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Economic update

Introduction – Delayed, not diminished!

The post COVID stimuli and easy monetary era saw corporates and households fix cheap debt and build up 'pandemic savings' in the face of uncertainty. The *long and variable lags* to RBA interest rate rises appear longer this cycle, in part, due to the generational opportunity to lock-in cheap funding. **Monetary policy transmission has been delayed, not diminished.**

Equity markets have been more bullish led by strong employment data, signalling positive economic fundamentals. Bond markets have been more bearish in their outlook with global debt having doubled since the GFC (roughly US$465 trillion) and rates having tightened very dramatically. Time will tell which camp is correct.

Quantitative Tightening (QT) is in its infancy. QT and a deteriorating US fiscal position are weighing on bond prices, meaning US yields have moved higher. Meanwhile, the VIX, a measure of equity market volatility, on the 1st of September, reached its lowest level since before COVID.

Both camps cannot be right. Borrowing from Howard Mark, "*economic models can't always be accurate, especially at critical moments such as inflection points – and that's when accurate predictions would be most valuable*".

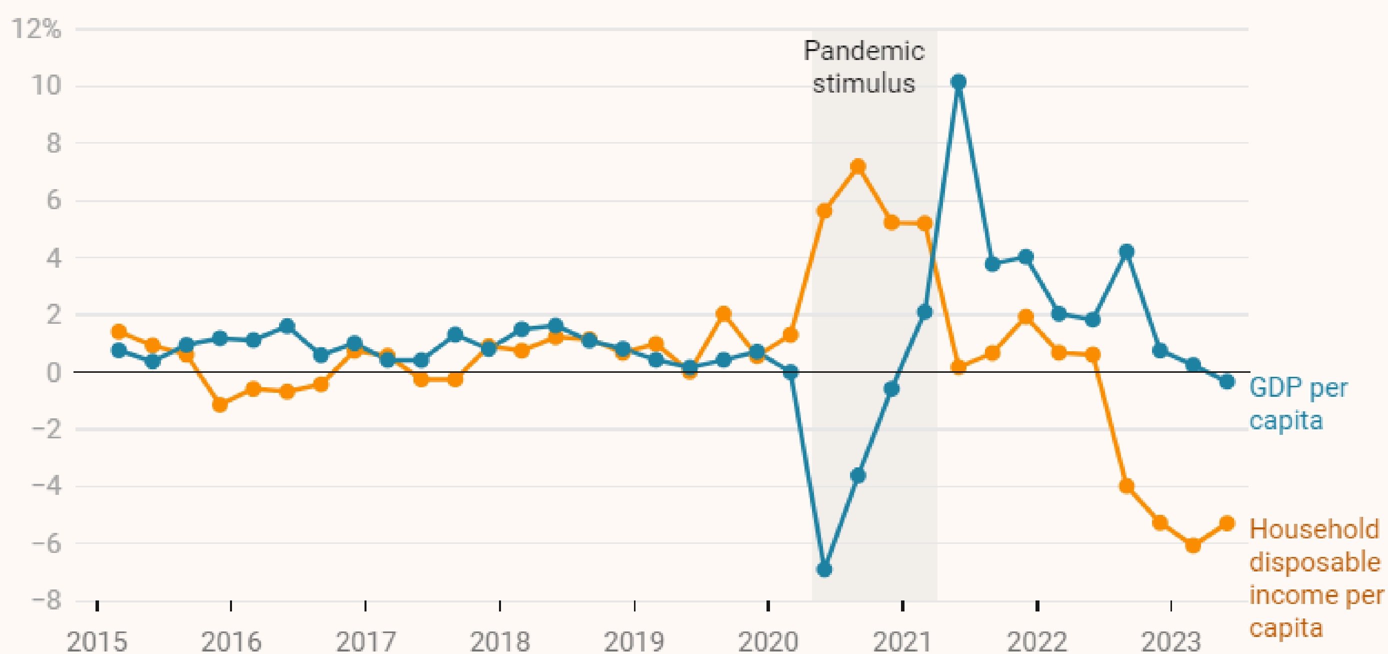
Scepticism of economic models has been validated in 2023 by the wide variation of outlooks. Perhaps the insight to be gained from such a diverse range of outlooks is that we are at some type of *inflection point*.

