➢Market and Economic Update–August 2023

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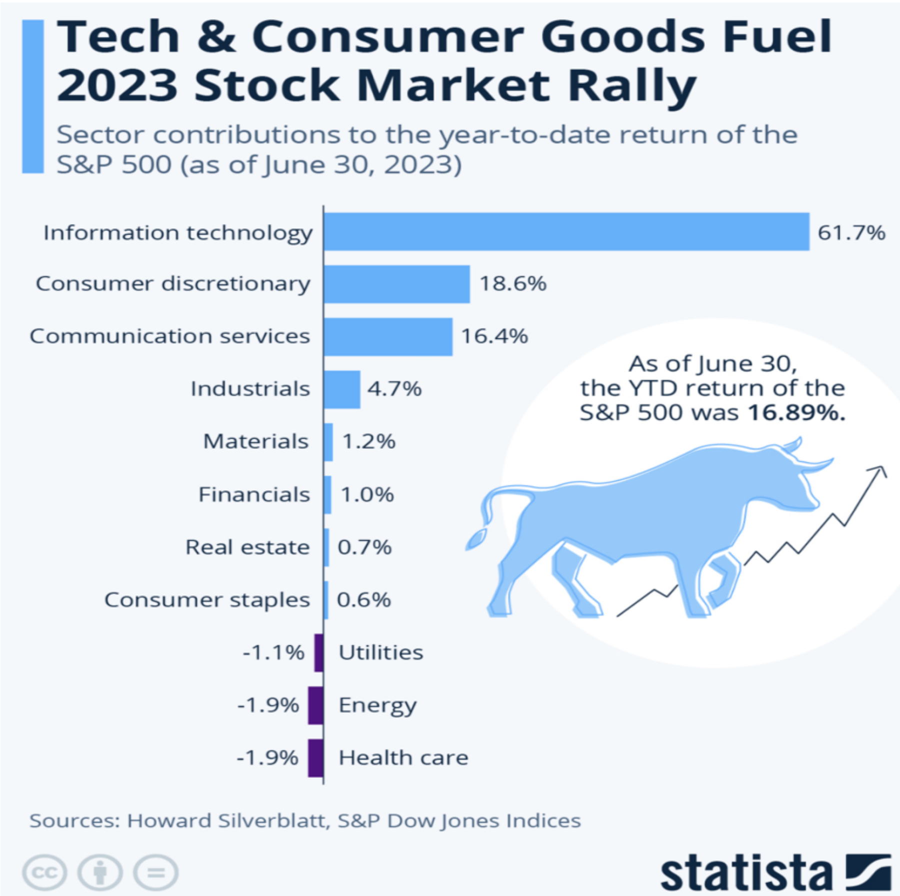
"If you have one economist on your team,
it's likely that you have one more than you'll need."
Warren Buffett

The Markets

So far this year



The above graph shows share market sector movement in asset prices January through June 30 this year.

Markets have generally remained buoyant, tracking in an upward direction.

Last month the market wondered about the standoff over the US debt ceiling.

More recently attention turned to the Fitch down grade of US debt, citing increasing debt, poor governance with the recent political standoff and what it says is looming recession in the US. Sounds bad on the surface.

The rising debt is not good but manageable and a long, long way from catastrophe.

The governance is political and less than fundamental to the long-term economic outcome.

Recession is possible / likely but at this point looks as though it could be short and shallow – the soft landing.

Stock Market Rally Broadened in June, July
S&P 500 Select Sector SPDR ETF Returns

Ticker	Sector	Jan - May Return	June - July Return
XLK	Tech	32.02%	8.56%
XLC	Communication Services	29.69%	10.52%
XLY	Consumer Discretionary	17.38%	14.60%
XLE	Energy	-12.44%	14.22%
XLU	Utilties	-7.90%	3.30%
XLF	Financials	-7.13%	11.24%
XLV	Health Care	-5.90%	4.94%
XLB	Materials	-3.42%	14.26%
XLP	Consumer Staples	-2.52%	4.24%
XLRE	Real Estate	-2.41%	5.97%
XLI	Industrials	-1.38%	14.01%

Source: Yahoo Finance

The table above ranks the change in trading prices of Exchange Traded Funds invested across the main sectors to July this year.

Trading prices continued to rise over June and July.

September and October are looming which can be a volatile time across markets. It will be interesting to see what develops this year.

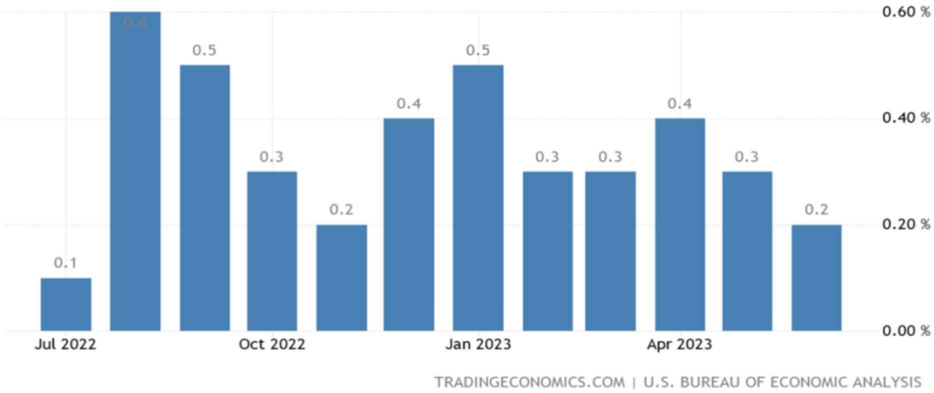
The US share market

The chart on the left shows the US share market (the Dow Jones) over the last six months (August 2023). The *chart on the right shows the US share market (the Dow Jones) over the last year (August 2023).*

Like last month, although markets have been generally buoyant, rising market indexes have mostly been driven up by only a few tech companies (the so called magnificent seven).

