➢ Market and Economic Update - September 2023

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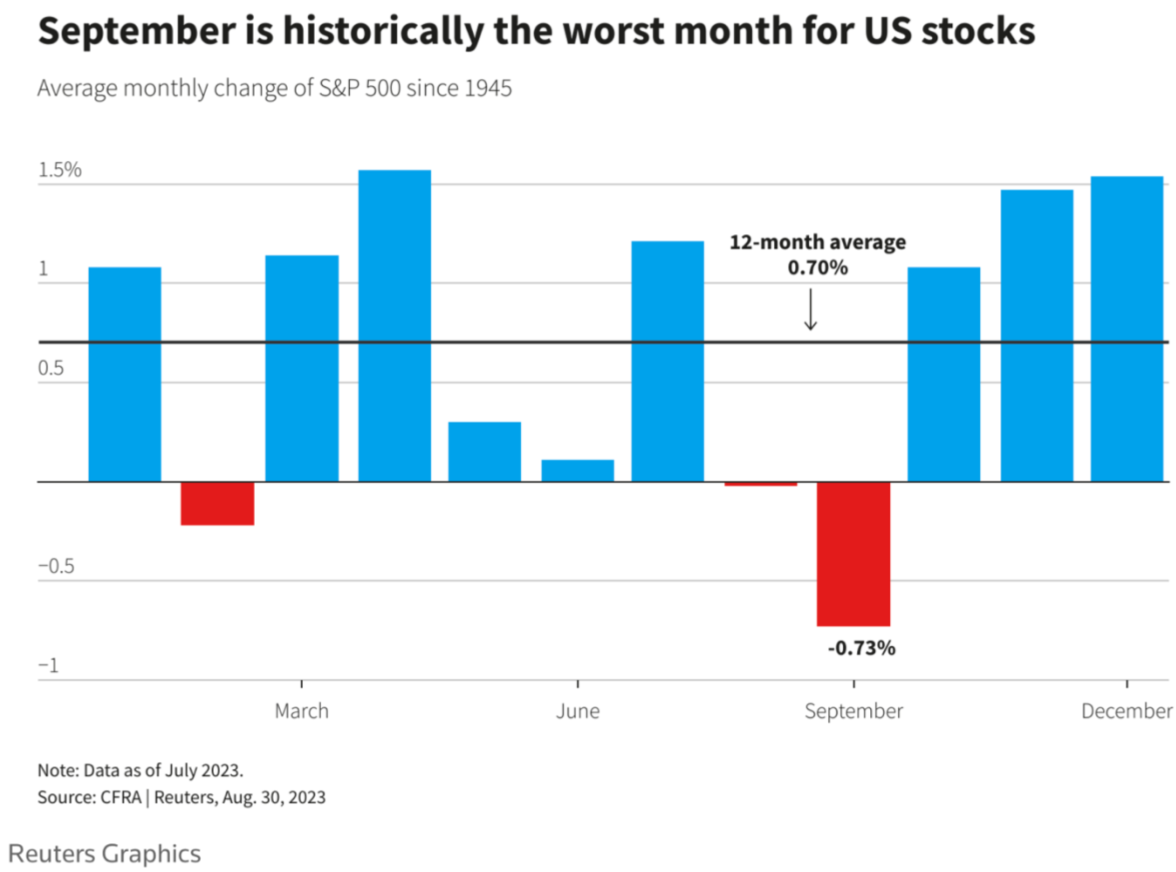
"If you have one economist on your team,
it's likely that you have one more than you'll need."
Warren Buffett

The Markets

What does September hold for us?



The above graph shows the average monthly movement in US stock prices since 1945.

August was notable this year for the downside volatility.

Here is how it went:
- The Dow Jones finished the month down -2.35**%** (from a low of -4.30%)
- The S&P by -1.77 (from a low of -5.52%)
- The Nasdaq by -2.16% (from a low of -8.25%)

Note the higher level of volatility across the Nasdaq (tech stocks).

One of my clients in Christchurch recently mentioned Ray Dalio, the founder of Bridgewater. He has written significantly about markets and the global economy over many years. Worth reading if you get the chance.

I noticed he sold out of Berkshire Hathaway recently as he predicted a major correction across the markets. His logic is sound regarding the macro view of the economy. Still markets are random. Predictions, however convincing are just predictions.

I have lost count of the number of predictions about looming corrections of epic proportions made over the last 40 years. They do happen (e.g. 1987, The Global Financial Crisis).

