Investment Newsletter – December 2023

2023 – An Eventful year

Welcome to the December letter.

What a year!

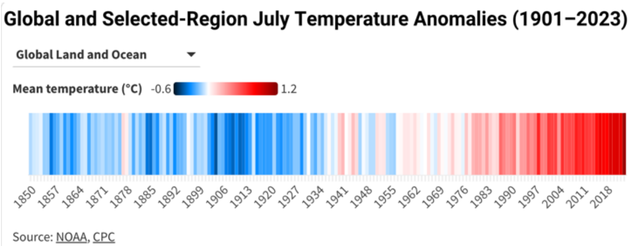
2023 has been an eventful year with the Doomsday Clock indicating an unprecedented level of world troubles, as discussed in a separate section below.

Let's do a quick review of the major global events during 2023.

Earlier in the year, Turkey and Syria suffered severe earth quakes, resulting in 50,000 fatalities. Finland became the 31st country to Join NATO in its ongoing consolidation of military power of Western Europe as a counterbalance to threats from Russia. Donald Trump became the first U.S. former or sitting president to be indicted for a crime of falsifying business records. India's population surpassed China's, becoming the new most populous country. One of our favourite rhythm and blues singers Tina Turner passed away. Twitter was seized by Elon Musk and rebranded as X.

NASA declared record summer temperatures in the U.S., with ***2023 being the warmest year on record since 1880***.

Figure 1: Northern Hemisphere July Temperature changes over the past century point to increasingly hotter days in recent decades



Russia's invasion of Ukraine has continued, resulting in more than 70,000 Ukrainian civilian deaths and 315,000 Russian soldier fatalities & injuries according to US intelligence reports. The war between Israel and Hamas began, with over 19,000 civilians reported dead. China and Russia have continued to drive a deeper political wedge with the U.S. and its allied countries over the issue of Taiwan, exacerbating mistrust between the two camps. This could escalate into a conflict in the South China Sea and beyond. We have covered the financial ramifications of this scenario, should it unfold, in the concluding article of this letter.

Australia won the Cricket World Cup by defeating India, yea! ***Meanwhile, India claimed the top spot this year as the world's fastest-growing economy at 7.6%, with its equity market booming***. Regular readers of this letter would know that we have long been believers in the Indian growth story.

Australian women's soccer team, the Matildas, reached the World Cup semi-finals for the first time ever and finished fourth, yea!!

Doomsday clock moves to 90 seconds to mid-night

The Doomsday Clock is a symbolic representation created by atomic scientists to show how close we are to a global catastrophe, with midnight symbolizing total destruction. Introduced in 1947 by the Bulletin of the Atomic Scientists, the clock's minute hand is adjusted based on the current global threat level from nuclear weapons, climate change, or disruptive technologies.

It has been reset 25 times since its creation. ***As of January 2023, it was set at 90 seconds to midnight, the closest ever to "doomsday," primarily due to threats of nuclear weapon use and deteriorating international conduct.***

The idea originated from the Atomic Scientists of Chicago, which included notable figures like Albert Einstein and J. Robert Oppenheimer.

Over the years, the clock's time has been advanced or reversed based on global conditions, particularly relating to nuclear threats. It was first moved in 1949 due to the Soviet Union's atomic bomb test. Significant moments of the clock being set back include 1960, 1963, and 1991, corresponding to major international agreements on nuclear disarmament.

