

Vince Pezzullo: How can investors position for the unknown in 2024?

By Vince Pezzullo

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Whatever happens to the US economy in 2024 – hard, soft or no landing at all, there are opportunities for active investors.

How can investors position for the unknown in 2024?

It's a key question facing markets as investors grapple with the changing likelihood of the three possible scenarios for 2024:

- A significant downturn
- A gradual and controlled slowdown, or
- Sustained economic growth

Each potential scenario – dubbed 'hard landing', 'soft landing' and 'no landing' – has important implications for investors, says Perpetual's head of equities Vince Pezzullo.

"In the middle of 2023, it could have been any of those three scenarios," says Pezzullo, who also manages Perpetual Equity Investment Company, which trades on the ASX as PIC.

"It all comes down to how things play out in the US — and that will have a flow-on effect to the rest of the world."

Under a hard-landing scenario, economic growth might fall rapidly under the weight of higher interest rates, pushing the economy into recession and sending unemployment sharply higher.

In a Goldilocks soft-landing scenario, growth and inflation slow but the economy is spared recession and employment remains strong.

In the least likely no-landing scenario, growth continues unabated by higher rates, forcing further tightening action by central banks.

Watch for second-order effects

Equity markets could come under pressure if the US economy falls into recession as reduced consumer spending drives corporate profits lower, says Pezzullo.

But the key to portfolio positioning is looking beyond the headlines and understanding the second- and third-order effects of a slowdown," he says.

"In a downturn, cyclical stocks tend to perform poorly while bonds do well.

"But there's some derivative effects too. In a hard landing, the Fed starts slashing rates — that means the US dollar should start falling.

"Periods of a lower US dollar are usually when emerging markets do well as money leaves the US in search of better returns.

"Capital flows to the highest return investors can get so and it has been flooding into the US market to get the higher cash rates that the Fed has offered. That's why the dollar is at 20-year highs.

"As Fed rates fall, capital should flow away from the US to other markets."

Balance sheet strength

Pezzullo says the threat of recession means it's critical to reassess portfolio companies for balance-sheet strength.

"We screen out bad balance sheets and we like good balance sheets, preferably with no debt.

"But what looks reasonable in one period can suddenly look excessive in the deep throes of a recession."

Importantly, equities are trading at reasonable valuations, he says.

The Australian market finished November at 15 times forward earnings, the US is on 18 times and emerging markets are trading at 11-12 times.

Australia slows down, but avoids recession

Australia is not immune from the effect of higher rates but has one important advantage that is likely to see it avoid recession — exceptionally strong population growth.

"We've had nearly a million people arrive in two years and this is why aggregate growth has been OK," says Pezzullo.

"Real GDP is growing, and nominal GDP is growing rapidly.

"Now it's also true that per capita growth is going backwards, but with high population growth, it's hard to have a recession because you're getting new consumers and new people bringing capital with them."

The downside of population growth is that it keeps pressure on inflation.

"There has been a big switch in the language used by the Reserve Bank which is now talking about 'homegrown inflation'.

"Population growth means higher demand and if demand is higher than supply, you are going to get inflation. This is partly why the RBA raised rates in November and why they could raise again in February.

"The big risk for Australia in 2024 is stagflation. That means elevated prices and reduced GDP growth. That's a scenario we haven't seen since the 70s."

Defensive picks

Pezzullo says he has prepared PIC's portfolio for the varied potential risks ahead by focusing on quality companies at reasonable valuations with strong market positions that should help them reasonably withstand whatever economic circumstances transpire.

“Our focus in PIC is high quality companies — quality means defensive earnings that are resilient to impact.”

Pezullo says top holdings in PIC include global wagering leader Flutter Entertainment, insurance giant IAG, French lottery monopoly La Francaise des Jeux, real estate owner Goodman Group, and hospital multinational Ramsay Healthcare.

“These are high quality, defensive companies that operate in rational markets. Their earnings will hold up really well during a downturn.”

About Vince Pezullo and Perpetual Equity Investment Company (ASX:PIC)

Vince is Perpetual’s head of equities and portfolio manager of Perpetual Equity Investment Company (ASX:PIC).

Vince has more than 20 years of experience in financial services including global experience as an analyst and portfolio manager.

Perpetual Equity Investment Company Limited (ASX:PIC) is a listed investment company which provides a simple and transparent way to invest in a diversified portfolio of high quality Australian and global listed securities.

PIC is managed to provide investors with an income stream and long-term capital growth.

Perpetual is a pioneer in Australian quality and value investing, with a heritage dating back to 1886.

We have a track record of contributing value through “active ownership” and deep research.

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