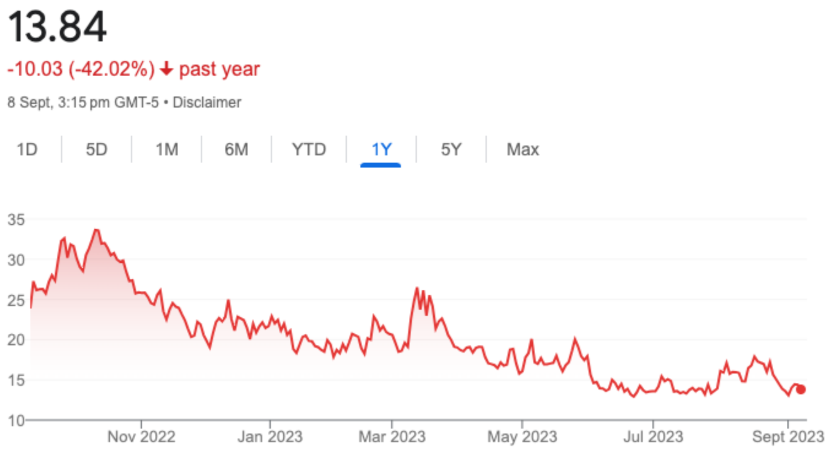
If you have been a client long enough, you might remember I made a prediction in 2003 (20 years ago!) about the Global Financial Crisis, calling it 'The 70 Year Hit' (markets have materially corrected roughly every 70 years if we look back in history, a bit like a reset). It eventually emerged late 2007 and across 2008 – The Global Financial Crisis.

As an aside, whilst I still watch the global economy (hence this report) you and I have less need to be concerned about the global economy because we invest in the business.

The point here is that Ray Dalio is all about the macro economy and asset allocation. He is very insightful and provides a great overview about different aspects of the global economy.

Warren Buffett is all about the business. Although he has done so in the past (once if my memory is correct), Warren Buffett has not sold out recently but does have a reasonable level of cash (not unusual over the last decade or so).

The Vix



The graph above tracks the level of volatility (the movement in trading prices) of the S&P 500 in the US over the last 12 months.

To the left of the graph above you can see volatility reached an initial peak on the 27th of September last year.

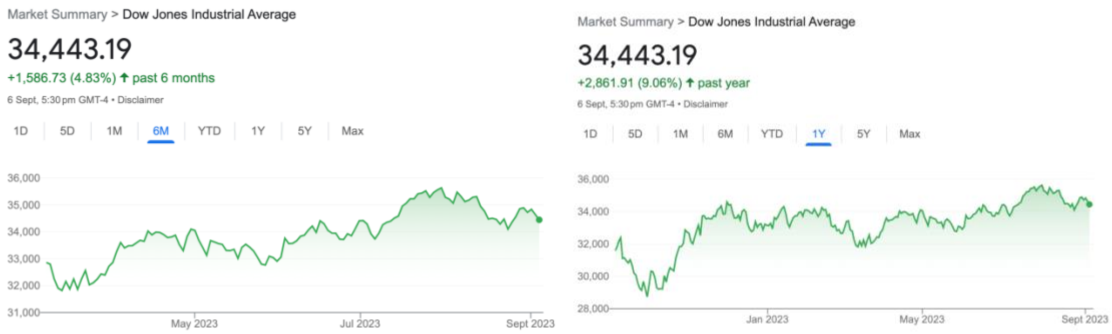
The next peak in the VIX came on October the 11th last year with the VIX hitting 33.63 (the higher the number, the higher the level of volatility).

The VIX currently sits at just under 14. This suggests that markets are calm, which indeed is generally where things are at.

Because inflation is generally tracking in the right direction in the US, the market takes the view that this may limit future interest rate rises by central banks around the world and in particular, those rate hikes by the US Federal Reserve.

The point here is that 14 is quite a long way from 33 (the calm before the storm?).

The US share market

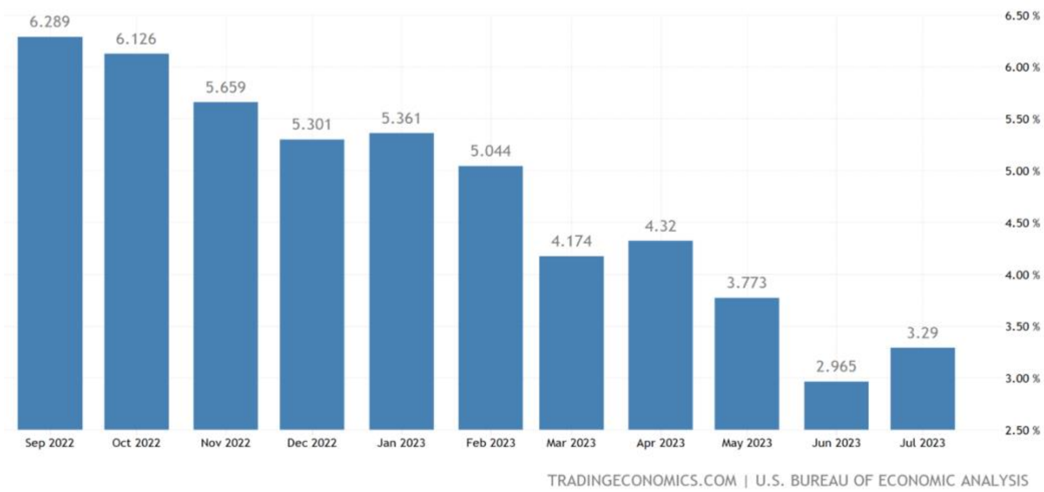


The chart on the left shows the US share market (the Dow Jones) over the last six months (to September 2023). The
chart on the right shows the US share market (the Dow Jones) over the last year (to September 2023).

