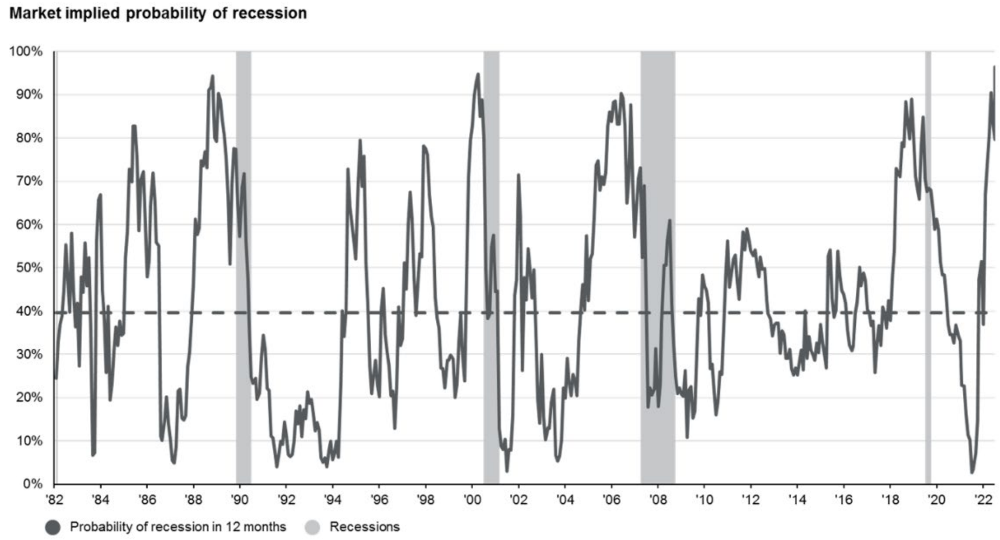
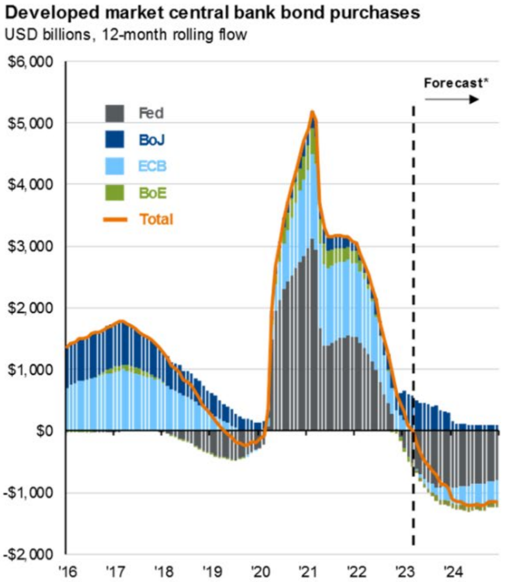
Economic Update

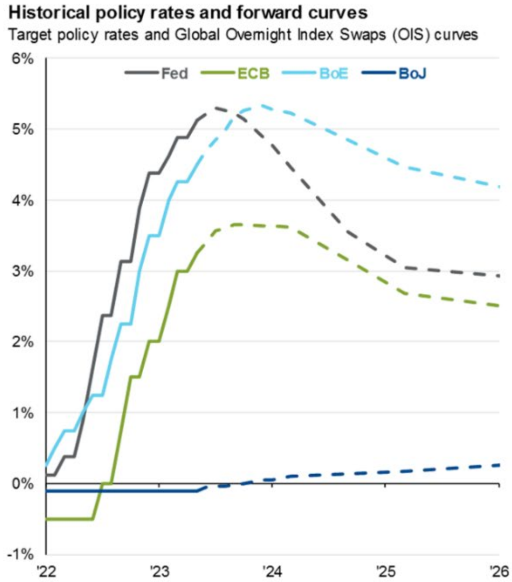
A picture tells a thousand words… welcome to our economic graphical novella!



Source: Bloomberg L.P., National Bureau of Economic Research (NBER), J.P. Morgan Asset Management

The above graph shows bond markets implied probability of recession, a calculation based on aggregating various yield curve inversions. Currently it is reaching for the stars, the highest it has been for 40 years.

