JULY. 2022, WINTER | ISSUE NO. 29

SNOWGUM QUARTERLY

INTRO

Two significant monetary policy shifts are underway, inflation is running at 40-year highs and markets are signalling the RBA cash rate could be as high as 3.5% by year end.

As expectations adjust to interest rates rises, asset class valuations have come back down to earth.

Although further volatility should be expected as interest rates normalise, economic consensus is not forecasting the calamitous outcome that media commentary is foretelling.

As the fund managers say, valuation matters, and with inflation likely to remain high for some years, staying out of the market for too long is value destroying.

KEY STATS

- Cash rate is on the up, presently 1.35%
- Unemployment in Australia is 3.9%
- Inflation is 5.1%

WHAT'S INSIDE THIS QUARTERLY:

ECONOMIC UPDATE

Intro // Inflation // Labour Markets // Interest Rates // China

Two significant monetary policy shifts are underway. Interest rates are rising, and Quantitative Tightening (QT) has commenced. Both seek to suppress inflation running at 40-year highs. Fiscal policy remains broadly stimulatory, with most major governments operating structural deficits.

Quantitative Tightening occurs when central banks shrink their balance sheet holdings of government bonds (Quantitative Easing - QE, is the opposite). By not fully repurchasing bonds at maturity, Central Banks balance sheets contract and with it, money supply.

"*We've never had QE before, therefore we've never had QT before. And if you actually think you understand what it's going to do, I think you're making a mistake.*" (Jamie Dimon, JP Morgan CEO).

Inflation

Inflation is red-hot around the world with interest rates rising expeditiously to combat pricing instability (exceptions being China and Turkey). RBA Governor Dr Lowe indicated inflation in Australia could be 7% by year end.

Some backwardation (when the current price of a commodity is higher than it is trading in the futures market) is beginning to present in markets. This signals the possibility that inflation may begin to mellow in coming months.

A key inflation driver, energy, should also have a lessening impact on inflation over time. Inflation is a rate of change measurement, so although energy costs will remain high, they are unlikely to match the unprecedented rise over the last 12 months in the coming 12 months. Other inflation drivers do look more persistent. Fertiliser shortages, climate changes and Russia's war of choice are amplifying food insecurity, sustaining increases in food prices. Employment markets also remain incredibly strong.

Labour markets

Employment metrics are breaking records. In Australia, the participation rate increased to an all-time high of 66.7 per cent. A further 69,000 full time jobs were added in May. Unemployment remains at 3.9%, a 48-year low.

There are 480,000 job vacancies, or 1.1 unemployed persons for every vacancy. We have reached full employment. Labour constraints are squeezing businesses.

Tight labour markets will sustain inflationary pressure, as will a minimum wage rise of 5.2%.

Interest Rates

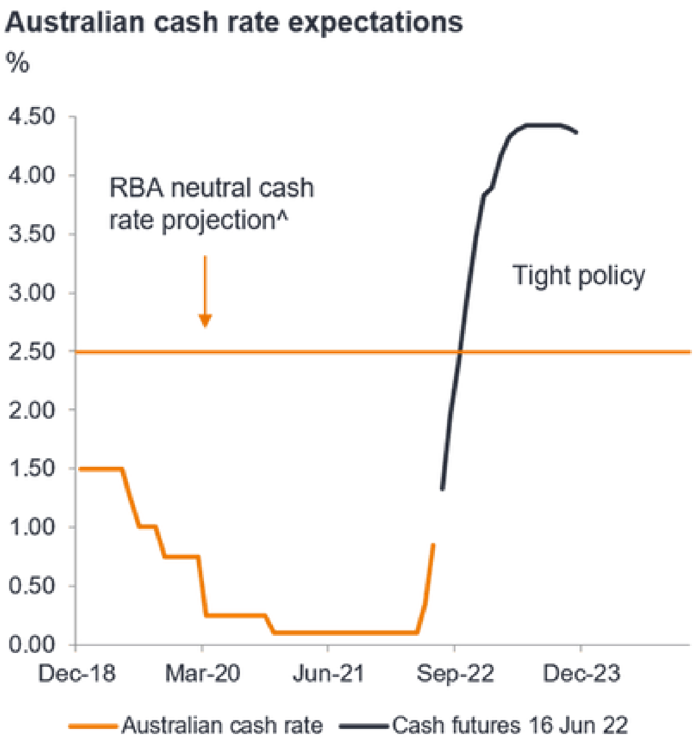
'The market' is pricing an RBA cash rate of around 3.5 - 3.7% by December 2022. If market pricing transpires it would prove catastrophic for Australia's overleveraged property market. AREIT's (property investment trusts) are down 28.33% in 2022 (as of 16 June 2022).

