➢ Market and Economic Update – November 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

October

The above graph tracks The Dow Jones Industrial Index from January 2023 to end of October 2023. The dark yellow dot connecting the dark yellow lines is above August 01 2023 (08/01/2023 in American speak).
Source: CNBC

The downside volatility over October.
Went like this:

- The Dow Jones finished the month down -1.14**%**
- The S&P by -2.21%

- The Nasdaq by -3.43%

The downside volatility over September.
Here is how it went:
- The Dow Jones finished the month down -3.5**%**
- The S&P by -4.9%
- The Nasdaq by -5.8%

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

From the peak of 35630 on August 01 2023, The Dow Jones Industrial Index declined to 32417 by the end of October.

So, yes we got some volatility but, no, it was not what we were hoping for.

Market volatility was modest, providing some pricing opportunity, but not as much as we would have liked.

The US share market - 6 month & 12 month look

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

We did not get the level of volatility that we wanted but still, some value has emerged.

Anyway, volatility is one of the few things we can guarantee in the future. It's not over and we may see even bigger levels of volatility in the future.

The Vix

The graph above tracks the level of volatility (the movement in share market trading prices) of the S&P 500 in the US since January this year to the end of October.

As you can see in the graph immediately above, volatility eased back in September then began trending up, continuing through October like we hoped. Just not as much as we would have liked (lower trading prices means your portfolio cash up value falls. That is when value emerges) 😉

Geopolitical events: fall then recover?

Australian Equity Market Performance Following Geopolitical Events

Event	Date	1 Week	1 Month	3 Month	6 Month	12 Month
Yom Kippur War	06 Oct 1973	3.6%	4.8%	8.8%	20.0%	-34.3%
Iran Hostage Crisis	04 Nov 1979	-0.4%	-2.0%	33.0%	17.9%	71.8%
USSR Invades Afghanistan	24 Dec 1979	3.4%	16.5%	6.4%	35.1%	49.7%
US Bombs Libya	15 Apr 1986	0.9%	-2.3%	-8.3%	8.4%	40.6%
Tiananmen Square Protests	04 Jun 1989	0.8%	-0.7%	17.3%	8.5%	2.8%
First Gulf War	02 Aug 1990	-1.2%	-5.6%	-17.3%	-14.8%	6.8%
Kosovo Bombing	22 Mar 1999	1.4%	2.7%	9.0%	7.3%	8.7%
9-11 Attacks on US	11 Sep 2001	-8.7%	-1.2%	2.7%	6.7%	-3.7%
Iraq War	20 Mar 2003	1.6%	3.5%	8.4%	13.5%	18.1%
Arab Spring	25 Jan 2011	-0.7%	0.4%	1.7%	-9.9%	-10.9%
Russian Incursion East Ukraine	14 Mar 2014	-2.1%	-0.5%	-0.3%	1.0%	7.7%
North Korea Launch Missiles	28 Jul 2017	-0.8%	-1.8%	2.2%	5.1%	8.4%
Saudi Oil Drone Attack	14 Sep 2019	0.9%	0.9%	2.4%	-21.1%	-11.9%
Average		**-0.1%**	**1.1%**	**5.1%**	**6.0%**	**11.8%**