With trading prices generally buoyant, we now look specifically for well positioned businesses that are growing, preferably medium sized business. Also, those holdings within your portfolio that have seen their trading prices decline materially but remain sound businesses are a good option for investing in currently.

The Personal Consumption Expenditure (PCE) Index

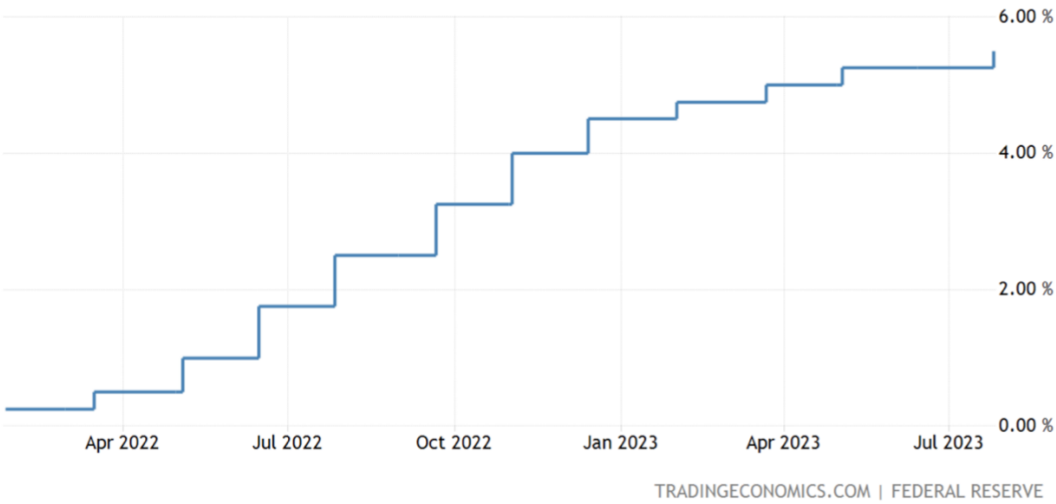


The graph above tracks the monthly change.

I include The Personal Consumption Expenditure (PCE) index again this month because it is closely watched by the US Federal Reserve. This latest update shows it moved in the right direction although not by much. The index increased by 0.2% in June, down from a 0.3% increase the month prior.

Again, not much but in the right direction.

Interest rates - USA



The above graph tracks the Fed Funds rate.

The US federal reserve increased the target range of the federal funds rate by 25 basis points to 5.25% - 5.5% in July. The market was expecting it so minimal volatility as a result when announced. This takes borrowing costs to the highest point since 2001.

Another rate hike is scheduled next month. Jerome Powell The Fed Governor will be hoping that the delayed effect of rising interest rates impacts progressively so that further interest rate increases might be less likely to be required.

The higher interest rates rise, the more pain for everyday people across America and elsewhere.

Although some economists are saying that The New Zealand Reserve Bank has done enough and interest rates have peaked already, with inflation looking 'sticky', it will be interesting to see if The NZ Reserve Bank has done enough.

Keep in mind too that New Zealand also needs to borrow to fund health care, the pension and other items.

Currency

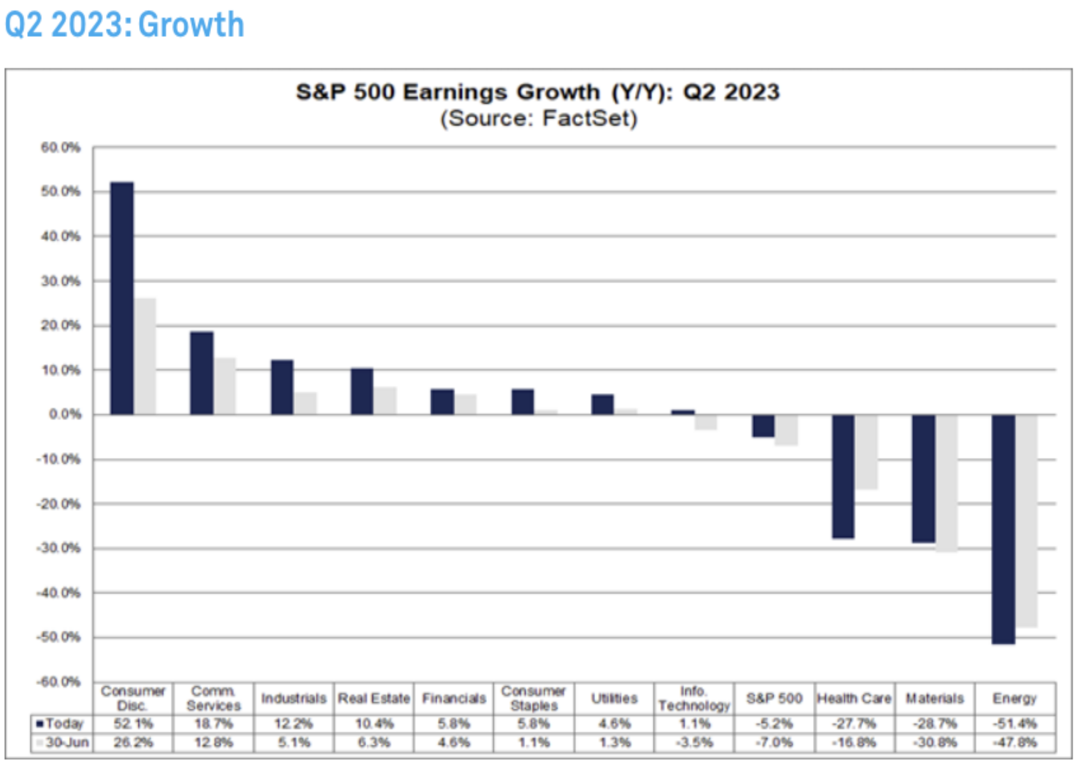
The above graph shows the movement in the cross rate between the New Zealand dollar and the US dollar.