As the future is unknowable, the best we can do is look at recent data and draw a sensible range of outlooks. **Each passing quarterly data set in 2023 provides further reason to remain cautious.** However, that caution will only be validated if weakness emerges in employment markets.

Australia economic growth

GDP growth of 0.4% in the March and June quarters against population growth of 0.6% and 0.7% respectively, means Australia is in a GDP per-capita recession. Household savings are at their lowest level in 15 years. **Household deposits shrank by $6 billion in the June quarter, the first quarterly decline since the June quarter 2007.** Fixed rate mortgages continue rolling off. As household spending is 50-60% of the economy, forward indicators remain weak.

In the June quarter, public spendings contribution to GDP growth was 0.3%, meaning the private sector delivered GDP growth of just 0.1% against population growth of 0.7%.



Source: Greg Jericho, The Guardian, ABS

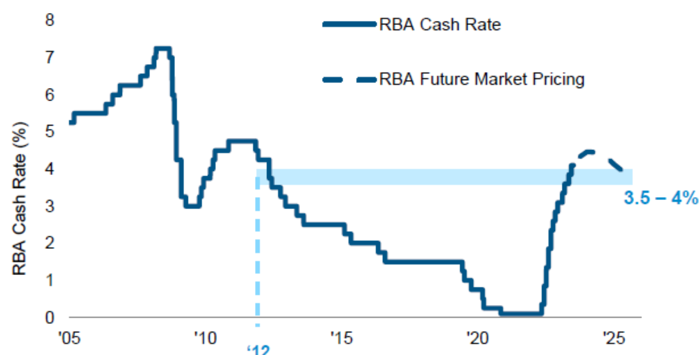
There remains little expectation Australia will fall into recession, but the data suggests recession in the next 12 months is far from improbable.

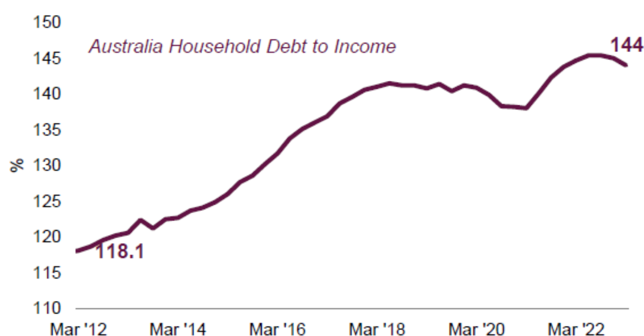
AMP holds a non-consensus view, anticipating a [RBA cut as early as Q1 2024](). Market consensus expects no change in rate settings until early 2025. AMP's non-consensus view is based primarily on two factors:

1. How restrictive the 4.1% cash rate is for consumers (see below graph from PIMCO).
2. The expectation that inflation is falling faster than the market is anticipating.

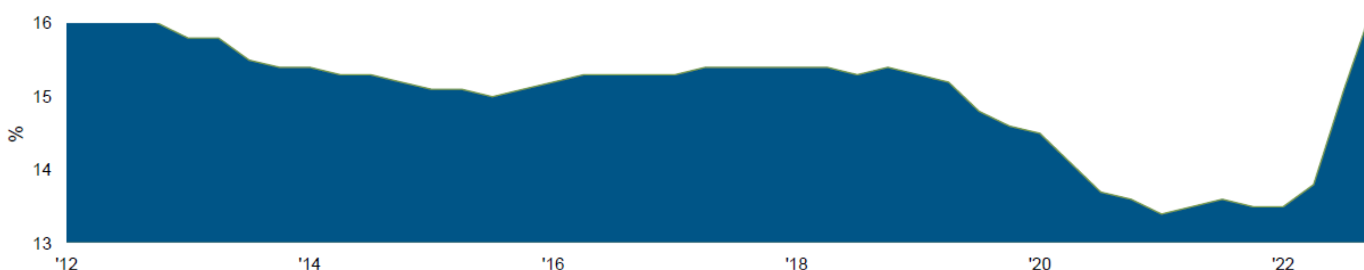
The strong labour market remains a significant counterweight to economic pessimism.

