Episode 144: An International Economic Forecast with Johanna Kyrklund of Schroders Investments

Patti Brennan: Hi, everybody. 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. Everybody, I am so excited about today's show. Joining me from London, England is Johanna Kyrklund, from Schroders.

I have to tell all of you, I was introduced to Schroders by our friends from Hartford Funds. The investment team was invited up to New York for a Schroders' symposium, which between all of us is a big deal and boy, was I impressed.

So impressed that I took a shot in the elevator and asked Johanna, "Would you by any chance be interested in doing a podcast with me about your views on the economy and this new paradigm shift that you express concern and opportunities called 3D Reset? She said, "Sure, Patti," with her London accent. Joining me today is Johanna Kyrklund. Thank you so much for joining us.

Johanna Kyrklund: Thank you so much for having me on your podcast. I'm very excited to be part of it.

Patti: I will tell you, I was so impressed, within five minutes, I just knew that you were different. I wonder if you could tell me, a little bit about your background. Tell us a little bit more about Schroders. It's not exactly a household name here in the United States, but incredibly well respected overseas. Why don't we open that way?

Johanna: Sure. Thank you, Patti. Basically, just my background briefly, I'm what's called a European mongrel in the sense that I grew up in Italy in Rome. I'm half Finnish, half British, so it's a very much European mix.

I moved to UK for university. I went to Oxford and then started working in the asset management industry. I've been focused on asset allocation, trying to work out where to allocate capital globally, since 1997.

I've been at Schroders since 2007, initially leading the multi-asset team, which basically is a team that invests across assets, and then becoming the chief investment officer in 2019.

Schroders is actually a company with a lot of history, has over 200 years of history. It's been in the United States, you might not know this, but you'll know it, Patti, because you attended our symposium.

We've actually been in New York for 100 years. It was our centenary last year. We manage just over $900 billion on behalf of all kinds of investors, institutions and individuals. Basically, I guess what we're really strong at is international active management. We're very strong in the overseas markets.

We have a lot of US clients and maybe we're not a household name, because we don't operate in the US equity market. We're much more focused on delivering the world to the United States. I'll pause there to see what other questions you might have. I hope that that summarizes things neatly.

Patti: It is such a great introduction, because to your point, Schroders has actually been in the United States for over 100 years, and it's so...I find the history of your company fascinating. It started almost like a family office and has grown into a very large, if I may say, empire, $900 billion of assets is a lot.

What is so impressive to me and was impressive at the symposium is that there's no bias. You're open to almost any asset class. You just want to find the best opportunities for your investors across the globe.

The intellectual capital also was so...The team, oh, my goodness, one person after the other just was as good as the next person or even better, especially with you leading that team.

Johanna: Thank you so much. Thank you.

Patti: You got it. Let's break this up into two segments, because the thing that was really interesting to me in the symposium was this idea of this 3D Reset. Can you explain to us what that really is, and what your outlook is?

Johanna: When I really started, this sort of thought in my head started actually in 2020 when I had COVID and I got stuck. I couldn't interact with my family. I was feeling myself off from the family. I ended up watching "Downton Abbey" from start to finish, [laughs] because I stuck on my own.

Obviously, Downton Abbey is set around the time of the First World War. If you think about the First World War, that impacted a whole generation and things were never the same after that. That got me thinking about the pandemic is that, I don't think you can have a shock like that to the world and then assume we're all going to go back to exactly the way we were before.

That got me thinking more about markets. I think that, already heading into the pandemic, there were a number of big, structural shifts. We were seeing a shift towards a peaking of the working age population.

In the last decade, we have very cheap labor because of globalization and automation and many other forces. That positive dynamic is going into reverse for a number of reasons, partly demographic, but also accelerated by the pandemic, which really shifted working patterns.

We often talk about how you're not going to get an inflation environment like the '70s, because you don't have organized labor, but if the whole global labor market's affected by the same shock at the same time, what happened at pandemic, it's almost as if they were organized.

Another key trend was deglobalization. We've been in environment in the last 20, 30 years, which is all about opening up new markets and new sources of labor. To some extent, due to more tense geopolitical environment, we're seeing a reversing of that. Obviously, we still have globalized supply chains.

At the margin, people are thinking a bit more about reshoring and nearshoring. Again, that was accelerated by the pandemic, because we also saw the vulnerability of global supply chains. Then finally, decarbonization, which ultimately is a major trend, particularly in Europe, but also in other parts of the world.

The point is that all of these things together mean that at the margin, there is a deterioration in the trade-off between growth and inflation, which means that central...If given level of growth, you will have a higher level of inflation.

