolio. What we're also looking at is high-quality corporate credit debt, those companies that have the AAA credit rating, which is the highest credit rating that you can get.

Safe, secure firms that will be able to see through this disruption caused by the virus, and continue to honor their financial obligations. All of those sort of companies and opportunities put in together establish some degree of quality. What that does is just adds that bubble wrap, that padding and protection that we think is really important for weathering the challenges over the next few weeks and months ahead.

PATTI: That makes sense in any environment, doesn't it? To a certain extent, having a portfolio laid out just as you've laid it out for us today is just really good planning because we should always expect that things are going to happen that we're not going to expect, and we can't predict.

We don't know if these things happen, and that bubble wrap can really protect our clients' futures by making sure that everything isn't going to break.

ALEX: Absolutely. That sort of diversification benefit is a long-term investment scheme. Regularly, when we talk to clients, they're always chasing after the latest hot topic. I would encourage right now, after the volatility we've seen in the last few weeks, think about the discipline that can be brought around by having diversified portfolios.

It is more important than ever that we're emphasizing that point, Patti.

PATTI: I can't think of a better time. I mean, we are living it right now. Companies that nobody would have ever thought would be in jeopardy of going into bankruptcy, whether it be the cruise lines, or airlines, or a company like Boeing, for crying out loud, Boeing, and yet they're on fumes.

Those people, like us, and as you are advocating, who have diversified, who have gotten that professional management, and to be perfectly honest with you, and folks, those of you who have been listening to my podcast in the past, this is an area that we don't play in the sandbox.

You either do it, or you don't. In my opinion, the best thing that you can do is to accept the humility, as I have, over 30 years of trying. I accept the humility and understand that there are people out there that specialize this. They live and breathe it. They know the companies. They know their ability to maintain those payments because that's what debt is. That's what bonds are. It's debt.

What companies and their senior management really emphasize having a strong balance sheet, lot's of cash, and are ready for almost anything that might hit them? Those are the companies that have that mentality going in, are the ones that are surviving and doing just fine right now. As much as we think we might want to know, because it's a household name, you just don't know.

The people that live and breathe this stuff, like the Alexes of the world, they do know. They've done the research. They knew a year ago these companies, how they could sustain something like this. Again, this is pretty extreme, and that's the whole point of diversification. Yeah, while they may have a bond with Boeing in their portfolio, they have 200 other issues that are just doing honky dory.

Here's one more question for you, and I'm just curious because I know that you've been thinking about this, Alex. This is a really significant disruption in our lives. You and your team, how do you view the way that we are working now, the way we may or may not travel, how we relax, eating out, and how we're even communicating? How do you think about the portfolios?

Should we adjust our portfolios accordingly? For example, should we be overemphasizing growth, which is that emphasis digital, pharma, and healthcare? Or, conversely, do you just think that everything is going to go back to where it was, two to three years from now?

ALEX: I think it's important to acknowledge that in the course of humanity, every now and then, we have these life-changing events that cause fundamental rethinks amongst society about how individuals conduct business, how they work, how they spend their free time. I believe that the coronavirus has the makings to be one of those society-changing events.

Therefore, we almost have to rethink many various aspects. We can probably spend the next hour coming up with a long laundry list of potential changes. Let me try and highlight a few areas, both amongst how consumers operate, but also how businesses are going to function.

Firstly, within the consumer, one of the biggest changes that we're probably going to see is just how individuals spend their time and money. We'll see large avoidances with crowds, going out and spending money in hard and fast brick-and-mortar retail stores, and instead favoring spending more money and time online. You'll also see how people decide to spend their finances also shift.

One of the challenges that this virus has highlighted is quite how many individuals were actually struggling with very limited amounts of savings. There wasn't a huge amount sitting in their bank accounts to meet sudden shocks and expenses. One of the things we'll see during the next expansion is that consumers adopt a much more fiscally conservative approach to managing their money.

Operating more as a saver than a spender. That's quite a dramatic change, so those shifts will be quite significant. On the business side of things, we'll also see some changes. Firstly, businesses are likely to be much more willing to allow their employees to work from home, or work remotely.

Firstly, it's great for them as they start to be able to cut down on expensive office space, allow businesses and employees to operate wherever they would like to do that. That more footloose, fancy-free approach is going to involve some degree of infrastructure investments, and people building up some technological capabilities to allow that to happen.

I do think that this prolonged period of working from home or working remotely will have encouraged businesses to embark on those programs. Another big change that we might also see is, businesses are going to likely rethink their supply chain management over the next few quarters and years ahead.

One of the things that the virus has really highlighted is some of the challenges with having geographically diversified supply chains. For the last 30 years, we've seen significant globalization. That has brought many economic benefits, but it's brought the challenge of having US companies operating supply chains that incorporate many other countries and regions around the world.

When we see these viruses hit, that's a big challenge as factories go offline. I think one of the things that we will see post this virus when the dust settles is businesses start to rethink how their supply chains are set up, and try and simplify them from a geographical point of view.

We also need to remember that, whilst it was only a few months ago, it may feel like years ago, but we were talking very much around trade tensions, they have not gone away entirely. Therefore, that, combined with the coronavirus, likely helps start businesses down this path towards simplifying the supply chain. That is just a few little nuts and bolts of maybe what we might see happen.

There will be much broader overarching discussions that we could do an entire new podcast on those topics, I think, Patti.

PATTI: I'm sure we could. Wouldn't it be great if you and I could fast-forward five years from now and just simply look back and know exactly how all of this played out?

ALEX: [laughs]

PATTI: It would be fun, wouldn't it?

ALEX: Yeah, if I had my crystal ball working like that, that would be one benefit for all of us, I think.

PATTI: You know what, Alex? While we can't exactly do that, I will say that having you here with us today was a great runner-up. I got to tell you, thank you so much for sharing your knowledge, your insights, and your wisdom with all of us today.

ALEX: Thank you very much for having me. I really enjoyed the opportunity.

PATTI: Folks, thanks to all of you for joining me as well. You all know me pretty well by now, and I know you know that I will always give it to you straight. There's a lot that we don't know yet. I believe there's going to be a lot more uncertainty and difficult times. I do believe we are going to get out of this, and we're also going to learn a lot in the process.

In the meantime, if you have any questions or want to know how to apply some of these insights that Alex shared with us today, please feel free to go to our website at keyfinancialinc.com. In the meantime, please stay safe, healthy, and by the way, sane. I hope you have a great day. Take care.