How restrictive will a 4.10% cash rate be in Australia?





Which means a 4.10% cash rate will be close to the most restrictive Australian households have experienced



Source: PIMCO

United States

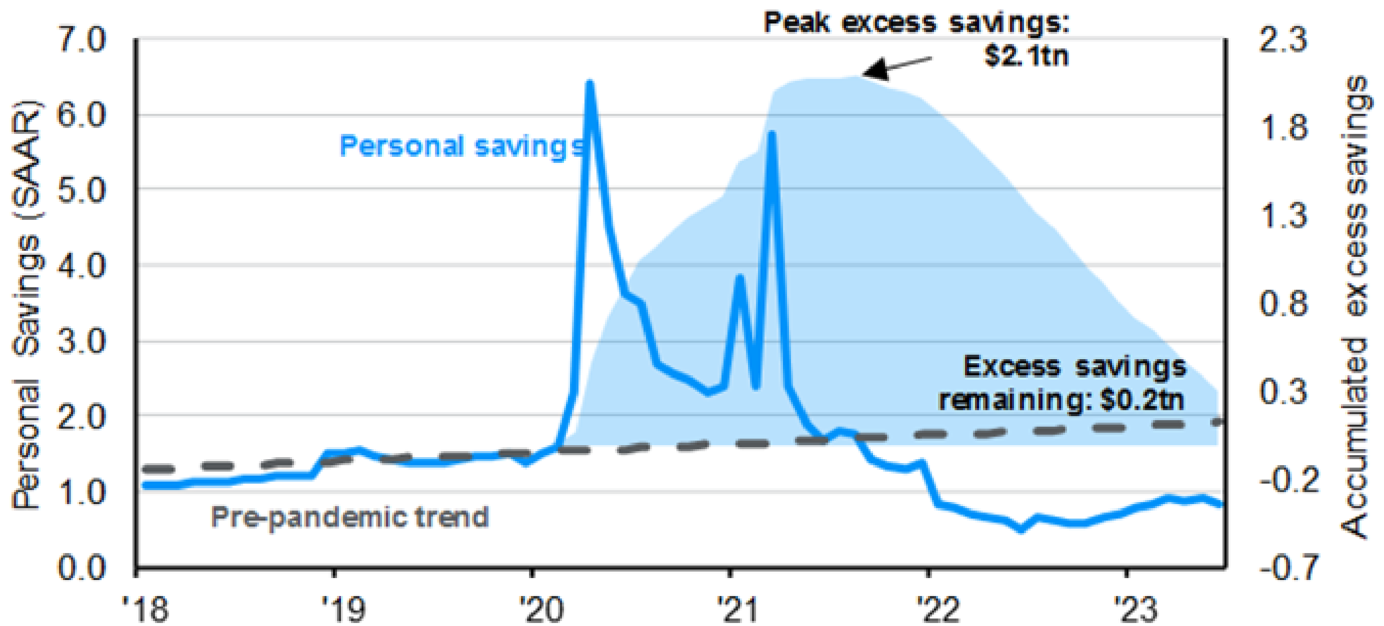
In the United States (US), Goldman Sach downgraded the probability of a US recession to 15% over the next 12 months, the mean probability in any normal year.

US corporates are only beginning to roll off fixed rate loans. Elevated interest rates are yet to meaningfully flow through corporate balance sheets. **US Federal Reserve interest rate transmission has been delayed, not diminished**. Commercial real-estate debt, with shorter maturity terms and elevated vacancies, as working-from-home reduces office demand, remains a potential source of financial system risk. The combination of maturing corporate and commercial real estate debt, refinancing at materially higher interest rates, makes Goldman Sachs 15% recession risk look optimistic.

The recent Senior Loan Officer Opinion Survey showed the lowest demand for loans since 2008, and nearly 50% of respondents indicated they are tightening lending standards, a level consistent with a recession.

Unlike Australia, where household consumption appears a source of weakness, a US slowdown (if it emerges) is more likely to be business led. It is well documented how insulated US households are from higher interest rates due to long-term low fixed mortgages. The US consumer was further supported by elevated pandemic-era savings, and more recently, expanding credit card debt.

