Investment Newsletter – October 2023

Challenges ahead – but don't discount a soft landing

Welcome to the October letter.

Another proxy theatre of war opens

The mainstream ***commentariat's assessment*** of the war between Hamas and Israel is ***cast in a narrow dimension of a 'territorial war'***.

While it is definitely that, and we are not here to take either side, our view is unequivocally that ***the wider perspective of this war's role in the paradigm of the great power contest between USA and China*** will become increasingly obvious with the passage of time.

The newly opened Middle East theatre of war involving Israel and Hamas in Gaza will likely evolve to include more states such as Syria, Iran, and other regional states fronted by non-state actors such as Hezbollah in Lebanon, Hamas in Gaza, and Houthi rebels in Yemen. This war is likely to prolong alongside the Russia/Ukraine war.

These two theatres of war, and there could be more that open up in other regions (North Korea?), are designed to engage the US to satisfy a grand strategic objective of China, as discussed in the following passages.

The next two decade's great power contest – China switches from being timid to assertive

China aims to be second to none as a global superpower. Please take note, as its goal couldn't be clearer!

Over the past decades, it has acquired the necessary resources and means and seems quite driven. China is fuelled by the ambition to reach the pinnacle of global power, where it believes it rightfully belongs. It ***anticipates achieving this peak by the year 2050***, coinciding with its centenary celebrations as the People's Republic of China. By that time, China aspires to be the global hegemon, a singular superpower. In terms of the timeline, the anticipated deadline for this goal is only a couple of decades away.

Since the rise to power of President Xi Jinping in 2013, ***China has pivoted to a more assertive posture***, breaking with Deng Xiaoping's advice, which advocated discretion. There has been a clear evolution towards this assertiveness.

In the years preceding Xi Jinping's ascent to high office, China benignly sought access to raw materials from around the world and low-barrier-entry to export markets. It offered a combination of development aid and infrastructure building in developing countries in exchange for access to local resources, supporting China's nascent manufacturing sector in the 1980s and 1990s.

As China experienced greater economic success, it continued to invest and finance local and regional projects throughout the 2000s. It was in the 2010s that a more confident China emerged, particularly after Xi Jinping's rise to power in 2013.

The ***assertiveness initiative*** is shaping up to overshadow all other objectives that China has.

The 2010s marked the end of a low-profile China and heralded a new era of "imperial ambition" with specific benchmarks set for 2025 and 2050.

The ***assertiveness initiative*** was demonstrated by the flurry of China's diplomatic activity in recent years. A closer look at the flurry of China's activities allows ***all its objectives*** to be classified ***into three categories***: trade (economical), the military and navy (security), and the future battlefield of cyberspace (cybersecurity).

Based on Xi Jinping's speech during the 19th National Congress in 2017, the year 2050 appears to be the target for ending the co-hegemonic status (i.e., global power sharing with the US). From this goal, one can infer that the intervening years from 2020 to 2050 will be characterized by co-hegemony or a cold/hot war—a period of transition. Setting aside the question of the plausibility of this vision being realized, the mere articulation of this vision lays the groundwork for a prolonged period of active contention between the two great powers. ***This is our primary argument.***

China benefits from US engaging in separate wars to support Israel and Ukraine

The Chinese military principles emphasize ***avoiding head-on battles against a powerful adversary***. Instead, with an element of surprise, they advocate for being proactive and offensive in exploiting enemy vulnerabilities through proxy wars initiated by countries aligned with China.

China maintains strong ties with Russia, which is indirectly engaging the US in the Ukraine war. Similarly, China has deep economic ties with Iran and is estimated to share defence systems. Iran, in turn, financially and militarily supports non-state actors such as Hamas and Hezbollah to engage Israel and the US in conflict.

Moreover, research by the RAND Corporation, a global public policy research organization, suggests that these war theatres are utilized by both the US and China to test their latest military technology, hardware, and operational concepts, potentially preparing for a direct confrontation between the two powers.