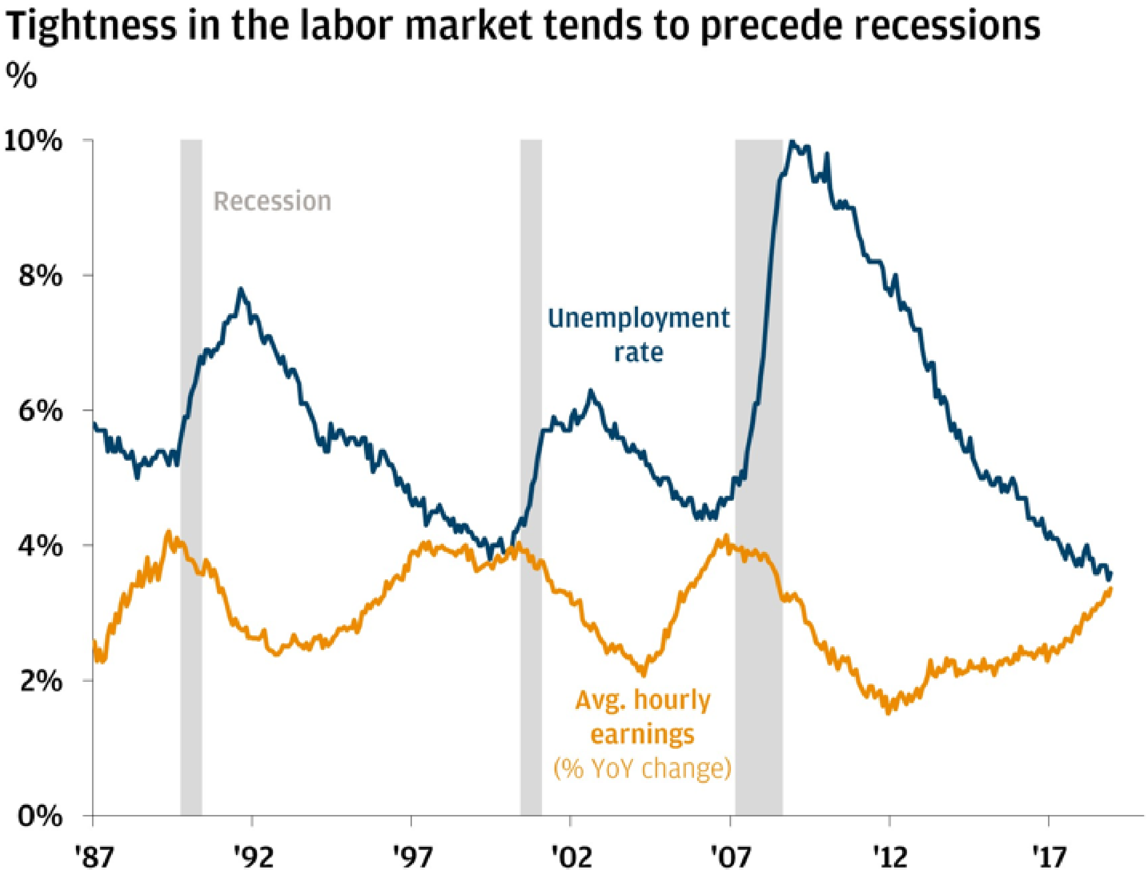




Source: BIS, Bloomberg, FactSet, J.P. Morgan Asset Management; (Left) Bank of England (BoE), Bank of Japan (BoJ), European Central Bank (ECB), Federal Reserve System (Fed), J.P. Morgan Global Economic Research

- Markets expect interest rates to be near their peak now (above right graph).
- Quantitative tightening (QT) is in its early stages (above left graph).
- QT may exacerbate market forces. US government Yields have begun moving out of step with Federal Reserve guidance.

The discussion of a looming recession is often qualified by pointing to strong employment. As the below graph demonstrates, labour markets tend to be lagging indicators. Tight labour conditions contribute to a need for Central Banks to tighten policy, as they are now.

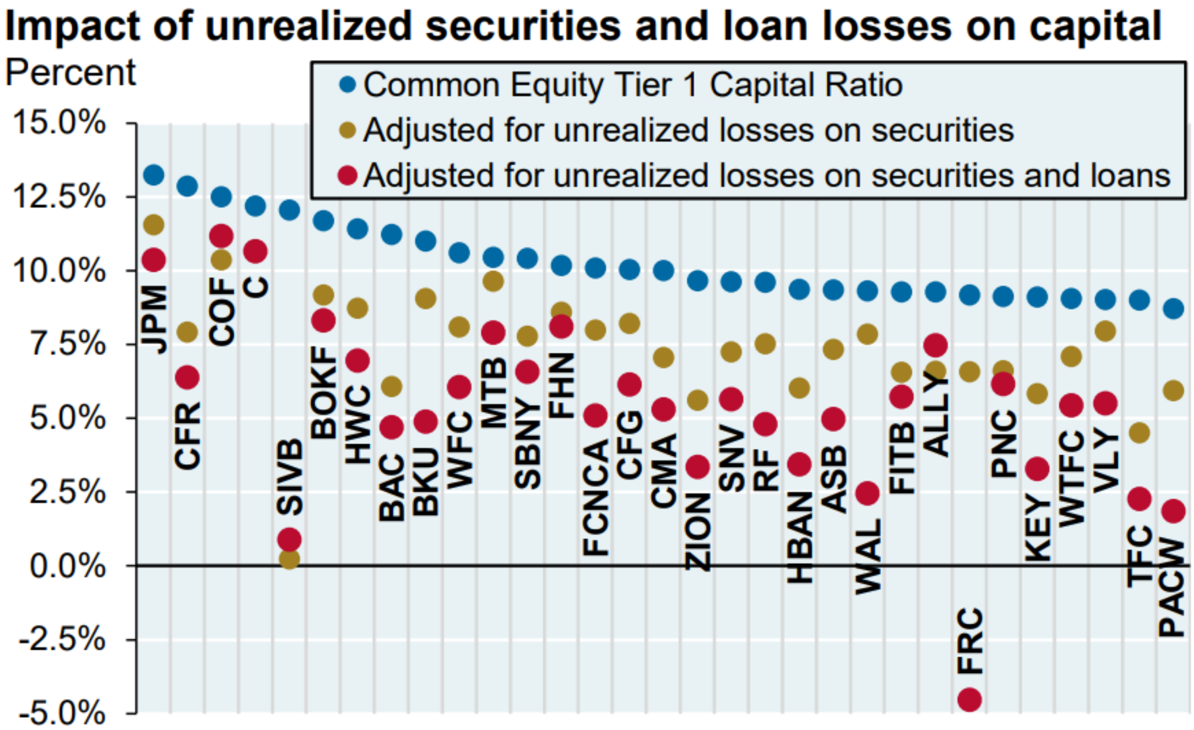


Source: Bureau of Labor Statistics. Haver analytics. Data to October 31, 2019

What is making bond markets so pessimistic?

Pessimism has been fanned by Central Banks purposefully engineering a slow-down. Unfortunately, Central Banks have no way of knowing how restrictive policy settings are until after the fact. Despite well understood long and variable lags, bond markets are expressing that interest rates might be too restrictive, particularly in the US. Or read another way, **although interest rates aren't nominally high by historical standards, after a decade of near zero interest rates, there is too much debt to support a normalisation of interest rates without breaking something.**