Pandemic-era savings are nearly drawn down and US credit card debt hit a record of US$1trillion, expanding US$45billion in Q1 of 2023. US consumer spending looks set to slow.



Source: JPMAM, guide to markets.

Given the possibility of an imminent decline in US consumer strength, the more positive economic outlooks, built upon the concept of a strong US consumer, should be called into question. The counterweight remains labour market strength, and if wage growth remains above trend, may see consumption supported.

Inflation & Employment

Australia's year on year inflation in August was 5.2%. Labour conditions remain tight with no evidence of widespread retrenchment. Forward labour indicators, like job vacancies, advertisement and quits (in the US) signal softening conditions.

A potential side-effect from acute hiring difficulties in the last 12-18 months is a reticence to jettison underutilised employees. **Labour hoarding is a feature of the US and if present in Australia might partially explain the dip in labour productivity. Retrenching underutilised employees would improve labour utilisation, increasing productivity, which in turn eases labour market and inflation pressures**.

Labour market weakness may even trigger a broadening out in the softening of labour conditions, should employers more willingly retrench underutilised employees, knowing labour can be sourced more easily.

Deflationary drivers continue from weakening Chinese producer prices and a devaluing Yuan. Deeply negative consumer sentiment around the world is resulting in excess production capacity re-emerging. For instance, UBS are forecasting car manufacturing production to exceed sales by 6% in 2023, with price cuts expected to clear inventory.

China's economic weakness is a mixed blessing for Australia's inflation fight. The AUD fluctuates with commodity demand. A deteriorating Chinese economy should result in weakening commodity prices, lowering input costs further. Simultaneously as the AUD weakens, imported goods cost more.

All in all, although oil price rises and labour market strength remain upside risks to inflation, the direction of inflation continues lower.

Interest rates & QT

A postmortem of central bank policy settings might delve into why Central Bank's didn't ratchet QT programs faster relative to interest rates. QT better addresses financial conditions associated with asset prices and profligate governments, which may have pushed less of the burden onto leveraged borrowers.

Although an unproven hypothesis, **an increased ratio of QT relative to interest rates is likely to generate more equitable monetary policy transmission.**

Inflation remains too high even though it is falling. There won't be a near-term shift from Central Banks unless we enter recession. Jerome Powel signalled higher for longer rhetoric in his September Fed meeting. Central Banks would prefer a recession to a second rise in inflation.

The RBA retains its tightening bias, albeit bond markets are not pricing in material rate rises. Internationally the European Central Bank has lifted rates to all-time highs. The German economy looks weak with composite purchasing managers index (PMI) negative at 48.50 and, manufacturing PMI at 39.10. UK house prices and sales are falling.

The only major economy not tightening is China.

China

China's changing economic paradigm appears to be settling in, and there is a lot to unpack.

Deflation

- China has producer price deflation and near-zero consumer price inflation.
- Deflation encourages a deferral of purchasing, risking a self-fulfilling cycle.
- As China has a lot of debt, accelerating deflation would test Debt Deflation economic theory. Keynes wasn't a convert, so we as mere mortals should proceed with caution. However, a combination of large debts with deflation is not an appetising recipe.

Property

Having discussed China's property market woes in detail in our last quarterly, this quarter we will balance this with some positives:

- Chinese property prices have doubled in 10 years, so most Chinese property owners have grown their wealth considerably.
- Recent property price falls haven't yet been dramatic – c.14% over the last two years.
- Chinese property buyers, until recently, needed a 50% deposit. Therefore household leverage ratios are modest.
- Chinese households are prudent savers, in part due to a poor social safety net.
- Chinese policy makers have:
  - Lowered deposit minimums to 35%.
  - Mandated a price floor on some developer property sales.
  - Pushed state owned banks to bail-out some developers to ensure project completions.
  - Reduced borrowing costs and bank reserve ratios.
  - Removed limits on multiple property ownership in some areas.

The raft of incremental policy reforms shows signs of arresting any rapid deterioration in property values. However sales volumes and new property investment remains low. There remain some 60-80million empty apartments (a modest estimate) in a country with a shrinking population (850,000 less people in 2022).

