Investment Newsletter – August 2023

The slowdown is becoming palpable

We'd like to begin this month's letter with a general reflection on the state of the economy. The comprehensive economic data released globally in major advanced economies over the past four weeks indicates a slowdown or contraction in business activity and consumption.

Economic activity is slowing, *everywhere …*

One way to gauge the pulse of the economy is by talking to businesses and asking how they are faring. We can get a good sense of whether businesses are satisfied with their current sales and trading activity, and whether they are battening down the hatches in anticipation of a slowdown. These surveys, formally known as the Purchasing Managers Index (PMI), can also serve as leading indicators for future trends in unemployment rate, inflation, business profitability, dividends, and share prices.

We specifically look for a general trend in these survey readings over successive months to confirm our assumptions of the near-term direction of the economy.

For consumption driven economies of Australia, US, and Europe the activity indicator to watch is **Services PMI** which surveys a range of services businesses. A reading below 50 indicates contraction of these businesses and profitability.

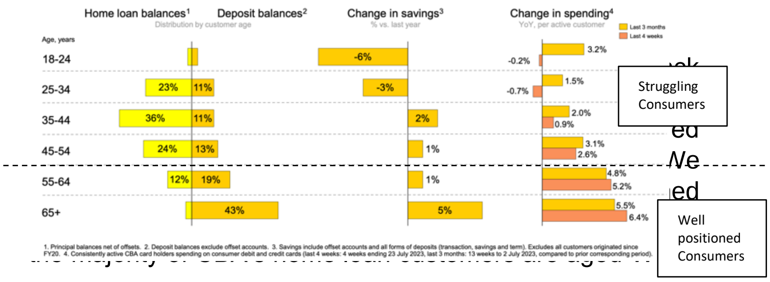
In July, the services PMI in Australia declined to 48.2 points. While the US reported a positive figure at 52 points, it has shown a clear declining trend over the past three months. In Europe, the PMI has also been consistently declining, currently standing at 50 points. On the other hand, in China, the **Manufacturing PMI** is of greater significance due to its export-oriented industrial economy. This PMI has also consistently fallen over the past three months, now registering at 49 points.

Looking at these surveys from various countries, and should these downward trends continue, we can only conclude unemployment is set to increase and corporate profits will decrease over the next six months. Some estimates suggest that the decline will likely continue into the middle or even late next year.

#…High interest rates start to bite…

Commonwealth Bank of Australia (CBA), in their full year results presentation this month showed the following chart which is worth sharing here.

Figure 1: Challenging environment for Household Savings and Spending



We have divided the chart into two sections using a black dashed line that runs horizontally across it. As highlighted in yellow, the majority of CBA's home loan customers are between 18 and 54 years. Furthermore, these customers tend to have the least amount of savings. Notably, their spending rate has decreased significantly in the past four weeks, as indicated by the orange highlight.

Contrastingly, the well-heeled customers of the bank are above 55 years of age with negligible to no loans and most of their banking is in the savings & deposits. These older age groups of consumers are the beneficiaries of higher interest rates on their deposits. As evident from the chart, this age group continues to exhibit strong spending growth, even as recently as the past four weeks.

It's possible that seniors are not only splurging on themselves but also covering some expenses for their children and grandchildren. This might be occurring because property values and share prices have generally remained stable, thereby preserving the net wealth and confidence of seniors. If seniors are bearing the expenses of younger family members, we don't view this as sustainable. It could prolong the need to maintain high interest rates, and eventually, the goodwill of seniors will run out.

#...Meanwhile interest rates continue to rise…

The chart below displays the interest rate at which the Australian government borrows money. This rate largely determines most other long-term interest rates in the economy for households and businesses. In August, this rate has been trading both aggressively and persistently, as though it is aiming to reach new highs. Even at its current levels, it suggests that companies with high debt levels may face increasing interest payments in the upcoming periods. This will reduce their earnings, assuming all other factors remain constant.

Figure 2: Interest rates remain high and pushing on the ceiling

#...Remain defensively positioned to growth

We maintain our view that investors should remain defensively positioned towards growth. We prefer high-quality stocks with low debt and recommend investment-grade credit funds for income.