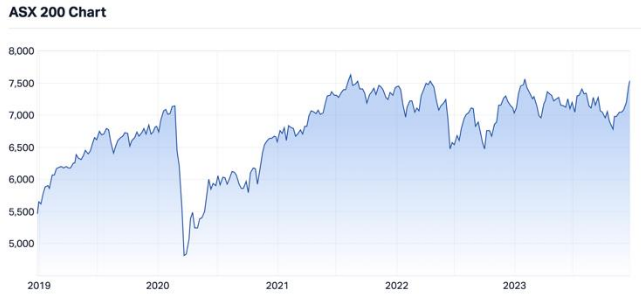
Since its introduction, the Doomsday Clock has become a powerful symbol in popular culture, appearing in music, television, films, and comics, reflecting global anxieties about nuclear war and other existential threats. The decision to adjust the clock's time is now made by a board of experts in nuclear technology and climate science, who meet biannually to assess global conditions. *We hope they set the clock back next time they meet, though we currently don't see the evidence of that happening!*

Reviewing the Share Markets in 2023

The Australian share market remains in a trading range of 6,500 to 7,500 since 2021 as shown in Figure 2. Over these past three years, there have been market rallies and there have been sell-offs of equal proportions, keeping the market range-bound.

As of the writing of this letter on 21 December, the Australian share market has grown by 7% in the 2023 calendar year.

Figure 2: Australian share market chart range bound over the past few years



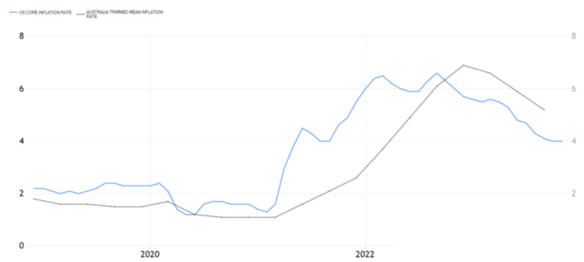
Similarly, the US equity market, which holds the majority of global equity exposure for investors, grew by 23% in 2023. Incidentally, the US share market (i.e., the S&P 500) has also been trading within a range since 2021, i.e. between 3,700 and 4,700.

Much of the gains in both equity markets in 2023 came from the recent rally over the past six weeks. Some refer to it as the annual 'Santa rally,' while others hope that the markets have rallied on forecasts that there will not be an economic recession next year. They anticipate that inflation will fall sufficiently to prompt rapid interest rate cuts, and that economic growth and business profitability will return to normal as consumers revert to their previous consumption patterns.

Slowing inflation does not necessarily mean that interest rates will be cut significantly or in tandem. The reason is that with employment remaining fairly tight in the economy, every dollar returned to employed consumers by the central banks—through potential rate cuts—could quickly reignite inflation, particularly services inflation, as consumers rush to spend the returned dollars. For this reason, we believe that the central banks may be cautious. However there are a number of sign to show that employment will soften next year, if this happens then rates will follow soon thereafter.

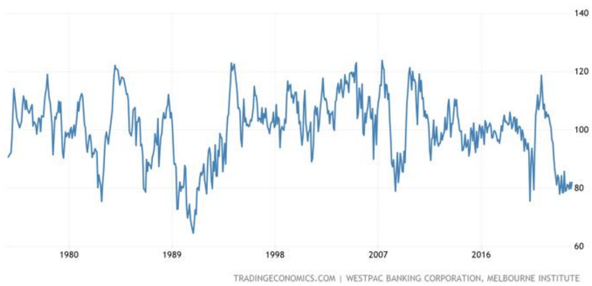
The chart in Figure 3 indicates that inflation in Australia is much stickier than in the U.S. and is only gradually trending downward. This is partly because the Reserve Bank of Australia (RBA) did not raise its official interest rate as sharply as the Federal Reserve did in the U.S. The cash rate in the U.S. is 5.5%, while in Australia, it is 4.35%. Part of Australia's persistent inflation can be attributed to its red-hot job market, with labour costs rising by 7.1% over the past year.