Rising market indexes prior to August were mostly driven up by only a few tech companies (the so called magnificent seven). The volatility over August was notable but not significant.

September has arrived so we look forward hopefully to more volatility to provide lower buy prices. The less we pay when initially investing, the lower the risk. Good businesses with quality earnings don't suddenly become bad businesses because their trading price declines for a while. The trading price and the intrinsic value are two different things.

The Personal Consumption Expenditure (PCE) Index



The graph above tracks the monthly change in The Personal Consumption Expenditure Index - US.

I include The Personal Consumption Expenditure (PCE) index again this month because it is closely watched by the US Federal Reserve and therefore is a key indicator for you and I. The latest monthly update shows it moved in the right direction although not by much. The annual rate was up 3.3%, in line with general consensus, although a bit higher from last month's 3.0%. Basically, we are on track here currently.

All eyes and ears were on the recent Jackson Hole meeting. Jerome Powell emphasised the need to implement interest rate hikes in order to effectively manage inflation.

He also suggested the Fed could hold rates steady at the upcoming September meeting … "as officials assess the incoming data, evolving outlook and risks". It will be interesting to see how the latest unemployment and new jobs data recently released is taken into account by the US Fed at their upcoming meeting on the 19th and 20th of this month.

Non-farm payrolls (simply, the number of people employed across the US) increased by 187,000 which was above the 170,000 expected. Usually this is a good thing but less so when the Fed are battling inflation.

On the other hand, unemployment increased slightly to 3.8%, the highest level since 2022. In theory this is helpful to the US Fed in their battle against high inflation.

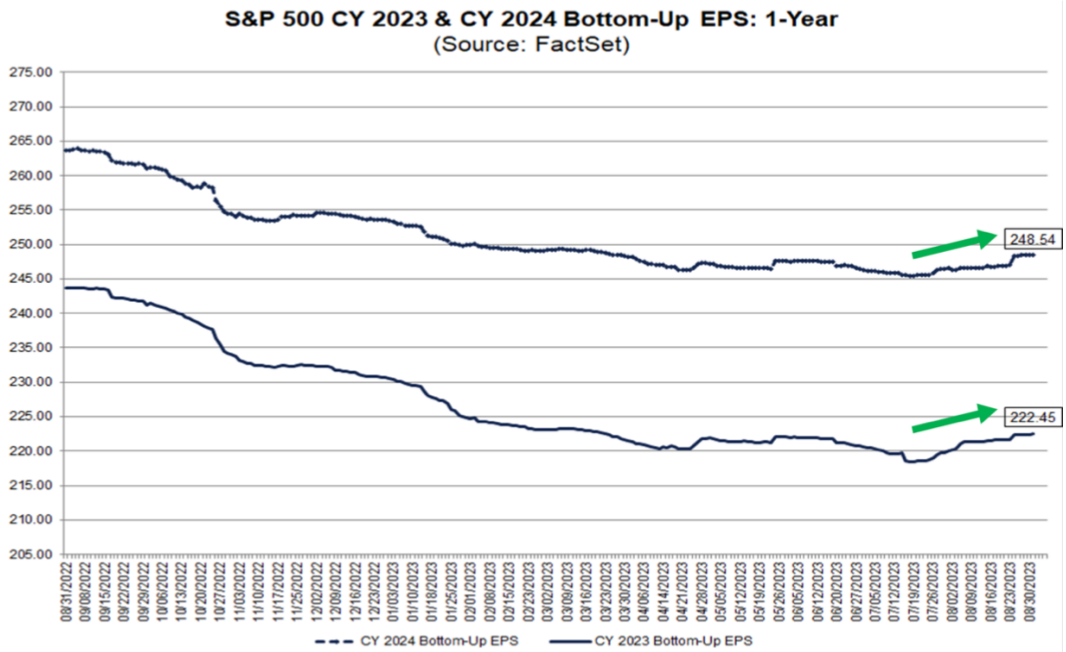
So, the decision about interest rates remains data dependant.

NZ – US currency cross rate

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 remains volatile and seems to fluctuate between 58 and 61 cents more recently.

Company earnings – USA



The graph above tracks the change in S&P 500 company earnings.

In short, company earnings are projected to stabilise and rise slightly over the third and fourth quarters of 2023.