The property sector will drag on China's growth for the medium to long term. Importantly, with continued policy support, the unwinding of China's dependence on property for growth does not need to be a disorderly event.

Property developers

While Chinese households are in general responsible, property developers appear to operate something akin to a Ponzi scheme.

- Property developers pre-sell apartments not yet built. Purchasers take on their mortgage for an apartment which may be years from completion (if completion does even occur). These proceeds are often used by developers to acquire more land for development and pre-sale, instead of project completion.
- Multiple large property developers have defaulted. There is no compelling evidence to suggest the broader industry is in better shape.
- The 'Trust Industry' (i.e. shadow banks) loaned capital to property developers. The Trust Industry packaged up these loans as wealth products. State backed Zhongrong International Trust has defaulted on more than 30 products.
- China's Trust Industry has assets of Rmb21tn. The direct exposure to real estate is reported at only Rmb1.1tn, as of the first quarter this year (according to the China Trustee Association). However, real estate company issued bonds are reported as bonds, not real estate. Bond exposures have ballooned. **It remains unclear how integrated property developer debt might be with the broader financial system. This remains an opaque systemic risk**.
- China's property development struggles warrant their own Wikipedia page.
- For scale, Chinese developers have debts of US$5 trillion. This is six times greater than America's US$800 billion sub-prime property debt

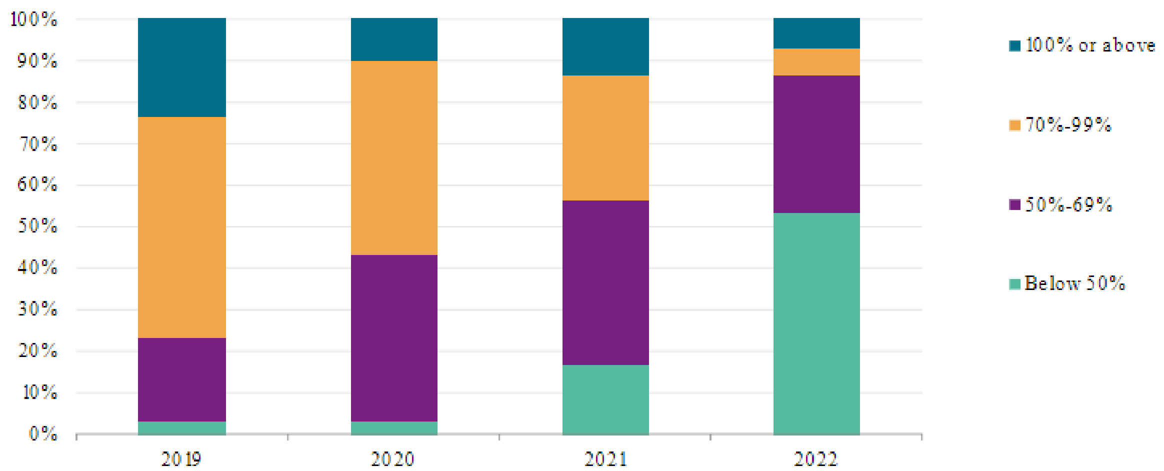
Chinese officials have proven effective at tackling individual economic issues in the past. There remain avenues to orderly windup overleveraged property developers and ensure pre-sold apartments are completed.

Unfortunately, China's property developer debt problems have metastasised to local governments.