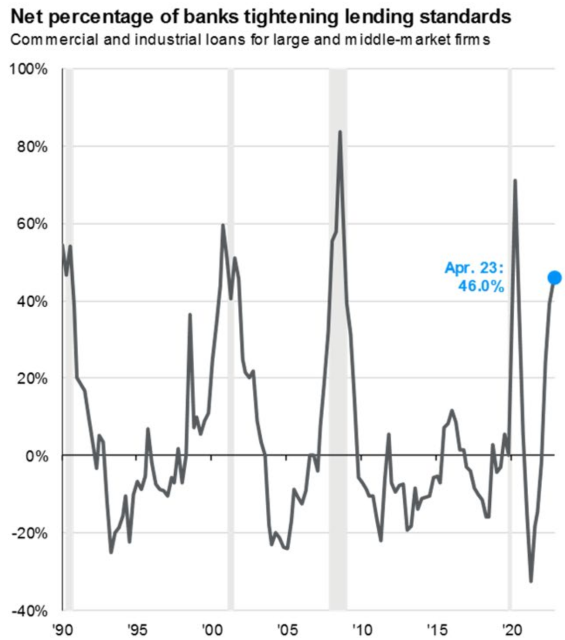
In the US, one of these 'variable lags' has been US banking weakness. A US bank's balance sheet is geared to long duration assets (long term mortgages or long dated US treasury securities). The market value of long duration assets collapsed as interest rates rose. If banks accurately marked up losses on their balance sheet (below graph), many banks would edge closer to insolvency. If an economic downturn eventuates, loan impairments from an elevated default cycle will further erode brittle balance sheets. The COVID induced reduction in office utilisation, leading to declining office real estate valuations is occurring at the same time shorter term loans on commercial property debt reprice precipitously higher. Commercial real estate is emerging as the most acute risk to US Banking stability.



Source: JPAM Q4 2022. All calculations based on 10-K reports.

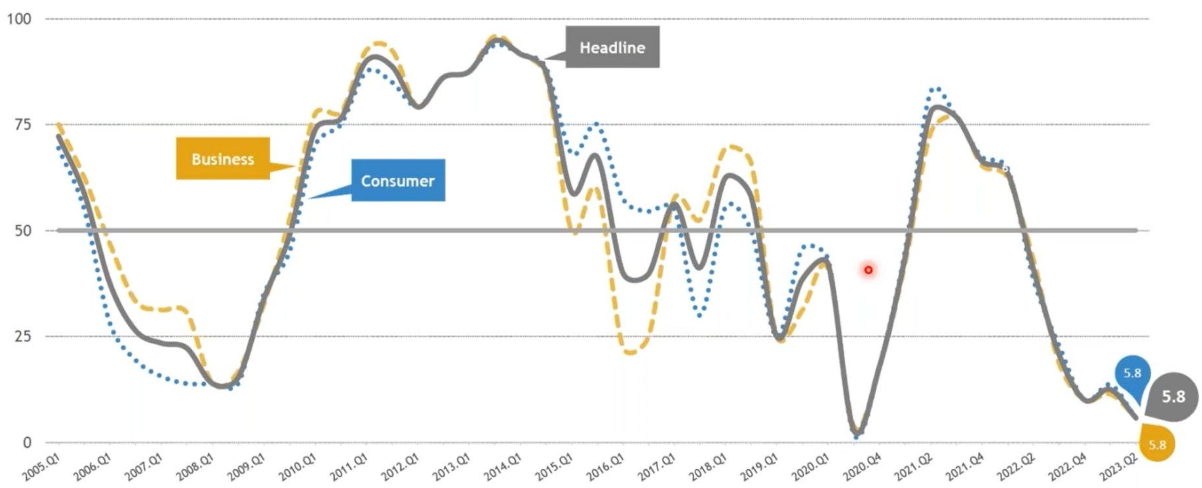
Positively, the demise of US banking balance sheet strength is not yet the systemic risk it was pre-GFC. As the graph below left shows, US banks are better capitalised. The Fed, through its GFC experience, has developed tools to efficiently inject liquidity and confidence into the banking sector.

The consequence of US Banks brittle balance sheets is a severe contraction in credit availability (right graph below).



Source: Bloomberg, FDIC, Federal Reserve, J.P. Morgan Asset Management. The tier 1 capital ratio is the ratio of a bank's core tier 1 capital (equity capital and disclosed reserves) to its total risk-weighted assets. It is a key measure of a bank's financial strength that has been adopted as part of the Basel III Accord on bank regulation. Guide to the Markets – U.S. Data are as of May 31, 2023.

In a survey of credit managers, availability of credit is now more restrictive than during the GFC, itself a credit crisis. **Credit is the lifeblood of any economy. Turn off credit and economic growth is improbable.** We discussed the febrile US banking sector in more detail [in our recent quarterly](#).



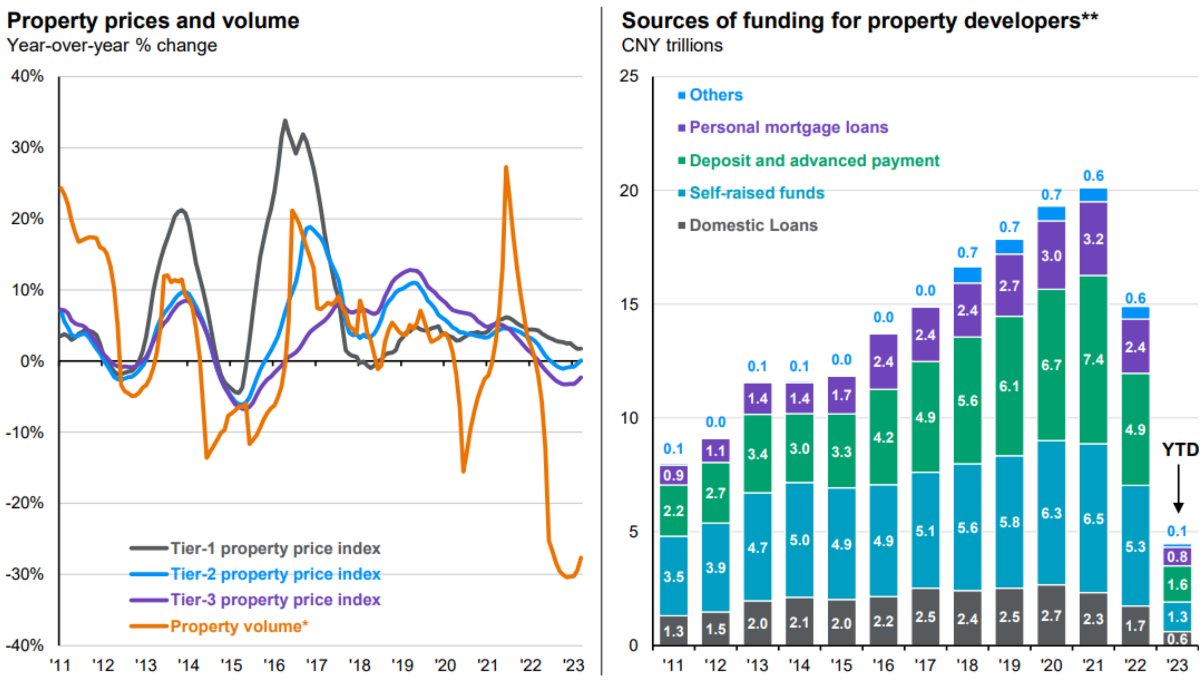
Source: American Bankers Association.