In a typical quarter, analysts often reduce earnings estimates during the first two months of the quarter. In the past, this is on average how things went in the first two quarters:

- During the past 5 years (20 quarters) the average decline in the bottom up EPS estimates during the first two months of a quarter has been 3.0%.
- During the past 10 years (40 quarters) the average decline in the bottom up EPS estimates during the first two months of a quarter has been 2.7%.
- During the past 15 years (60 quarters) the average decline in the bottom up EPS estimates during the first two months of a quarter has been 3.4%.
- During the past 20 years (80 quarters) the average decline in the bottom up EPS estimates during the first two months of a quarter has been 2.9%.

Over July and August this year, analysts increased EPS estimates for S&P companies for the third quarter.
More specifically, EPS estimates for the third quarter increased by 0.4% (from $55.86 to $56.10) from June 30 to August 31.

Company earnings announcements are important because investment analysts use earnings to calculate the current value of the company.

Small declines in earnings projected over many years into the future can mean a large decline in the value of a business today. This can sometimes make the current share price look expensive. Unexpected declines in earnings (an earnings miss) that are sometimes announced by company managers can see investors flee and the trading price decline sharply.

I would not place too much emphasis on one quarterly result though. The market however can take a different view at times.

Anyway, this latest information suggests that, except for an unexpected event or piece of news to the negative, earnings may have 'turned the corner' as it were.

The Global Economy

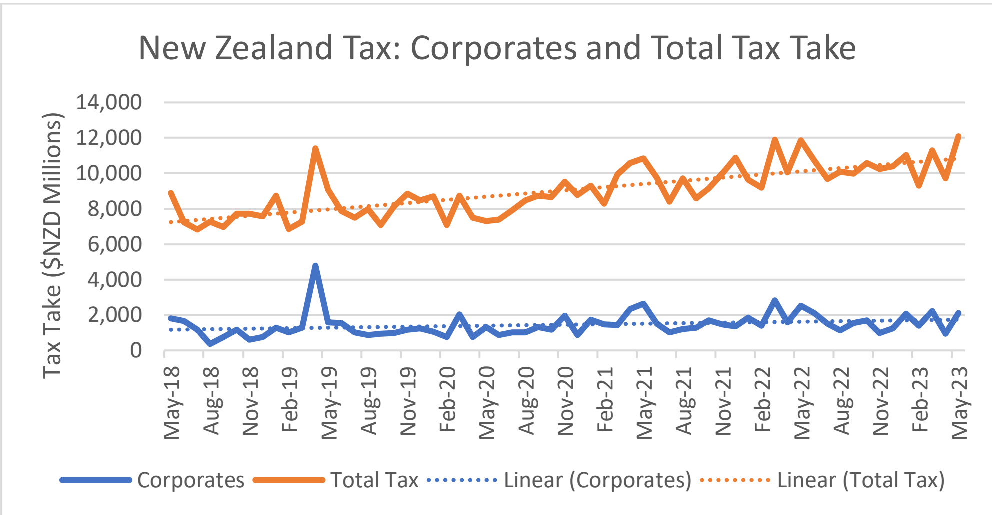
By Morgan Edwards – brief bio

Diversity is Best

This past week (August 30) I was subject to a torturous one hour long 'analysis' of the international economic landscape. This was intended to show economic risks faced by the organisation I work for.

In this presentation, it was opined that the United States would collapse economically through defaulting on its debt, that quantitative easing (erroneously referred to in the presentation as money printing) has created the current inflationary episode, and a general sense of surprise that interest rates have been raised as much as they have been. I hope that this last point isn't lost on you given the analysis provided in prior MAEUs.

There was even the odd insight that was completely incorrect. An example of this was that the tax take here in New Zealand was down as corporate profits were declining. The data demonstrates otherwise. While I haven't depicted corporate profits in a graph, the latest StatsNZ data indicates that corporate operating profits were up 2.3% in March 2023 over December 2022.



The graph above depicts corporate tax and the total tax take in New Zealand between May 2018 and May 2023. Of course, this data is sourced from the Treasury. For reference, the tax take was $12 billion dollars in May 2023, up from $9.7 billion in April 2023.

Note that there was no evidence (academic, empiric or otherwise) to substantiate these points. Just good ol' 'this is my job, and you shall listen'. Pure ideology rather than evidence.

While fighting back the urge to respond to these 'insights' (joking, of course), I was struck by the lack of pluralism contained within this analysis. Economic pluralism refers to the use of different perspectives within economic analysis.

After all, diversification is a key risk aversion tactic used widely across the market.

While there are, and indeed should be differences in opinion, you must present the *evidence* for this opinion for it to be worthy qualified analytical fact.

For instance, what states in the past have defaulted? What has been the monetary system in place at the time? How strong were the state's institutions at the time of default? Are we talking about internal or external default? I must say, this last one is more clear cut.