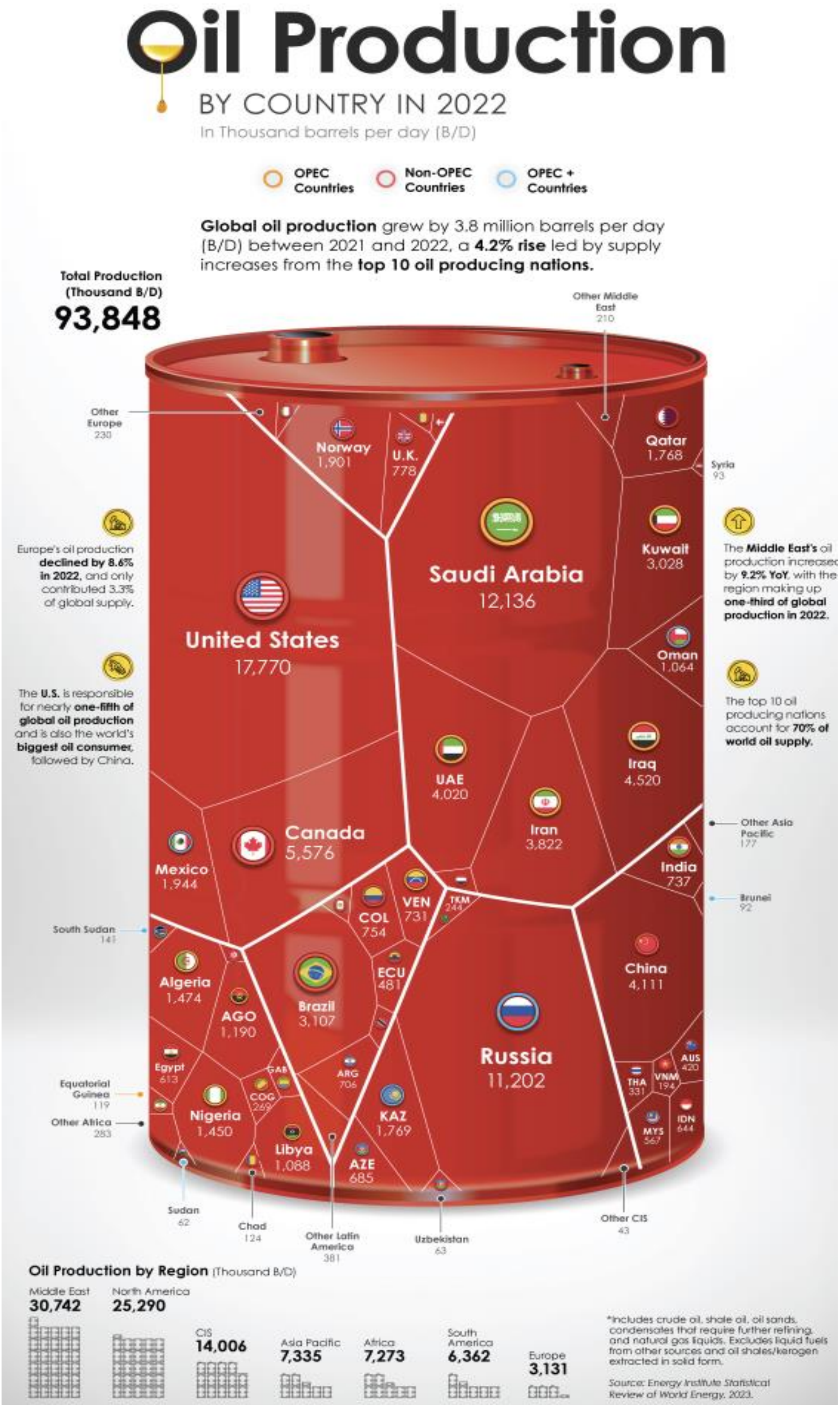
New Zealand Equity Market Performance Following Selected Geopolitical Events

	1 Week	1 Month	3 Months	6 Months	12 Months
9-11	-7.2%	-4.2%	9.2%	9.9%	8.3%
Iraq War	-0.6%	3.6%	15.0%	18.9%	31.8%

The table above to the left shows how various war events from the past have impacted on the Australian share market.

Although the outcomes are mixed, we can see that usually, markets track higher over the 12 months after the event. Israel have gone in like they said they would – 'stage two' of their plan is now underway. It is early days.

Both sides are backed by larger and more powerful countries. There are lots of scenarios that could play out. But then, that's always the case in these situations. Oil prices are worth watching. Although not an issue currently, a shortage could increase demand and push inflation upwards.



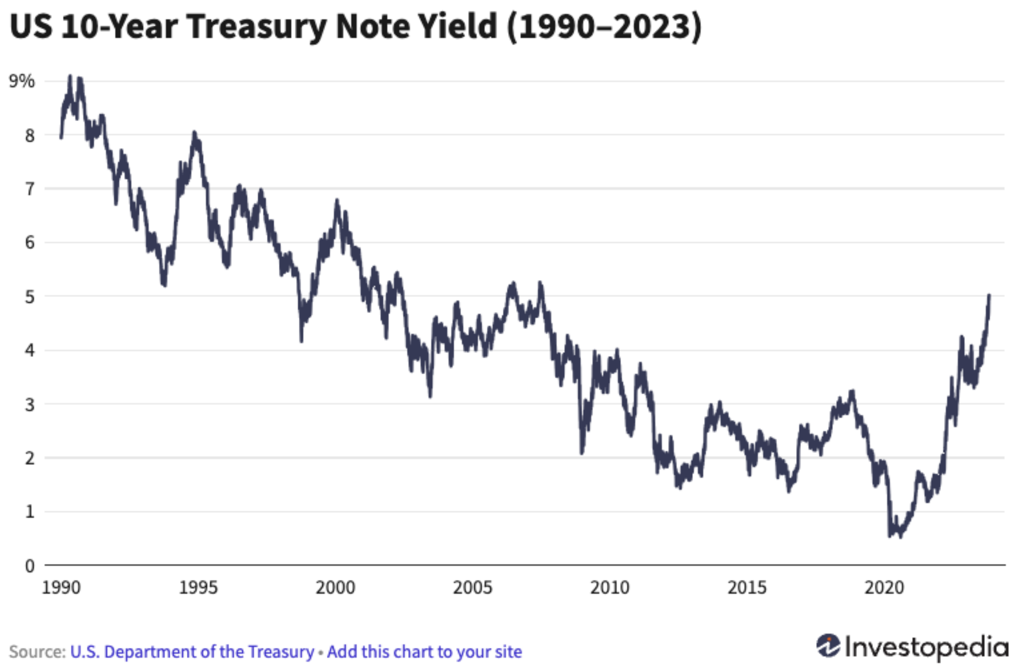
The diagram above shows the major oil producers globally.
Source: Visual Capitalist.