US banking weakness is in part due to the fixed rate nature of US household mortgages. The US household remains in good health with more than half of US mortgages fixed at less than 3% for the long term (15+ years). The strength of the US consumer may blunt a US downturn.

<u>China</u>

The same cannot be said for the Chinese consumer. Chinese consumers are hoarding cash. There appears a crisis of confidence. Not only is a record amount of income being saved, but there is unwillingness to invest savings. Private investment is down relative to 2022, itself a poor year.

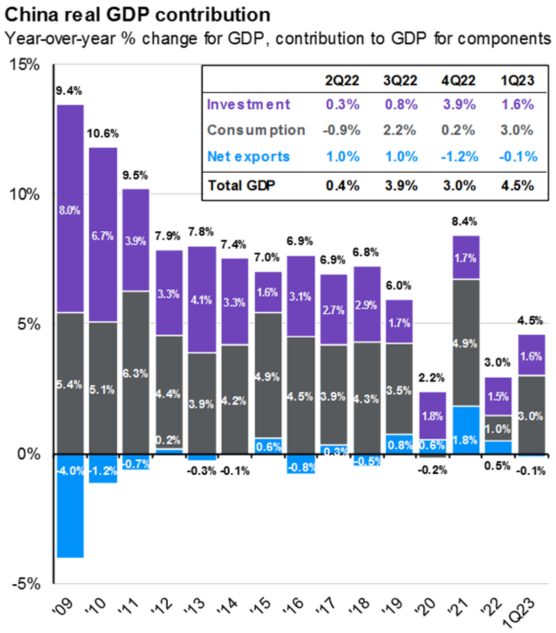
Chinese House prices are weak and [housing starts are down by 21.2% in the first four months](#) of 2023, against 2022. China is oversupplied with housing, Real Estate developers continue defaulting, and land sales are falling precipitously (left graph below).

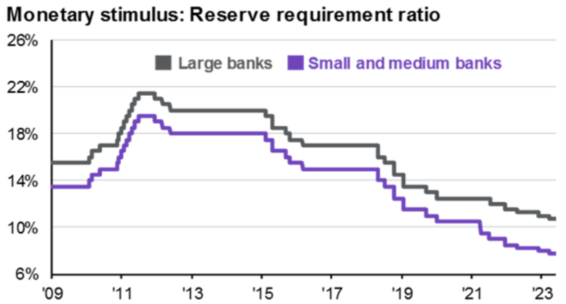


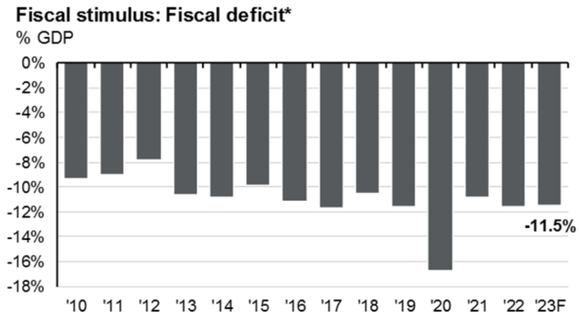
Source: CEIC, National Bureau of Statistics of China, J.P. Morgan Asset Management. Data as of 30 April 2023.

Stimulus is the watchword… Unfortunately for China, stimulus is typically injected by local governments, funded by land sales to property developers. With confidence in property non-existent, property developers (above right graph) are struggling to raise funding and both local governments and developers are struggling to service existing debt burdens, let alone coordinate capital activities to generate land sale to fund new stimulus.

Chinese authorities are leaning on other measures to arrest a potentially damaging downward cycle of economic weakness and falling confidence perpetuating each other.