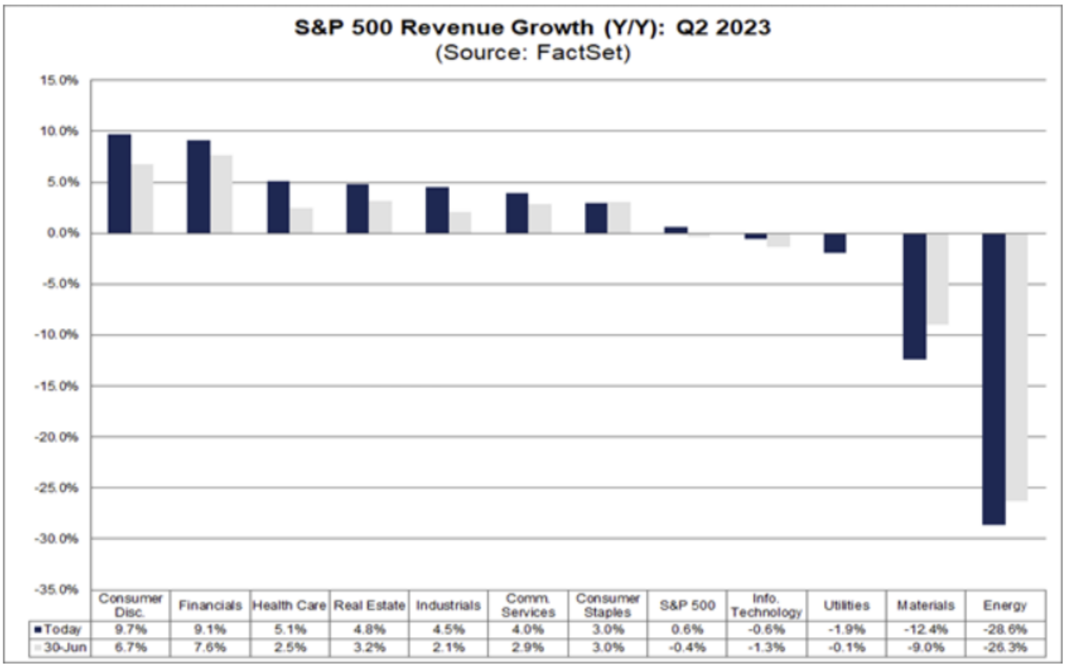
The Cross rate between the US dollar and the New Zealand dollar has been somewhat volatile over the last year or so.

As a result, I have at times held back buying US dollar-based assets from time to time.

The cross rate seems to fluctuate between .59 and .64 cents more recently which, at the lower end is not ideal but still okay to invest.

Earnings – USA





The top graph (previous page) shows overall earnings (profit) growth over the last 12 months as at the end of the second quarter. The lower graph shows overall Revenue (turnover) growth over the last 12 months as at the end of the second quarter.

At the late stages of the Q2 earnings season for the S&P 500, both the number of companies reporting positive earnings surprises and the magnitude of these earnings surprises are above their 10-year averages. However, the index is also reporting its largest year-over-year decline in earnings since Q3 2020.

Overall, 84% of the companies in the S&P 500 have reported actual results for Q2 2023 to date. Of these companies, 79% have reported actual EPS (earnings per share) above estimates, which is above the 5-year average of 77% and above the 10-year average of 73%.

This number also marks the highest percentage of S&P 500 companies reporting a positive EPS surprise since Q3 2021 (82%).

In aggregate, companies are reporting earnings that are 7.2% above estimates, which is below the 5-year average of 8.4% but above the 10-year average of 6.4%.

So, earnings have continued to decline over the last 12 months, but not significantly. Still, a good outcome, so far.

Looking ahead, we move closer to September / October where there can be volatility. Along with that comes better buy prices too.

The Global Economy

By Morgan Edwards – brief bio

How Did The 1970s Crisis End?