That means you're going to have a more proactive monetary policy with zero-rate environment is over. That leads us into all kinds of implications for how we allocate assets, how we think about investments. The point is, we do believe that in the last two or three years, we've been moving into a new investment regime.

Patti: That's interesting. 3D, if I hear you right, stands for demographics, decarbonization and deglobalization, right?

Johanna: Yes.

Patti: The demographic part of this is that, with the change in demographics, there are more older people and less younger people in the workforce, that's going to have an impact on inflation and the ability of those younger people to deliver goods and services to the older group. Do I have that, right?

Johanna: Yes, and you're seeing it already in the data. An economic relationship is known as the Phillips curve, which looks at the link between the unemployment rate and wage growth. That relationship was very flat in the last decade.

Wage growth was very weak, pretty much no matter how low unemployment was, while we saw a steepening of that curve over the last two or three years, as in for given level of unemployment, we're getting a higher wage level. You're already seeing more persistent wage growth than what we'd become used to in the last decade. That's partly due to demographic shifts, yeah.

Patti: That's probably here to stay. People are actually getting cost of living raises here in the US and on a worldwide basis. Is that right?

Johanna: Yes, absolutely. Because, again, we're still in a situation where there's some shortage of labor. I could talk forever about this topic, but actually, in the last decade, what we found was that baby boomers were staying in the workforce for longer, possibly because of the financial crisis.

It was actually their presence in the labor market in the States that was depressing wage growth. We're now seeing that cohort retire accelerated by the pandemic. Now you're seeing the reassertion of more normal wage growth, more similar to what we had, say in the 1990s.

Patti: That's really interesting. That is so true. I see it with boots on the ground right here in West Chester, Pennsylvania. I can really appreciate your perspective, especially over there in London, and recognizing that it's not just overseas, it's also happening right here in the United States.

When you think about decarbonization, what is the impact of that on the worldwide economy and leadership especially?

Johanna: Decarbonization means that ultimately, we're diversifying our energy sources. That is quite fundamental. You're changing essentially the lifeblood of the global economy, or certainly diversifying that lifeblood.

That distorts investment patterns quite heavily. You're seeing a lot of bottlenecks in terms of, for example, metals needed for electric vehicles, for example, but then at the same time, a chronic underinvestment in traditional fossil fuels, which is also constraining supply on that front.

Again, what we end up with compared to the last decade where typically energy prices were pretty low, is an environment where we're more vulnerable to supply shocks, more vulnerable to higher prices. That, of course, is a geopolitical angle as well, which has exacerbated that, but that is really...Decarbonization is a somewhat stagflationary trend.

Patti: Fascinating. How about deglobalization? I think this idea of reshoring, or having this supply chain closer to our borders--I was so fascinated to learn at the symposium that Mexico is now our biggest trading partner over China--That's a really interesting trend that probably is going to be here to stay, right?

Johanna: Absolutely. We're seeing this on a number of fronts. I think even Schroders for example, we've been...Of course, the UK has become a low cost...I'm joking, it's not that bad, but since Brexit, we're in a slightly more difficult position, but we will be bringing jobs back to the UK, right?

Patti: Mm-hmm.

Johanna: Now, there's a number of things going on here. One is, a more geopolitically tense environment. We're moving to a multipolar world, which is changing the dynamics.

Generally, people are feeling the need to, at the margin, protect their supply chains, and make sure they're not too reliant on a highly globalized supply chain. On top of that, the pandemic exposed the vulnerability of global supply chains.

Then there's a political reason as well. Essentially, the system we had in place over the last decade, which was one of a globalized labor force, manufacturing being outsourced to overseas economies, ultimately the average person wasn't doing well enough out of the system in the West, and that led to a shift in political policies.

For example, we had the Brexit vote in the UK. We've seen for example, the slogan 'Make America Great Again' in the United States, all of this is a response to the fact that actually as I said, the average person wasn't doing well enough. There have also been political impetus to bring jobs back.

All of this ultimately leads to, at the margin, we're still dealing in a highly globalized economy, but what I would call the invisible hand of Adam Smith on steroids, driven by extreme globalization is slowing down. Again, that was a very deflationary force in the last decade, and it's going to be less so now.

Patti: With that in mind, if inflation is here to stay, if you translated that into where you deploy resources, what do you think about the implications for the bond market for example? Is that still going to be a good place to have capital?

Johanna: Yes. I think the key thing is, so first of all, we're not saying inflation was going to be high, but we're going to be setting...We're after the deflationary environment of the last decade. We're going to have a more normal inflation cycle and the return of a rate cycle, which we didn't have for a very long time.

