Market and Economic Update – December 2023

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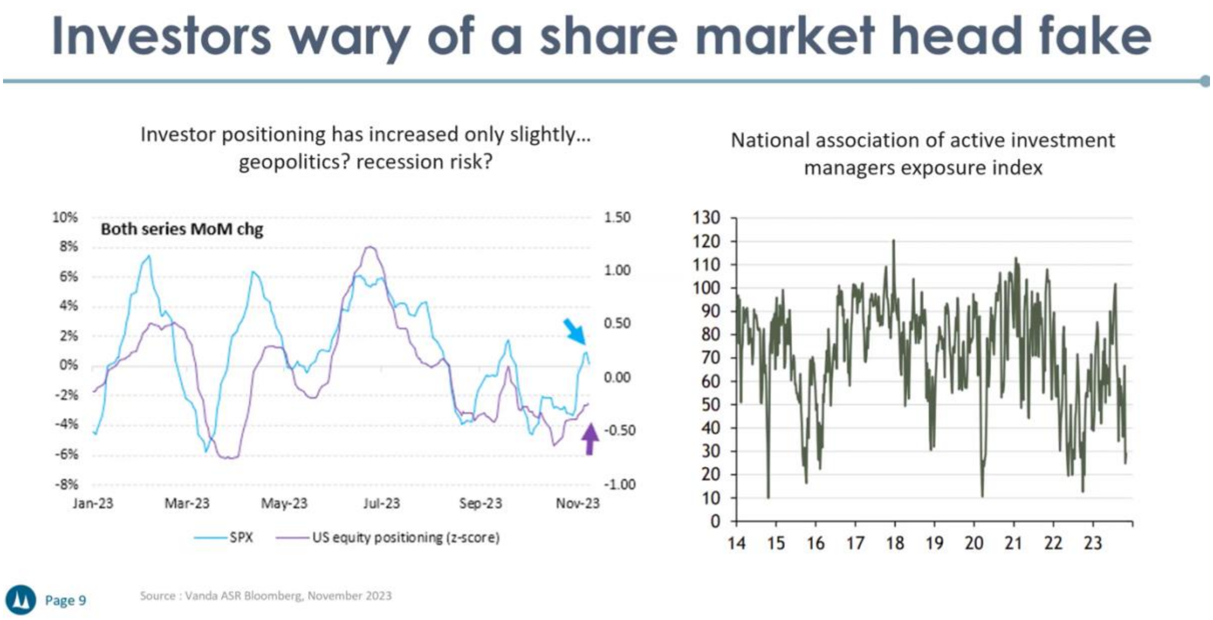
"People calculate too much and think too little."
Charlie Munger

The Markets

Markets cautiously position for growth.



The graph to the left compares the movement in S&P 500 index (SPX)(the blue line) with the overall market positioning (the purple line). Note minimal movement in the purple line compared to the blue line – markets are buying but fund managers not so much. The graph to the right shows the active fund managers cautious positioning – the drop in the black line points to minimal movement into growth assets - Harbour Asset Management graph.

Trading prices have moved up however active fund managers in aggregate remain on the side lines to some degree.

This suggests that the weight of money is not fully in the markets – a wait and see approach. Inevitably fund managers will want to be more fully weighted in the market to maximise growth. This can push trading prices up, especially if they all move at the same time.

The upside volatility over November.
Here is what happened:
- The Dow Jones finished the month + 6.30**%**
- The S&P by + 5.24%
- The Nasdaq by + 5.82%