Another primary reason for China indirectly engaging its formidable adversary (the US) in an increasing number of proxy wars is to ***elevate US' cost of direct conflict to***

economically prohibitive levels. This cost can also manifest in terms of mounting casualties in proxy wars. The goal is to inflict significant pain on the US solely through these proxy wars. By keeping the US distracted, mired, exhausted, and/or financially drained, the intent is to render it incapable of focusing on containing China's rise to global hegemon status and its anticipated emergence as a true superpower by 2050.

Prominent Chinese foreign policy analyst like Wang Jisi, dean of the Peking University School of International Studies, has argued that the U.S. war with Iraq benefited China because *"It is beneficial for our external environment to have the United States militarily and diplomatically deeply sunk in the Mideast to the extent that it can hardly extricate itself."*

Similarly, Renmin University professor Shi Yinhong has recently argued that *"Washington's deeper involvement in the Middle East is favorable to Beijing, reducing Washington's ability to place focused attention and pressure on China".*

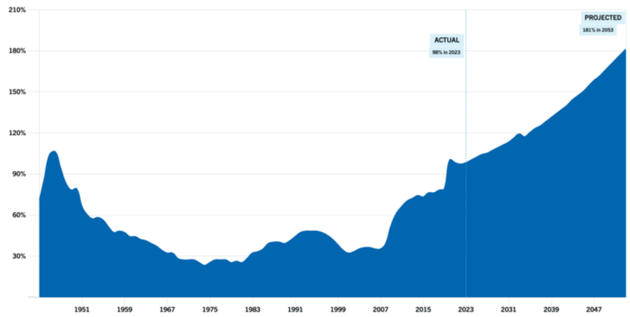
The rising cost of war shows up in rising bond yields

Even before factoring in the latest costs of the escalating Israeli conflict, the US budget is deeply in deficit. That is, tax revenues are declining due to a weakening economy, the interest bill is soaring due to sharply higher interest rates, and the amount of debt the US government continues to accumulate is staggering.

Figure 1: US Federal Revenue & Spending as % of GDP – living beyond means

Source: Congressional Budget Office and White House Forecasts

Figure 2: US Total Debt as % of GDP



Source: Peterson foundation

The US government budget is expected to continue running into deficits, well, forever! Given this outlook, is it any surprise that investors are beginning to question whether they are being adequately compensated for lending to such a spendthrift borrower?

Additionally, the US is likely to pull other allied countries, such as Australia, into similar fiscal deficits due to their anticipated participation in proxy wars and the war-induced global economic recession that now seems increasingly probable in 2024.

Complicating matters, China, which is the focus of the US's primary power competition, also happens to be its third-largest lender (buyer of US government bonds) after the Federal Reserve and Japan. For the past few years, China has decisively chosen not only to stop lending to the US but also to rapidly reduce its previous holdings of US government bonds. Additionally, Japan is finding it increasingly challenging to lend more to the US due to its own domestic economic issues.

As a result, we now find ourselves in a situation where, at a time of record government borrowing, there is a near-record low number of lenders willing to purchase US bonds. Consequently, bond yields have risen. The market is doing the heavy lifting for the Fed. The end result is it is looking less likely that official interest rate settings will need to change.

GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,049	0.34%	-3.51%	-1.80%	8.87%
ASX 200 Futures	AUD	7,086	0.48%	-3.17%	-0.49%	12.17%
Dow Jones	USD	33,508	-0.47%	-3.50%	0.70%	16.65%
S&P 500	USD	4,288	-0.27%	-4.87%	4.35%	19.59%
Stoxx Europe 600	EUR	450	0.38%	-1.74%	-1.66%	16.08%
FTSE 100 (UK)	GBP	7,608	0.08%	2.27%	-0.31%	10.36%
DAX (Germany)	EUR	15,387	0.41%	-3.51%	-1.55%	27.01%
CAC (France)	EUR	7,135	0.26%	-2.48%	-2.56%	23.82%
Nikkei 225	JPY	31,858	-0.05%	-2.34%	13.61%	22.83%
Emerging Markets Equities						
MSCI Emerging Markets	USD	953	0.92%	-2.81%	-3.79%	8.79%
Shanghai Composite	CNY	3,110	0.00%	-0.30%	-4.96%	2.85%
South Korea	KRW	2,465	0.00%	-3.57%	-0.48%	14.36%
Taiwan	TWD	16,354	0.00%	-1.69%	3.06%	21.82%
Brazil	BRL	116,565	0.72%	0.71%	14.41%	5.93%
South Africa	ZAR	66,500	-0.27%	-4.01%	-5.67%	15.87%
Foreign Exchange						
AUDUSD	Currency	0.6435	0.12%	-0.76%	-3.74%	0.55%
AUDGBP	Currency	0.5274	0.15%	3.09%	-2.68%	-8.03%
AUDEUR	Currency	0.6086	0.05%	1.77%	-1.30%	-6.81%
AUDCNY	Currency	4.70	0.22%	-0.03%	2.30%	2.51%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,347	3.05%	6.30%	-2.74%	8.56%
LME COPPER 3MO ($)	USD/mt	8,271	0.64%	-1.80%	-8.03%	9.40%
LME NICKEL 3MO ($)	USD/mt	18,694	-1.02%	-7.86%	-21.58%	-11.43%
SILVER FUTURE Dec23	USD/oz	22.45	-1.28%	-9.52%	-9.66%	13.94%
ICE Newc Coal Fut Oct23	USD/mt	156.35	-3.04%	-1.36%	-27.92%	-52.46%
62% Import Fine Ore in USD	USD/t	115.41	0.00%	1.70%	-5.22%	20.72%
Gold Spot $/Oz	USD/oz	1,849	-0.87%	-4.72%	-6.13%	11.32%
WTI Oil	USD/bbl	90.79	-1.00%	9.44%	22.66%	29.48%
Henry Hub	USD/mmBtu	2.68	-2.19%	4.28%	27.62%	-58.13%
Corn	USD/Bu	476.75	-2.41%	3.42%	-27.82%	-29.63%
Wheat	USD/Bu	541.50	-6.44%	-5.50%	-21.78%	-41.24%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	4.49%	+0.03%	+0.46%	+1.19%	+0.60%
US	USD	4.57%	-0.00%	+0.46%	+1.10%	+0.74%
Germany	EUR	2.84%	-0.09%	+0.37%	+0.55%	+0.73%
Japan	JPY	0.77%	+0.00%	+0.11%	+0.41%	+0.52%
Italy	EUR	4.78%	-0.09%	+0.66%	+0.68%	+0.26%
Australian Rates						
Cash Rate	AUD	4.10%	+0.00%	+0.00%	+0.50%	+1.75%
90-Day BBSW	AUD	4.15%	-0.01%	+0.02%	+0.44%	+1.09%
180-Day BBSW	AUD	4.41%	+0.01%	+0.04%	+0.62%	+0.84%
CBOE Options						
CBOE VIX (Volatility Index)	Index	17.52	1.04%	29.11%	-6.31%	-44.59%

Data as of 30 September 2023

ECONOMIC NEWS

• **In Australia -** the central bank (RBA) left the cash rate unchanged at 4.1% in both September and October policy meeting. However, RBA retained a tightening bias with members reiterating further tightening may be needed if prices remain sticky, while acknowledging higher borrowing costs are already beginning to align demand with supply.

In the second quarter of 2023, the economy continued to grow steadily, with the GDP increasing by 2.1% compared to the same period last year and 0.4% compared to the previous quarter. This growth was primarily driven by exports. Despite higher interest rates and rising prices, businesses remained resilient. However, consumer confidence declined significantly in September and reached a "deeply pessimistic" level. Australia achieved its first budget surplus since the global financial crisis in 2008. This surplus amounted to A$22.1 billion over the 12 months ending in June, which is equivalent to 0.9% of the GDP. This surplus was made possible by a very tight job market and high commodity prices, which boosted the country's financial resources.