Figure 3: Core Inflation in Australia and US



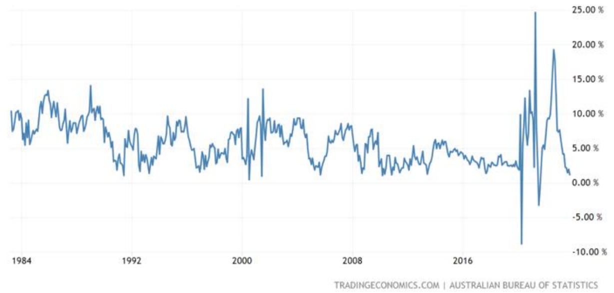
Over the past year, the RBA has worked tirelessly to shift consumer sentiment toward a more pessimistic outlook in an effort to engineer a slowdown in consumption and thereby cool down inflation in an economy with tight resources. As illustrated in Figure 4 below, this strategy appears to have been effective, as there is a noticeable emotional toll on consumers due to the rate increases to date.

Figure 4: Consumer Confidence remains at GFC lows



More importantly, consumer retail spending growth has slowed considerably. However, with unemployment remaining low at 3.9% the RBA will wait for signs of weakening in the labour market before cutting. We think softer employment numbers will start showing earlier than expected.

Figure 5: Retail Sales growth has dropped right back



There are things to be concerned about, ongoing tensions between China & U.S. could easily cause supply chain disruptions and sudden spike in inflation.

The ageing demographic causing labour shortage remains a key input to wage pressures in advanced economies. The global transition to renewable energy infrastructure will likely continue to create excess demand for key inputs such as materials, labour, and capital. Military build-up in deeply divided world is another area of increasing demand for labour and funding. And finally, bulging government debts globally is unlikely to receive willing funding from the debt markets on low rates with a cheer!

It makes for concerning reading unless you look deeper.

Underemployment in Australia which is a leading indicator for the unemployment number has sparked higher.

Productivity growth in America is forecast to run at nearly double the previous decade. How? Well if you are an employer and you have challenged with labour – you naturally turn to robotics. Whilst we will in the future have less labour, we also likely will need far less labour. Computers and robots will take away thousands of jobs, in some way, a smaller workforce in the future is all that will be required.

We hope you enjoy the festive season and savour the precious moments. See you in 2024.

