PBS Episode 145: What is Economic 3D Reset? A Conversation 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.

Joining me for a second episode is Johanna Kyrklund. Johanna is a chief investment officer at Schroder's.

If by any chance you couldn't listen to episode number one, go back and listen to that because she was amazing. I will tell all of you that I had the privilege of being invited to Schroder's Symposium in New York and was introduced by our friends at Hartford.

I knew about Schroder's and their international expertise, but I didn't realize at the time that they've been in the US for over a hundred years, so I wanted to learn even more about the company. It was originally founded over 200 years ago, almost as a family office. We met the great-great-granddaughter of the founder. It was so interesting.

I think you all know me pretty well by now. I'm introduced to a lot of people in the US as well as on an international basis. I've been to London; I've been to Australia. I have had the opportunity to meet some really impressive folks. I've got to tell you, within five minutes of listening to Johanna and her team, wow, the collective intellectual capital that they have there is impressive.

As I said in the first episode, Johanna and I were in the elevator together going down to the lobby, and I just happened to mention, "By any chance, would you be interested in doing a podcast with me?"

She's located in London, and I am so honored that we have Johanna Kyrklund, the chief investment officer of the very well-respected Schroder's on the line with us as we speak. Johanna, thank you so much for joining me.

Johanna Kyrklund: Thank you very much for inviting me, Patti. I'm delighted to be on your podcast.

Patti: In the first episode, we went over your background. I didn't realize that you went to Oxford. I was so impressed with you within five minutes at the symposium. I didn't realize the pedigree that you bring to the table. Thank you so much for joining us. Good for Schroder's for recruiting you, keeping you, and giving you the freedom to really use that intellect that you have.

I think that the explanation that you gave to us in the first episode about this concept of the 3D reset is fascinating and how it all came about. I wonder if you could take a moment and revisit that concept of the 3D reset and what it might mean for our listeners and people watching the show today.

Johanna: Yes. Briefly, what we've been talking about is a shift in the investment regime. There are three structural trends which we believe are affecting the trade-off between inflation and growth. One is demographics. We've reached a peak in the working-age population, so we've been seeing the great retirement, as it's sometimes called, accelerated by the pandemic.

We're seeing deglobalization, so a move to a multipolar world. Concerns about security, global supply chains, and a political focus on bringing jobs back home to improve the standard of living in the West for the average person, because we've seen a rise in income inequality.

Finally, decarbonization, focused on climate change. Of course, in Europe, we also have a geopolitical reason for wanting to, certainly, [laughs] reduce our reliance on Russian energy, and so focus on shifting our sources of energy, which again, distorts investment patterns.

All these things together mean that, for a given level of growth, we'll have a high level of inflation. We've seen the return of the rate cycle. In the last decade, we had zero rates around the world, very much consistent across all economies. Now we're seeing a much more proactive approach to monetary policy around the world. As I said, the return of that rate cycle.

As we all know, interest rates are quite fundamental to how everything is priced in the financial world. That has quite big implications for how we manage our money.

Patti: That is fascinating. What a great summary. I think that one of the things that I learned from you was the impact of this deglobalization, how the unintended consequence was rising inequality within each country and the feeling that, wait a minute, this isn't fair anymore.

The impact politically that it's having on parties. I thought it was, in the polarization that we're feeling here in the United States, just a US issue. What I'm learning is that it's on a global basis. Do I have that right?

Johanna: Absolutely. I mentioned Brexit in the UK, which is very symptomatic of this. We also see, for example, in Germany, the rise of Alternative für Deutschland, which is an extreme far-right party. Of course, the election of more populist figures in places like the Philippines. This is all over the place.

Patti: It's so interesting. We didn't talk about this in the first episode, but there was a statistic that I heard about a week ago that talked about elections on a global basis.

What that statistic said was that 20 years ago, 70 percent of incumbents that were running for re-election got re-elected. Today, 20 percent of incumbents are getting re-elected. That basically goes to that theme of yours that says, there's rising inequality, people just want change, any kind of change.

Johanna: Yeah, this is not working.

Patti: It's not, and that's the way people feel. I think that one of the other things is the differences in the economies, the differences throughout the world.

Again, I must watch a lot of this stuff. I saw Christine Lagarde about a week ago, and she is the president of the ECB, basically, the central bank for Europe. -- she came out and said, "We are not cutting interest rates anytime soon."