Israel and Palestine produce minimal oil but the Middle Eastern region accounts for almost one third of the worlds oil supply.

The above graph tracks the price of crude oil.

So why haven't oil prices spiked upwards sharply?

The markets, it seems, are currently more concerned about the 10 year treasury yield reaching 5% and therefore a possible soft outlook for the world's main economies. We need to be careful not to underestimate the impact of higher for longer interest rates in the US and elsewhere.



The graph above tracks the US 10-year Treasury.

Interest rates higher for longer is well publicised. The impact is still manifesting across the US and other economies - the latent effect. Markets are currently a bit on edge about it. More volatility ahead probably – good.

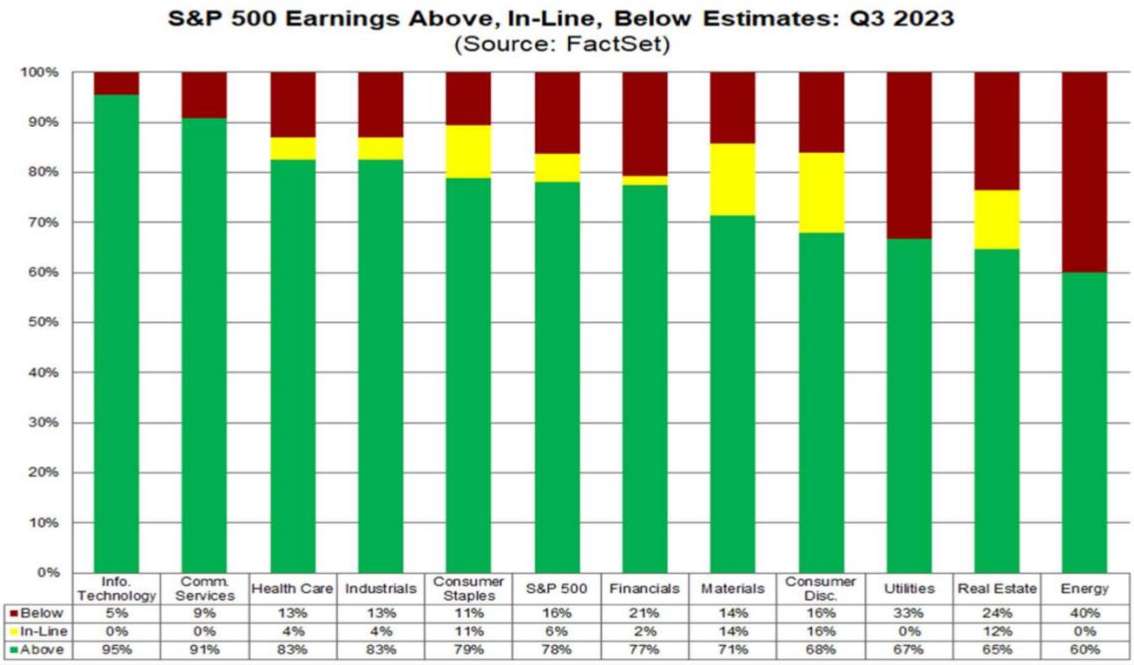
NZ – US currency cross rate

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 continues to fluctuate around 0.58 cents.

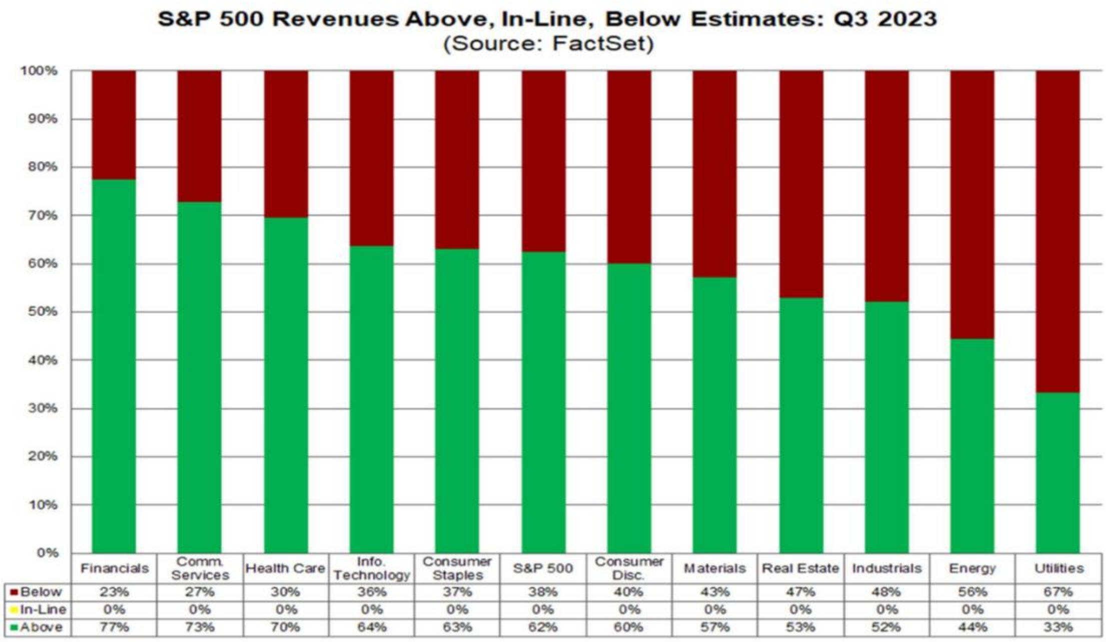
The outlook for the New Zealand dollar is to possibly increase against the US dollar somewhat if the gap between US interest rates and NZ interest rates increases (e.g. US interest rates fall and New Zealand interest rates remain higher for longer).