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	Value	1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,087	0.74%	4.52%	-0.06%	-2.70%
ASX 200 Futures	AUD	7,094	0.57%	4.58%	0.62%	-1.31%
Dow Jones	USD	35,951	1.47%	8.77%	9.25%	3.94%
S&P 500	USD	4,568	0.38%	8.92%	9.28%	11.95%
Stoxx Europe 600	EUR	462	0.55%	6.45%	2.18%	4.90%
FTSE 100 (UK)	GBP	7,454	0.41%	1.80%	0.10%	-1.58%
DAX (Germany)	EUR	16,215	0.30%	9.49%	3.52%	12.63%
CAC (France)	EUR	7,311	0.59%	6.17%	2.99%	8.49%
Nikkei 225	JPY	33,487	0.50%	8.52%	8.41%	19.73%
Emerging Markets Equities						
MSCI Emerging Markets	USD	987	0.41%	7.86%	2.98%	1.52%
Shanghai Composite	CNY	3,030	0.26%	0.36%	-5.46%	-3.86%
South Korea	KRW	2,535	0.61%	11.30%	-1.62%	2.54%
Taiwan	TWD	17,434	0.36%	8.95%	5.16%	17.17%
Brazil	BRL	127,331	0.92%	12.54%	17.53%	13.20%
South Africa	ZAR	69,647	0.50%	9.04%	-0.50%	1.58%
Foreign Exchange						
AUDUSD	Currency	0.6605	-0.18%	4.23%	1.57%	-2.70%
AUDGBP	Currency	0.5232	0.38%	0.34%	0.09%	-7.05%
AUDEUR	Currency	0.6066	0.56%	1.23%	-0.30%	-6.99%
AUDCNY	Currency	4.71	-0.23%	1.55%	2.08%	-0.71%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,193	-0.95%	-2.60%	-2.36%	-11.48%
LME COPPER 3MO ($)	USD/mt	8,465	0.58%	4.36%	4.64%	2.74%
LME NICKEL 3MO ($)	USD/mt	16,645	-2.79%	-8.19%	-19.15%	-38.32%
SILVER FUTURE Mar24	USD/oz	25.66	0.85%	10.17%	4.98%	12.37%
ICE Newc Coal Fut Jan24	USD/mt	133.50	4.38%	1.83%	-10.25%	-59.06%
62% Import Fine Ore in USD	USD/t	125.33	0.65%	5.54%	27.32%	29.33%
Gold Spot $/Oz	USD/oz	2,036	-0.38%	2.65%	3.75%	15.15%
WTI Oil	USD/bbl	75.96	-2.44%	-5.64%	13.31%	-1.94%
Henry Hub	USD/mmBtu	2.75	0.92%	-17.66%	30.95%	-59.54%
Corn	USD/Bu	461.75	2.67%	-3.55%	-22.26%	-30.25%
Wheat	USD/Bu	570.25	2.56%	2.52%	-4.04%	-26.09%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	4.41%	+0.05%	-0.51%	+0.81%	+0.88%
US	USD	4.33%	+0.07%	-0.60%	+0.68%	+0.72%
Germany	EUR	2.45%	+0.02%	-0.36%	+0.17%	+0.52%
Japan	JPY	0.67%	+0.00%	-0.28%	+0.24%	+0.42%
Italy	EUR	4.23%	+0.06%	-0.50%	+0.15%	+0.36%
Australian Rates						
Cash Rate	AUD	4.35%	+0.00%	+0.25%	+0.50%	+1.50%
90-Day BBSW	AUD	4.37%	+0.00%	+0.01%	+0.34%	+1.32%
180-Day BBSW	AUD	4.59%	+0.01%	-0.17%	+0.38%	+1.10%
CBOE Options						
CBOE VIX (Volatility Index)	Index	12.92	-0.46%	-28.78%	-27.98%	-37.22%

Data as of 30 November 2023

Economic News

• **In Australia –** the Reserve Bank of Australia (RBA) decided not to change interest rates, keeping them at 4.35% during their December meeting. They mentioned that they don't expect salaries to increase much more in the near future. Also, they are unsure about how much people will spend in the coming times, as many families are currently facing financial difficulties. Additionally, the RBA now thinks that the overall increase in prices (inflation) will be higher than previously expected, reaching around 4% by the middle of 2024. They believe that inflation will not fall back into their preferred range of 2-3% until the end of 2025. On a positive note, the RBA has slightly increased its expectations for the country's economic growth, predicting it will grow by 1.75% by mid-2024.

• In US - The economy grew faster than expected in the third quarter of 2023, with the GDP increasing by 5.2% on an annualized basis, the quickest growth in nearly two years. This growth was mainly due to more spending by businesses and the government. However, factory activity has been decreasing for 13 months in a row, the longest decline since the dot-com bubble burst. This decline is partly due to a continuous drop in new orders, which has been happening for 15 months, the longest since the early 1980s. Although the prices factories pay are still decreasing, this decrease is slowing down, suggesting the worst of the price drops might be over.

The Federal Reserve's Beige Book report showed that the U.S. economy has been slowing down recently because consumers are spending less on non-essential items. People are expecting inflation to be higher in the next 5 to 10 years, reaching the highest level since 2011. Expectations for inflation over the next year also increased. There are growing concerns about high borrowing costs and the future of the economy, which are negatively affecting people's confidence.

• In China – the People's Bank of China (PBOC) says in its report that China is on track to reach its growth goal of about 5% in 2023. They believe that inflation is under control and don't see a risk of long-term decreasing prices (deflation). However, both manufacturing and service industries saw a decline in November. The manufacturing industry shrank for the second month in a row, and the services industry also decreased for the first time this year. Moody's Investors Service, a financial company, has changed its view on Chinese government bonds to a negative one. They are concerned because China is using extra government spending to help local governments and is facing major problems in its real estate market, which could be risky for the country's financial health.