As promised in last month's MAEU, I will take you on a guided tour of what ended the 1970s Economic Crises. Namely, we will have a look at how the rapid rise of interest rates, beginning in 1979, laid the foundation for a new international economic order, and how this expunged inflationary pressures from the international economy.

I have included page numbers for the relevant quotations, if you are interested in taking a look.

In 1978, economists Fred Hirsch and Michael Doyle wrote a chapter titled 'Politicization in the World Economy: Necessary Conditions for an International Economic Order' in a book entitled Alternatives to Monetary Disorder.

This provided an in-depth account for the rationale and design of a potential post-Bretton Woods international monetary regime. Hirsch and Doyle note that the economic regime of the 1980s and beyond would be looser 'than the international order established on paper (and at least substantially in reality) in the original articles of the IMF and in the provisions of the GATT' (1977, p. 55).

Here, a bold contribution is made regarding the nature of the creation of this new regime. Hirsch and Doyle state that 'a degree of controlled disintegration in the world economy is a legitimate objective for the 1980s and may be the most realistic one for a moderate international economic order' (1977, p. 55).

The desire for a 'controlled disintegration' is derived from the desire to evolve from the dense interconnectivity present within the international economic system during the Bretton Woods era. The objective of a 'dis-integrated' international system would be to 'create a framework capable of containing the increased level of politicization that emerges […] from the changed balance of forces in both domestic economies and the international economy' (1977, p. 55).

Thus, the implied structure of the new international monetary regime would be one of state subservience to the 'forces' of domestic and international capital mobility.

This is emblematic of the growing neoliberal orthodoxy of the period. On the structure of such a system, Hirsch and Doyle state that there would a clear demarcation between the rich 'leaders' of the international economic system and those 'poorer' states on its periphery.

In 1978, former Federal Reserve Chairman Paul Volcker provided a continuation of Hirsch and Doyle's insights in a speech entitled the Political Economy of the Dollar (available here: https://www.newyorkfed.org/medialibrary/media/research/quarterly_review/1978v3/v3n4article1.pdf.)

This speech can be interpreted as an 'authoritative' perspective of the Federal Reserve on the role of the US dollar in international monetary affairs. Volcker channels Hirsch and Doyle's insights by reaffirming that a 'controlled disintegration' of the world economy is a legitimate goal for the 1980s.

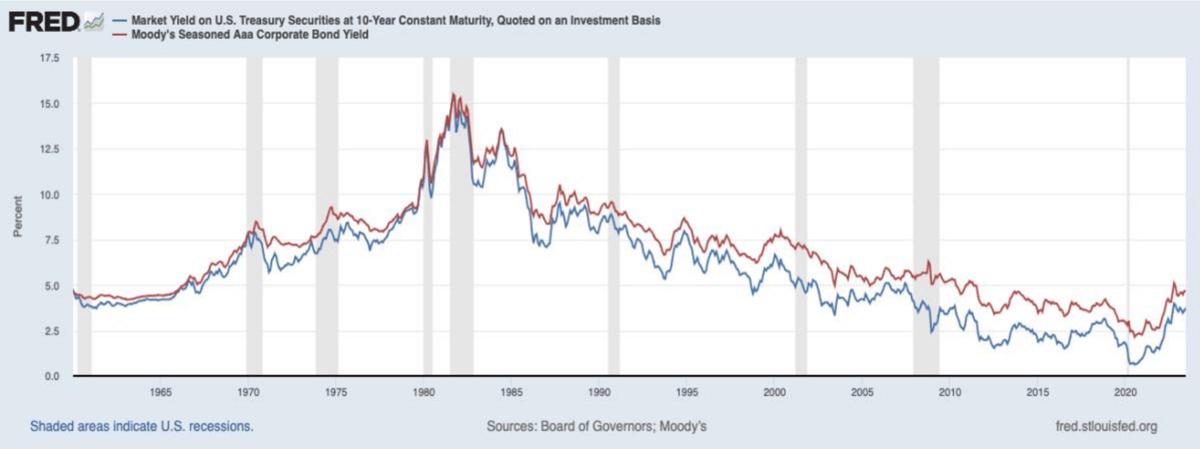
Notably however, Volcker states that the goal of the 1980s should be to manage integration, noting that the 'underlying pressures toward integration and interdependence are growing stronger, not weaker' (1978, p. 2).

With regard to the United States' position in international economic affairs, Volcker notes that '[t]he United States no longer stands astride the world as a kind of economic colossus as it did in the 1940's, nor, quite obviously, is its currency any longer unchallenged. Now, other centers of strength and power have arisen in the industrialized world' (1978, pp. 1-2).

The 'Volcker Shock' became the event that would precipitate both the 'controlled disintegration' and managed integration of the international economy. Namely, the 'Volcker Shock' refers to the rapid increase of interest rates by the Federal Reserve beginning in 1979.