That means we need to recalibrate the ranges we expect for bonds. In the last decade, we got used to, in many cases, even negative yields from bonds. It seems crazy to remember that now, but that's where we were certainly in Europe.

In that environment, we were still owning bonds because of their negative correlation with equities. We own them at any yield. In an environment where you have the return of a rate cycle and potentially more inflation in the system, i.e. no longer deflationary environment, bonds are not as diversifying.

We would expect the correlation between bonds and equities to be closer to neutral at best, if not slightly positive, but you own them for their yield. The good news is that yield has been restored in fixed income. We're owning it for the old-fashioned reason to generate income in your portfolio.

The point is that, we have to recalibrate the ranges. You need to be compensated by a yield for owning fixed income. There's absolutely a role for fixed income, but you need to get a yield now, and you don't own it for its correlation benefits, you own it based on the yield it can deliver for you.

This year, I think it's a good year for bonds because they have good starting yields, and if the Fed starts to cut rates, you could see also some capital appreciation. The point is, we have to have different ranges for when we own bonds, and potentially be more ready to take profits when the opportunity comes.

Patti: I'm curious, you've mentioned here in London, overseas, Europe, etc., if we go back to the 3D Reset and your outlook, is every economy affected the same way?

Johanna: No, it's really interesting because essentially, we're seeing the emergence of new forms of policy. If you think about it, over the last 20, 30 years, almost starting with Reagan, and Arthur Laffer, we got used to an environment which was all about keeping government spending under control, so tight fiscal policy and loose monetary policy.

That was the orthodoxy over the last couple of decades which reached the extreme after the financial crisis with zero rates. That system as I said, wasn't working for the average person, we're now moving to a new world.

As everyone is trying to work out what the right policy mix is, is that whole framework's being challenged, different economies are going down different paths, partly based on the cards that they have been dealt.

Take the United States. The United States has a significant advantages, its reserve currency status, safe haven, that means that the US has actually been able to run looser fiscal policies than other major economies, because you still have demand for your bonds and you've ended up with much stronger growth as a consequence.

In Europe, we're really on the path of fiscal consolidation, partly because certainly continental Europe is very concerned about too much government spending. They're quite old school in that sense. They were scarred by inflation during the Weimar Republic of the 1930s in Germany, so they're still very focused on the old policy mix of keeping fiscal policy under control.

Japan, having been mired in deflation for a really long time has been running a very loose monetary policy, because they want some inflation in the system.

Basically, we see a huge policy divergence around the world, as everyone responds to this new regime in different ways, partly based on their philosophy, but also their, as I said, the cards they've been dealt, and their ability to do things.

Patti: It was so interesting at the symposium, boy, did you nail it. You told all of us in the audience that United States is probably going to do just fine on the equity side, and you also mentioned Japan, also doing quite well. Sure enough, we ended the year and both economies, both markets surprised, I think everybody. Good for you for that outlook.

Johanna: Thank you.

Patti: You nailed it. Very impressive. Here's a question. When you think about this paradigm shift, I'm just curious, you mentioned Germany in the '30s, etc., how often do these shifts tend to occur?

Johanna: I've been focused on asset allocation since 1997. We're getting on to...this will be...I'm now losing track, but is it 26, 27, 26 years? Something like that?

Patti: You're going. You're almost there at three decades. Impressive.

Johanna: I haven't seen this kind of shift in that time. As I started in the late '90s, we're just moving into that more deflationary dynamic. We moved into the tech bubble, and Asia was already having its crises in the late '90s.

This concept, if you think about it, in the '90s we'd already had a situation where people were really focusing on getting their government finances under control. We saw this with the German reunification. We saw this in Canada under Paul Martin.

Around the world, everybody was getting their fiscal books in order over the '90s. Ultimately, there was a whole debate, if you remember in the late '90s people were saying, "Oh, is it fire versus ice? Will inflation come under control?" It did.

For most of my management career, I've been in that environment of falling inflation, fiscal policy being run tight, ultimate monetary policy being run loose. It's the first time I've seen a major shift. These are quite big, structural shifts. I've never spoken about a different regime in the years I've been managing money.

Patti: I think that's a great way to end our first episode together, Johanna. I think it will be really interesting -- in the second episode -- to see what this shift means in terms of your outlook for the future, where do you see the opportunities? Are there any landmines? I think your perspective and your insights are fascinating.

My next question is going to be, now, how do you apply all of that? Johanna Kyrklund, thank you so much for joining us today from Schroders from London. Thanks to all of you for joining us, as well. This is Patti Brennan. We are Key Financial, Wealth Management with Wisdom and Care. Have a great day.