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SNOWGUM QUARTERLY

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INTRO

In 2022 inflation awoke from its long slumber and Central Bankers were caught napping. They then responded with the fastest interest rate rises in history. Fortunately, there are early signs of success, with inflation expectations remaining subdued.

OECD investment in China has plummeted. China appears to be reevaluating their geopolitical isolation.

Yields have nearly doubled in many fixed income markets. Equity valuations now trade much closer to long terms averages, albeit the US remains relatively expensive.

KEY STATS

- Cash rate is on the up, presently 3.10%
- Unemployment in Australia is 3.40%
- Inflation is 7.30%

WHAT'S INSIDE THIS QUARTERLY:

Key Statistics

Economic Update

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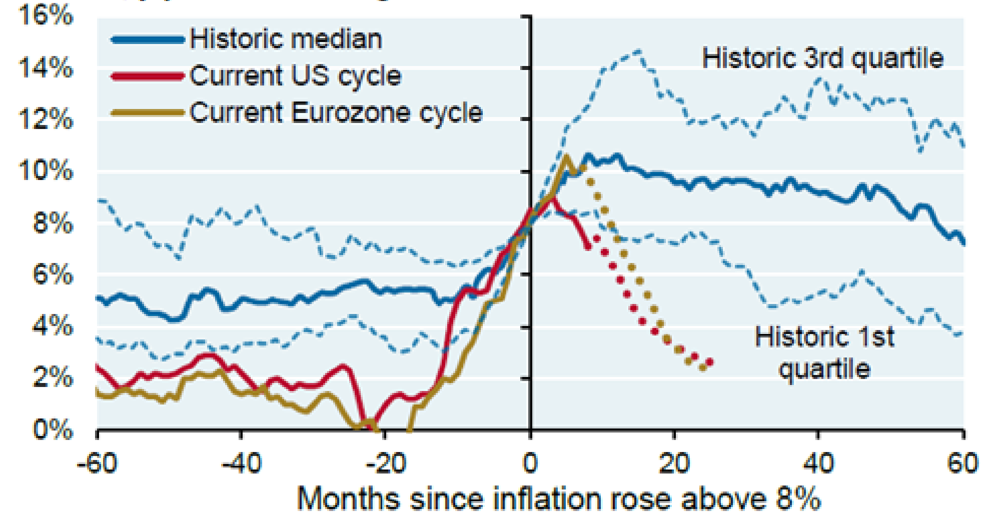
ECONOMIC UPDATE

In 2022 inflation awoke from its long slumber and Central Bankers were caught napping. They then responded with the fastest interest rate rises in history. Fortunately, there are early signs of success, with inflation expectations remaining subdued.

Developed market inflation episodes since 1970
Percent, y/y inflation change



Source: Jim Reid, Deutsche Bank, Bloomberg, JPMAM. November 2022. Dotted lines indicate Bloomberg consensus.