Local Government Debt

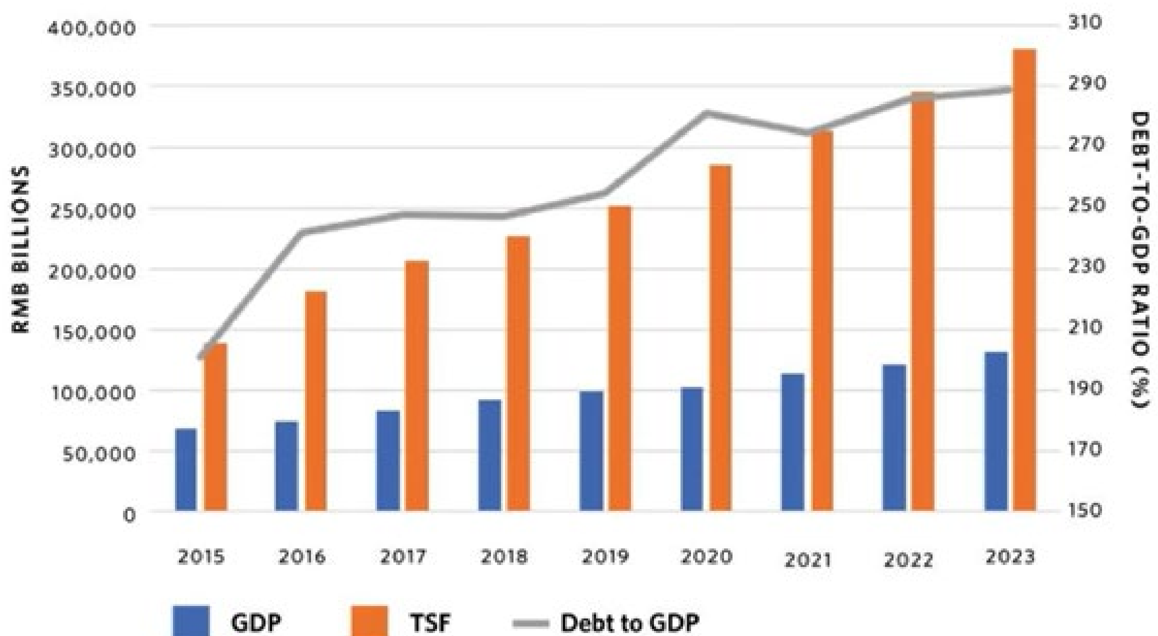
The most pressing emerging economic issue in China is the deteriorating state of local government balance sheets.

- **Local governments rely on land sales for 38% of their revenue** (estimates vary from 30-40%), but land sales have dried up. Land sales data ceased being reported in early 2023.
- **Local government 'off balance sheet' debt is troubling**. Local government's issue corporate bonds via Local Government Financing Companies (LGFV) to access debt outside of central government limits. According to Goldman Sachs, the LGFV have RMB60trillion of debt (US$8trillion). LGFVs issue corporate bonds to facilitate investment in often unproductive or even loss-making infrastructure. **Only 53% of short-term debts (maturing in less than 12 months) can be covered by cash on hand.**
- Guizhou province (a local government area in China) has a GDP per capita of approximately USD 10,000. It has debt of c.130% of GDP. Interest on debt is growing faster than GDP.
    - Guizhou boasts 23 of the world's 100 tallest bridges, an example of where money is spent on unproductive vanity projects.
    - There are signs Guizhou is insolvent.
- Like much of the 'Trust Industry', it remains unclear how deeply shadow banks were integrated with LGFV bonds. There is some indication wealth products have been built by packaging up LGFV Debts.



Source: S&P Global Ratings

As Keynes said, if you pay a worker to dig a hole and another to fill it in, those two payments contribute to GDP whilst generating no productive benefit. **China's GDP readings are increasingly meaningless. Fulfilling a growth goal is always achievable if you ratchet up debt to fund investment irrespective of whether the investment is productive. Debts are growing faster than GDP, indicative that debt is being allocated unproductively.**



Source: [Carnegie endowment for international peace. Michael Pettis.]

For a deeper dive into LGFV issues, this [research report from S&P is excellent]

Beyond property linked weakness, there are broad economic challenges.

