Investment Newsletter – February 2023

Inflation has savers and borrowers in a tight contest – who will win?

BACK TO BEING BUSY

Well, we are only in February and the quieter and relaxed holiday period of Christmas & New Year already seems like a distant past.

People are back at work and busier than ever as both the unemployment rate and under-employment rate remain at historic lows despite some recent evidence of job losses. China is reopening its economy with vengeance to make up for the lost time of the past two years of Covid-19 lock downs. The Australian economy will win by proxy from China being its biggest trading partner and Chinese tourists and students are set to return to Australia in the coming months. India is another major growth story for the decades to come and an ever more important trading partner for Australia.

Furthermore, the transition of our economic system to being based off renewable energy remains a major economic growth theme for the next few decades. Europe & US are competing with each other right now in enacting trillion-dollar budgets to invest in their economies for transitioning to renewable energies. If the past fifteen years were described as of low growth, stagnation, and economic drift then this decade and the next will be defined by a focused and globally concerted shift to renewable energy systems, it is a major infrastructure investment theme of this half of the 21st century. Australia will also be moving in earnest from all the observations we can make at the political and investments level.

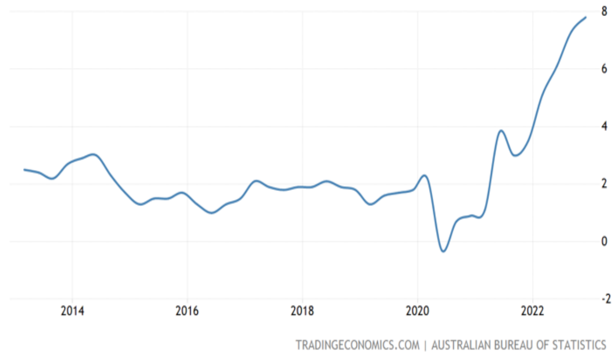
The other major investment theme right now is of growing economic competition between China (and its allies) on one side and US (and its allies) on the other. You may call it the Cold War 2.0 of this century, but at the most basic level this contest should see greater government leadership (big government theme we have written about in the back article of this letter) in setting the direction and priorities of economic development in these respective countries and their allies. This will mean bringing back aspects of critical and advanced manufacturing back on-shore or in aligned countries, it will also lead to greater government supported innovation funding in technology for defence and commerce. In short it paints a picture of focused growth.

In the near term, though, the mainstream economic forecasts remain of a slow-down but no recession in Australia, unemployment to remain at low levels throughout the expected slower growth period of 2023 & 2024.

SO, WHAT'S THE PROBLEM YOU MIGHT ASK?

The problem is as below; inflation is running at almost 8% in Australia and the risk is that it may not come down to the desired 2% for some time, maybe years.

Figure 1: Australian Inflation Rate



Right now, investing is all about keeping as close to the rate of inflation as possible. The further your investment portfolio's returns are below the rate of inflation, and the longer high inflation persists, the more the decline in real value (or in common speak purchasing value) of your wealth. For a lot of people that would mean a fall in their standard of living in the near term.

The twist and the challenge for investors is that the higher the rate of inflation the more challenging it will be to beat inflation through investment returns. In some respects, in high and higher inflationary environment almost everyone loses, in the stable but moderate inflation some will win and some will lose depending on how you position your portfolio. So, the greatest hope right now is that as the RBA have borrowers bogged down and distracted in making higher interest payments on their loans, this will slow down consumption and also inflation. While this is definitely happening in the US where inflation has been trending lower, the same cannot yet be said for Australia. Australia is yet to turn the corner on inflation.

While we hope for lower or even moderate inflation, we cannot entirely base hope as our investment strategy. As a starting point you should remain fully invested and not hold too much excess cash or very low returning income investments as these will see real wealth decline if inflation persists. To give you a feel for what that decline in purchasing value of cash looks like in numbers, we have provided the following example.