Company earnings (profit) – USA



*The bar graph above shows the proportion of companies that grew **earnings** more than expected and the proportion that grew earnings less than expected.*

Company revenue (turnover / sales) – USA



*The bar graph above shows the proportion of companies that grew **revenues** more than expected and the proportion that grew revenues less than expected.*

For the third quarter this year, S&P 500 companies are so far reporting year over year growth in earnings of 2.7% and year over year revenue growth of 2.1%.

If the 2.7% earnings growth is confirmed, this will be the first quarter of year over year earnings growth reported by the S&P 500 index since the third quarter of 2021. Fragile, not in a straight line, but heading in the right direction.

The Global Economy

By Morgan Edwards – brief bio

The Infrastructure Deficit and Productivity Paradox

The New Zealand General Election came on October 14, but the issues that have and will face New Zealand continue to linger. At the time of writing, the negotiations appear to be lingering too!

So, what are some of the issues the new National-led government faces? As the title implies, the Infrastructure Deficit and Productivity Paradox figure highly on this list. It is worth noting that I deem these problems to be interrelated, for reasons I will explain shortly.

By way of introduction, the Infrastructure Deficit refers to the dilapidated and underfunded nature of New Zealand's infrastructure. This infrastructure includes roading, bridges, hospitals and Three Waters networks.

The Productivity Paradox refers to New Zealand's lack of productivity gains despite implementation of policies aiming to boost productivity.

An intellectually simple way to string these two issues together is with the following thought experiment.

Imagine if there were a large city with inadequate roading infrastructure. For instance, it might take 45 minutes to get across a 300-metre bridge in peak morning rush hour traffic. If, for instance, a new harbour crossing or some form of high-speed transportation were implemented in this city, we could hypothesise that labour productivity would rise. This rise would be the result of increased labour being able to move more freely and complete the tasks required of their work, given that people would be wasting less time in traffic etc.

The problem with these issues is that there is now inadequate desire from central government to engage in the funding necessary to fill these gaps. The funding required is huge. Over the next 30 years, it is estimated that expenditure on:

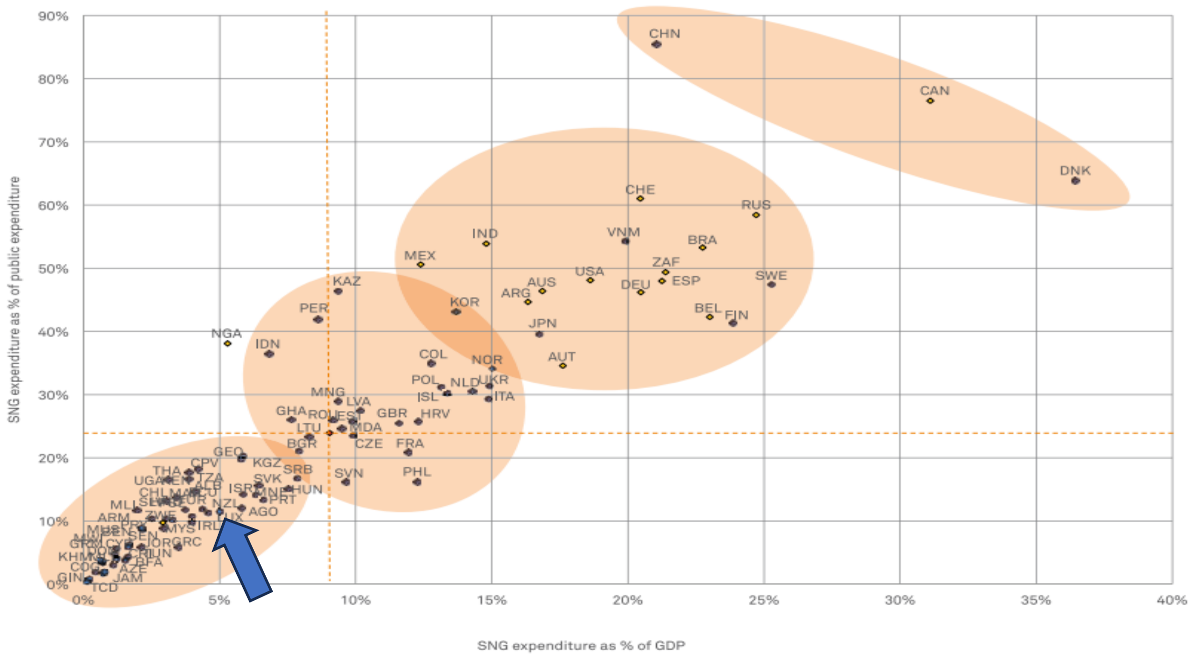
- Healthcare facilities will be around $14,000,000,000 *to bring them up to standard,*
- Three Waters infrastructure will be between $120,000,000,000 to $185,000,000,000.