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GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,410	0.09%	2.88%	-0.89%	6.70%
ASX 200 Futures	AUD	7,358	0.01%	2.75%	-0.43%	9.17%
Dow Jones	USD	35,560	0.28%	3.35%	4.32%	8.26%
S&P 500	USD	4,589	0.15%	3.11%	12.57%	11.11%
Stoxx Europe 600	EUR	471	0.12%	2.04%	4.00%	7.54%
FTSE 100 (UK)	GBP	7,699	0.07%	2.23%	-0.93%	3.72%
DAX (Germany)	EUR	16,447	-0.14%	1.85%	8.72%	21.97%
CAC (France)	EUR	7,498	0.29%	1.32%	5.86%	16.27%
Nikkei 225	JPY	33,172	1.26%	-0.05%	21.39%	19.32%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,047	0.36%	5.80%	1.49%	5.35%
Shanghai Composite	CNY	3,291	0.46%	2.78%	1.09%	1.16%
South Korea	KRW	2,633	0.93%	2.66%	8.56%	7.39%
Taiwan	TWD	17,145	-0.85%	1.36%	12.32%	14.30%
Brazil	BRL	121,943	1.46%	3.27%	7.50%	18.20%
South Africa	ZAR	73,634	0.70%	4.14%	0.28%	17.86%
Foreign Exchange						
AUDUSD	Currency	0.6717	1.01%	0.80%	-4.79%	-3.84%
AUDGBP	Currency	0.5234	1.14%	-0.29%	-8.61%	-8.81%
AUDEUR	Currency	0.6108	1.23%	-0.02%	-5.96%	-10.62%
AUDCNY	Currency	4.80	0.94%	-0.72%	0.66%	1.99%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,283	2.72%	6.09%	-13.67%	-8.28%
LME COPPER 3MO ($)	USD/mt	8,832	1.95%	6.21%	-4.24%	11.54%
LME NICKEL 3MO ($)	USD/mt	22,293	-0.06%	8.66%	-26.53%	-5.61%
SILVER FUTURE Sep23	USD/oz	24.97	1.95%	8.48%	2.13%	19.57%
ICE Newc Coal Fut Oct23	USD/mt	144.70	-2.23%	-9.14%	-41.56%	-50.51%
62% Import Fine Ore in USD	USD/t	110.46	0.00%	2.01%	-6.29%	5.89%
Gold Spot $/Oz	USD/oz	1,965	0.29%	2.38%	1.90%	11.28%
WTI Oil	USD/bbl	81.80	1.51%	15.57%	4.52%	-4.27%
Henry Hub	USD/mmBtu	2.58	1.98%	4.03%	-3.01%	-69.03%
Corn	USD/Bu	504.00	-3.26%	-9.11%	-25.86%	-18.22%
Wheat	USD/Bu	665.75	-5.47%	4.64%	-12.55%	-17.58%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	4.06%	-0.01%	+0.04%	+0.51%	+1.00%
US	USD	3.96%	+0.01%	+0.12%	+0.45%	+1.31%
Germany	EUR	2.49%	+0.00%	+0.10%	+0.21%	+1.68%
Japan	JPY	0.61%	+0.04%	+0.21%	+0.12%	+0.43%
Italy	EUR	4.10%	-0.01%	+0.03%	-0.05%	+1.08%
Australian Rates						
Cash Rate	AUD	4.10%	+0.00%	+0.00%	+1.00%	+2.75%
90-Day BBSW	AUD	4.28%	-0.01%	-0.08%	+0.94%	+2.13%
180-Day BBSW	AUD	4.67%	-0.02%	-0.04%	+0.99%	+1.90%
CBOE Options						
CBOE VIX (Volatility Index)	Index	13.63	2.25%	0.29%	-29.74%	-36.10%

Data as of 31 July 2023

ECONOMIC NEWS

• **In Australia,** The RBA kept its key interest rate unchanged at 4.1% in both July and August policy meetings, following a cooling of inflation pressures and weaker household spending, while keeping the door open to future hikes, as the bank forecast inflation easing to around 3.25% by the end of 2024 and falling back to within the target in late 2025, GDP growing at 1.75% over 2024 and unemployment rising to 4.5% by late next year.

In the second quarter of 2023, the inflation rate increased by 6% compared to the previous year, which is a slower growth than anticipated. On a quarterly basis, it went up by 0.8%. Consumer confidence saw a slight improvement in July from the previous month, but overall, people are still feeling quite pessimistic.