Whereas here in the US, a lot of people think that the Federal Reserve is going to start cutting interest rates, maybe by the summer. What do you think about that divergence, that difference between the two approaches?

Johanna: It's very interesting because, again, against the backdrop of these structural shifts, everybody's having to rethink what their policy is, and people are coming to different conclusions.

Now, in the case of Europe, they have a history of being concerned about inflation. Ultimately, they need to keep a lid on bond yields because you have quite high levels of sovereign debt in some of the peripheral economies like Italy. They're very focused on the stability of their bond market. For that reason, they're really prioritizing getting inflation under control.

There is a bit of a difference between the ECB and the Fed. The Fed, on the other hand, has a dual mandate. Probably the key economic scar that you guys have is the Great Depression, so there's a much greater focus on growth, even in central bank policy in the United States, which goes back, as I said, a hundred years.

You have the dual mandate, you're focused not just on inflation, but also unemployment. Also, crucially, you can get away with higher levels of fiscal spending and potentially higher levels of inflation because of the reserve currency status of the US dollar and the fact that the US bond market is still seen as a safe haven.

They're different choices. This is why the ECB is on a more traditional path of keeping inflation under control, keeping fiscal policy under control, while in the US, you're being more stimulative.

The final point to make on that, though, is I do think that expectations of a Fed pivot are potentially over-egged. We've seen the market try to price very extreme Fed rate cuts twice already. There was an attempt in 2022, again in 2023, and again even at the beginning of this year. We're talking about six rate cuts in the United States starting in March. We do think that's too extreme.

We expect three rate cuts in the United States, but we think the Fed can afford to wait until June to get started. We think market expectations for the Fed are also a bit aggressive.

Patti: I love the way you framed that, Johanna. It's so interesting how we have these scars in our countries, we have the Depression, Germany has the bread lines with fighting inflation, and that has a tremendous impact on policy.

We in the United States, the Federal Reserve, probably has a little bit more flexibility because we do have the reserve currency of the world and they do have that dual mandate. They do care about growth, but not at any cost. I think that's what Jerome Powell is coming out and saying, that their goal is to get inflation back down to two percent.

Over in Europe, that is the drop-dead line in the sand that the ECB is focused on. They're not focused on growth; they're focused on inflation. That alone is going to impact how markets do, US, international, etc., as well as currency.

With that in mind, what's your outlook? What do you think about bonds, equities, US, international? Are there any overweight, underweight, any concerns that you might have?

Johanna: I think it's interesting. The first point to make is that one can come up with different asset allocations for different regions. If I think about the United States, I'd probably still favor US equities over US bonds, because especially in an election year, I think that policy will be more supportive of equities than it will be of bonds.

That's my general tendency in the United States. I still like credit in the United States because the evidence is the corporate balance sheets are still in good shape. There's still opportunity to generate return.

If I think about Europe, I think that we have some great companies in Europe, but the bond market, the European investment-grade market is very interesting because, again, the ECB is so focused on keeping inflation under control. Probably we like the European bond market for that reason.

In Japan, again, favor equities over bonds. You don't want to own JGBs. The likelihood is the Bank of Japan will start to tighten later this year. Right now, the Japanese equity markets really benefited from the high level of stimulus.

If we think about China, China of course is the one major economy that's mired in deflation. There, you probably want to be favoring bonds over the equities just because, again, they have a major issue with their property market.

One thing is, compared to the last decade where we were used to thinking about things at pure asset class level, there's much more regional divergence.

Then the final point I'd make is, it's also interesting to see the deviation in valuation. I've always said US equities are reassuringly expensive. Yes, they look expensive globally, but there's a good reason, it's because the earnings are so strong. I have no problem with the valuation of the US market, even if it might look a bit high. As I said, it's reassuringly expensive.

The rest of the world, although the market went up a lot last year, most of the international markets significantly lag the United States, so valuations look quite cheap outside of the US in equities. I find that an interesting opportunity as well.

Patti: I'm curious. We talk about US versus international. Given your outlook especially on, say, European bonds, what about the people that might be listening to this podcast? We are located here in the US. We've got a very strong dollar. Is that still going to be in your opinion, a good investment for someone located in the United States?

Johanna: To misquote Oscar Wilde, rumors of the dollar's death are greatly exaggerated or something. The point is that, again, the dollar looks quite expensive, but it is supported by a higher rate environment than the rest of the world.