Deteriorating macro conditions

- **Export demand has fallen** 14.5% year on year due to a slowing global economy.
- **Chinese youth are increasingly unemployed** (>21% being the last official figures), with data no longer published and uncertainty over the accuracy of official data anyway.
- **Foreign direct investment is down 87% in the quarter to June**, year on year.
- **China's birth rate, according to Goldman Sachs, fell to 0.75 in 2022.** The population is shrinking, and dependency ratio is growing. Demographic headwinds are getting worse.
- **Household consumption, as a proportion of GDP remains low**.
- **Many of China's Belt and Road loans are non-performing, at risk of default**. Credit risk management appears non-existent.
  - For example, Laos owes 84% of its GDP to foreign lenders, half of this being owed to China. As Laos currency devalues in 2023, USD denominated Chinese debt becomes more expensive. China has deferred Laos repayment and other indebted emerging countries to stave off default.
  - Laos borrowed from China to pay Chinese builders for development of high-speed rail that connects China, via Laos, to Singapore and Thailand.
- The diminishing confidence in doing business in and with China, in addition to the strength of developed market interest rates relative to China, **is weighing on the Yuan. Capital is leaving China, when it can.**
  - China's state-owned banks have been selling US dollars to buy Yuan.
  - An ominous reason for currency intervention was hinted at by a BIS study. **Chinese financial system holds US $3-4trillion of foreign denominated debt**. A rapid devaluation of the Yuan would negatively impact Chinese banking balance sheets, weakening the financial sector.
- Chinese monetary authorities are caught between a rock and a hard place. **Ease monetary settings to support economic activity accepting further weakening of the Yuan, risking a banking crisis; or limit monetary easing to protect against currency devaluation at the expense of providing economic support to weakened exporters.**

China wrap-up

- **There is a complete disregard for prudential standards and credit risk management at the corporate and government level.** The irony is that individual households are prudent and are savers, with resulting reduced consumption often considered the Chinese economic 'Achilles Heel'.
- "Valuation with Chinese Characteristics" is now emerging, potentially speaking to a future approach to financial reporting the CCP may employ to 'manage' its economy.
- The Trust Industry (shadow banking) *may* have entangled the broader Chinese financial system into two key frailties, local government debt and property developer debt. This risks financial contagion, albeit most banks are state owned so risks should be mitigated.
- Centralised GDP mandates have led local governments to shun market-principles in capital allocation. Local governments appear to have exhausted fiscal limits.
- **Consumer spending remains a relatively small proportion of the Chinese economy, in part due to large government capital ownership and the low wage-share ordinary households have in economic output.** To address this, Chinese workers need to be paid more income.
  - If higher wages are paid, China's competitive export advantage might be eroded. Boosting incomes may not lead to a material GDP uplift, and even an uptick in consumption would have a lower impact relative to other economies, due to the small GPD share consumption comprises.

China's economic model requires a dramatic reset.

If {economic growth = productivity growth + population growth} China's shrinking population and unproductive capital allocation paints a bleak future. **Japanification mightn't be so bad an outcome, with the level of debt and opaque integration of that debt across financial markets risking something more turbulent.**

Investment perspectives

The possibility of various negative catalysts remains high, with the reward for being defensive having grown with each passing quarter in 2023. The latest financial catchcry is "T-Bill and chill", speaking to the reasonableness in cash-like (treasury bills) returns relative to risks.

Fixed income

A growing theme in markets is the withdrawal of Central Banks liquidity as QT ratchets up. The resulting flood of bonds with a diminishing pool of buyers may continue pushing bond yields higher, irrespective of interest rate settings, challenging longer dated maturity exposures in the short term.

Bond market pessimism has been proven to be wrong so far in 2023. However, with each passing quarter the likelihood that their pessimism will be vindicated increases. Historically, bond yields peak when cash rates peak. While it can be difficult taking defensive investment exposures, when there is an eventual change in market psychology and dynamics, defensive investors will be rapidly rewarded. Interest rates take the escalator up and elevator down.

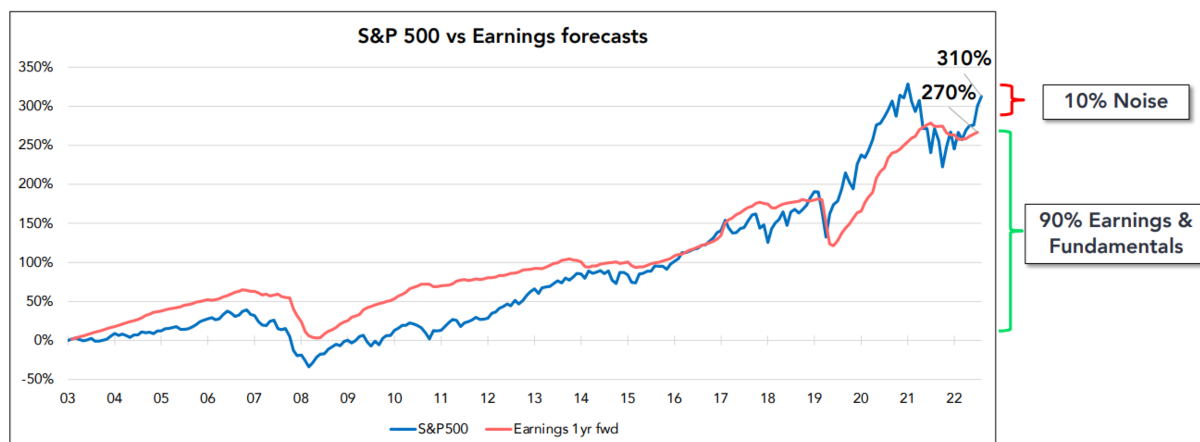
If the economy continues to perform well, corporate defaults will continue to rise as maturities rollover. Maturing debt will seek refinancing at elevated interest rates that will remain elevated in a growth scenario. As increasing defaults are likely to slow the economy, it's hard to see how a growth scenario is sustainable.