To fully flesh out the picture, the Briefing to the Incoming Minister for Infrastructure in February 2023 predicted that general infrastructure expenditure will be $930,000,000,000 (at $31 billion per year every year for the next 30 years).

While you *have* to take these numbers with a grain of salt – they are projections after all – the figures above leave us with a hefty *financial* price tag.

Recall here that roading (except state highways) and Three Waters infrastructure is funded by Local Government through rates. So, how does our Local Government expenditure as a percentage of GDP (x-axis) and Local Government expenditure as a percentage of central government expenditure (y-axis) stack up?

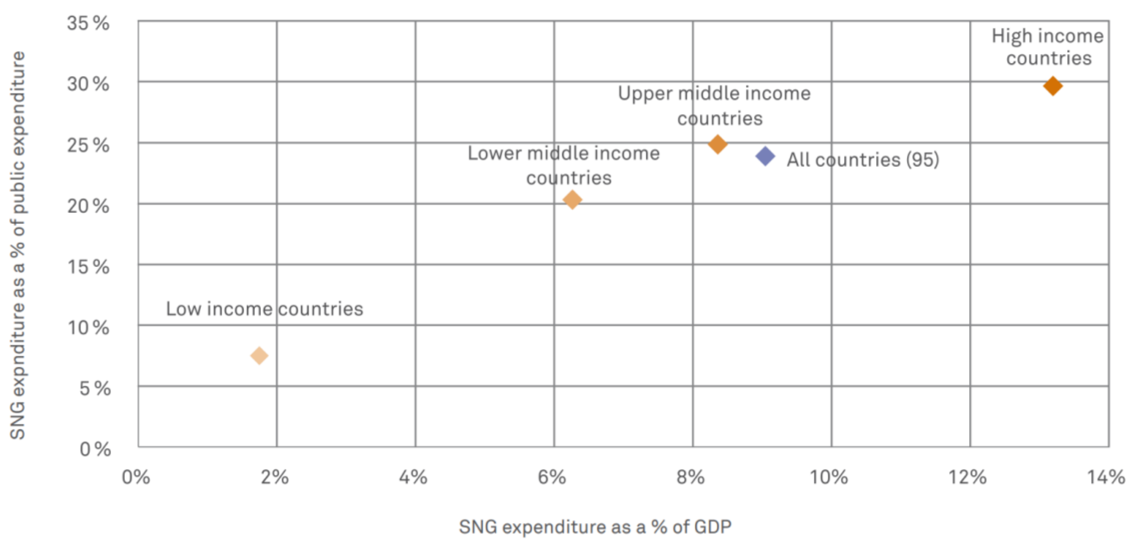
Figure 7. **Subnational government expenditure as a % of GDP and public expenditure (2013)**



The graph above depicts Local Government expenditure as a percentage of GDP (x-axis) and Local Government expenditure as a percentage of central government expenditure (y-axis). The blue arrow points to NZ.

As per the above graph, New Zealand is at the pointy end of the big blue arrow in the bottom left of the sample.

Figure 9. **SNG expenditure and income country groups (2013)**



The graph above offers a generalised perspective of the first graph.

As you'll be able to see above, New Zealand is in amongst low-income countries at the bottom left of the graph. High-income countries tend to be at the top right of the graph.

Yes, you are reading that correctly. New Zealand's local government expenditure as a percentage of the respective measures of GDP are equivalent to that of a *low-income country.*

While the financial aspects of fiscal policy are obviously intrinsically important, what is arguably more important when discussing matters of fiscal policy are the resource costs of undertaking this necessary infrastructure expenditure and the costs of inaction. The short-term implications of the 'affordability' of action are ultimately detrimental to the future wellbeing of the nation.

When we speak of resource costs, we are talking about the resources necessary to undertake the work. For instance, do we have enough construction workers? Do we have enough cement and steel? For the costs of inaction, can we afford to have unsafe drinking water? Can our communities cope with the closure of health facilities because they are unsafe?

In taking this perspective, a very simple intellectual change, we have turned the 'dollars and cents' mentality endemic to government on its head.

Thus, is running a fiscal surplus and not spending money (note I didn't say saving!) a sign of responsibility?