• **In US -** The US Federal Reserve decided to keep the benchmark interest rate unchanged. They indicated that interest rates would remain higher for a longer period, with one more 0.25% increase expected this year followed by a 0.50% rate cut in 2024. This is different from the market's expectation of a 1.00% rate cut.

The Federal Reserve also revised its GDP growth forecasts, raising them by 1.10% for 2023 and 0.40% for 2024. They kept the growth expectations for 2025 and 2026 steady. In terms of core inflation, they lowered their expectations by 0.20% for 2023 but maintained them for 2024 and 2026. They increased the expectations for 2025 by 0.10%.

Consumer confidence declined in September, reaching its lowest point in four months, mainly due to concerns about the economy and the job market. However, short-term inflation expectations dropped to their lowest level since early 2021 in September, with one-year ahead outlook falling by 0.30% to 3.2%, and five-to-ten-year expectations remained steady at 2.8%, the lowest in a year. Factory activity contracted in September, but it was the least contraction seen in nearly a year. This was partly due to strong production growth since July 2022 and an increase in factory employment.

• **In China –** Factories stabilized in September with the official gauge of manufacturing activity returning to expansion in for the first time in 6-months.

• **In Europe -** The European Central Bank (ECB) increased interest rates by 0.25% to 4.5%. However, ECB President Christine Lagarde hinted that this might be the highest point, suggesting a potential shift in their approach. The ECB lowered its forecasts for the euro-area economy, reducing the 2023 GDP outlook by 0.20% to 0.7%, the 2024 outlook by 0.50% to 1%, and the 2025 outlook by 0.10% to 1.5%. They also lowered the core-CPI (Consumer Price Index) forecast for 2024 and 2025 by 0.10% to 2.9% and 2.2%, respectively.

The European Commission also adjusted its estimates, reducing the euro-area's 2023 and 2024 GDP growth forecasts by 0.30% to 0.8% and 1.3%, respectively. They downgraded the 2023 inflation forecast by 0.20% to 5.6% but increased the 2024 inflation outlook by 0.10% to 2.9%.

In the second quarter of 2023, euro-area GDP growth was revised lower by 0.20% to 0.1% quarter-on-quarter, mainly due to poor export performance. Economic confidence in the euro-area slowed for the fifth consecutive month in September. Consumer confidence dropped significantly, while the services sector slightly declined, and the industrial sector showed some improvement. In September, euro-area Consumer Price Index (CPI) decreased to nearly a two-year low of 4.3% year-on-year, with core inflation slowing to its lowest rate in a year.

• **In India -** In September, the unemployment rate decreased to 7.09%, reaching its lowest point in a year. Joblessness in rural areas dropped to 6.2%, down 91 basis points from the previous month, while urban unemployment also decreased to 8.94%, a drop of 115 basis points. In the same month, manufacturing activity remained robust, surpassing other Asian economies. Both demand and production increased significantly, and businesses gained new customers in important international markets.

• **In Germany** - the economy is expected to shrink in the third quarter of 2023 due to cautious consumer spending, worsening manufacturing conditions, and increased financing costs. Inflation dropped to a two-year low in September, with the Consumer Price Index rising by 4.3% year-on-year. While there was a slight improvement in business outlook in September, it remains historically low, and the economy is likely to contract again in the third quarter. The labour market also weakened, with firms' willingness to hire employees reaching its lowest point since February 2021 in September.

THE LONG READ

THE ERA OF TIGHT CREDIT IS HERE TO STAY

In past articles, we have discussed why we believe inflation and interest rates (cost of capital) will remain high for an extended period.

There are three primary reasons for this prediction:

1. The emerging "Cold War 2.0" between the US and China, which is already prompting a costly reconfiguration of global trade.
2. The disorderly transition to renewable energy, exerting significant pressure on the supply of materials and skilled labour.
3. Ageing demographics, which will reduce the supply of capital and labour in the economy. Conversely, this demographic shift will boost demand for goods and services across various sectors to cater to the rapidly ageing population.