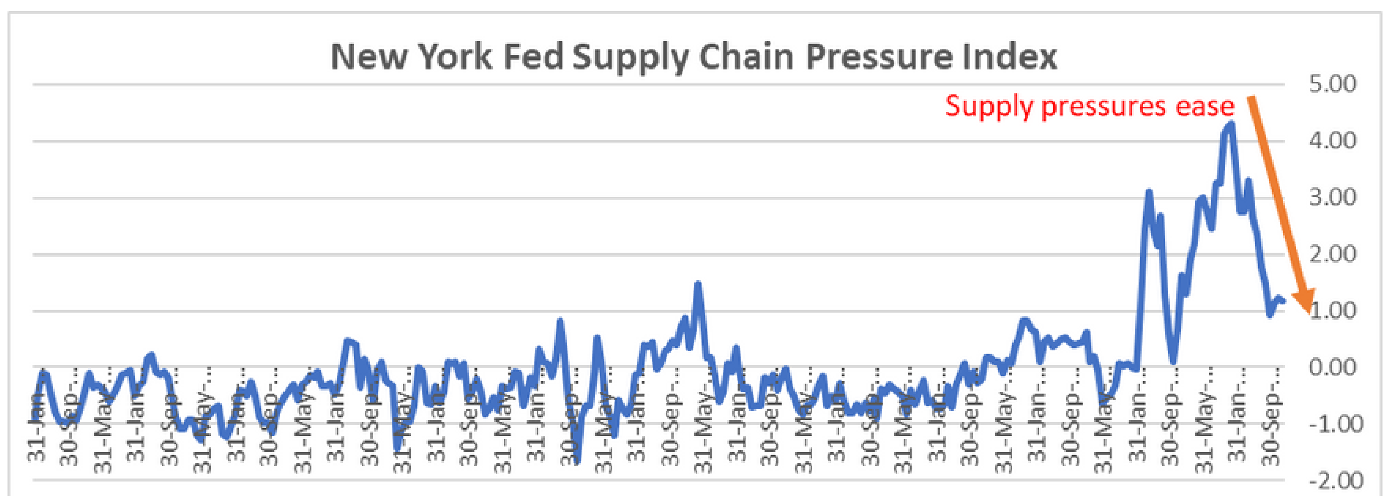
There is general agreement that inflation expectations (red and green dotted lines in the graph) predict a fast moderation back towards inflation targets (20 months). This expectation of such relatively rapid moderation of inflation has rarely been seen before, although the pre-covid benign inflation environment was itself also unusual.

For Central Bankers of developed economies, the highest point of their tightening cycle may occur as early as the first quarter of 2023.

The projected moderation of inflation in 2023 is driven by:

1. Supply chain normalisation
2. Negative consumer sentiment and consumption
3. Energy market normalisation

1. **Supply chain** pressures are easing. Normalising freight costs and China's reopening, albeit bumpy and at significant human cost, sees supply side dynamics stabilise.



Source: New Yor Federal Reserve

Inventory supply, increased to meet elevated pandemic-era demand, is now at record high levels (see below graph).

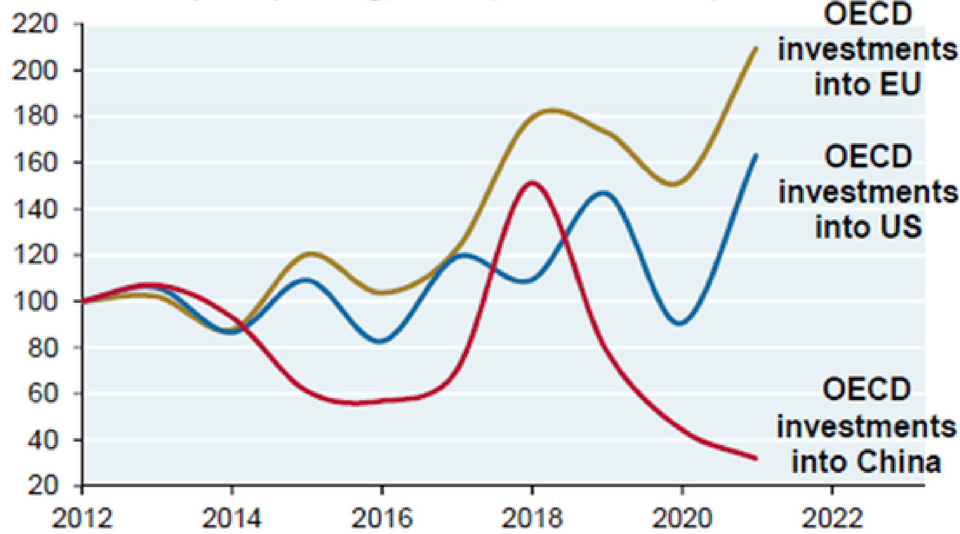
2. Consumer sentiment bottomed in late 2022. In 2023, consumer spending will continue to be impeded by tighter financial conditions (higher interest rates). Weakening and altered consumer demand (increased share of spending flowing back into services), and elevated supply, could possibly become deflationary.