Few economists, and particularly those whose employers are large residential mortgage lenders, think the RBA will raise interest rates to 3.5%.

But, as the RBA is at pains to say, Australian household and corporate balance sheets are well positioned to absorb rate rises.

Economists at CBA, AMP and Macquarie Bank (amongst others) think the terminal rate (where RBA interest rates peak) will be somewhere closer to 2-2.5%, and some are speculating interest rates will lower in the second half of 2023. Their primary rationale for a more moderated terminal cash rate is high Australian household debt and the resulting sensitivity to interest rate changes.

So why is there a difference between economist expectations of 2-2.5% and the market expectations of 3.5%+?



Source: Janus Henderson

1. Global opportunity cost. Fixed interest investors allocate capital in a global market. The Australian dollar is a ‘risk on’ currency. Australian Government bonds may warrant a risk premium to reflect the downside foreign exchange risk for foreign investors in the event of an economic slowdown. Concurrently, yields on US and EU bonds are sufficiently attractive to draw capital away from Australia Government Bonds.
2. Quantitative Tightening. The rapid withdrawal of a large purchaser of government bonds may be causing a shortfall in demand. Reduced demand lowers the value (increasing the yield) of bonds.
3. Markets are correct and economic consensus is wrong.

We are leaning towards the pricing differential being explained by a combination of the first two factors.

Should that prove true, it is prudent to modestly increase duration (expected time frame of an income stream) exposures within portfolios. That is, for the first time in some years, we are suggesting investors again look at fixed interest investments!!

More interesting to explore is what if markets are correct and the terminal rate ends up being 3.5% or higher. This would lead to poor investment outcomes for all investors, but could it happen?

Some economists (albeit the minority) think we are moving into a new era. This new paradigm (economists might call it a secular shift) is one with more inflationary drivers, and thus a higher natural rate of interest to combat inflation. If correct, markets may be accurately or even under-pricing the potential interest rate rises. The themes underpinning this secular transition to a higher natural interest rate are:

- Increase in business capital expenditure (CAPEX). Business investment as a percentage of GDP has been flat or in decline over the last 30 years. Additional CAPEX is required to retool supply chains, infrastructure, human capital and inventory to improve operational resilience/relevance. COVID shone a light on supply chain frailties. CAPEX will also be increased to support the de-carbonisation transition.
- Demographic trends. Globalisation introduced a large low-cost labour force from Eastern Europe and Asia to western markets. Population growth and labour market utilisation appear to have peaked and supply chain disruptions have dampened appetite for foreign investment. Concurrently, female labour force participation has also plateaued in developed markets. These demographic trends were deflationary, their cessation is inflationary.
- Fiscal policy appetite. Governments have discovered budgetary levers, through COVID, not previously accessible.

> Pushing money into an economy is politically simpler than extracting it. Fiscal largesse increases competition for finite resources, which is inflationary.

If interest rates move higher, the investment outlook for low-income and long duration assets, at either end of the risk spectrum, such as low/no profit equities, residential housing, and long dated low yield government bonds, looks poor.

Cryptocurrency, which we don't consider an investment, being the worst of all worlds, could (and we think should) conceivably go to zero.

