Snowgum Economic Update

It was the best of times, it was the worst of times; and so it was for markets in 2019. Equity markets ended 2019, and have begun 2020, with the confidence of a Donald Trump tweet. Tumescent growth sees markets at record highs, with the US and Chinese economies performing solidly. Investment portfolios with significant equity exposures have done very well over the last 12 months. Conversely, the wallflower at the party was fixed interest. December 2019 saw the worst monthly return in the Australian Bond Market since September 1994, with the index falling 0.74%.

Some questions you might be asking.

> Q: What has caused the sharp run up in equity markets?
>
> A: The growing expectation that interest rates remain low and may head lower. As a result, cash and fixed interest capital were moved into equity and property markets by investors looking for higher returns, so pushing up asset prices.
>
> Q: What caused the sharp negative returns in bond markets in December?
>
> A: ‘Duration risk’ sensitivity associated with low interest rates. When interest rates are so low, any change (or expectation of change) in interest rates has an enhanced relative effect on discount rates. An interest rate drop from 1.25% to 1.00% is a significant 20% reduction in the risk-free rate.
>
> Q: What has caused the spike in inequality?
>
> A: Wealthy people already own lots of assets. Low interest rates and quantitative easing created excess demand for limited investment opportunities, bidding up asset prices. The wealthy got wealthier, with those joining investment markets later getting a lot less assets for their money.

So, if the answer to so much of what is happening in investment markets is caused by low interest rates, it follows that the **key questions** investors should be asking are:

1. How long will interest rates remain low?
2. What are the consequences of low interest rates?

How long will interest rates remain low?

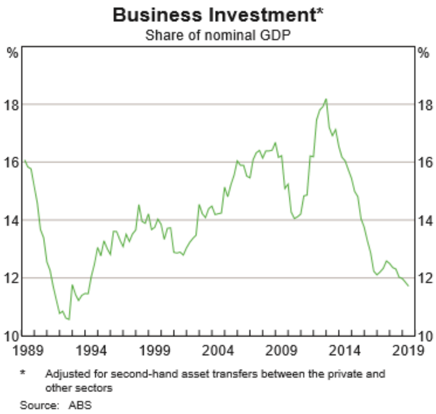
In Australia (and much of the world), the RBA (and global central banks) sets interest rates primarily to keep inflation between 2-3%p.a. When inflation looks to exceed this range, the RBA raises interest rates, increasing the cost of businesses and consumers accessing credit. If inflation appears to drop below the target band, the RBA lowers interest rates, lowering the cost of businesses and consumers accessing credit, allowing them to increase spending and investment.

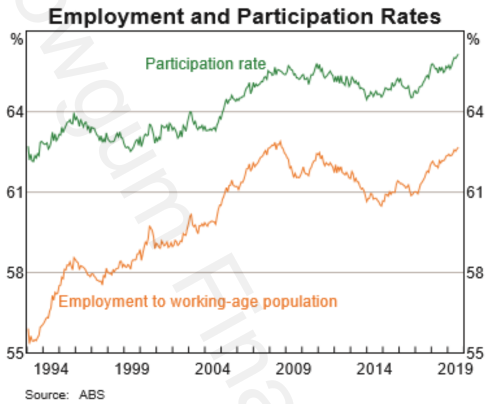
Expansionary policy is the lowering of interest rates to encourage an expansion in business investment and consumer spending. This *typically* drives up wages and input costs as the increased competition for limited resources sees market forces bid up the value of those inputs (including labour). Businesses incur these higher input costs and as a result must raise the price of their own goods and services … thus inflation.

It appears that this typical scenario is not occurring. Businesses are spending more (although at diminishing rates) and jobs are being created. But this increased use of capital inputs, including labour, have not generated price rises or wage growth. Thus, no inflation.

There are several cyclical factors causing this usual scenario not to occur.

Businesses investment in areas like technology and software generate material productivity gains, resulting in a diminished need for more substantial business investment. Importantly, as there is virtually no marginal cost in supplying additional software/technology services, there is no scarcity of supply to push up the cost of this input.





As for the other capital input, labour, although jobs are being created, unemployment has not contracted sufficiently to drive up wages. Many major economies, including Australia, have seen a record high participation rate achieved. This has been associated with three structural changes in labour markets:

1. An increasing proportion of women are engaging in the workforce
2. An increasing proportion of older (over 65) people continue to work
3. An increase of underemployment, associated with emergence of the gig economy and increased freelancing opportunities

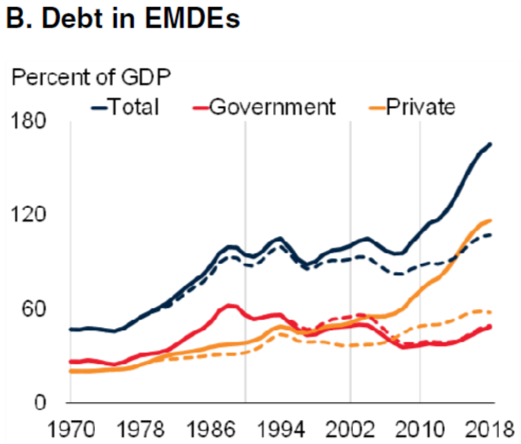
These structural trends in labour markets and business investment do not appear to be a one-off or short-lived phenomenon. As such, they will continue to constrict the ability of workers to bid up wages, so hampering inflation.

