Investment Newsletter – November 2023

There are three kinds of lies: lies, damned lies, and statistics

Welcome to the November letter.

We'd like to commence this month's letter by taking a moment to consider a reminder to investors that they should approach investment decisions backed by statistics with a healthy dose of scepticism, rather than taking them as absolute gospel.

The most misleading form of statistics are those computed on data from surveys (e.g. economic/market surveys). When these surveys are presented as neat mathematical graphs they tend to project an un-deserving legitimacy. We are not suggesting statistics are entirely useless, however, they can be manipulated or misused to support false or misleading arguments. Ultimately, investors and their advisors need to lean on their critical thinking and take care in analysis when interpreting statistical information. ***Basing portfolio decisions on flawed statistics can and do lead to losses in investment portfolios.***

For example, let's consider the chart in Figure 1, which is regularly published by the RBA. This chart surveys participants, typically including financial market economists, analysts, and experts from various financial institutions such as banks, investment firms, and research organizations.

Participants are asked to provide their predictions and expectations for the future movements of the RBA's official interest rate. They may be asked to forecast the interest rate over different time horizons, such as the next 6-12 months.

Figure 1: This chart is a survey of expectations (predictions) regarding the level at which interest rates will peak in the coming 6-12 months.

* Daily 4:30PM except for latest data point, which is 9:00AM; Highest expectation across all tenors.

Sources: RBA; Refinitiv.

So, let's examine the chart together. On the left-hand side, in early 2022, all these surveyed experts were predicting that interest rates would peak below 2.5% at that time. They were hopelessly wrong because, instead of peaking, interest rates were just beginning to rise. Investors, fund managers, and advisors would have also been mistaken in following these predictions by staying invested in low-interest-bearing investments. Ultimately, investors would have incurred losses due to the negative returns in the following months as rates continued to rise.

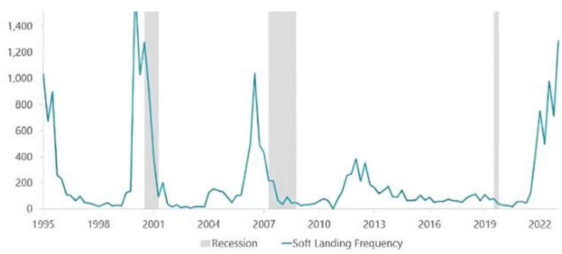
The surveyed experts, in some ways, represent the apex of the inverted pyramid of market participants who make investment decisions. These survey predictions are initially presented as charts and numbers, which are subsequently adopted by the broader market. These wild predictions are then disseminated and echoed repeatedly through financial media, market commentary, and fund manager reports. ***What initially began as wild guesses from individuals in a survey covertly transform into more significant assumptions and inputs for investment decisions.***

You can observe that interest rate predictions have been range bound between 3.5%-4.5% for the past 1.5 years. These are wild fluctuations, meaning the surveyed experts haven't a clue. In any case, we don't take these predictions too seriously, we rely on our own painstaking research of economic fundamentals, which ultimately drive inflation and interest rates.

Speaking of wild predictions, here's another one: the expected soft landing of the economy. You can observe that every time interest rates have been raised as part of a campaign since the early 1990s, market participants have talked up predictions of a gentle, soft landing for the economy. However, in reality, these predictions have proven flawed and rate rises have led to recessions.

In the back article of this letter we discuss our outlook for the Australian economy in 2024.