• In Europe - In November, the economic activity in the Euro area, measured by the PMI (Purchasing Managers' Index), decreased again. Also, inflation wasn't as high as expected. The overall increase in consumer prices (CPI) was 2.4% compared to last year, and the core inflation rate, which doesn't include volatile items like food and energy, also went down for the fourth month in a row to 3.6%. This slowdown in inflation is happening across most categories and is at the lowest level in two years. Because of these changes, Christine Lagarde, the President of the European Central Bank (ECB), said that the bank can now take a break and see how its previous actions to control inflation are working. However, she also warned that there are signs of weakening in the job market in the Euro area.

• In India - The economy grew faster than expected, with the GDP increasing by 7.6% in the third quarter of 2023, which is more than the 6.5% predicted by the Reserve Bank of India (RBI). This growth was mainly due to a big increase in manufacturing and more government spending, likely because of upcoming elections. In November, the unemployment rate dropped significantly thanks to more jobs in farming and rural areas. However, the growth in service-related businesses was the slowest it's been in a year because businesses are worried about high inflation. This concern in the service sector partly balanced out the strong performance in manufacturing, leading to the lowest overall business activity (composite PMI index) since November 2022. To manage the risks, the RBI has told banks to keep more money aside for certain types of consumer loans, increasing the safety buffer from 100% to 125%.

• In Japan - The economy decreased in size in the third quarter of 2023, with the GDP going down by 2.1% compared to the previous quarter. This decline was mainly due to less spending by businesses, especially on goods (excluding software) which only increased a little (0.3%). Additionally, the increase in imports negatively impacted the economy. The manufacturing industry was particularly hard hit, reaching its lowest point since February. While the service sector did get a bit better, it wasn't enough to offset the overall decline. As a result, the combined measure of business activity (the composite gauge) fell to its lowest level for the year.

THE LONG READ

Understanding the Financial Implications of US-China Tensions

As global markets grapple with the escalating tensions between the United States and China over Taiwan, investors are wondering how to navigate this complex landscape. A recent essay in Foreign Affairs Magazine titled "Preparing for a Long War With China" offers a crucial perspective on the potential for conflict and its implications for global investment returns (particularly the US & Australian market context). My discussion in this article aims to provide investors with the possibilities for investment returns in the context of potential war between China and the US. I will take a look at how markets responded in past wars to help us understand the likelihood of market behaviour in the event of this war.

The Rising Spectre of US-China Conflict

The essay noted above points to the increasing probability of a conflict, particularly given China's recent military actions and claims in the Indo-Pacific region. Taiwan is underscored as a potential flashpoint, given its strategic and economic significance.

The essay discusses several possible scenarios of how a conflict might unfold, ranging from a swift Chinese conquest of Taiwan to a more extended, conventional war involving a US-led coalition. It also addresses the spectre of nuclear escalation, a concern given both nations' arsenals, but suggests that historical precedence indicates a restraint in using nuclear weapons.

The analysis points to the likelihood of a protracted conventional war, one that could be less devastating than a nuclear conflict but still exact enormous costs (economic, social, humanitarian). This kind of conflict would likely involve new forms of warfare, extending over a vast geographic area, and challenging both US & China in unprecedented ways.

The War Puzzle: Contradiction in the Stock Market

Given the enormous size of the US and China economies and their economic shadow on the global economy you would naturally be justified in having grave concerns for the global economic output and investment market returns should a war broke out between the two nations.

However, there is a peculiar phenomenon known as the ***"war puzzle"*** in stock market volatility that has long baffled financial academics. ***This intriguing anomaly, where stock markets exhibit lower volatility during periods of war***, stands in stark contrast to the expected increase in uncertainty and instability typically associated with conflicts.