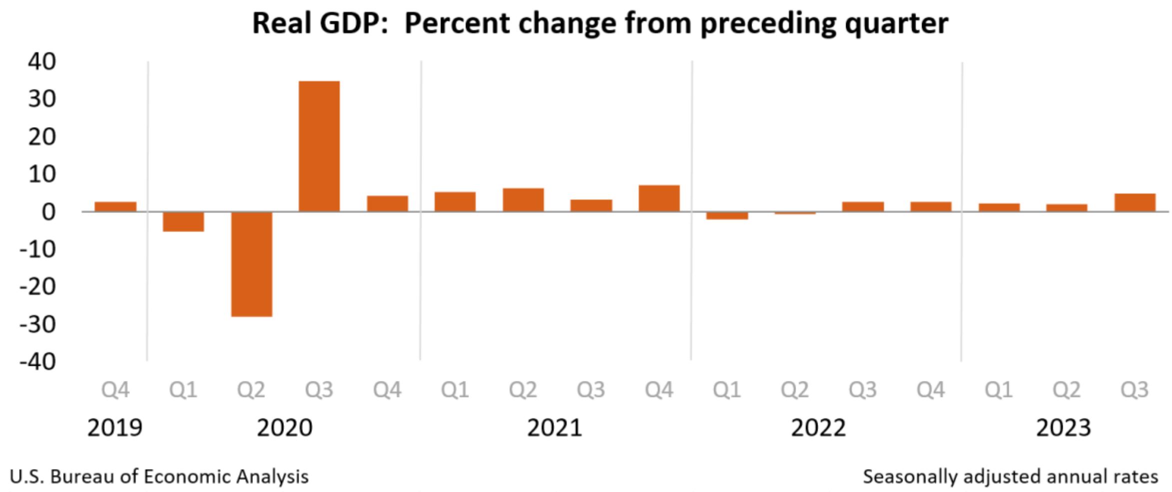
Is a fiscal surplus, which by definition squeezes the non-governmental sector, a smart move when it implies that the non-governmental sector must fund the majority (if not all) expenditure?

Some questions to ponder while we await the next Government.

Now, onto our whistlestop global tour.

United States

The latest quarterly economic data for the United States points to some good news. Namely, economic growth accelerated to 4.9% in the third quarter. This is up from 2.1% in the second quarter.



The graph shown above depicts quarterly economic growth from Q4 2019 to Q3 2023.

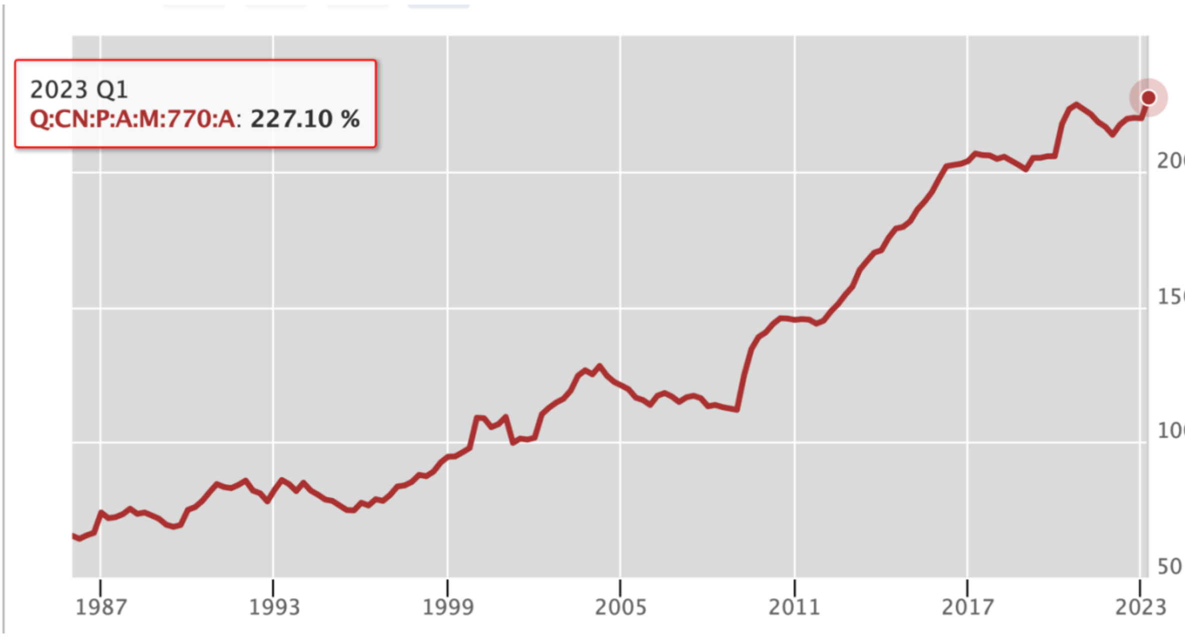
Note that this is the highest quarterly growth since Q4 2021. Note also that the US has posted its largest budget deficit outside of the acute COVID years (2020-2022).

Don't worry – the sky isn't going to fall in.