• **The US Federal Reserve (the Fed)** recently increased its interest rates to a range of 5.25% to 5.5%, marking the highest rate since 2001. The Chair, Jerome Powell, hinted at possible further hikes, but decisions will be rooted in forthcoming economic data. On a brighter note, the Fed has shifted its view on the economy, now seeing its growth as "moderate" instead of merely "modest," and has set aside concerns about an impending recession. Meanwhile, US consumer confidence soared in July, reaching a two-year peak. Many feel this is the healthiest the economy has been since March 2020, though they anticipate a 3.4% rise in prices in the upcoming year. Broadly, while the US economy has enjoyed growth since May, some regions anticipate a potential slowdown. Factory performance in July wasn't exactly stellar, marking the ninth month of decline. However, indicators like new orders and production rates are showing promise. The White House is optimistic for 2023, forecasting a 0.4% growth in the US economy. But their growth projection for 2024 has been trimmed to 1.8%. Inflation is predicted to be 3.3% in 2023 and 2.5% in 2024, while the anticipated unemployment rates are 3.8% for 2023 and 4.4% for 2024, both lower than earlier estimates. On the financial front, credit rating agency Fitch has downgraded the US's rating due to concerns about debt management and other fiscal challenges, though they believe the outlook remains stable. This decision has drawn criticism from US Treasury Secretary, Janet Yellen, who labelled it as "arbitrary" and "outdated."

• **In China –** Economic growth slowed down in the second quarter of 2023. The GDP rose by 6.3% compared to the previous year and only 0.8% from the previous quarter. The slowdown became even more evident in July: manufacturing decreased, the services sector weakened, and home sales dropped by a significant 33.1%, marking the largest decline in a year.

• **In Europe -** The European Central Bank (ECB) has increased interest rates to 3.75%. While they haven't made a clear decision about the next meeting, they've given investors some reassurance. They've hinted that they're close to concluding their phase of increasing interest rates. This comes as ECB President, Christine Lagarde, shared that the immediate economic prospects for the Eurozone aren't looking great, mainly due to a drop in local demand.

On the bright side, the economy of the Euro area began growing again in the second quarter of 2023. The GDP went up by 0.3% compared to the previous quarter and by 0.6% year-over-year. This comes after a period of decline and then stagnation.

However, inflation is still a concern. In July, the Consumer Price Index (CPI) rose by 5.3% compared to the previous year. Interestingly, the core-CPI, which doesn't include volatile items like food and energy, was even higher at 5.5%. This is the first time since 2021 that the core rate has surpassed the general rate.

Lastly, the private-sector economy in the Euro area had a rough July. It declined more than expected, hitting its lowest since November. Indicators such as order inflows and output expectations suggest that this downturn might intensify in the near future.

• **In commodities -** Commodities have seen some significant changes recently. For instance, the price of WTI oil increased by 15.6% over the past month, reaching US$81.8 per barrel. This rise comes as the Energy Information Administration (EIA) predicts that in 2023, global oil consumption will surpass production. Contributing to this scenario, both the OPEC+ alliance and other oil producers are expected to slightly reduce their output, bringing the total global oil supply to about 101.1 million barrels a day, which is just a bit less than the anticipated demand.

• **In Politics** - Fears of a China-Taiwan conflict grew as Chinese warplanes made their largest incursion into Taiwan in 3 months. Following this, President Xi Jinping urged increased military drills in the Taiwan Strait. In response, the U.S. announced a $345m military aid package for Taiwan.

THE LONG READ

Demographic Destiny: A Game-Changer for Smart Investors

The global phenomenon of aging populations poses significant challenges to countries around the world. The burden of an aging demographic has far-reaching consequences on various aspects of society, including supply of labour and inflation, lower economic growth, fiscal instability of government budgets leading to forever more government borrowing and risks to their credit ratings, and weaker geopolitical influence. These consequences need to considered when allocating capital to different markets in investment portfolios.

In this article, I will present key arguments surrounding demographic challenges ahead that appear to weigh in favour of United States, Australia, and India compared to Germany, Japan, and China which look decisively weaker. Let's explore key indicators such as demographic profiles, labour market dynamics, economic resilience, and geopolitical influence to see why I have arrived at above conclusion.