Say, you have \$100k cash savings in a bank transaction account earning 1% or less in this inflationary environment because you are being extra cautious. Also, assume if inflation doesn't fall below 5% for the next 3 years despite RBA's best efforts, then your \$100k cash value will be equivalent to \$89k in the next three years in terms of purchasing power i.e. a decline of -11%. At 8% rate of inflation, the decline in the purchasing value of your cash is much worse of -18% to \$81.6k! Imagine if you were living in Europe right now where inflation rate has been over 10% p.a. If that inflation rate persists in Europe, then cash purchasing value there declines -23% in three years, and Europe is already more than one year into the high rate of inflation.

With that background, you can now appreciate why the central banks are so committed to raising interest rates to bring down inflation and if inflation doesn't come down enough then interest rates are going up to a level where they get even with inflation. This is central banks' fight for the savers in the economy while, admittedly, sacrificing borrowers, pushing some into unemployment, and even chancing a recession along the way! Central banks right now are in the mindset of ***whatever it takes*** to bring down inflation and protect the value of savings in cash and lower income generating securities such as bonds.

Is it just pure altruism in favour of savers on the central banks' part? Not entirely. Inflation in the short to medium term also raises the costs of government expenditure because much of their expenditure is inflation linked ranging from pension payments, welfare, government investment projects, to paying for the government bureaucracy etc. Inflation linked spike in government expenditure widens government deficits and increases their need to borrow more in a weaker economy to keep it running. All this is tantamount to governments becoming even more reliant on bond investors, both institutional investors and private investors like us.

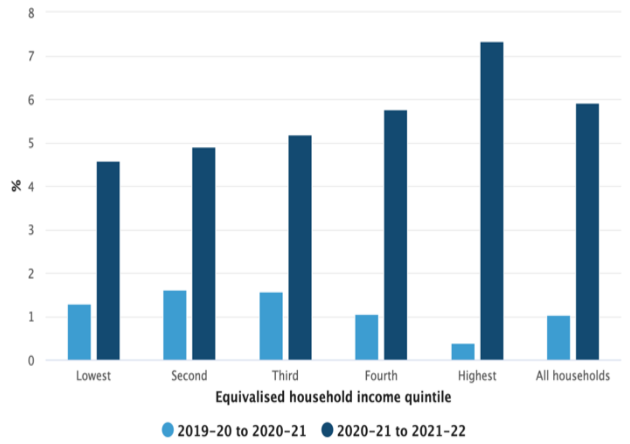
But here is the interesting part, central banks' chiefs mandated for controlling inflation are ultimately reporting to the finance ministers of their respective countries. Finance ministers borrow money from the investment markets to run their economies. It is not for too long the investment markets are going to continue putting up with buying bonds at investment returns of 2% or 3% p.a. when inflation is running at 8%. The signal from bond investors loaning trillions of dollars to governments is clear, bring inflation down to protect our real bond values or else!

Furthermore, Finance Ministers and their governments also regulate pension funds and large institutions to hold certain amounts of government bonds as part of requirements for portfolio diversification while promoting government debt (bonds) as low risk investments. This mandated allocation is also based on a tacit understanding by all concerned that governments and their central banks will manage inflation around the target of 2%. Consequently, unless inflation is brought down in alignment with the commitment to 2%, the governments are facing a real shock to their borrowing capacity and steep rises in interest payments on their bonds. You don't have to look too far back for how badly this can turn for governments than last year when the UK government put out a highly inflationary budget which would have seen a steep and fast decline in the real value of those investors stuck in UK bonds.

So what did the investors in UK government bonds do in response to the inflationary budget? They sold the bonds faster than the government got a chance to respond, this was rational market response to inflation likely to become entrenched at high levels and the anticipated decline in the real value of UK government bonds. Of course, the selling also meant the loss of credibility of UK's central bank and government in the eyes of bond investors. Consequently, the UK government saw its PM and finance minister fired, budget austerity and commitment to interest rate rises was reinforced to bring down inflation and protect the savings of bond investors. This was a test case for the rest of the major countries and since then other countries have hardened their approach to interest rate rises even more.