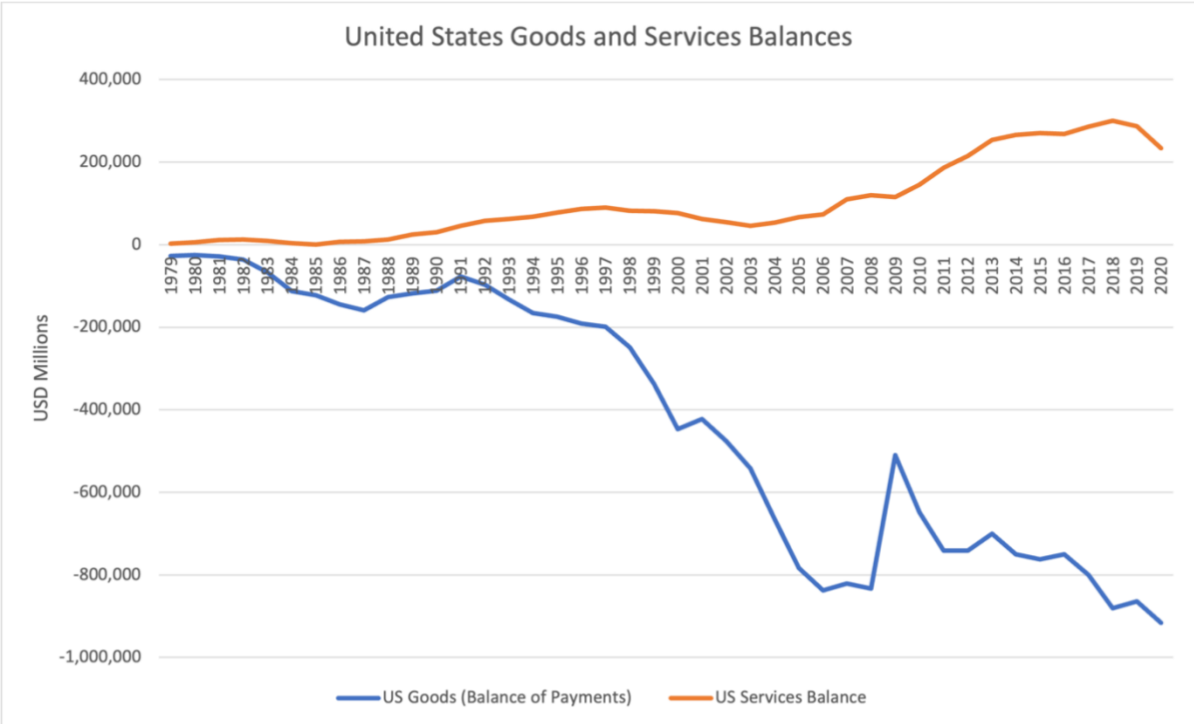
The Volcker Shock served to reverse longstanding interest rate differentials between states within the international economy, while also raising the interest rate for short term assets such as corporate debt.

This instigated an elevated level of capital flows – what can be referred to as capital magnetism - from the rest of the world, notably from Western Europe and Japan, into the United States during this period.



To give you an insight into the level of capital magnetism into the US during this time, the graph above depicts the 10-year Treasury yield and AAA rated corporate bond yields between 1960 to the present day.

These heightened interest rates resulted in more capital going into the United States than what there was coming out of it – a trade deficit.



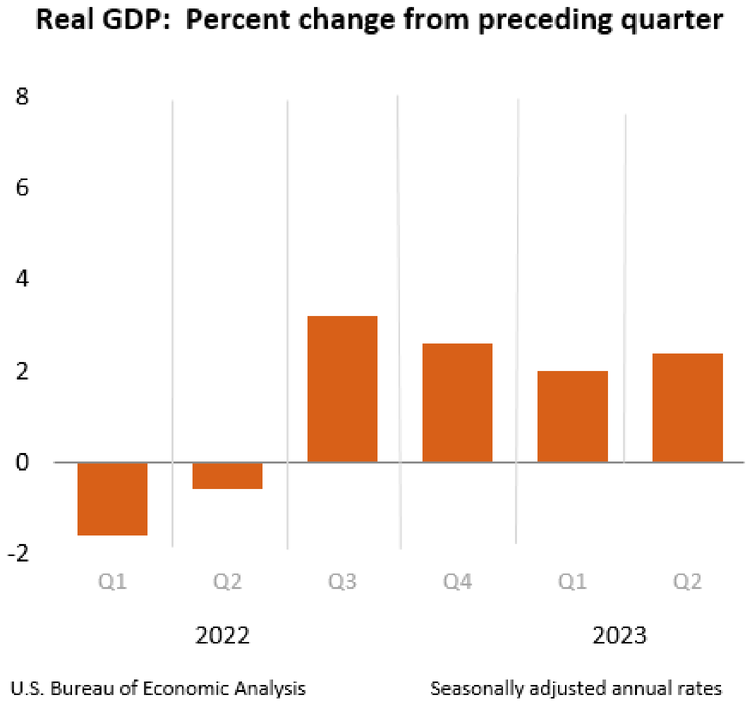
The graph above depicts the widening US trade deficit between 1979 and 2020. Note the increasing services surplus, indicative of an international expansion of the US banking system.

To reach the nub of the point, what these economic dynamics did was institute an international economic system where supply and demand dynamics were equal. The equality of these dynamics ameliorated the inflationary dynamics inherent in the unstructured 1970s international economic system.

The success of this system was attributed to the primacy of monetary policy and 'central bank independence'. However, it is a very complex tapestry when you look a little deeper (perhaps a takedown of central bank independence will be on the cards next month).

