Global Matters Weekly

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Macro Matters

by Richard Stutley, CFA

When I raise the issue of the importance of macro, I tend to get the same responses, which fall into two categories: 1. It can't be done; no one has a good record predicting macroeconomic variables like GDP growth. 2. Why bother? Even if you had perfect foresight of what these variables were going to be, you wouldn't be able to predict the market's reaction.

Addressing the second point first, the reason predicting macroeconomic variables is desirable is that they have a bearing on your future payouts from any investment: if GDP growth is weak or negative, company sales are likely to be lower; if inflation is high, the squeeze on real incomes is likely to have a similar effect by reducing consumer discretionary spending; if interest rates go down, holders of government bonds stand to profit, other things being equal.

The biggest factor affecting the performance of most companies is not the size of the wider economy, but whether anyone actually wants to spend money on their product. Hence while every company has a sensitivity to macroeconomic variables as described above, that is not to say that idiosyncratic risk is not key. At times, the macro is dwarfed by these company specific factors, at which point macro doesn't matter, but this will not be true at all times and for all companies. Ignoring cyclical businesses and companies with less than perfect finances in order to avoid having to think about the outlook for growth and interest rates, curtails one's investment universe.

Predicting key variables like growth, interest rates and inflation is extremely difficult, even for professional forecasters[1]. However, establishing reasonable bounds for key variables is more achievable. For example, are central bank rates of 10% in the US likely next year?

We are realistic about our forecasting abilities but we do not assume that anything between plus and minus 10% carries an equal probability. We pay close attention to historical norms. The hurdle to moving away from these norms is high, given that this time is rarely different. In many instances history reveals the natural level of key variables, to which they revert over time by virtue of the natural stabilisers that exist within economies.

As with all big problems, the key is to reduce it into something manageable, which for us means a set of four scenarios. Currently we believe the most likely outcome for the global economy is a strong rebound in growth, with higher attendant inflation than during the pre-pandemic period. In each of these scenarios we don't immediately assume asset class x will go up and asset class y will go down. Instead we think about what is likely to happen to the key variables that influence investment returns. For example, by trying to understand what is likely to happen to company sales in a range of scenarios, we can then interrogate the price we're being asked to pay for equities today. This means we can tolerate a recession without running into cash, if we think the price we're paying for equities and credit adequately compensates us for this scenario.

The key distinction is between a top down investment approach akin to an investment clock, and using macro as an input to a bottom-up, valuation driven approach. We don't believe in investing on the basis of macro, but nor do we ignore it. Macro variables don't tell you what investment returns are going to be: they contribute to the payouts you are going to receive in future, at which point you need to decide what you are going to pay for those payouts today.

1 T Stark, 'Realistic Evaluation of Real-Time Forecasts in the Survey of Professional Forecasters', Federal Reserve Bank of Philadelphia Research, philadelphiafed.org, 2010

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