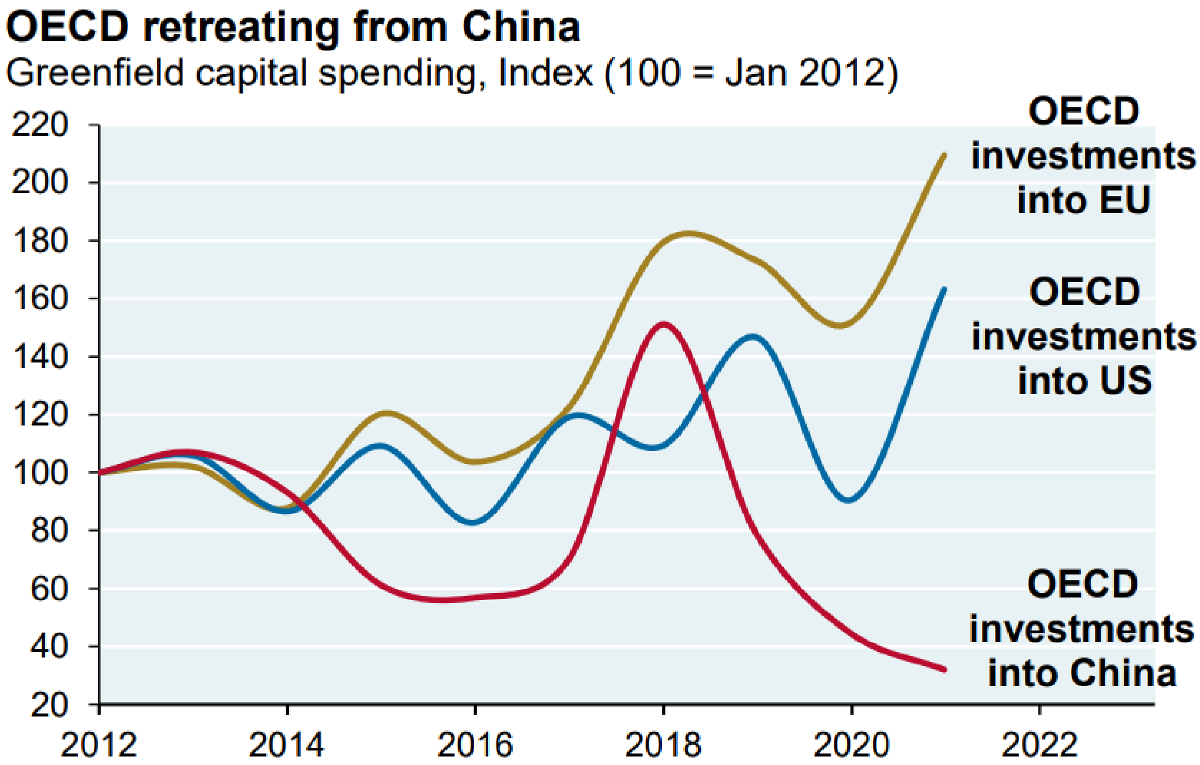




Source: FactSet, J.P. Morgan Asset Management; (Left) CEIC; (Top right) People's Bank of China; (Bottom right) China Agriculture Development Bank, China Development Bank, Ministry of Finance, People's Bank of China, Wind. **The fiscal deficit is a J.P. Morgan Global Economic Research estimate of the augmented fiscal deficit. It measures the aggregate resources controlled by the government and used to support economic growth.

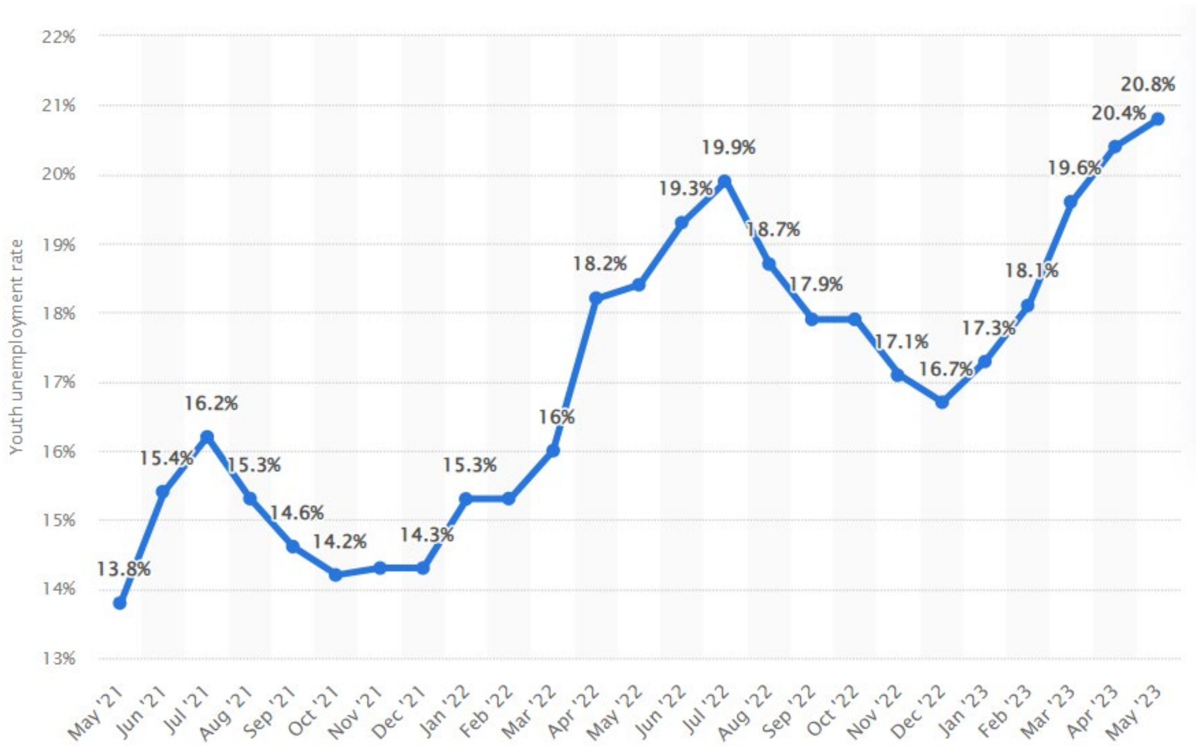
Chinese fiscal stimulus continues (above bottom right) and monetary settings (above top right) continues to be loosened. Lower reference rates (interest rates) have seen the Renminbi decline c.7% against the US dollar in 2023. This *should* have boosted demand for Chinese exports…

As we know, China and the US are no longer mates. But China's equivocation towards Russia's unprovoked war in Ukraine has rapidly altered the EU's relationship with China. Diplomacy might be nuanced, but capital markets are not. OECD markets have cemented their retreat, which began before Russia's invasion, from new investments into China (below graph). The antithesis towards China combined with slowing Western economies are dual headwinds for Chinese exports.