Our view is that inflation is unlikely to come down to 2% anytime soon for a range of reasons including the ongoing war in Ukraine, China reopening putting pressure on prices, domestic retail spending this time around is actually being supported by higher income earners with more disposable income and much stronger cash savings (Figure 2). So even if the lower income households are forced down in their consumption, you may continue to get an overhang of ongoing consumption from higher income households in the months ahead. Chinese tourists and strong export profits are also positive for Australian economy and consumption ahead.

Figure 2: Australian household consumption growth by income bracket



It would be a reasonable outcome if inflation moderates to around 4% in the next year or two. Investors should consider, Term Deposits that yield over 4%, Credit & hybrids of equivalent or higher income, and stocks that balance dividend income and growth over longer term.

GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,477	-0.07%	6.22%	7.65%	7.24%
ASX 200 Futures	AUD	7,425	-0.03%	6.19%	9.08%	10.97%
Dow Jones	USD	34,086	1.09%	2.83%	3.78%	-2.98%
S&P 500	USD	4,077	1.46%	6.18%	-1.30%	-9.72%
Stoxx Europe 600	EUR	453	-0.26%	6.67%	3.40%	-3.34%
FTSE 100 (UK)	GBP	7,772	-0.17%	4.29%	4.69%	4.12%
DAX (Germany)	EUR	15,128	0.01%	8.65%	12.19%	-2.22%
CAC (France)	EUR	7,082	0.01%	9.40%	9.83%	1.19%
Nikkei 225	JPY	27,327	-0.39%	4.72%	-1.71%	1.20%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,032	-1.20%	7.85%	3.80%	-14.63%
Shanghai Composite	CNY	3,256	-0.42%	5.39%	0.07%	-3.15%
South Korea	KRW	2,425	-1.04%	8.44%	-1.08%	-8.95%
Taiwan	TWD	15,265	-1.48%	7.98%	1.77%	-13.63%
Brazil	BRL	113,431	1.03%	3.37%	9.95%	1.15%
South Africa	ZAR	73,431	-1.23%	9.67%	17.54%	8.27%
Foreign Exchange						
AUDUSD	Currency	0.7055	-0.07%	3.55%	1.00%	-0.17%
AUDGBP	Currency	0.5727	0.19%	1.65%	-0.22%	8.95%
AUDEUR	Currency	0.6495	-0.18%	2.03%	-4.96%	3.26%
AUDCNY	Currency	4.77	-0.10%	2.12%	1.32%	6.01%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,644	2.10%	11.19%	6.25%	-12.48%
LME COPPER 3MO ($)	USD/mt	9,223	0.14%	10.16%	16.48%	-2.98%
LME NICKEL 3MO ($)	USD/mt	30,344	3.85%	0.99%	28.47%	35.90%
SILVER FUTURE Mar23	USD/oz	23.84	0.43%	-0.85%	16.25%	4.86%
ICE Newc Coal Fut Mar23	USD/mt	244.15	-5.00%	-28.10%	-26.84%	70.44%
62% Import Fine Ore in USD	USD/t	117.87	-0.08%	5.54%	12.99%	-11.04%
Gold Spot $/Oz	USD/oz	1,928	0.27%	5.72%	9.20%	7.30%
WTI Oil	USD/bbl	78.87	1.25%	-1.96%	-12.58%	3.53%
Henry Hub	USD/mmBtu	2.67	-6.02%	-23.29%	-67.91%	-51.83%
Corn	USD/Bu	679.75	-0.59%	0.18%	10.30%	8.59%
Wheat	USD/Bu	761.25	1.16%	-3.88%	-5.76%	0.00%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.55%	+0.02%	-0.50%	+0.50%	+1.66%
US	USD	3.51%	-0.03%	-0.37%	+0.86%	+1.73%
Germany	EUR	2.29%	-0.03%	-0.29%	+1.47%	+2.28%
Japan	JPY	0.50%	+0.01%	+0.07%	+0.31%	+0.32%
Italy	EUR	4.16%	-0.04%	-0.56%	+1.13%	+2.86%
Australian Rates						
Cash Rate	AUD	3.10%	+0.00%	+0.25%	+2.25%	+3.00%
90-Day BBSW	AUD	3.34%	-0.03%	+0.08%	+1.19%	+3.27%
180-Day BBSW	AUD	3.68%	-0.06%	-0.09%	+0.91%	+3.43%
CBOE Options						
CBOE VIX (Volatility Index)	Index	19.40	-2.71%	-10.48%	-9.05%	-21.87%