Figure 2: It always starts as a 'Soft Landing'



Note: Soft landing frequency is the count of mention of the term "soft landing" in company filings, transcripts, and presentations since 1995. Data as of September 30, 2023. Source: NBER and Bloomberg

GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-y
Developed Markets Equities						
ASX 200	AUD	6,781	0.11%	-3.80%	-7.23%	[illegible]
ASX 200 Futures	AUD	6,783	0.03%	-4.28%	-6.53%	[illegible]
Dow Jones	USD	33,053	0.38%	-1.36%	-3.07%	[illegible]
S&P 500	USD	4,194	0.65%	-2.20%	0.58%	[illegible]
Stoxx Europe 600	EUR	434	0.59%	-3.68%	-7.07%	[illegible]
FTSE 100 (UK)	GBP	7,322	-0.08%	-3.76%	-6.97%	[illegible]
DAX (Germany)	EUR	14,810	0.64%	-3.75%	-6.98%	[illegible]
CAC (France)	EUR	6,886	0.89%	-3.50%	-8.09%	[illegible]
Nikkei 225	JPY	30,859	0.53%	-3.14%	6.94%	[illegible]
Emerging Markets Equities						
MSCI Emerging Markets	USD	915	-0.73%	-3.94%	-6.33%	[illegible]
Shanghai Composite	CNY	3,019	-0.09%	-2.95%	-9.16%	[illegible]
South Korea	KRW	2,278	-1.41%	-7.59%	-8.94%	[illegible]
Taiwan	TWD	16,001	-0.92%	-2.16%	2.71%	[illegible]
Brazil	BRL	113,144	0.54%	-2.94%	8.34%	[illegible]
South Africa	ZAR	63,874	-0.58%	-3.95%	-12.00%	[illegible]
Foreign Exchange						
AUDUSD	Currency	0.6337	-0.58%	-1.52%	-4.20%	[illegible]
AUDGBP	Currency	0.5215	-0.45%	-1.13%	-0.97%	[illegible]
AUDEUR	Currency	0.5992	-0.22%	-1.54%	-0.22%	[illegible]
AUDCNY	Currency	4.64	-0.45%	-1.26%	1.47%	[illegible]
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,252	-0.66%	-4.07%	-4.44%	[illegible]
LME COPPER 3MO ($)	USD/mt	8,111	-0.37%	-1.93%	-5.64%	[illegible]
LME NICKEL 3MO ($)	USD/mt	18,130	-1.94%	-3.02%	-25.14%	[illegible]
SILVER FUTURE Dec23	USD/oz	22.95	-1.90%	2.24%	-10.95%	[illegible]
ICE Newc Coal Fut Jan24	USD/mt	131.10	-4.55%	-21.28%	-36.76%	[illegible]
62% Import Fine Ore in USD	USD/t	118.75	-0.05%	1.63%	11.51%	[illegible]
Gold Spot $/Oz	USD/oz	1,984	-0.61%	7.32%	-0.31%	[illegible]
WTI Oil	USD/bbl	81.02	-1.57%	-8.76%	9.32%	[illegible]
Henry Hub	USD/mmBtu	3.34	5.36%	24.63%	47.14%	[illegible]
Corn	USD/Bu	478.75	0.10%	0.42%	-24.72%	[illegible]
Wheat	USD/Bu	556.25	-1.72%	2.72%	-10.25%	[illegible]
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	4.93%	+0.05%	+0.44%	+1.59%	[illegible]
US	USD	4.93%	+0.04%	+0.36%	+1.51%	[illegible]
Germany	EUR	2.81%	-0.02%	-0.03%	+0.49%	[illegible]
Japan	JPY	0.95%	+0.05%	+0.18%	+0.55%	[illegible]
Italy	EUR	4.73%	-0.01%	-0.06%	+0.55%	[illegible]
Australian Rates						
Cash Rate	AUD	4.10%	+0.00%	+0.00%	+0.50%	[illegible]
90-Day BBSW	AUD	4.36%	+0.02%	+0.21%	+0.68%	[illegible]
180-Day BBSW	AUD	4.75%	+0.04%	+0.34%	+0.90%	[illegible]
CBOE Options						
CBOE VIX (Volatility Index)	Index	18.14	-8.15%	3.54%	14.96%	[illegible]

Data as of 31 October 2023

ECONOMIC NEWS

• **In Australia –** The RBA left the cash rate unchanged in October, however, resumed raising interest rates in November, increasing its cash rate to a 12-year high of 4.35% and revising up its inflation forecast slightly to 3.5% by end-2024.