Source: fDi Markets 2021

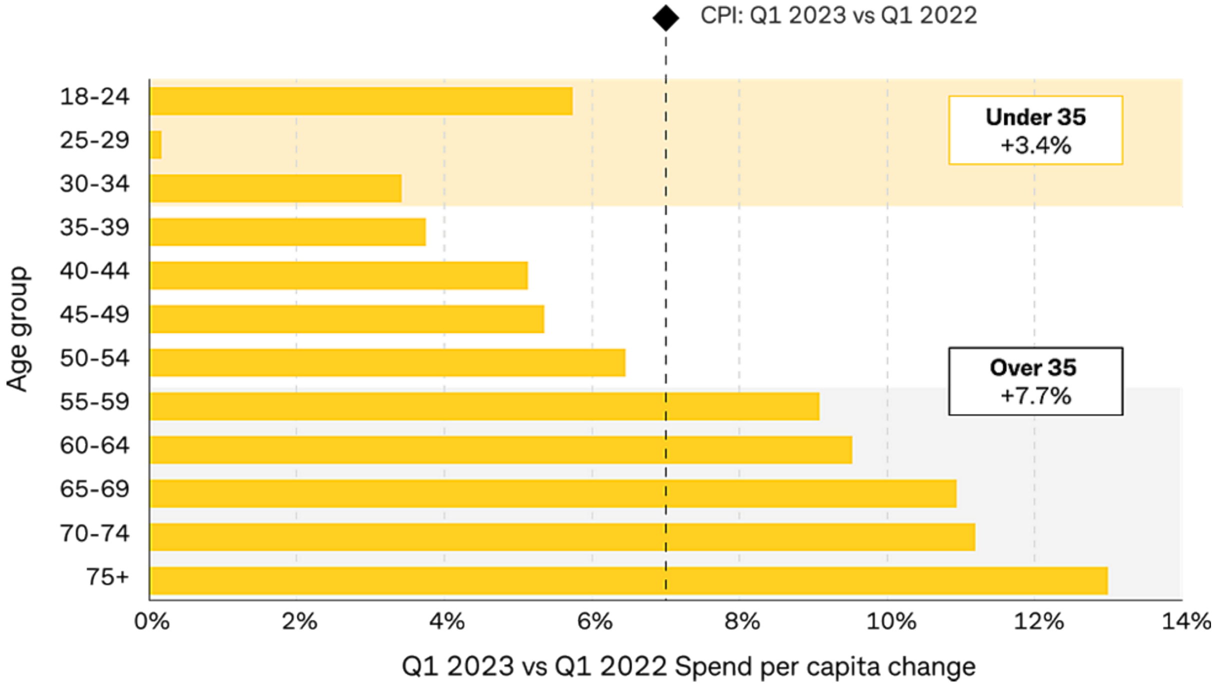
As the year commenced, some economists were optimistic that the Chinese consumer would splurge following the reopening from severe COVID restrictions. China was hoped to be the economic growth engine in 2023. As the year progresses things are looking increasingly 'bitter', especially for Chinese youth, with one in five unemployed (below graph). The latest inflation read for China was c.0%, Producer Price Index is negative, meaning goods produced are declining in value. As discussed above, traditional stimulus hasn't come to the rescue.



Source: China's National Bureau of Statistics.

Australian economy

While things are dire for China's youth, it's Australia's youth through reduced spending, doing the RBA's heavy lifting in their fight against inflation.



Source: CBA

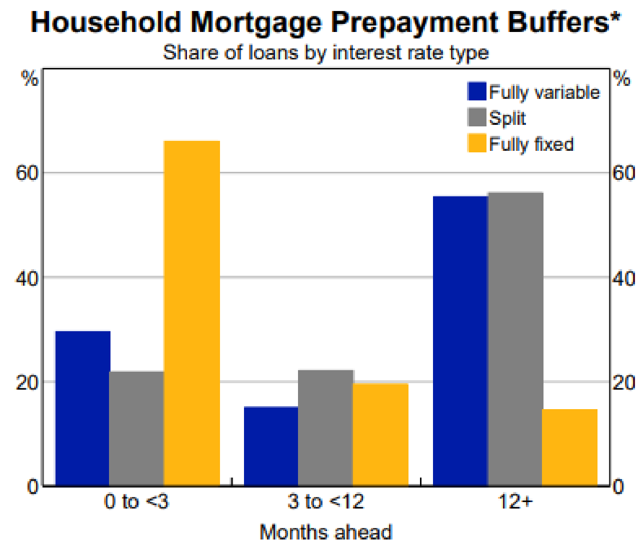
Rising rents and mortgage servicing costs, largely an impost on those between 18-55, have seen consumption spending behaviour correlate with age. With annual inflation recently at c.7%, spending growth below this percentage was a contraction in real terms, while increased spending from baby boomers continues to stoke inflationary pressures.

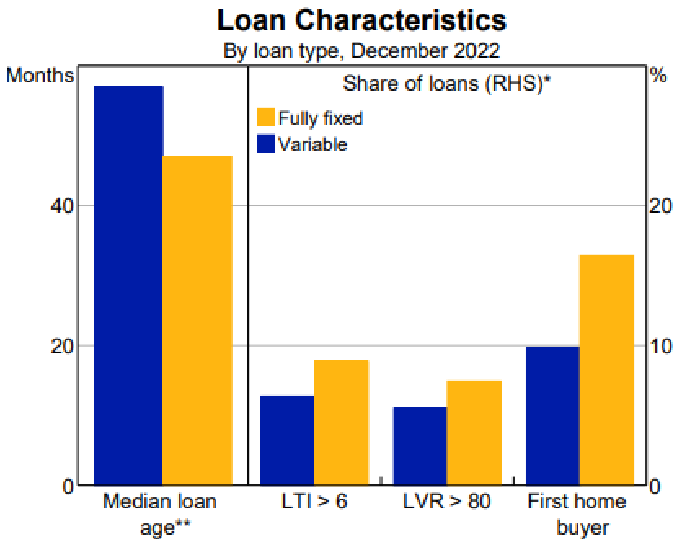
A factor for further investigation by monetarists is if monetary policy transmission is blunted by wealth inequality. Older Australians are more likely to own their home without a mortgage, own an investment property and have money on deposit. As a result, their spending capacity has increased with higher interest rates and rents in this cycle.

Unusually, house prices and rents have not fallen as expected in response to higher interest rates.

Higher rents and house prices are supply side policy failures. Rents and house prices are not increasing due to higher interest rates. They simply reflect an acute lack of new housing and inefficient utilisation of existing housing. Successive government policy failures are making the Central Bank's job of fighting inflation more challenging.