3. Energy prices have fallen to pre-invasion prices, materially benefiting from a mild northern hemisphere winter. "*The 40% and 50% increase in U.S. used car and global energy prices, respectively, contributed 4 percentage points to U.S. headline inflation in 2022. If those prices just stabilize, U.S. headline consumer price index (CPI) inflation could fall from about 8% to 4% (annualized) relatively quickly*" – PIMCO. Those prices have not only stabilised, they have continued to contract.

If the lead economic actor in 2022 was inflation, the supporting actor was **labour markets**. Employment remains tight with unemployment rates at historically low levels. The US December jobs report showed that the US economy and labour markets remain resilient, while wage growth slowed slightly.

US consumers continue to draw down on pandemic era savings, although both consumers and businesses retain healthy balance sheets. The combination of balance sheet and labour market strength should see the US avoid a deep recession, if one is experienced. Rising inventory levels, low consumer confidence, increasing debt servicing costs and falling asset prices will lead to a slow-down across major developed economies through 2023. This is in line with IMF forecasts.

Source: Bloomberg LP



On the brighter side, the prospect of excess household savings accumulated over three years of lockdowns could buoy a Chinese economic recovery through the remainder of 2023.

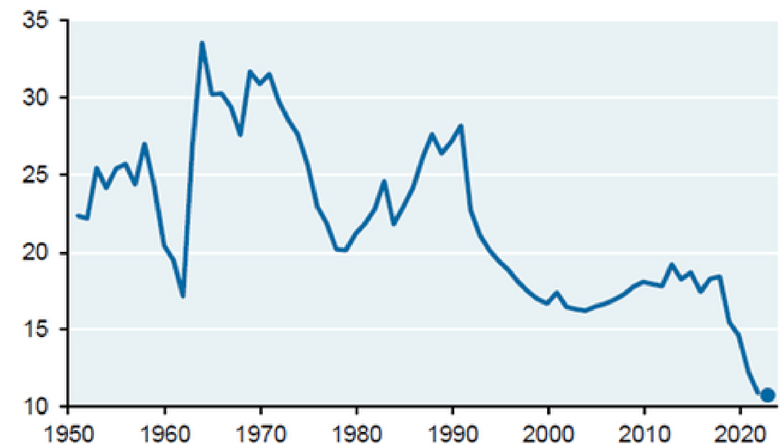
Anecdotally, an uptick of Chinese tourists around Sydney has already been noted.

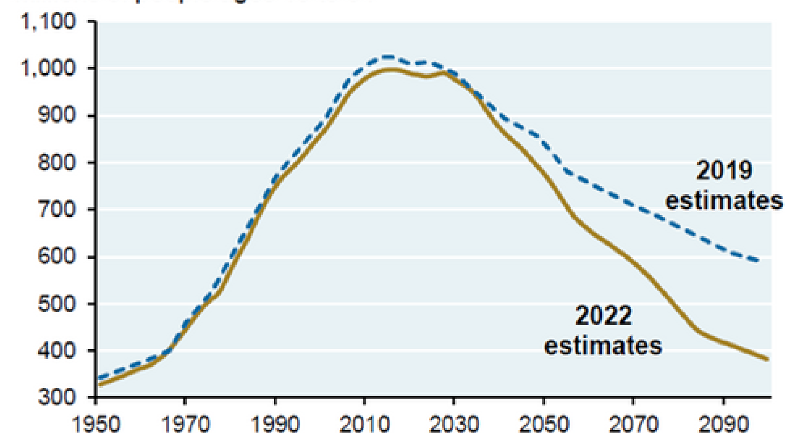
Ostpolotik, the expectation that economic integration with Russia would lead to geopolitical stability, now lies in the policy scrapheap. Lessons learned from Russia's invasion of Ukraine are being applied to trade relations elsewhere.

While China embraces Russian foreign policy so deeply, at odds with European values, a course correction appears improbable. China appears to be recognising the peril of alienating most developed market economies, seeking a reset with trading partners (outside the US).