Data as of 31 January 2023

ECONOMIC NEWS

• **In Australia** Inflation accelerated to the fastest pace in 32 years in December Quarter 2022 with the basket of consumer prices (CPI) increasing +7.8% p.a. and prices charged by the wholesalers rose +5.8% p.a. Australia's consumer confidence jumped +5% in January, the largest monthly gain since April 2021, despite inflation expectations rising slightly in the month with consumers expecting prices to rise +5.6% over the next 12-months.

• **Global growth outlook.** The International Monetary Fund (IMF) raised its 2023 global economic growth outlook to +2.9% with most advanced economies seeing improving outlook, with China and India ahead of the pack at growth rates of 5.2% and 6.1%, respectively. World economic growth is expected to be 3.1% in 2024.

• **In the US -** The Fed (central bank) slowed rate hikes, increasing target rate by +0.25% to 4.5-4.75%, however, announced further rates hikes are in store with Fed Chair Jerome Powell announcing that policy will need to remain restrictive "for some time" and there will be no cuts this year as "substantially more evidence" is required to be confident that inflation is on track to decline to the Fed's 2% target while pointing out that the Fed can now say for the first time that the disinflationary process has started.
The US economy expanded at a faster-than-forecast pace in December Quarter 2022 with GDP rising at a 2.9% p.a. albeit the pace of growth was slower, as expected, from 3.2% p.a. reported in September Quarter 2022. However, warning signs of recession emerged with weakening demand among American consumers with personal consumption up +2.1% p.a. over the quarter. US consumer confidence unexpectedly retreated in January with consumers' six-month outlook dropping by the most since June, however, current conditions index rising to the highest since April. U.S. manufacturing downturn deepened in January with a gauge of factory activity coming in at the weakest since May 2020, fuelled by a further pullback in orders and factory production, both of which fell further into contraction territory and to lowest since mid-2020. Labour market burned red-hot in January as hiring unexpectedly surged with nonfarm payrolls increasing 517k and unemployment rate falling to a 53-year low of 3.4%.

• **China's** economy grew +2.9% p.a. in December Quarter 2022, the second slowest pace since the 1970s, and China's population contracted in 2022 for the first time since 1961, pointing to repercussions for the labour market, demand for housing and the country's pension system in coming years. However, outlook for 2023 remained bright with almost all of China's provinces targeting economic growth of >5% in 2023 with most of China's 31 provincial-level jurisdictions seeing their economies expanding +5-6.5% p.a. Budget deficit jumped to a record $1.3 trillion in 2022.

• **Europe.** ECB raised interest rates to 2.5%, the highest since 2008, and announcing it would deliver another hike of the same magnitude in March despite President Christine Lagarde calling risks to the growth and inflation outlook more balanced now. Euro-area inflation slowed more than expected in January with CPI advancing +8.5% p.a., however, a gauge of underlying inflation held at an all-time high of +5.2% p.a.. Euro-area economic confidence rose for a third month in January, climbing to the highest level since June with all major underlying indicators, from industry to services to consumer sentiment, also increasing.

• **India's** government unveiled a $550bn budget for 2023 with the government increasing capital spending by +33% to $122bn to ramp up infrastructure spending and cutting personal income taxes to boost consumption, while aiming to narrow the budget gap by to 5.9% of GDP. India's Statistics Ministry forecast the country's GDP to grow +7% p.a. in 2023 vs 6.8% expansion forecast by the RBI.

GLOBAL MARKETS

US markets were stronger in the month, with the Dow Jones up +2.8% and S&P500 up +6.2%, as investors continued to bet a decline in inflation should see the U.S Feds pause its monetary policy tightening with US short-and long-term inflation expectations improving in January, with consumers expecting prices to advance +3.9% over the next year, the lowest since April 2021 and inflation to rise +2.9% p.a. over the next 5-to-10 years.
European markets were weaker with the Stoxx Europe 600 Index down -3.4%, UK FTSE down -1.6% and German DAX down -3.3%.