So, with inflation appearing to remain benign for the medium term, the expectation is that interest rates will continue to remain low.

What are the consequences of low rates?

The answer to this question is somewhat simpler.

As my high school economics teacher described it, the interest rate is the price of money. So, as the price of money decreases, debt becomes cheaper. We tend to consume more of something when it costs less. As a result, there has been a mammoth expansion in ‘debt consumption’. This debt consumption has had a pronounced effect on debt demand markets, like residential property.



High debt levels can reduce inflation as the capacity for consumer discretionary spending is reduced by debt servicing obligations. Although servicing constraints are presently masked by low interest rates, large amounts of private debt may prove to be a longer-term dampener on economic growth.

The above graph on the left shows Australia’s debt expansion and residential property price growth. The graph on the right, from the World Bank, tells us the debt story playing out in emerging markets. The dotted lines show the emerging market debt excluding China. The solid line is emerging market debt including China. Chinese private debt consumption has been substantial.

Unless China undergoes a productivity transformation, which is against a steep productivity growth slowdown in emerging and developing economies [World Bank 2019], China’s economic fortunes are likely to be hindered in coming years. They could suffer a GFC like implosion, or, and we think more likely, move into a multi-decade economic malaise. Like that of Japan in the 1980’s. The Chinese government’s legitimacy depends on satiating the desire of its people to continue to grow their prosperity.

For more detail on the state of play of low interest rates and debt, it is worth reviewing the World Bank report here, published shortly before Christmas 2019. They summarised:

> *“Global growth is projected at 2.5 percent in 2020, just above the post-crisis low registered last year. While growth could be stronger if reduced trade tensions mitigate uncertainty, the balance of risks is to the downside. A steep productivity growth slowdown has been underway in emerging and developing economies since the global financial crisis, despite the largest, fastest, and most broad-based accumulation of debt since the 1970s. These circumstances add urgency to the need to rebuild macroeconomic policy space and undertake reforms to rekindle productivity*”.

Macroeconomic policy

Successive government deficits in most major economies have driven up sovereign debt. Efficient serviceability of this debt, without cutting government services, depends on maintaining low government bond rates (being the rate the governments borrow at; – this is linked to central bank rates). If interest rates rise, governments with high debt, like Japan and the US, will face fiscal pressure to curtail government services, raise taxes or materially devalue their currencies.

However, additional rate cuts, as we have discussed, will do little to stimulate inflation, but will punish savers further and push asset prices higher, increasing systemic risk.

We would like to see central banks become more flexible in their policy setting. For example:

1. Central banks could be more flexible on lowering the downside of their inflation targets.
2. Central banks could be more nuanced in interest rate setting. A 0.25% rate movements becomes relatively more significant as rates approach zero. Small rate movements (0.05-0.10%) might allow dovish sentiment to be maintained whilst preserving more material rate cuts for actual economic hardships.

Investment Implications

As discussed above, low interest rates appear to be here to stay. Investors searching for investment returns are forced into riskier assets.

As investors seek opportunities, and as asset prices are already high, care is required to avoid paying unreasonable prices for reasonable assets. We discussed specific investment opportunities in our previous quarterly commentary, so will not go into specific investment commentary here.

We take the view that interest rates will probably remain low. Nevertheless, we still want to position investments to have medium term resilience should inflation emerge (leading to interest rates rising). If interest rates were to rise, markets would make a sudden U-turn. In the event this happened, the best protection against a permanent loss of capital is investing in a business that generates organic earnings growth. Should interest rates rise, markets will retreat, but underlying businesses with earnings growth are best positioned to recover.

As always, shares in businesses (even those with earnings growth) are not to be bought at any price. The challenge is determining what is a reasonable price. Using historical risk-free rate benchmarks, or other usual valuation metrics, are not necessarily reliable indicators of fair value in this economic climate. With interest rates so low, you can expect to pay more for good investments, as well as accept more moderate returns.

With reference to Howard Mark's latest memo and research from Annie Duke at the University of Pennsylvania:

> *"What makes a decision great is not that it has a great outcome. A great decision is the result of a good process, and that process must include an attempt to accurately represent our own state of knowledge. That state of knowledge is some variation of "I'm not sure"… Good decision makers embrace uncertainty, instead of focusing on being sure, they try to figure out how unsure they are, making their best guess at the chances that different outcomes will occur."*

As investment custodians, we are not certain interest rates will remain low. However, we are taking that likely view and seeking downside protection, not in traditional 'fixed'-interest positions, but by seeking out companies with earnings growth.

By Matt Vickers

Snowgum Financial Services