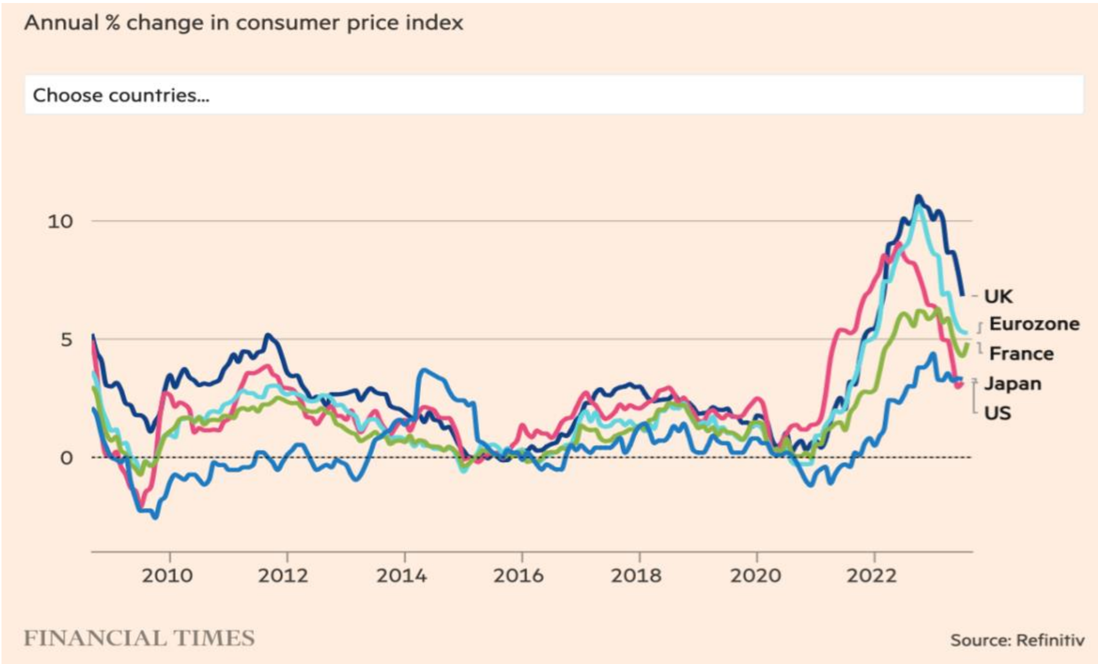
With regard to interest rates, what is the underlying *theory* of money? How does this theory translate into price dynamics? How is the theory exercised in policy terms?

These questions should be central to economic policy analysis. At this point in time, most analysts fail to see these key points. This is detrimental to their insight and, more importantly, the people that lose from their poor insight.

With that out of the way, onto our regular whistle-stop tour of the global economy.

United States of America

The US hosted the annual Jackson Hole Symposium – simply referred to as Jackson Hole – between the 24th and 25th of August. This is a meeting of key central bankers who discuss, perhaps above all else, monetary policy and its expected trajectory. The theme of this year's symposium was 'Structural Shifts in the Global Economy'.



The above graph depicts the rates of inflation for selected Advanced Economies (AE).

On the topic of structural shifts, and perhaps the intellectual shift that will accompany this, note the markedly lower inflation rate path for Japan. This is despite their continued adherence to 'loose monetary policy'.

China

In the past month, China has exhibited *deflation*, a vast departure from inflation evident in Advanced Economies (AE) elsewhere. Namely, consumer prices fell -0.3% in the year to July.