Australian Share Market. The ASX200 gained +6.2%, as IMF forecast Australia to likely dodge recession in 2023 while upgrading 2023 inflation forecast to 5.5%.

Commodities. WTI oil price declined -2.0% to US$78.87/bbl, demand is still constrained despite China's bid to reopen its economy from Covid-19 lockdowns. Oil markets are expected to tighten in second half of 2023.
THE LONG READ

A NEW ERA AND A NEW DEAL

In this month's article we wish to shed some light on some accelerating changes that we can see are underway in the western political economies, namely but not only, the US and Australia. As long-term investors it is our responsibility to keep one eye on the horizon of the economic landscape and one on the immediate chaos of the markets. Our goal is to be informed of the changes underway and then optimize our portfolios accordingly to ensure we successfully navigate the future with as little volatility as possible for highest possible returns.

The readers should not be surprised in the revelation that prevailing political philosophy behind economic policies of a country ultimately create the conditions for investment markets to operate in. Political philosophy combined with economic policies can also be described as political order. The choice of a political order determines how a nation wishes to manage its economy. Political order doesn't change from one election cycle to another but perhaps once or twice every hundred years. At the core of a political order is the philosophy of how big or small the role of government will be in organizing, shaping, and participating in the economy of the nation.

In the last one hundred years, America has had two political orders: the New Deal order that arose in the 1930s and 1940s, crested in the 1950s and 1960s, and fell in the 1970s; and the neoliberal order that arose in the 1970s and 1980s, crested in the 1990s and 2000s, and fell in the 2010s.

The New Deal order of big government was an era ushered in by Democrat President Franklin Roosevelt (FDR) between 1933 and 1939 which involved comprehensive program of economic relief and reform in industry, agriculture, finance, waterpower, labor and housing. This was FDR's response to not just resurrect the US economy from the ravages of the great depression of 1929-39 but also re-shape the way government got involved in the economy over the long term.

FDR and the New Dealers unleashed the power of the central state in ways rarely done during peacetime. Some of this work focused on a highly visible overhaul of the country's economic infrastructure. New Dealers built countless roads, bridges, airports, dams, schools, and libraries. The federal government placed extensive new controls on the country's financial system. New Dealers postulated that expenditures well beyond government revenues were a positive good to smooth out ups and downs of business cycles, as were the deficits and government borrowings they generated. A large national welfare state emerged for the first time, much of it funded by the New Deal's commitment to progressive taxation.

When the Republican party took over power in 1952 they did not dismantle the New Deal order. To the contrary they went harder as they found themselves in the middle of an emerging threat from communist Russia and the red wave of communism spreading globally. This required the US government to be seen as a strong central government able to coordinate its resources for defense and a strong economy to resist the communist threat.

In the 1950s, the US government doubled down on big government, and social democratic policies to demonstrate it was the leader of the "free world" and that it could take better care of its ordinary citizens than the leaders of Soviet communism could provide for theirs. There are clear similarities here to the current political wedge developing between China on one side with an authoritarian one-party political system, while US on the other side with its strong democratic traditions. The current re-shoring of critical supply chains back to the US or friendlier countries such as India and away from China is an example of an extending role of government. The Chip Act in the US to fund semiconductor industry to widen its lead on China is another example of big government intervention in the context of US/China cold war that is underway. And it doesn't stop here.

From the mid-1940s to the mid-1960s, the New Deal order rode a wave of global power unlike anything America had experienced before. However, the 1960s and 1970s were the New Deal order's moment of reckoning. As race and Vietnam war became the two most important issues in American politics, they created divides among Democratic Party constituents that the New Deal order could not bridge. These divisions were followed by the long economic recession of the 1970s, a recession whose consequences endured because they were associated with underlying changes in the world economy where resource rich countries started wielding economic power and brought serious economic damage from steep rises in energy prices. Those were the years of polycrises i.e. series of crises. These three forces— race, Vietnam, and economic decline— battered the New Deal order in the 1960s and 1970s beyond a point where it could repair itself.