United States

The latest economic figures from the United States have been released – and it is rosier than expected.



The graph above depicts US GDP growth. Between Q2 2022 and Q2 2023, growth measured 2.4%.

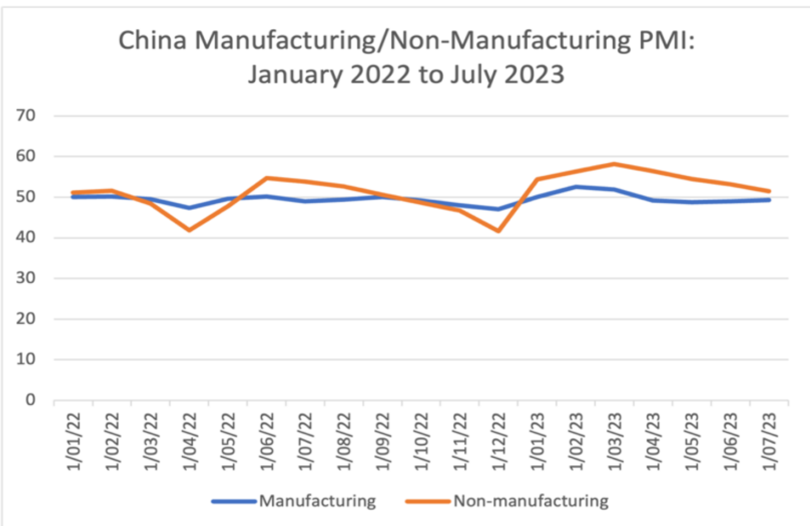
This broadly outperformed analysts' expectations and is in spite of continued interest rate hikes by the Federal Reserve.

However, it is worth noting that economic growth may well be progressing *because* of interest rate hikes. The logic for this is simple really – interest rate rises increase the incomes of those within the upper register of the income share.

Increasingly, this is becoming more and more apparent within economic data and largely corroborates the insights of my masters' thesis. Although, I don't think this is perhaps something to celebrate fully.

China

In news hot off the press, China's purchasing manufacturers index (PMI), which measures monthly growth (or decline) in activity within the manufacturing sector, has declined for a fourth straight month.



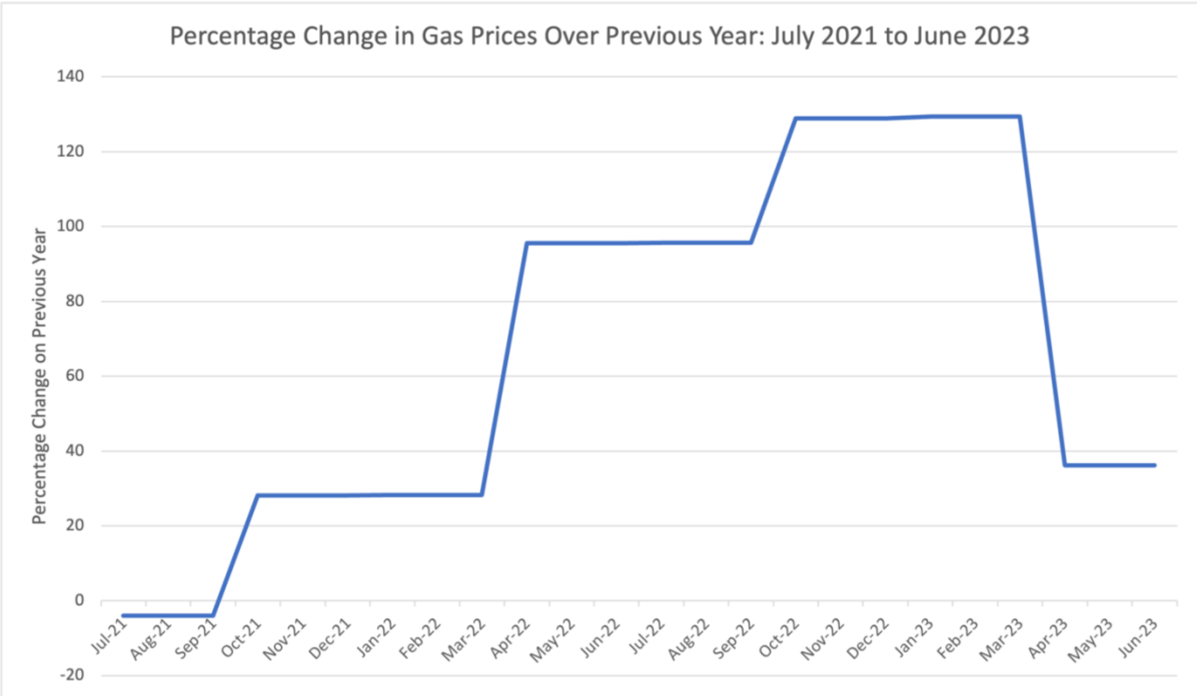
The graph above depicts China's manufacturing PMI (the blue line) of 49.3; remaining below 50 since March 2023. Non-manufacturing PMI (the orange line) is also trending downwards, presently at 51.5.

These insights continue to exemplify the 'choppy sideways' dynamics present within international macroeconomics.

United Kingdom

Continuing on the topic of inflation, Ben Bernanke has been appointed to head an inquiry into how the Bank of England failed to accurately forecast persistent inflation.