Although the above framework is logical, rapid technological innovation and continued globalisation (even if at a slower rate) could be sufficient deflationary drivers to offset the above inflationary drivers.

Proposing a secular shift is underway, leading to a higher natural rate of interest, would be at odds with the longer term (800 year) trend in declining natural interest rates. As such, we think it is a bold call and one we are unwilling to make at present without further evidence.

So, at this stage we think the market is incorrectly pricing the terminal cash rate and agree with economic consensus. But we do not have strong conviction of this and ultimately, interest rates will not stop rising until inflation is contained.

For a new material shift to be underway, we'd like to see evidence businesses are increasing CAPEX.

China

Three headwinds are affecting the Chinese economy:

1. Their dynamic zero COVID approach. The resultant lock downs are impacting production, consumption, and logistical fulfillment, which is supressing economic activity. Confidence within China, as well as from foreign investors, is fading.
2. Property market deflation. Property sales are down 30% to 50%. COVID lockdowns are exacerbating an already weak property market.
3. Demographic trends. Slowing urbanisation and an ageing population, although considered a longer-term headwind, are beginning to inhibit short term policy responses.

The planned nature of the Chinese economy meant that in past economic slowdowns, there was an expectant policy response:

- Increased infrastructure investment (usually debt funded)
- A lowering of interest rates
- Depreciation of the currency

Xi Jinping has in recent years shown a resolve to deleverage the Chinese economy. Xi is admirably focused on longer term sustainable economic development.

However, this means the debt fuelled infrastructure stimulus approach is decreasingly attractive. Further, infrastructure investment, which is typically focussed on urban transformation, is less beneficial as urbanisation slows.

"*Between the end of 2008 and the second quarter of 2020, China's debt burden grew from 139 percent of GDP to 283% of GDP – a scale and speed unprecedented in modern history*" (US China Economic & Security Review Commission. Section 2. Vulnerabilities in China's Financial System and Risk For the United States).

China's currency has depreciated. As developed markets begin raising interest rates, in contrast to China's central bank, the interest rate differential has narrowed. This, in addition to other reasons, begun attracting capital away from China. This in turn depreciates China's currency (as the graph below shows).

An ageing population in China is contributing to the transition from a healthy current account surplus to a small current account deficit.

As the pool of workers shrinks, relative to a growing retiree base, the Chinese are now consuming savings faster than they retain earnings from GDP output for investment. The IMF anticipates this to accelerate as the country ages.

"*According to UN forecasts, by 2045 China's working-age population will drop to 54.4 percent of China's total population (compared to 65 percent today), while the country's population over 60 will grow to 31.4 percent of the total population (compared to 17.4 percent today). A 2019 report from the Chinese Academy of Social Sciences warned China's declining birth rate—a legacy of the "one-child policy"—and simultaneous increase in life expectancy will exacerbate these trends, leading the country's national pension fund to become insolvent by 2035*". (UN. World Population Ageing 2019).

"*Morgan Stanley estimates China will need at least $210 billion of net foreign capital inflows per year through 2030 to finance the country's emerging current account deficit*". (Morgan Stanley. Facing current account deficits, China looks abroad for capital).

Source: WSJ (Tullett Prebon)

As interest rates rise globally, with China now operating current account deficits, policy makers risk exacerbating a capital flight away from China should interest rates be lowered there.

Aside from imported inflation pressures, another inhibiter to further currency devaluation is political sensitivity. China's leadership will seek to avoid a perception that capital markets have lost confidence in Chinese policy makers.

Regulatory risks continue to surprise in China. Reports have emerged of a 'run on banks' happening in a handful of regional banks. The CCP has used the COVID quarantine app to target frozen depositors, forcing them into quarantine to prevent them from protesting!

The combination of poor economic conditions and limited policy tools to address this are reflected in equity market pricing... "*Chinese equities as a whole are trading at about 10x earnings, about 1 standard deviation below fair market value*" – (Goldman Sachs, Kinger Lau, Chief Equity Strategist in Macro Research).