A concurrent challenge for a Politburo made up of 60+ year old men is how to encourage youthful Chinese passion. The declining birth rate, amplified through lockdowns, is emerging as a drag on longer term economic growth. Chinese youth unemployment, at around 17%, coupled with unaffordable housing is no aphrodisiac.

Well known frailties in the Chinese property sector remain, but the manufacturing hub of the world looks set to get back to business in 2023.





Policy risks remain. Traditionally Central Banks have had only one primary ‘blunt’ instrument, interest rates, to guide the economy; they could simply raise, lower, or maintain the interest rate. However, since the global financial crisis, Central Bankers acquired extra levers – Quantitative Tightening (QT) or Easing (QE). This combination of interest rate settings and QT and QE in their inflation targeting activities is novel from a historical context. As a result, the possibility of monetary policy mistakes remains a key risk in 2023.

INVESTMENT UPDATE

“*In my 53 years in the investment world… I remember only two real sea changes, I think we may be in the midst of a third one today*”– Howard Marks.

Inflation and the resulting policy response from Central Banks crashed the ‘free money’ party. The hangover is most acutely felt at either end of the risk curve. Bonds had their worst year in history (and disastrous if viewed through a risk/return lens), while growth focussed ‘profitless innovation’ and digital ‘assets’ put on a magic show… a disappearing act.

Investment mirage

Only a handful of sectors were resilient in 2022, the worst year in markets since the GFC. Energy and commodity businesses saw revenues grow, benefitting from elevated commodity prices due to supply disruptions. In addition, some private assets performed well, according to their asset managers.

Private assets are not marked-to-market, meaning their valuations are determined by asset managers, not market participants. There will be outperformances, however for many private assets, in particular unlisted property, valuations might be a mirage.

In the instances where public markets get a chance to vote on private assets, they’re valuing these assets up to 40% below the asset manager’s assessment. It doesn’t mean public markets are right, however, the gravity defying gap between the two divergent valuations can only be temporary. Unless there is a quick rebound in markets, which appears unlikely, investors should be cautious of private assets, or at least their valuations.

The blending of unlisted property investments into MySuper investment options has provided some degree of downside protection for large Superannuation funds. It will be interesting to see how APRA’s Superannuation performance test digests this.

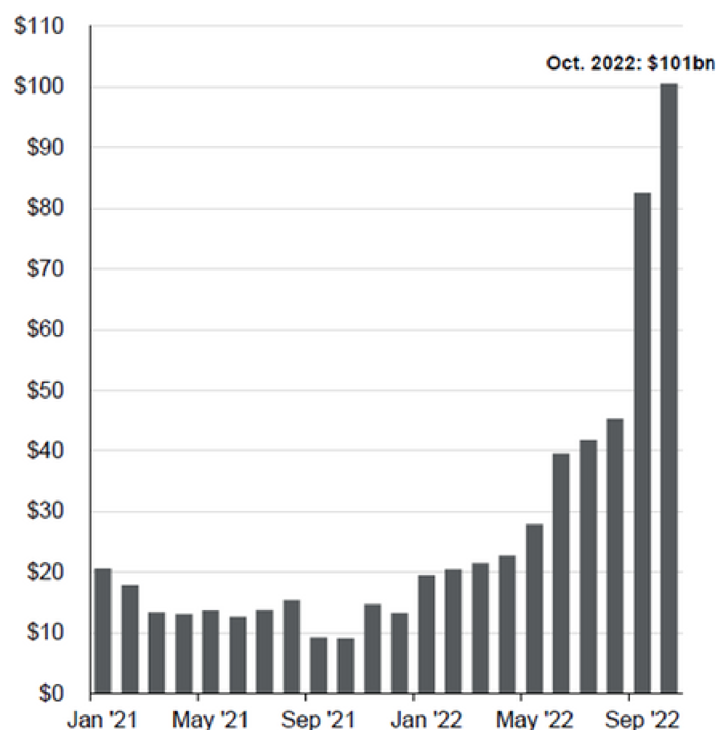
The return of returns (fixed incomes)

Got some spare cash? A term deposit gets you close to 4%. For the first time in some years returns can be had without needing to 'fly too close to the sun' and taking some significant risks.