In the third quarter of 2023, the inflation rate increased more than anticipated. The Consumer Price Index (CPI) went up by 5.4% year-on-year, and the core CPI, which excludes volatile food and energy prices, increased by 5.2% year-on-year. However, factory inflation, measured by the Producer Price Index (PPI), slowed down, with a year-on-year growth of 3.8%, compared to 3.9% in the second quarter of 2023. Additionally, consumer expectations for inflation in the next 12 months rose by 20 basis points (0.20%) month-on-month to reach 4.8% in October.

• **In US -** The US Fed held interest rates at a 22-year high of 5.25-5.5% for a second straight meeting, signalling financial conditions have tightened significantly while also saying it isn't yet confident to judge whether monetary policy is restrictive enough to bring inflation back to the 2% target, leading to swaps now showing traders see an only 16% chance of another hike by January and have fully priced in a cut by June instead of July. According to Fed's Beige Book survey, the outlook for the U.S. economy is stable or may show softer expansion, with prices continuing to increase at a modest pace overall with sales prices increasing at a slower rate than input prices, as businesses struggled to pass along cost pressures because consumers had grown more sensitive to prices.

• **In China –** GDP grew +4.9% p.a. in September Quarter 2023 on strong consumer spending, leading to Chinese President Xi Jinping stepping up support for China's economy, issuing additional sovereign debt and raising the budget deficit ratio for 2023 to about 3.8% of GDP. A measure of foreign investment into China turned negative for the first time since records began in 1998 in September Quarter 2023 with China's direct investment liabilities in its balance of payments declining by $11.8bn, highlighting how foreign companies are pulling money out of the country due to geopolitical tensions and higher interest rates elsewhere. Factory activity fell back into contraction in October while expansion of the services sector unexpectedly eased. Trade data for October offered a mixed picture for the economy's outlook, as an unexpected +3% p.a. pickup in imports was offset by signs that global demand for Chinese goods is struggling to gain traction with exports dropping -6.4% p.a., resulting in trade surplus of $56.5bn.

• **In Europe -** The European Central Bank (ECB) has decided to keep interest rates the same, marking the first time they haven't changed in over a year. They are maintaining the deposit rate at a high of 4%, with the goal of helping consumer prices reach the 2% target. In October, inflation in the Euro-area slowed to its lowest point in over two years, with consumer prices rising by 2.9% year-on-year. Additionally, the Euro-area economy contracted by 0.1% in the third quarter of 2023 (up by 0.1% year-on-year). The private sector in the

Euro area also started the fourth quarter on a weak note, with the Purchasing Managers' Index (PMI) hitting a three-year low in October.

• **In India -** RBI kept interest rates unchanged at 6.5%, however, struck a hawkish policy tone while announcing the bank is considering selling bonds in order to soak up extra cash, despite its survey revealing Indian households expect inflation to fall in the coming months. India's services activity in October grew at the slowest pace in seven months as a pickup in inflation expectations dampened overall business sentiment, and manufacturing activity slipped to the lowest in eight months.

• **In Germany** - The German government has lowered its expectations for the German economy in 2023, now predicting a contraction of 0.4%. They have also adjusted their 2024 outlook to a growth rate of 1.3%, and for 2025, they anticipate a growth of 1.5%. Inflation is expected to slow down to 2.6% in 2024. In the third quarter of 2023, the German economy contracted by 0.1%. In October, inflation slowed significantly, with consumer prices rising by 3% year-on-year, the slowest rate since June 2021. Investor confidence improved for the third consecutive month in October, even though the index for current conditions worsened slightly. Business outlook also saw a slight improvement in October, with both the expectation index and the measure of current conditions unexpectedly advancing.