"*We have a view that previously Chinese GDP growth might be 5-6%. As [Xi Jinpin] try's to achieve some other goals, the cost will be slower GDP growth… perhaps Chinese growth will only average 4-5% growth [in the medium term]*" – (Hui Shan, Goldman Sachs Chief China economist).

If that is the downside case, Chinese markets look like an attractive contrarian investment.

We are not as optimistic and lean more towards the Lowy Institute's findings.

"*China will likely experience a substantial long-term growth slowdown owing to demographic decline, the limits of capital intensive growth, and a gradual deceleration in productivity*" (Roland Rajah and Alyssa Leng. Lowy Institute. Revising down the rise of China).

In China, economic growth has continued consistently for nearly 40 years. Economic growth encouraged and rewarded risk taking, speculation and leverage. Sustained robust GDP growth and government forbearance has likely papered over many poor capital management decisions.

"*It's only when the tides goes out that you discover who has been swimming naked*" (Warren Buffet).

It has become apparent Chinese property developers forgot to tighten the draw string on their togs, but there is no telling which other market participants will bare all if GDP growth further slows.

INVESTMENT UPDATE

Asset classes have provided correlated negative returns through 2022, with few places to hide.

"*Interest rates are the gravity of markets*" (Warren Buffet, Berkshire Hathaway).

As expectation adjusted and interest rates rose, asset class valuations adjusted back down to earth.

In the last quarter we attended several investment summits to hear from fund managers and analysts on their outlook for markets. Listening to fund managers is a little like Groundhog Day. They ostensibly say the same thing:

"*We do fundamental analysis to discover and invest in undervalued businesses the market has mispriced, delivering superior long-term returns*".

Few can do this sustainably (above their fee) and there is a mountain of nuance in value determination.

A recurrent theme this year amongst fund managers was the truism that "*valuation matters*" and "*quality counts*". When hasn't this been true? A kinder interpretation would be that these comments reflect other events unfolding in markets.

'Turds'

The demise of questionable and opaque areas of 'investment' markets may have come as a surprise to some, but they shouldn't have. Cryptocurrencies and the buy now pay later (BNPL) sector, both delivering negligible value to society, have seen valuations begin to drift closer to intrinsic societal contribution.

Or as Simon Mawhinney of Allan Gray put it, when discussing cryptocurrencies: "*if it smells like a turd and looks like a turd… it just might be a turd*".

Sentiments seemingly shared by Paul Krugman and Charlie Munger; and Mawhinney even borrowed some of Munger's semantics from comments he made before the dotcom bubble burst - "*if you mix raisins with turds, they're still turds*" (Charlie Munger, Berkshire Hathaway).

The ongoing increase in interest rates will continue to ratchet pressure on cryptocurrencies. Money in the bank, soon to generate income at a predictable rate, which can be used to put food on the table, will push the tide out further on tokens/crypto's…