The insightful paper "Stock Volatility and the War Puzzle" by US Bureau of Economic Research published in 2022 delves into this paradox, offering a compelling explanation that sheds light on the intricate interplay between government spending and market stability.

Wars, synonymous with unpredictability and economic upheaval, are logically expected to cause significant fluctuations in the stock market. However, historical evidence suggests otherwise, with ***stock markets tending to be more stable during wartime***. This paradox raises an intriguing question: how can periods characterized by significant geopolitical instability result in more stable stock markets?

This anomaly, observed in both the World Wars and other significant 20th-century conflicts, is often attributed to increased government spending in defence sectors. Such spending provides stability to these industries amidst broader economic volatility. The study's findings extend beyond the defence sector, indicating a broader impact on the stock market and the economy at large. The stabilizing influence of defence spending during wartime suggests that government expenditure in this area can significantly affect overall market behaviour, offering a buffer against the volatility typically associated with economic disruptions during conflicts. This stimulatory effect of Governments was also experienced during Covid-19 pandemic of 2020/21.

War and Peace: A Stock Market Perspective

Since 1885, the U.S. has found itself directly involved in or affected by world wars for approximately 20% of the time. Interestingly, stock markets have shown comparable nominal returns during both war and peace periods.

The US stock market was far more volatile during World War I than during World War II. The market rose nearly 100% during the early stages of World War I (1915 recorded the best single-year increase in the history of the Dow Industrials), then fell 40% when the United States became involved in the hostilities, and finally rallied when the Great War ended.

In stark contrast, World War II presented a more tempered picture with greater involvement of the central banks. The stock market fluctuations were more contained, never straying beyond 32% from pre-war levels. By the time Germany signed its unconditional surrender on May 7, 1945, the Dow Industrials were 20% above the pre-war level. The detonation of the atomic bomb over Hiroshima, a pivotal event in the history of warfare, caused stocks to surge 1.7% as investors recognized that the end of the war was near.

The onset of the North Korean War against its southern neighbor on June 25, 1950 caught investors off guard, with the Dow dropping a significant 4.65%—a greater fall than the one following the attack on Pearl Harbor. Yet, the stock market's reaction was more subdued as the conflict progressed, never dipping more than 12% below the pre-war level.

The Vietnam War was one of the longest and least popular of all US wars. The starting point for US involvement in the conflict can be placed at August 2, 1964, when two American destroyers were reportedly attacked in the Gulf of Tonkin. A year and a half after the Gulf of Tonkin incident, the Dow reached an all-time high of 995, more than 18% higher than before the Tonkin attack.

The announcement of the war on terror against Iraq in March 2003 caused investors to sell the Dow by 15% only then to recover by the same amount in eight days to March 20, when the shock and awe offensive by the US military actually commenced against Iraq.

The real impact of wars on stocks becomes evident when we consider inflation. In wartime, inflation in the US has soared to nearly 6%, a stark contrast to the sub-2% rate seen in peacetime. This significant difference means that the real, inflation-adjusted returns on stocks have been much higher during peaceful times than during war.

In case of potential US, China war I expect defence, technology, manufacturing, essential materials, and banking sectors might experience stability or growth, driven by increased government spending.

Bond Market Considerations

For bond markets, the primary concerns in a wartime economy is higher inflation rates and the record borrowing of the governments to fund the war. I would largely be invested in very short duration government and high-quality corporate bonds. I would also stick to the US$ and Australian dollar debt as foreign non-reserve currencies will struggle under the global political and economic uncertainty.

While the potential for a prolonged US-China conflict presents a multifaceted challenge for global investors. Staying informed and calm is recommended. If history is any guide, use the war related drawdowns in the market to buy-up high-quality stocks for long term real returns.

For enquiries:

- geoff.walley@investwisely.co
- Phone (02) 9634 6698 (within Australia), or
- Write to:
  Investwisely Pty Ltd
  PO Box 6127
  Norwest NSW 2153