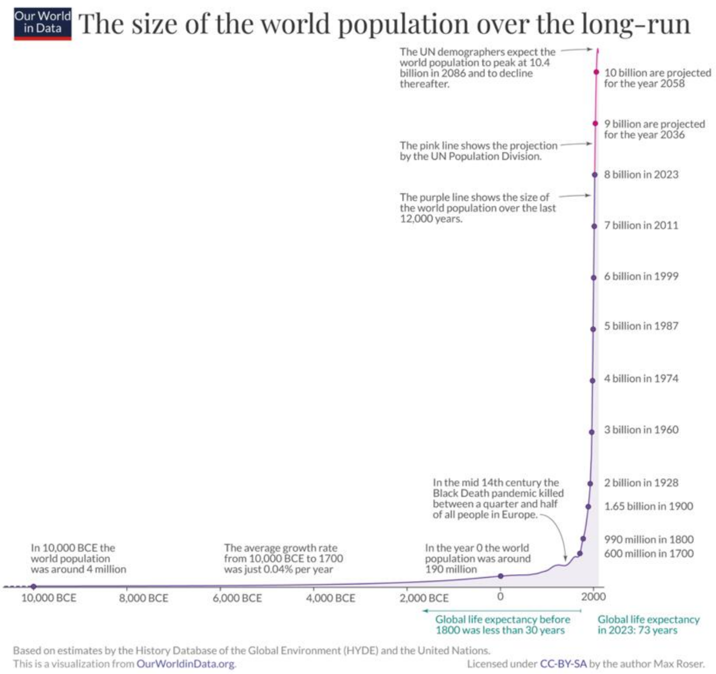
In this article, we shall delve deeper into the last point, examining how the ageing demographic will profoundly influence the cost of capital (interest rates). It's essential for us to recognize the impending lower growth environment resulting from reduced access to credit, adjust our investment return expectations, and strategize our investments accordingly.

First, there was demographic stability accompanied by high borrowing costs

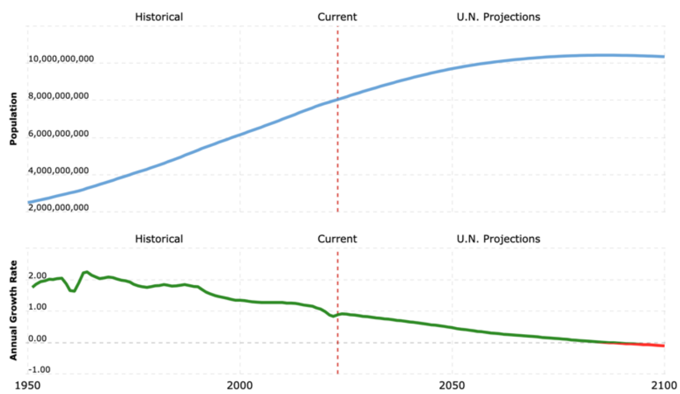
From ancient civilizations up to just before the industrial age, the primary age groups - children, young workers, mature workers, and retirees - remained relatively balanced, with little fluctuation. Young workers outnumbered mature workers. The latter typically earned more, saved more, and spent less, whereas young workers were more inclined to borrow and spend. Given the limited number of mature workers, their savings were not sufficient to meet the borrowing demands of the younger population. In other words, with few savers and many spenders, the demand for capital often outstripped supply, leading to consistently high borrowing costs.

Then came industrialisation and urbanisation causing a fall in prices and cost of capital

Industrialization altered the balance between younger and mature workers. With its advent, average lifespans began to extend, and infant mortality rates saw a substantial decrease. This shift led to explosive population growth in nations as they each embarked on their industrialization journeys. The chart below is particularly illuminating, illustrating that the bulk of this population surge occurred post-industrialization. Historical demographers estimate that around the year 1800, the global population was approximately 1 billion. This suggests that from 10,000 BCE to 1700, the population growth was rather slow, averaging an annual increase of just 0.04%. However, post-1800, marking the dawn of industrialization, this dynamic changed dramatically. The global population, which stood at around 1 billion in 1800, has now grown eight-fold to approximately 8 billion.