As the below graph shows, fixed income yields have doubled in a number of markets around the world during the last 12 months.

Default rates and credit spreads remain low, albeit some expansion of credit spreads has flowed through in late 2022. Distressed debt levels crept up dramatically in late 2022, with an insufficient expansion in credit spreads of non-investment grade credit yet.

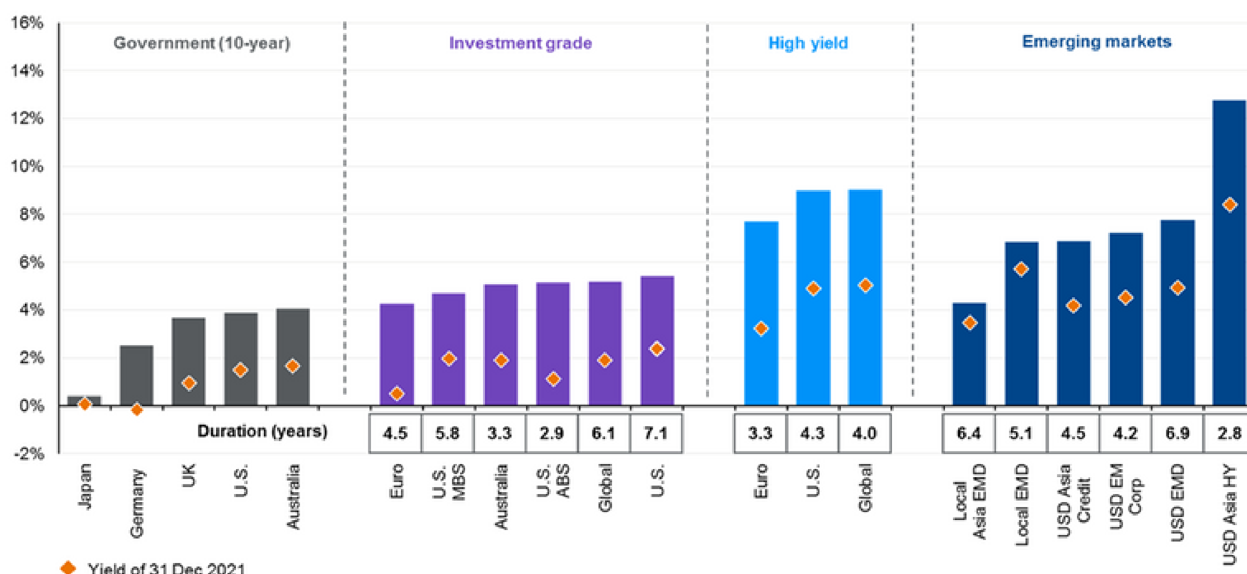
Investors should be selective in capital allocation as emerging risks are either not priced in yet or liquidity has limited the accurate recalibration of risk premiums. Default rates, trading around 2% over the last few years can be expected to double.



Source: JPMAM

Equity markets

Active management, overlooked during the past 'growth at any cost' cycle, is likely to have its day in the sun over the coming years. A higher discount rate, pegged to central bank cash rate settings, is once again a greater influence on risk and return considerations and so where to invest. No longer is it as acceptable to run a business unsustainably and expect to maintain investor's support.