• **US markets were lower,** with the Dow Jones down -1.4% and S&P500 down -2.2%, amid concerns over climbing Treasury yields, interest rates staying elevated for longer and rising geopolitical concerns. The ASX200 declined -3.8%, as RBA announced a growing number of Australian households are in the early stages of financial stress, while lenders remain in a solid position to absorb loan losses if needed.

• **Long-dated US treasury yields were higher,** 2-Yr yield at 5.07% and 10-Yr yield at 4.93%, amid a heavy slate of new corporate debt sales and supply concerns ahead of a series of three auctions despite U.S. Treasury announcing plans to slow the pace of increase in its quarterly long-term debt sales amid a widening fiscal deficit.

THE LONG READ

GROWTH WILL SLOW IN 2024

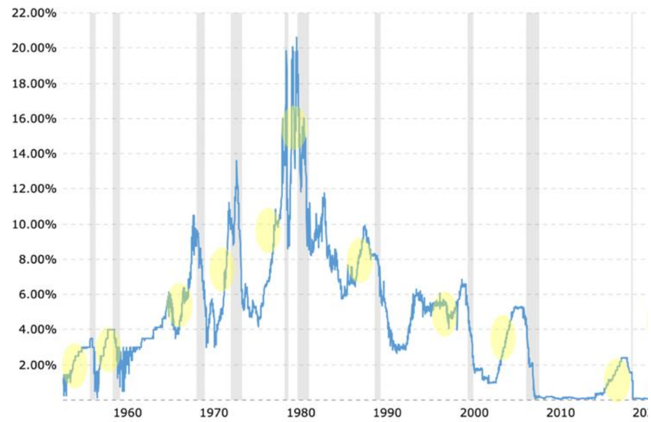
Markets are hoping that inflation will be brought back down to 2%-3% sometime in the next 12-24 months while simultaneously paving the way for the RBA to cut interest rates. The implication is that the RBA will be able to cut interest rates just in time to finely balance positive economic growth with stabilizing inflation. If only real-life economics worked that seamlessly!

Interest rate hikes waged as a campaign cause recessions

The regular readers of these articles would know that we draw a lot of inspiration from reading the patterns of economic history. So, in that vein, let's revisit an important lesson of history about the direct link between rising interest rates and economic recessions. This link is unbroken, just like night follows day!

Please allow us to indulge you with observations from what is probably the only chart, shown below, that you need to pay attention to right now if you are agonizing over the question of the economic growth outlook over the next 12 months.

Figure 1: US Fed Funds rate and economic recessions as shaded, 1950-2023



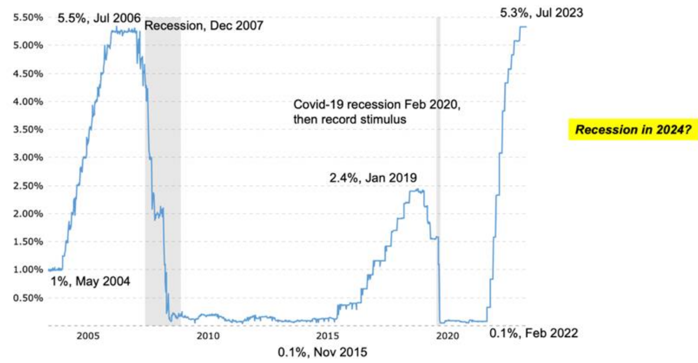
Source: https://www.macrotrends.net/2015/fed-funds-rate-historical-chart

We want to be clear here that while we are drawing on U.S. interest rate history, we believe that the conclusions also apply to the Australian economy, particularly when much of the debt in Australia's economy stands at mostly short-term interest rates.

The chart in Figure 1 shows ten economic recessions between 1950 and 2020. The recessions are shaded in grey bars, where the thickness of each grey bar represents the duration of each economic recession. What you should find obvious in the chart is that each economic recession was preceded by a campaign of interest rate increases. This happened every single time! For emphasis, we have highlighted the interest rate hiking campaigns by central banks.