However, there's another trend reversing this population growth, known as urbanization. Over the past forty years, urbanization has been gaining momentum, leading populations to gravitate towards urban centres. Accompanying urbanization, educational levels have risen, women have entered the workforce in significant numbers, lifestyle preferences have evolved, and birth rates have begun to decline. The chart below predicts global population growth to peak at around 10 billion in the next thirty years. After this peak, the population is expected to decline by the century's end. It's crucial to note that these growth figures, leading up to stagnation, are skewed upwards by developing and under-developed countries. If we exclude the impact of these countries and focus solely on advanced nations, it's evident that their populations have already begun to plateau.



Data Source: [United Nations - World Population Prospects]

Let's circle back to the point I made earlier regarding industrialization, which initially spurred population growth and now appears to be leading to stagnation. Over the past thirty years, particularly in advanced countries like the US, Australia, Europe, and China, an increasing number of young workers have transitioned into the category of mature workers, spanning ages 40 to 60. This cohort of mature workers expanded synchronously across these advanced nations. These individuals, being better educated and employed in specialized, high-skilled jobs, commanded higher salaries. Consequently, they saved more and invested more capital. This dynamic drove up the supply of capital while driving down its cost. The manifestation of this trend was evident as interest rates consistently dropped over the past three decades, reaching an unprecedented low, almost zero, in 2020.

This decline in the cost of capital catalysed a surge in the production of goods and services, ushering us into an era characterized by abundance. Such was the magnitude of this abundance that even unconventional ventures, like cryptocurrencies, received ample funding.

Between 1990 and 2020, a confluence of factors resulted in the most affordable capital and swiftest economic growth ever witnessed in human history. This period was marked by the peculiarities of the fiat age, characterized by extensive money printing. Additionally, the post-Cold War era's hypergrowth, stemming from the stability of global trade and governance institutions under the aegis of a singular superpower, the US, played a crucial role.

Mature workers shift into retirement in droves, everywhere

As droves of mature workers retire in this decade and the next they will shift from saving to consuming their capital. This call on capital will continue as more mature workers pile into retirement and as retirees live longer to fund retirement. So, the diminishing supply of capital from savings will increasingly become obvious. Diminishing supply of capital will thus cause a rise in cost of capital.

We simply don't have a sufficient number of skilled younger workers to replace the retiring mature workers. Looking further down the age spectrum, birth rates are not robust enough to replenish the population mix. Simply put, the influx of younger workers advancing into the mature worker category won't be ample enough to sustain the significant capital supply we've seen in past decades.

This decline in mature workers will also likely lead to governments experiencing reduced tax revenues, as the pool of top tax bracket-paying mature workers dwindles. This demographic shift arrives at a particularly inopportune time. Governments will grapple with escalating costs associated with healthcare, aging, and pensions for the retired workforce.

Concurrently, the private sector will face increased capital demands, especially as it must fund the most significant energy transition in history over the next two decades. Moreover, there's the ongoing challenge of reconfiguring the global industrial base to mitigate geopolitical risks. On top of this, governments in advanced economies face another looming challenge: managing rising interest bills due to heightened interest rates and unprecedented recent spending—a trend that, by all indications, will persist. ***Given these factors, is it any wonder that government bond yields are skyrocketing?***

We have entered a long period of opposite trend: a limited supply of capital accompanied by elevated capital costs.

Investors should consider directing their savings into high-quality corporate credit, play duration selectively (i.e. the length of time you lend money) as during the transition to high cost of capital environment the surety of getting your capital back is not certain along with the promised regular payments. Growth stocks still have an important part in any portfolio, but the growth stocks you buy today need to be holdings that generate income and profit, gone are the days when market share was the only focus.

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