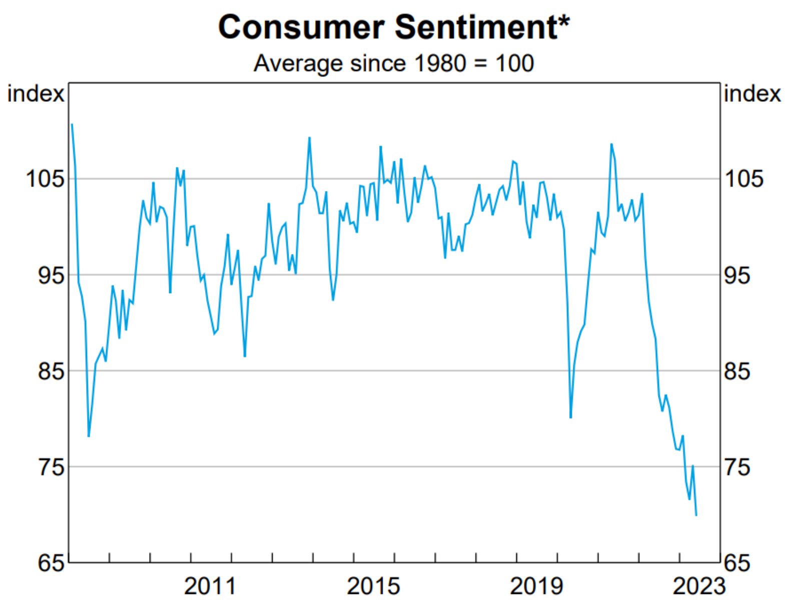
If a recession arises in Australia, it will be driven by a collapse in consumption and living standards of younger Australians. More than 30% of fixed rate loans roll off in the next 6 months. Fixed rate loans tend to have lower financial buffers (below left graph) and be riskier loans (below right graph). **This cohort of mortgage holders are about to see interest servicing costs triple**.





Source: RBA

If you need confirmation things are not rosy for the consumer, look to consumer sentiment (graph below). Instead of being a stochastic index with rolling moving averages providing general insights, consumer sentiment looks like a steeply descending black diamond ski run!!



Sources: ANZ-Roy Morgan; RBA; Westpac and Melbourne Institute.

As consumers tighten their belt, discretionary spending will be the first sector to waive the white flag. Ian Verrender, at the ABC, reported on leaked early data out of David Jones. It showed spending fell 10% nation-wide year on year for the first week in June. In the suburbs, sales fell 23%, with some regional areas seeing declines over 30%.

Household consumption is 50-60% of Australian GDP. **Household consumption is the economy. The surprise would be if this deep a level of negative consumer sentiment did not translate into a recession**. CBA, who analysed spending data across its customer base in early June, noted declines in all areas of consumption, with the only increase in spending being on food. [NAB also recently mirrored that commentary.]

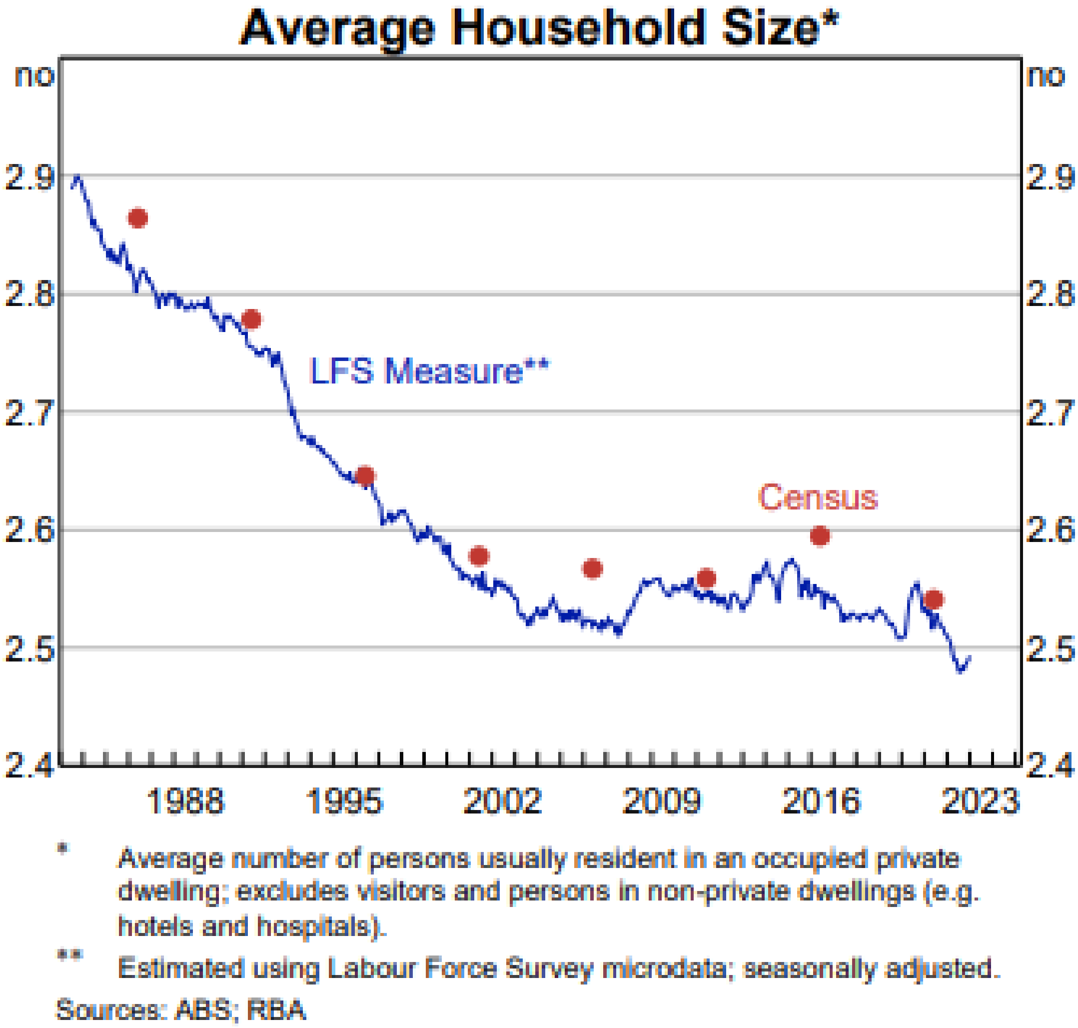
With New Zealand and the EU in recession, Australia looks poised to follow suit.