To delve deeper into the above thesis, let's take a closer look at the two past recessions.

Figure 2: Interest rate campaigns preceding the Global Financial Crisis 2007-2008



Source: https://www.macrotrends.net/2015/fed-funds-rate-historical-chart

Firstly, the global financial recession in 2007-2008 was preceded by an aggressive two-year rate hiking campaign by the U.S. Federal Reserve. The federal official cash rate rose from 1% in 2004 to 5.5% in 2006, and then interest rates were left at that tight setting for another 12 months until late 2007. By that time, the damage was well and truly done to the economy, as many households and companies that had borrowed at low fixed rates for 2-3-5 years were going to eventually refinance at new rates that were just too high to service.

The economic activity in late 2007 was thus eventually choked by the debt burden on corporate and household balance sheets that was financed in the low-interest years at fixed rates that came to a grinding halt for refinancing at much, much higher rates.

In some respects, borrowers had over 1.5 years once rates had peaked in July 2006 to gradually sell down highly leveraged assets and lower their debt levels, but they didn't. The credit markets finally and suddenly raised the white flag and locked up, making debt prohibitively expensive or, in a lot of cases, unavailable altogether. ***The crisis was seen coming by many but was unheeded by most until it was too late.***

The recession arrived in 2008, and the equity markets had, let's just say, a decent sell-off. If you had the historical chart in Figure 1 on hand between 2006-2007, you would have known that the risks of rising interest rates would eventually have their day of reckoning. This is particularly true in economic cycles when debt goes from being at very cheap rates for a number of years and then resets to much higher rates in a short period of time.

Interest rates have been low for the past decade, and now they are not. The rate-hiking campaign of +5.2% between February 2022 and July 2023 was even faster than the 2006-2007 campaign. ***Do we really believe that this time it is different and that the aggressive rate-hiking campaign of the past year will not lead to the 11th recession to match the pattern of the past 80 years? Really?***

As a further comment, reflecting on the lead-up to the recession in early 2020 during Covid-19, you might say, *'Well, hang on, the thin bar depicting the short recession in early 2020 was actually caused by Covid-19 lockdowns and not necessarily the interest rate increases of circa 2.3% between 2015 and 2019.'*

Well, if you review the mainstream economic commentary from late 2019 as I did by opening my firm's macroeconomic strategy paper dated October 2019, we noted as follows: *'Economic data from most parts of the globe continues to point to moderating economic conditions, and the IMF has downgraded (again) their 2019 global economic growth expectations.'* The commentary certainly suggested that the economic cycle by 2019 was in its late stage, months before Covid-19

In fact, The Economist magazine went a little further in its 11 July 2019 issue: *'At the end of July, America's economy will have been growing for 121 months, the longest run since records began in 1854, according to the NBER, a research body.* ***History suggests there will be a recession soon.'***

How to prepare for a recession in 2024?

One of the keys ways to prepare for a recession is to have balanced portfolio. We have begun to add long term fixed interest exposure. This exposure acts as counterweight to the equity market in the event that a recession is more pronounced than expected.

The market is not currently priced for perfection. The market PE is at average levels. Our view is that the market will actually be comforted by a short sharp recession if it comes. The worst outcome for markets is not recession, but stagflation. Once we get clarity that rates have peaked and inflation is tracking back to trend, recession or not, the market will start to reward good companies accordingly.

This market is not the same as 2008, the market has priced in many risks such as recession, inflation, interest and geopolitical concerns. There will be a slowing of growth in 2024, and it may trigger a recession, but many business are far better placed to manage. In 2008 there were many companies who had a business model with no way to profitability. In 2023 the largest companies in the world generate more spare cash flow than some countries GDP.

We think despite the headwinds that are clear for everyone to see, staying invested in this market will deliver solid long term returns.

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