The big government political order by the 1970s led to stale and stagnant US economy (and other major western economies) with high tariffs, fixed exchange rates, high union power, high unemployment, unproductive labor practices, and closed economies.

A breath of fresh air and seed of economic re-invigoration was sowed from the election of the Republican president Ronald Reagan in 1981. Reagan began to implement his neoliberal (i.e. less regulation) vision for American life across a broad front: deregulating the economy; stripping the government of power and resources; reshaping the courts and their jurisprudence; establishing new rules to "free" political conversation from the grip of establishment. The collapse of the Soviet Union was complete by 1992 and it further cleared the way for markets to be freed of the shackles of government regulations. The contest between big government of the free world and the big government of the Soviet Union was now over.

The 1990s and 2000s were the free reign neoliberal years with the wave of de-regulation continuing as inefficient and stagnant public assets became privatized. New private investments were encouraged across industry and sectors to lift productivity and innovation. Financial markets became increasingly innovative under George Bush II, however, excessive debt build up in the housing market in the US led to the Global Financial Crisis (GFC) in 2008-2009 which was serious enough to almost bring down the financial system. This was the moment of reckoning for the neoliberal order, which by this time had a thirty-year run. Some serious cracks started to show in the neo liberal order as people started to question the ability of free-markets to self-correct on their own.

The GFC was a serious setback to the free-market order as the governments and central banks had to step in to underwrite the viability of banks and financial markets in a number of ways and to a level that was unprecedented financially. The post GFC years have been one off low-growth and political indirection and drift in the US and Australia. The revolving door of prime ministers in Australia in a short period of the past few years was symptomatic of stagnation and lack of vision for the country and economy. The economic inequality that had become a defining feature of the American economy since the 1980s continued to widen. And the consequences of that chasm were hardening. Then arrived another major crisis of the Covid-19 pandemic in 2020, once again requiring the government to take center stage in financially underwriting the economy and ensuring it doesn't fall into an abyss. Majority of the public accepted the government's command and control role of managing the crisis in return for economic safety and health. The government enacted and enforced lock-down controls, paid people to stay at home, prevented businesses from collapsing.

The during and post-Covid-19 period of economic management meant that the extended role of government in our lives, once again, reset the social contract between governments & citizens. This social-contract has been hardening ever since as our economy and politics responds to rolling years of poly crisis with Russia & Ukraine war causing global energy and inflation crisis and the increasing assertiveness of China as a global military power. Additionally, the serious existential threat of global warming to humanity which requires focused, considered, and coordinated response from both business and governments. It is appearing likely that big government will emerge as significant player in this epic energy transition to renewables. For example, Victoria's labor government has pledged to take back control of the state's electricity grid to speed up transition to renewable energy. The government plans to co-invest with industry superfunds.

Based on the evidence above and the recent article penned by treasurer Jim Chalmers where he is convinced of the need to re-design markets to better serve the needs of the times means free-markets will increasingly be met with government intervention which may include capping the allowed rate of return in some sectors, wage price negotiation rules may drive labor cost inflation in high services businesses and thus reset margins. Equally there will be opportunities for companies that benefit from re-shoring and certain strategic industries will attract favorable regulation and funding support. Labor's share of total income is likely to rise in the 2020s in order to reverse previous decades' growth in inequality. However, the labor income is likely to lead to positive economic growth due to labor's propensity to spend over savings. Advanced manufacturing will be part of big government agenda to compete in a polarized political world. Digitization of payments will continue to be priority for big government economies to reduce black economy, lower transaction costs, and raise tax collections.

In the 2020s, the role of active investment management will be essential as investors will need to continue asking which of their portfolio companies' activities fit with the priorities of governments and which don't. There are great opportunities ahead for investors as was the case in the New Deal order years of 1950s,60s.

For enquiries:

- geoff.walley@investwisely.co
- Phone (02) 9634 6698 (within Australia), or
- Write to:
  Investwisely Pty Ltd
  Shop 7, 1 Circa Boulevard
  Bella Vista NSW 2153