Recall that a fiscal deficit indicates that the non-governmental sector is net saving overall. While presumptuous (yet theoretically and empirically valid), we can infer that government expenditure is contributing positively to GDP growth.

China

The China rollercoaster continues. It is always useful to take a step back and take a look at the bigger picture economically. Here, credit is the best way to do this.



The graph above depicts credit to the non-financial sector in China from 1986 to the present day (Q12023).

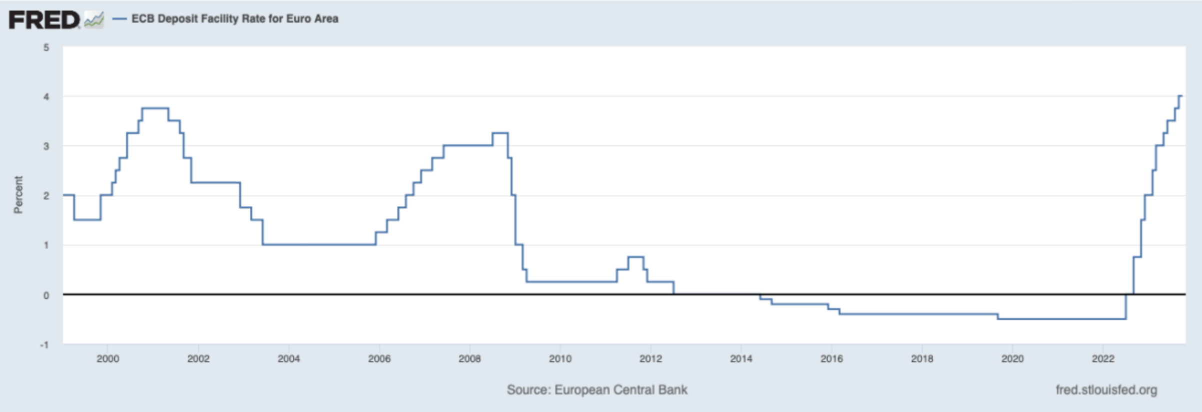
That near vertical line between 2005 and 2011 (wonder what happened there…) and the persistent rise thereafter tells you all you need to know really.

While recent MAEU updates on China have been up and down and up and down, credit continues to be relatively buoyant as a percentage of GDP. However, as Minsky noted, ‘stability is destabilising’.

So, while credit is up (which would most likely have had a positive impact on the PMI mentioned in last month’s MAEU), there continue to be risks posed to financial stability. We’ve been seeing hints of this for years, namely through China’s property market.

Euro Area

The latest European Central Bank (ECB) decision saw interest rate hikes paused after their 10th consecutive increase.



The graph above depicts the ECB's key interest rate (the deposit facility rate) since the ECB's establishment in 1999.

The ECB is taking a 'precautionary' approach after some cooling in measured inflation. Let's see what happens in the Euro Area economy over the next few weeks.

United Kingdom

In continuing our theme of problematic data, the UK Unemployment Rate declined to 4.2% in Q3 2023 from 4.3% in Q2 2023.

The graph above depicts the UK employment rate from the early 1970s to the present day. Well, eagle eyed readers will notice that it says '2023 May-Jul' rather than '2023 Jul Sep'. The ONS haven't updated their graph yet.

While this implies a good outcome, all may not be what it seems. Unemployment data is compiled from a survey undertaken of a sample of the population. The sample results are extrapolated out to provide a picture of the workforce as a whole.

However, as reported by the Financial Times, the response rate for the survey has declined from 50% about 10 years ago to just 15% nowadays. This means that the picture created through the extrapolation process becomes murkier and murkier.

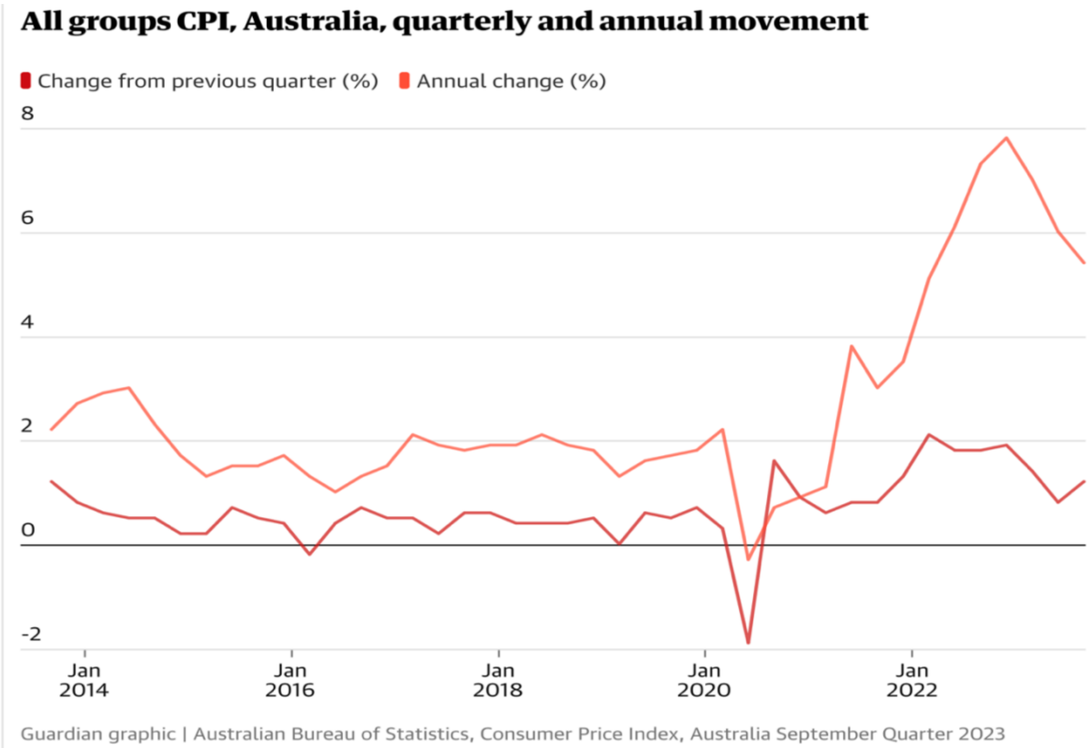
This has been dubbed the 'Data Crisis'.