Demographic Profiles

Understanding the age structure and population trends of different countries is crucial in evaluating the burden of aging demographics. The great industrial powers of Germany, Japan, and China are currently facing significant demographic challenges characterized by low birth rates, declining populations, and rapidly aging societies. China's population is both ageing and decreasing with projections of a decrease by 48 million, or around 2.7%, between 2019 and 2050. Additionally, according to the United Nations World Population Prospects, these countries are projected to have older populations with median ages exceeding 50 by 2050.

In contrast, the United States, Australia, and India display more favourable demographic profiles. While they also face the challenges of aging populations, their demographic advantages are notable. The United States and Australia have relatively higher birth rates, 12.0 per 1,000 and 12.1 per 1,000 respectively, and younger populations compared to Germany (9.3), Japan (7.0), and China (10.6). Similarly, India has a large and growing population at 17.0 births per 1,000, with a median age projected to be only 38 by 2050.

These demographic advantages provide the US, Australia, and India with larger potential workforces and a greater capacity for economic productivity.

Labour Market Dynamics

The labour market dynamics play a crucial role in determining a country's ability to address the challenges of an aging demographic. Shrinking workforces and labour shortages can hinder economic growth and productivity. However, the

United States, Australia, and India, with their younger populations, are better positioned to sustain labour market stability and mitigate the negative effects of demographic shifts. According to the Bureau of Labour Statistics, the United States has maintained a relatively high labour force participation rate compared to Germany, Japan, and China. Australia has also demonstrated a higher labour force participation rate, bolstered by robust immigration policies. India's growing population provides a significant workforce potential.

These factors indicate a larger proportion of the population actively contributing to the labour market, thus supporting economic output and mitigating potential labour shortages.

Specifically, when there are more people who can work, it means there are more hands and minds to do the job. This can make the economy stronger because there are more people available to produce goods and offer services. Having a bigger potential workforce also means that there are more people who can learn new things and come up with fresh ideas. This can lead to innovation and help businesses grow and create new products and services.

So, in the United States, Australia, and India, having a large and relatively younger potential workforce can help their economies become stronger and more productive. It's like having a big team of people working together to make things and make the country better.

Economic Resilience

The economic resilience of a country in the face of aging demographics is critical to managing the associated burdens. Germany, Japan, and China confront the challenge of sustaining economic growth and managing public finances amidst rising healthcare and pension costs. These countries may experience reduced economic growth rates and increased fiscal pressure, which can strain government budgets and hinder public investments.

In contrast, the United States, Australia, and India exhibit greater economic resilience. According to the International Monetary Fund (IMF), these countries have projected economic growth rates that outperform many other advanced economies. The IMF also highlights the positive correlation between demographic factors such as labour force growth and economic performance. The US and Australia, with their younger populations and robust labour markets, have the potential for sustained growth. India, with its large and dynamic workforce, offers significant economic opportunities.

Geopolitical Influence

Aging demographics can also influence a country's geopolitical influence and global standing. Germany, Japan, and China, despite being significant global players, face the challenge of diminished influence due to potential economic and societal pressures associated with aging populations. Older populations tend to have different priorities and interests than younger generations. They may focus more on social welfare and healthcare, which can lead to increased government spending in these areas. This shift in focus can divert resources and attention away from other areas crucial for geopolitical influence, such as defence, foreign policy, and diplomatic initiatives.

The United States, Australia, and India, on the other hand, are better positioned to maintain their geopolitical influence due to their favourable demographic profiles, economic resilience, and relatively stronger labour markets.

Therefore, the burden of aging demographics poses complex challenges for countries worldwide. While Germany, Japan, and China face significant obstacles associated with declining populations and aging societies, the United States, Australia, and India possess demographic advantages that position them more favourably. These countries have relatively younger populations, more robust labour markets, economic resilience, and potential for sustained growth. While no country is exempt from the consequences of aging populations, the United States, Australia, and India demonstrate a comparative advantage in navigating the burden of demographic changes, positioning themselves for greater stability and influence in an aging world. Those investors taking a long-term view of the markets, need to consider investing in countries that have relatively more attractive demographic profile rather than getting stuck in countries where the demographic weaknesses are set to get worse in the years ahead.

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