Philip Lowe has attempted to walk a narrow path with the RBA not pushing interest rates as high as other jurisdictions. His hope was to protect employment from being overly sacrificed whilst taming inflation. Recent commentary from the RBA signals patience (and hope) is fading.

Inflation

Inflation continues moderating, falling to 5.6% in the month of May down from 6.8% in April. This fall was partly explained by one-off policy factors around fuel prices. Initially high inflation was attributed to product and supply side factors but has morphed into service inflation. Service inflation has potential to be stickier and harder to tame.

Rents are a key driver of service inflation, with vacancy rates remaining low, this looks set to continue. However, vacancies may have bottomed with a slight vacancy rise noted in May. Younger renters are opting to move home with more condensed living arrangements emerging amongst other ages. Household size hit record lows through COVID lockdowns, possibly from a desire for more space. Increases to density might support some easing in rental pressures, albeit collapsing home building approvals and elevated immigration will buttress low vacancies for the medium term.



The complicated inflation picture proved enough to merit a pause in interest rates in July. However, expectations remain high for a further rise in August. Quarterly inflation data due on July 26 is the key data to watch before the RBA meets in August.

The coming 6 months *may* prove to be a tipping point in the economic cycle**. A technical recession is a growing probability, rates are restrictive, and the economy has already slowed** (c.0.2% GDP growth in the first quarter of 2023). We anticipate commentary shifting from concerns about high inflation to consternation about slowing growth and labour market jitters.

Uncertainty remains as to how resilient labour markets will be. A technical recession would be welcomed, if it is not accompanied by a material expansion in unemployment, albeit some slackening is appropriate. The risk of engineering a slowdown is that an economic downturn becomes reenforcing. As household consumption slows, the retail, tourism, hospitality, and construction industry will begin laying off employees. The uptick in unemployment will lead to a further decline in consumption which will in turn require more businesses to jettison employees. This can quickly gather pace and broaden across industries. This is the proverbial hard landing that economists talk about.

These are interesting times and as John Kenneth Galbraith said, there are two types of forecasters, "*those who don't know, and those who don't know they don't know*". **This is the first time we've forecast a recession since writing these quarterlies (issue no. 33).** We'll find out what type of forecaster we are in 12 months!

There are some that question the value of macro considerations. Howard Marks says it best "*Thinking about the macro environment and how it influences our proper risk posture falls squarely within our responsibilities as investment managers. But the bottom line is that, at Oaktree* [and Snowgum]*, we approach these things with great humility, diverging from our neutral assumptions and normal behavior only when circumstances leave us no other choice*".

Investment commentary

Defensive

If a recession is probable in the next 12months, portfolios should hold an increased exposure to fixed income and cash. Infrastructure is still featuring in portfolios because of its inflation hedging capabilities, should inflation prove wilier to tame than the indefatigable Central Bankers expect.

Although international government bonds provide better yields, Australian government bonds are attractive as Australian household leverage might see a sharper lagged reaction to higher interest rates, leading to unpriced rate cuts delivering capital upside in 2024. The Australian government doesn't represent sovereign risk. At some stage markets should require compensation for lending to an overleveraged US Government in structural deficit.

In the international fixed income complex, liquid corporate investment grade credit remains attractive, particularly where active management can augment duration on the credit terms. Private credit may prove increasingly attractive as access to bank credit abates. Although the merits of private credit appear reasonable, we are cautious as the emerging asset sector is yet to see performance through an elevated default cycle. We anticipate private credit outcomes to be widely dispersed, with defaults negatively correlating to manager competency.

A higher weighting to cash also provides liquidity to be used when opportunities arise, while still generating north of 4% as you wait.

Growth

"The average YTD return on Amazon, Apple, Google, Meta, Microsoft, NVIDIA and Tesla: 84%. The average YTD return for the rest of the S&P 500: just 3.7%. Apple's market cap is now the same as the entire Russell 2000 Small Cap Index, the largest 7 companies represent the highest share of market cap on record (25%), and the percentage of stocks beating the S&P 500 on a trailing 3-month basis is just 11%, surpassing the March 2000 low of 20%" – Michael Cembalest, JP Morgan.

At the end of 2022 many were saying it was the death of growth and return of value investing. This debate amongst equity investors between growth and value has never been particularly instructive.

While growth has outperformed in 2023, it makes little sense for Tesla's share price to have doubled whilst simultaneously downgrading earnings. There are opportunities across value or growth, if you accept interest rates are likely to remain higher for longer, the 'growth at any value' manager has likely had their time in the sun.

At a time like this, when it seems probable a recession may arise, but its timing is uncertain, sourcing returns uncorrelated to market beta (index changes) seems sensible (long/short managers, distressed debt etc.)

Where direct equity positions are taken, we ask:

1. Is it a good business? A simple question requiring understanding of:
    a. Whether the business has pricing power or a production cost advantage.

    b. Is the business likely to be operating predictably and profitably in ten or twenty years?
2. Is this business valued fairly?
3. What is the investor's opportunity cost? Allocating across asset classes or use cases like paying down a mortgage/investment debt should factor into thinking.
4. What is the investor's timeframe?

In 2022 and 2023, the precipitous change in interest rates has shifted how an investor might think about factor 2 and 3 above. However, by focussing on quality businesses (factor 1), with long term futures, an investor can remain largely unconcerned about medium term economic cycles, particularly if their timeframe (factor 4) affords this.

Fixed income investing is back, and longer duration exposures again provide traditional portfolio diversification benefits. Like any investment, precise timing is impossible. If inflation proves stickier, these longer duration bonds may initially drag on returns, but once certainty emerges that Central Banks have tamed the inflation dragon, upside bond returns will follow.

It's also important to ensure equity allocations aren't thrown out with the recession bathwater. As this is such a widely forecast recession, one must assume some amount of pain is priced in, with equity investing starting from a more reasonable base than before the tightening cycle.

By Matt Vickers