At the margin, I'd say this year, I think the dollar could see a slightly weaker trajectory. We talked about the ECB. Christine Lagarde is not for turning on inflation, so very focused on keeping rates in Europe a bit higher.

We're seeing the Bank of Japan potentially moving to a more restrictive policy later this year. You could see a weaker dollar this year, which could be an opportunity for dollar-based investors to go overseas for equities.

On bonds, I'd stick with your home bond market for some boring reasons to do with hedging costs. Basically, for equities, there are opportunities overseas as well.

Patti: Outstanding. I can tell you that those of us who have been deploying assets into international securities for a decade or longer, we've been waiting for that moment when the international securities would then begin to outperform the US, because, of course, people tend to compare their portfolios against the S&P 500.

Especially since it's probably not going to perform overall as well, if the US S&P 500 is the number one performing asset class. It's not that we want that to end, it's just that, I believe, and I think that you believe as well, diversifying on a global basis is really a good idea. We never know what's going to happen in the future, what economies are going to do well, what economies are not.

The impact of this potential paradigm shift, as you referred to as 3D reset, what impact could that have on the United States' dominance, if you will? No one knows. We're not going to know for a decade. To be diversified worldwide is probably a really good idea.

Johanna: Yes, as you say, it's diversification. I was looking at a chart recently, the market cap of the Magnificent Seven as they're sometimes called, the high-performing influential companies in the United States. The combined market cap of those seven stocks now exceeds the combined market cap of China, Canada, France, UK combined.

Patti: Wow.

Johanna: It feels like, thinking about stock weights in your portfolio, it's worth having some diversification. Again, there is no reason why the Magnificent Seven cannot keep doing well, but I'm just saying, it's important not to put all your eggs in one basket.

Patti: Especially because of the way that index works, that Magnificent Seven, if they even just tread water, the most important thing is that you want to have something performing while it treads water. It is so fascinating to think about that.

I know that a lot of people were predicting that they had gone too far too fast. Of course, it was around artificial intelligence. Personally, as I think about that, I think that once we think that through artificial intelligence and what that could mean for other industries. As industries begin to apply that, they can do quite well - as well as other nations.

I think that having money everywhere, very well diversified economically, in different economies as well as different industries, is probably going to be a better way to grow assets in a reliable manner, because we don't know what's going to happen, right?

Johanna: Yes.

Patti: Johanna, I can't thank you enough. I do have one more question, though. If you were to think about potential landmines, things that you worry about, what would that be at this point in time?

Johanna: Two aspects, maybe three. Three. One is just inflation. Again, we're all expecting rate cuts this year. If that, for some reason, gets pushed back further and we get no landing, I don't think the market's priced for that. That's something we need to consider. That's one risk.

The second risk, I'd say, is we must watch what's going on in the Red Sea. I think that we've got used to thinking about a globalized world, digital economy, but we still live in a physical world where a lot of stuff must be transported through some narrow straits.

In general, in that kind of environment where a group of rebels can undermine global supply chains, we need to be alert to those supply shocks still.

Then the last thing, of course, is we all have our eyes on the presidential election in the United States. We've talked today about the fact that global investors are still happy to finance government spending in the United States. Certainly, if we were to see a major shift in fiscal policy towards more fiscal profligacy, that could test the patience of foreign investors in the US bond market.

Patti: That's a good point about what's happening in the Red Sea. It is interesting that a bunch of rebels could disrupt the global supply chain as they are doing right now. That does speak to some of the vulnerability that all of us have as it relates to the rebels, terrorists, etc.

Unfortunately, there are still two wars that are being fought. The geopolitical risks, that's still there. I don't necessarily want to hyper focus on the risks. They're always there and there will always be opportunities as well, and I think that having you here on this show today has been so enlightening. I really appreciate your perspective.

Yes, there may be a paradigm shift, but it doesn't mean that there aren't opportunities for people to grow their assets after inflation in a diversified portfolio.

Johanna Kyrklund, thank you so much. I can't thank you enough for being on the show today from London. Thank you for sharing your insights, your intellect, and your time.

Thanks to all of you who are listening, who are watching, and for joining us on the Patti Brennan Show.

I'm Patti Brennan. We're Key Financial, "wealth management with wisdom & care."

If you have any questions on anything that Johanna mentioned or any questions at all, please feel free to visit our website at www.keyfinancialinc.com.

Thanks again for joining us, and I hope you have a great day.