As I pointed out the other month, the inaccuracies of data coupled with the crippling short-termism of modern politics (as touched on in the introduction to this month's MAEU), present near crippling implications for the implementation of effective policy.

This is compounded by issues relating to the basis of economic theory (think back to our analysis of monetary dynamics several months ago). We therefore need to be much more cautious when analysing and using data to form our insights.

Australia

Australian inflation rose 1.2% in the third quarter. The cause for this? It has been largely attributed to rising oil prices. No surprises there.



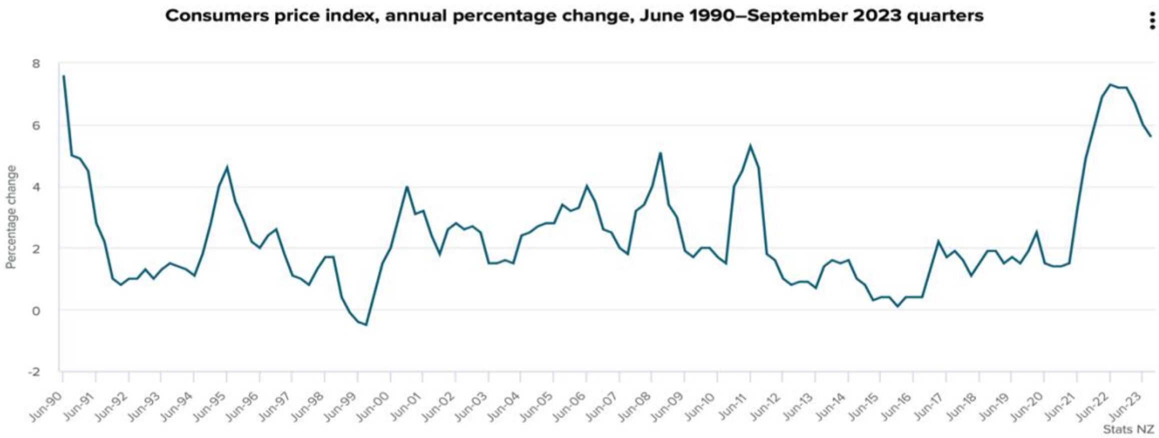
The graph above depicts Australian inflation as measured through the CPI for the past 10 or so years.

As you can see, annual CPI inflation continues to trend down. Unsurprisingly, banks are now predicting the RBA to have a new rate hike in November. The fickleness of macroeconomics, eh?

Oh, and a general misunderstanding of monetary dynamics. Short-termism at its best.

New Zealand

Infometrics have published a report entitled ‘Slowing Inflation Paves the Way for Soft Landing’. This is off the back of slightly lower CPI inflation at 5.6% annually (still up on a quarterly basis however) and positive GDP figures.



The graph above depicts annual inflation as measured by the CPI,

The fickleness of macro strikes again! Yes, while inflation is declining on an annual basis, significant challenges still remain.

Moreover, as an unanswered question that came up during my Master’s thesis, there is ambiguity over *who* drives economic growth. Namely, my research implied a vast proportion of society does not impact economic growth at all. Rather, it is the top income earners who drive economic growth through their consumption of goods and services.

While the numbers may state a soft landing in time, I doubt that the least well off – the vast proportion of modern society – would experience the ‘soft landing’ prophesised by Infometrics. This only goes to solidify the ‘Data Crisis’ outlined earlier.

Conclusion

Inflation isn’t the only macroeconomic issue we face. The Data Crisis, poor macroeconomic theory, and short termism are rearing their heads more.

Couple this with an unwillingness to engage meaningfully with the concurrent infrastructure and productivity crises and right there you have a recipe for some real long-term trouble.

See you next month.

"Investing can be scary. I can provide you with a stunt double for the risky parts."