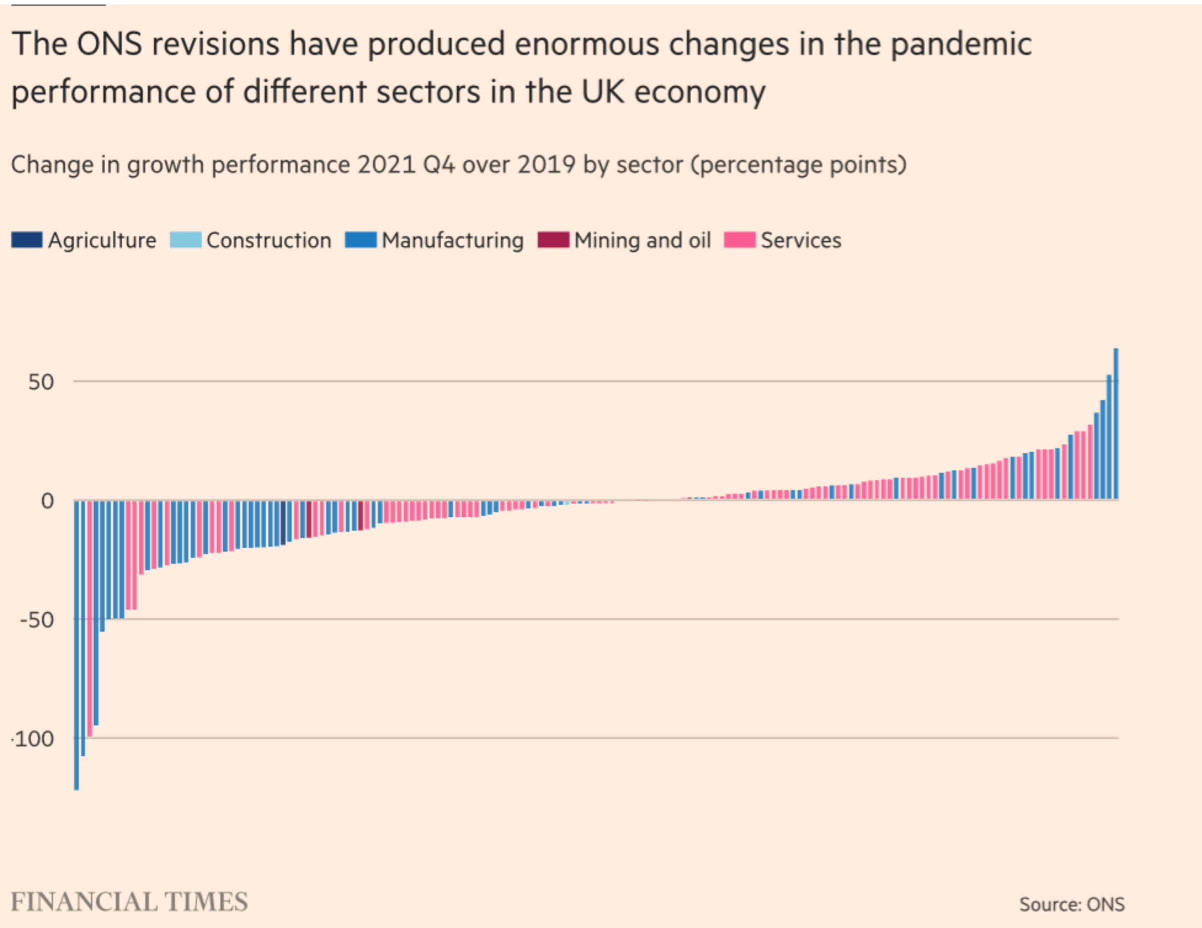
The above panel of graphs depict food transport and shelter costs in China since 2019.

While obviously not a direct comparison, you can see that price increases have been quite muted in China compared to other AEs (think of the UK and the precipitous rise in energy prices). I should note that the decline in the price level in China is more reflective, at this stage, of *the price of pork* and its respective weighting in the CPI basket.

Historically, there seems to be a connection between the level of credit to the private non-financial sector and the movement of prices. As discussed in the June MAEU, this is the result of demand (expressed through credit) falling sharply in relation to supply.

United Kingdom

A different type of analysis for the UK today. Recently, the Office for National Statistics (ONS) revised many economic datasets. This has resulted in a fundamental reappraisal of the UK's immediate post COVID-19 economic performance.



The above graph depicts the changes made to the data. While it is certainly impossible to determine exactly what has changed, you can infer the size of the change by the left-hand scale.

To explain these differences, the ONS reported that in 2020 manufacturers were adding to stocks, rather than running them down. In 2021, the ONS analysed the inputs and outputs of each sector, rather than turnover which had guided its initial insights. The Financial Times reported that:

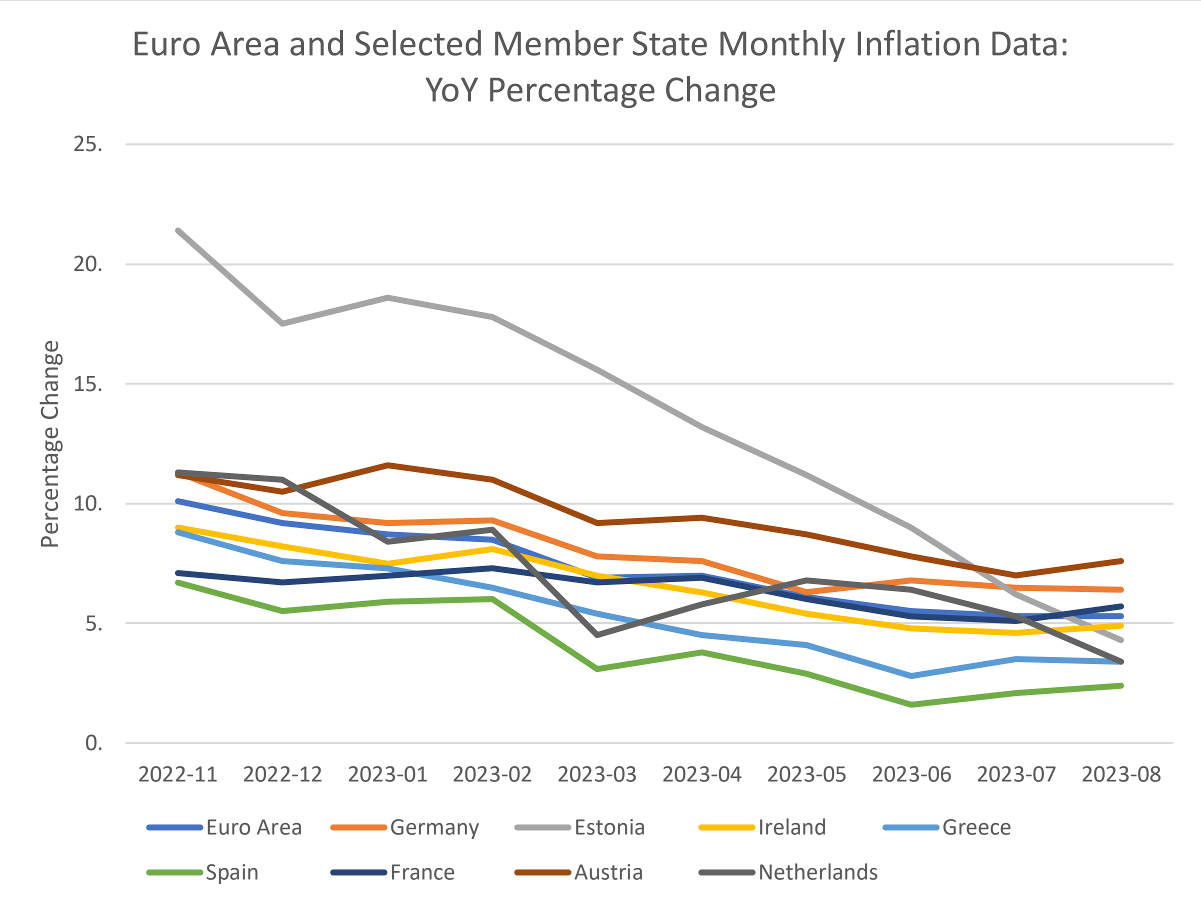
> *This is why some industrial sectors such as steelmaking perform so much worse in the new data. The ONS found that far more of the added value from producing iron, for example, was coming from the energy the sector used and there was much less additional value generated by turning it into metal.*
>
> *By contrast, the wholesale and retail sectors streamlined their cost bases in the Covid period and so produced more value than previously estimated.*

While some data, such as exchange rates, are easy to quantify, other data is not. Hence, having a diverse arsenal of economic theory to supplement the insights of data is extremely important.

Eurozone

Inflation in the Eurozone remained steady at 5.3%.

Of course, this masks country specific trends (for instance, Spanish inflation is around 2%). Regardless, the persistent inflation has been attributed to – you guessed it – elevated input (read energy) prices.



The above graph depicts annual percentage change in inflation (measured monthly) for the Euro Area (total), and other selected Euro Area member states.

You can infer from the graph above that inflation is indeed trending down within the Eurozone and the graphed Eurozone economies.

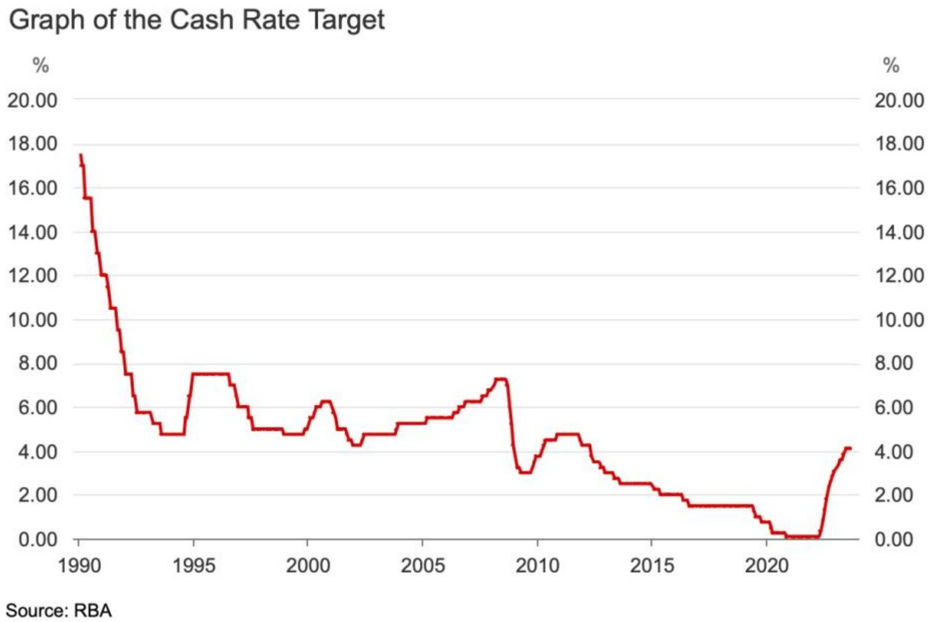
While it is impossible to tell from this graph, given that it looks like spaghetti and that I haven't graphed all the Eurozone economies, it appears that the European South (namely the PIIGS of Portugal, Ireland, Italy, Greece and Spain) are demonstrating lower inflation rates than the European North (generally more affluent countries). This might warrant further analysis in future.