Bernanke, who failed to see the impending 2008 Global Financial Crisis, blamed the 'Great Moderation' (the stabilisation of macroeconomic dynamics after the 1970s to 2008 – see above) on good luck, and failed to incorporate the role of credit into financial crises (stating that credit should have no macroeconomic impacts in his *Essays on the Great Depression)*, has been deemed a worthy voice to bring reason to the folly of the Bank of England's economic foresight.



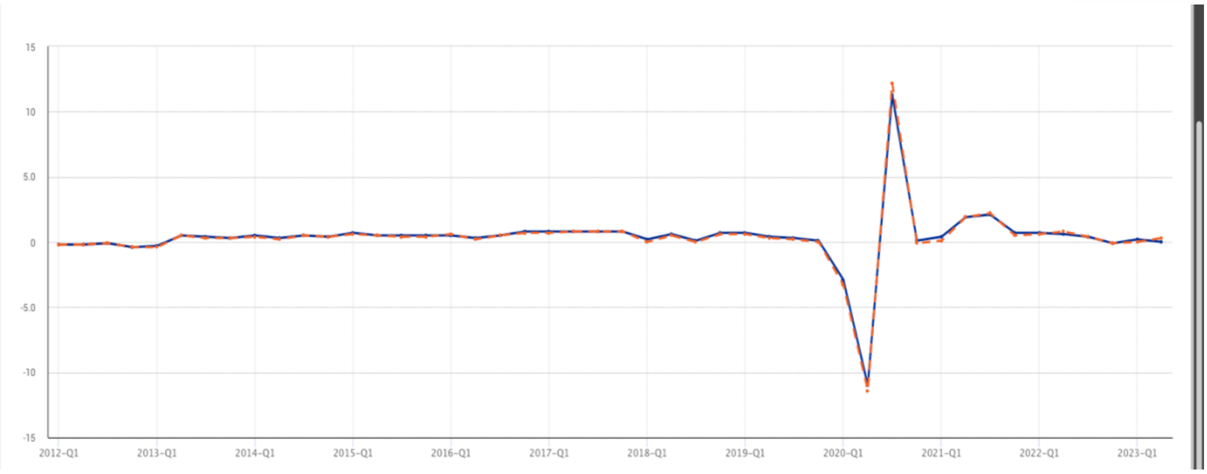
The graph above depicts gas prices in the UK between July 2021 and June 2023.

While I have used a variation of this graph previously, it makes some very clear points. First, at the most recent point in time, the rate of gas price inflation is still 36.2%. As gas is a key input cost, then it is no surprise that this continues to boost prices.

The second point is that maybe the Bank of England, and all other central banks for that matter, should stop using stupid assumptions as the basis for their macroeconomic modelling. Your model is only as good as your assumptions, the Right Honourable Tim Groser once noted to me.

Euro Area

In the Euro Area, inflation has fallen and economic growth has returned - slightly. In more hot-off the press news (July 31), growth in the Euro Area has ticked up to 0.3% from 0.0% in Q1 2023.



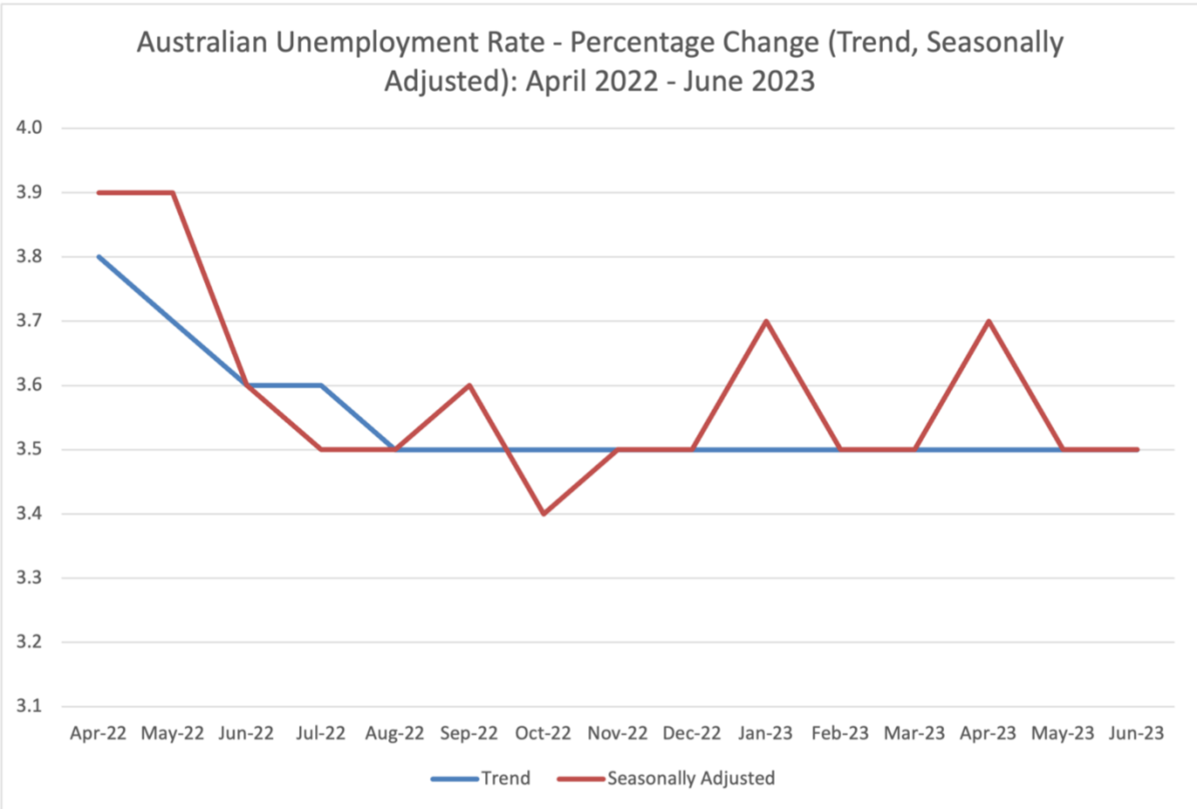
The above graph, a screenshot from Eurostat, depicts Euro Area GDP growth since Q1 2012.