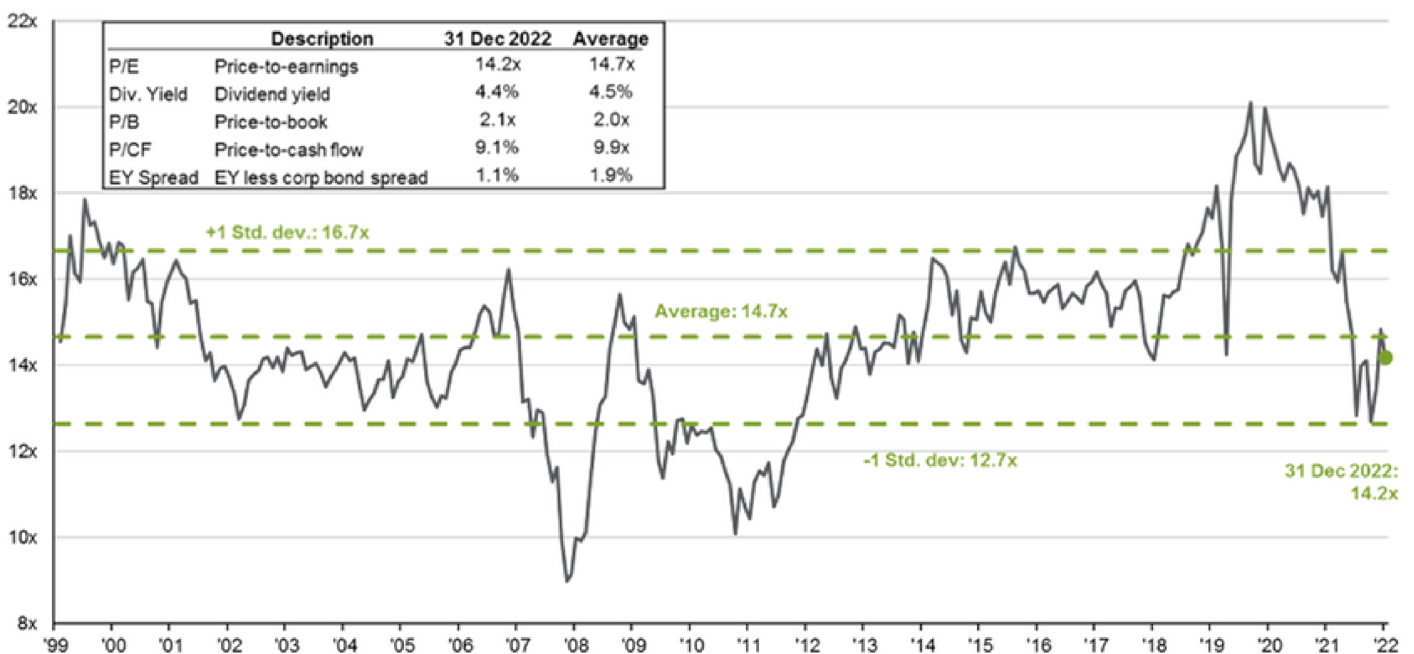
Source: JP Morgan Asset Management

Perhaps we will look back on the low interest post GFC years as an outlier in capital markets. When income isn't generated but that 'asset' trades at a high valuation, wealth has not been created, it has been transferred. For every profitless tech and crypto fortune created, an equal amount of wealth has been lost by others.

Markets, being forward looking, have priced in realism. Although earning downgrades and negative shocks are likely to be a feature in 2023, the equity valuation starting point is approaching long term valuation norms, and should be comforting for long term investors.

By Matt Vickers

ASX 200 Index: Forward P/E ratio



	Description	31 Dec 2022	Average
P/E	Price-to-earnings	14.2x	14.7x
Div. Yield	Dividend yield	4.4%	4.5%
P/B	Price-to-book	2.1x	2.0x
P/CF	Price-to-cash flow	9.1%	9.9x
EY Spread	EY less corp bond spread	1.1%	1.9%

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Dividend yield is calculated as the next 12-month consensus dividend divided by the most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM (next twelve months) cash flow. EY (earnings yield) minus corporate bond yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) less the yield on the AusBond Credit (5-10y) Index. Guide to the Markets – Australia. Data as of 31 December 2022.

Any advice contained in this update is of a general nature only and does not take into account your circumstances or needs. You must decide if this information is suitable to your personal situation or seek advice. Prior to investing in any particular product, you should read the Product Disclosure Statement.

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