Australia

At its meeting on September 5, the Reserve Bank of Australia decided to keep their official cash rate at 4.10%.

Pointedly, the RBA noted that '[i]nflation in Australia has passed its peak and the monthly CPI indicator for July showed a further decline. But inflation is still too high and will remain so for some time yet'.

Regardless of the cause of inflation (i.e., whether it's caused by monetary factors or not – it isn't) interest rates will remain high for some time yet. This will appease the emotional aspects of central bankers' decision making processes as they continue their 'fight against inflation'.

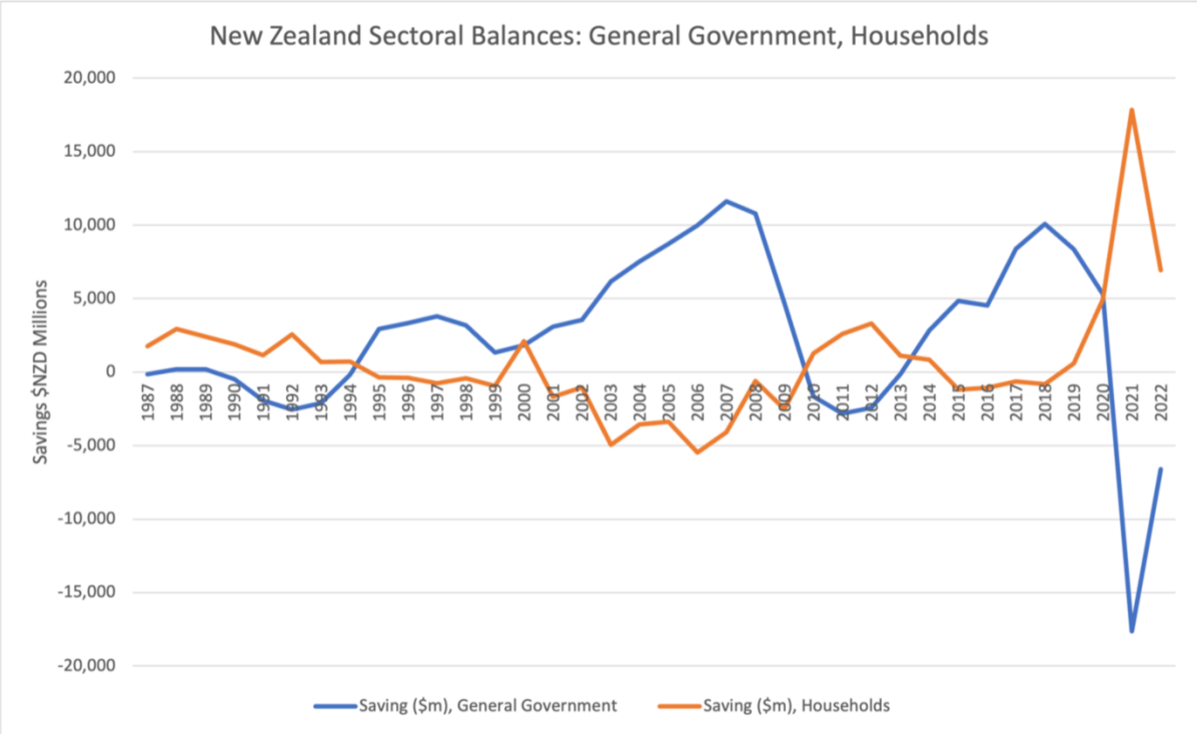


For your reference, the above graph depicts interest rates in Australia since 1990.

New Zealand

On August 27, the government announced a four-billion dollar cut in its expenditure over the next four years. While there are many implications of these funding decisions, one implication we'll look at briefly are the impacts on the sectoral balances.

The sectoral balances stipulate that for one sectors' surplus(deficit), then the other must be in deficit(surplus). At the country level, we can assume that for every governmental sector surplus, there will be a non-governmental sector deficit of an equal size.



The above graph depicts the sectoral balances for New Zealand between 1987 and the present day.

For the statistically minded amongst you, there is a correlation coefficient of -0.84 thereby indicating a strongly inverse correlation between these two variables. In other words, these two items move in opposite directions as they change, not in the same direction.

The thing to keep in mind here is that this will have a clear impact on the trajectory of non-governmental sector expenditure, which in turn will have an impact on macroeconomic activity (economic growth).

All in all, our monthly economic sightseeing trip around the world has returned the same broad insights - choppy sideways.

The same inflationary forces, albeit receding, continue to rest with central bankers' grasp of reality. I wonder how much this will change in a month. We will wait and see!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