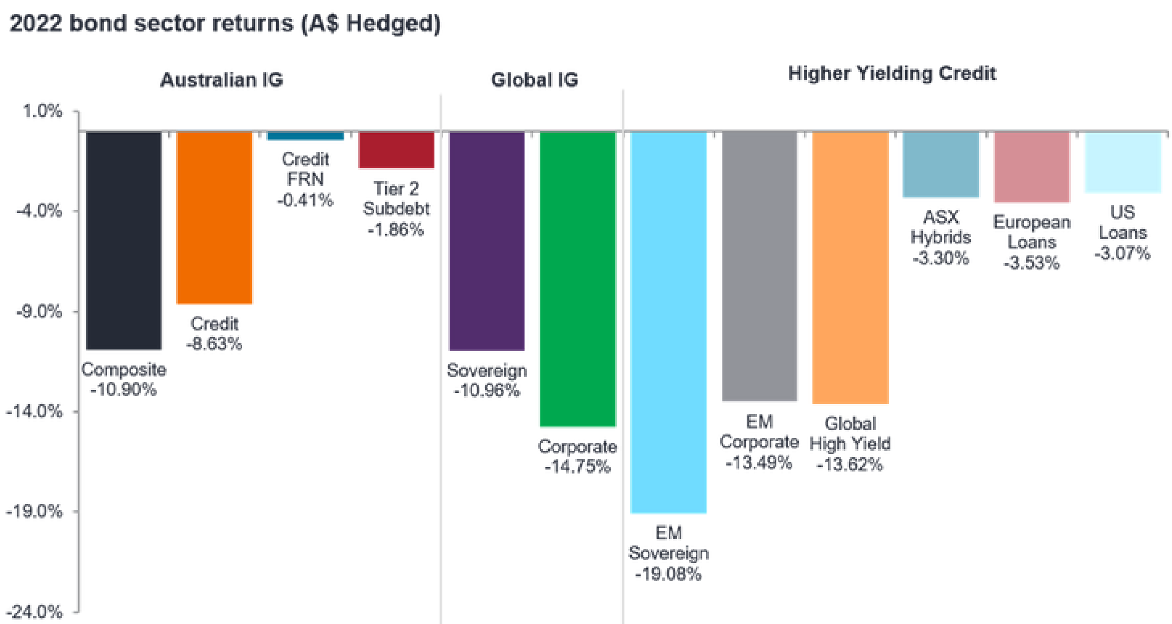
"*If something doesn't generate income, but trades at a high valuation, no wealth has been created… it is simply being transferred. In the end valuation does count*" (Warren Buffet, Berkshire Hathaway).

Fixed income

Over the last two to three years, prior to any update on fixed interest assets, there would be a deep sigh from the fixed interest analyst/manager before commencing their presentation. That sigh contained a mixture of depression, resignation and despair, reflecting the complete lack of relative value of the fixed interest asset class.

No tougher job existed than to sell negative real yields to investors, where nominal yields could often be less than 1%.

Much like a dying animal, it was kinder to 'put down' these exposures with a clean exit from portfolios. If you didn't do the necessary quick kill, these 'lowest risk' exposures have delivered effectively -10% of returns in 2022 (on top of virtually no returns for the previous few years).



Source: Janus Henderson

With so much pain priced into markets, and valuation drawdowns potentially behind them, a spark of optimism has been noticed amongst fixed income managers.

Yields are now between 3.5%-4%. There may even be capital upside with economists thinking central bank tightening should cause enough pain at 2-2.5% to ease inflation.

So, for the first time in years, there is a rationale for fixed income allocations to be considered as part of a diversified portfolio. [More info here for a fixed interest asset class wrap-up].

Equities

There are dual narratives facing investors. One is buoyant labour markets and surplus demand, both signalling a strong economy. The other is a sharply rising (but then inverted) yield curve, historically pointing to the tightening of credit (rising interest rates) triggering a recession.

The media is amplifying the second part of the narrative – that interest rate tightening might be a harbinger of economic doom. When in fact, a return to more normal monetary conditions, from emergency settings, should be relatively digestible for a strong economy.

Household and corporate balance sheets are in materially better shape than in 2008 for instance.

Equity markets also act as a good inflation hedge, with businesses absorbing higher costs by passing these on as price increases.

So, although the pathway of returns looks volatile, equities have now digested the prospect of a significant volume of interest rate movements ahead. The resetting of valuations has made equities more appealing than 12 months ago.

Summary

Although further volatility should be expected as interest rates normalise, economic consensus is not forecasting the calamitous outcome that media commentary is foretelling. As the fund managers say, valuation matters, and with inflation likely to remain high for some years, staying out of the market for too long is value destroying.

Keep to your investment plan, don't succumb to emotional drivers that misinform decision making, and remember that investing through all periods of time has proven to do well over the longer term.