The shock of COVID and its largely anaemic aftermath are clearly visible in the graph.

Australia

While the Reserve Bank of Australia kept interest rates at 4.1% in early July and the RBA have appointed a new Governor to begin in September, the RBA still abide by dangerous myths.

The dangerous myth in question involves the belief that for inflation to be ameliorated, then the unemployment rate must increase.



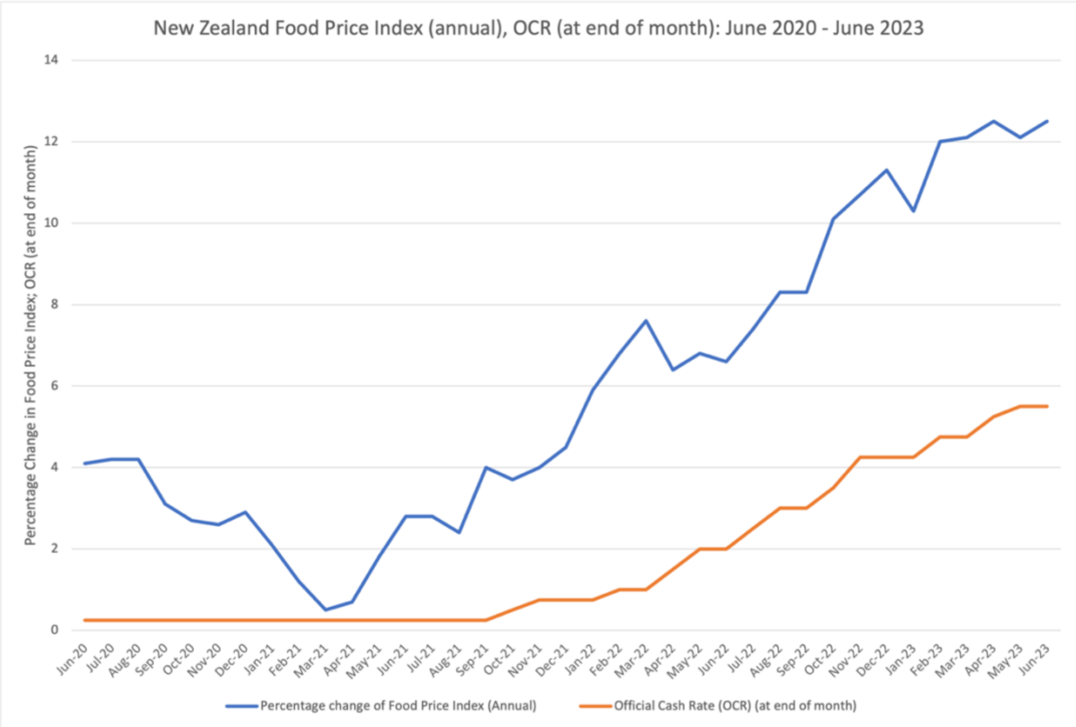
For reference, the above graph depicts the unemployment rate in Australia between April 2022 and June 2023. As is clearly visible, the unemployment rate does not exceed 3.9%.

Time will tell about how ‘well’ Australian fiscal and monetary policy can work to snuff out employment within the Australian economy, thereby contributing to more hardship and strife for the most vulnerable within Australia.

New Zealand

Rejoice! The RBNZ decided to maintain interest rates at 5.5%.

Almost simultaneously, inflation measured through the CPI increased less than expected. However, food prices continued to rise. I suppose those elevated interest costs will feed through (no puns intended) for a while yet.



The graph above depicts the annual change in the food price index (FPI) and the official cash rate (OCR) as measured at the end of every month. This sample is between June 2020 and June 2023.

Despite the slight decline in the CPI index, the food price continues to rise *almost in lock step with the OCR*.

While the factors that precipitated elevated food prices (rising costs of trade, supply chain issues) have largely (but not fully) abated, factors such as elevated interest rates that have continued to fan the flames continue.

Also, no surprises about ruling out imposing wealth and capital gains taxes (see my first MAEU).

In Conclusion…

As we conclude this edition of the MAEU, it seems that the world will not tip into an abyss just yet. While there are glimmers of light around, the international economic system seemingly trudges on with its choppy sideways action.

Until next month!