Each passing quarter lends itself to consider increasing the weighting of government bond allocations within a portfolio, as frustratingly boring as that may sound. For Australians, that probably means Australian bonds given the strength of the US dollar, or hedged US government bond exposures nearer the front end of the curve.

Equities- Concentration Risk

A red herring in markets has been the performance of seven AI associated companies, which as a group, have returned 92% in 2023 on average, with the S&P up 12.4% (as at October 6). Over the same period, an equal-weight version of the index, which gives the same slot to each company regardless of size, has only gained 0.1%.

Earning growth across the S&P 500 is 1%. Strong US market performance in 2023 has little to do with earnings growth.



Source: Plato Asset Management

Yet, over the long term, earnings drive returns. So, we are either:

1. Poised for a strong economic expansion to drive earnings growth, or
2. Equity market correction., or
3. A combination of both.

There is no doubt AI innovation will generate productivity gains that lead to significant earnings upside to key winners, of whom investors should retain some exposure. The miscalculation would be to extrapolate more widely the narrow performance of a handful of businesses into a rosier economic outlook.

China

As discussed in detail above, the pathway of the Chinese economy is a known unknown. It might enter a sustained downturn and well managed transition of China's economic model, seeing commodity prices ease mildly. Or it might be more violent than this, putting pressure on financial markets. The CCP is unlikely to let the economy slip into crisis, as that would equally be a political crisis. Markets appear optimistic, with iron ore and commodity prices remaining elevated. Iron ore exposures appear risky as China's economic growth paradigm must change.

The complexity of foreign relation laws is enough to turn many off investing into China. We note there remain bold investors, notably Platinum's Andrew Clifford, who see this as a great investment opportunity because of depressed valuations - genuine contrarians. Hats off to them if they are successful.

Property

If an investor is interested in increasing their property exposure, there are discounts available in listed markets. However unlisted property valuations remain opaque.

Valuation dispersion is best seen in the discount between market values of listed property groups and the management's self-determined valuation of their property portfolio (Net Asset Value (NAV)).

- Scentre Group's NAV is $18.2B – Market value is $13.4B (26% discount)
- GPT NAV is $11.2B – Market value is $7.9B (29% discount)
- DEXUS NAV is $12.2B – Market value is $7.8B (36% discount)
- Vicinity's NAV is $10.6B – Market value is $7.9B (25% discount)

Commercial property bargain hunters might see this as an opportunity. The market clearly thinks those assets are overvalued by management.

Private Markets

Private market assets have been caught in a transacting quagmire. Vendor expectations on what their business or property is worth were framed by the excesses of 2020 and 2021, whereas investment managers quickly adjusted down valuation methodology with higher interest rates through 2022. On top of this, the delay in revaluing existing private investments relative to instantly repricing public markets has seen institutional investors breach private market mandate limits. Mandates are preventing some institutions allocating further capital into private markets, limiting the pool of private capital available to purchase assets.

As private equity (PE) capital becomes scarcer and vendor expectations reprice down, a further economic slowdown may add to the macro factors driving down entry (and exit) prices for PE transactions. This might prove to be an excellent 12 to 24-month window to commence private equity investments. Time will tell if 2023 and 2024 are good 'vintages'.

By Matt Vickers