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%

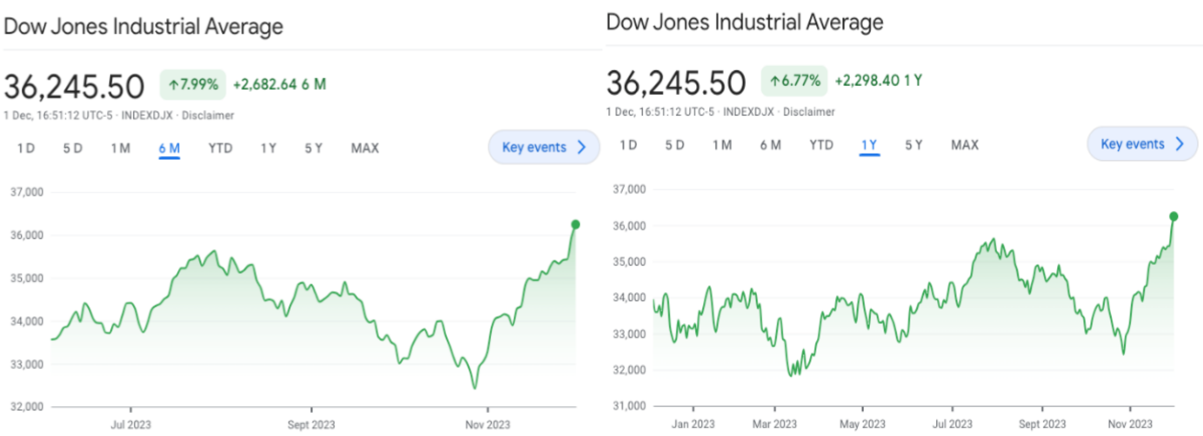
The downside volatility over September.
Here is how it went:
- The Dow Jones finished the month down -3.5**%**
- The S&P by -4.9%
- The Nasdaq by -5.8%

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% (from -8.25%)

From the peak of 35,630 on August 01 2023, The Dow Jones Industrial Index declined to 32,417 by the end of October. The Dow Jones currently sits at 36,245.50 as of the 1st of December 2023.

So, whilst the volatility over September and October was not what we were hoping for, we move forward, continuing to focus on future investment portfolio growth.

The US share market – 6 month and twelve month look



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

We will see more volatility. Looking ahead, we may also see markets track up in a choppy fashion over 2024/5, especially when signals about interest rate cuts emerge. They are inevitable – it is a question of timing.

Trading prices may already reflect lower interest rates by the time they arrive. The point is that higher trading prices will need the support of earnings and revenue growth. Meantime, earnings and revenue growth may need to navigate recession like conditions (currently looking like a soft landing though) and higher unemployment to some degree.

The Vix

The graph to the left 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 this year. The graph to the right 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 December 01 this year.

From 18.14 to 12.63. The two graphs immediately above, show volatility eased back in September then began trending up, continuing through October like we hoped. Not as much as we would have liked and continuing to track down.

This brings us to economic activity and the possibility of US / global recession.

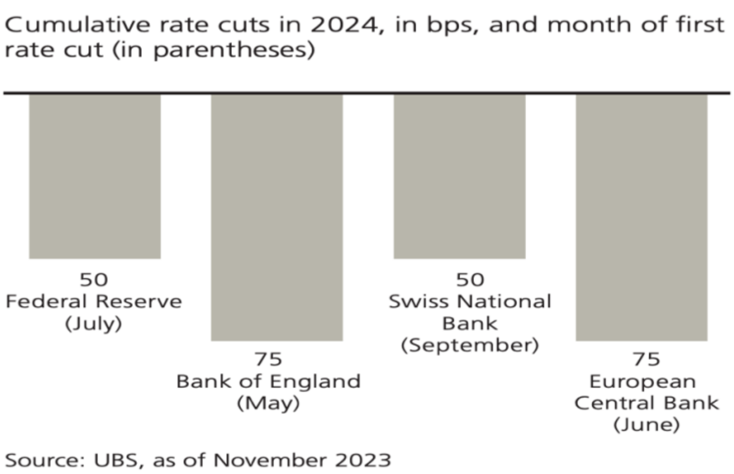
UBS real GDP growth forecasts

2023		2024	
2.4%	▶	1.1%	US
0.5%	▶	0.6%	Eurozone
5.2%	▶	4.4%	China

Source: UBS, as of 13 November 2023

The table above shows economic growth projections for 2023 and 2024.

The table above aligns with other data that also shows slowing economic growth and a 'soft landing'. This suggests if recession occurs, it may be shallow and short, all things equal. The reality is, recession could actually expediate interest rate cuts.



The graph above shows one possible interest rate cut scenario (Visual Capitalist).

The delayed, ongoing impact of higher interest rates is still underway; however, Central Banks will want to avoid signalling interest rate cuts too soon because this could result in a reignition of inflation. That could lead to interest rates higher for longer and the probability of another rate hike.

Still, that would upset the markets creating some sharp volatility – you know what that means … lower trading prices and better buying for us as investors😉

Evolution of US 4th quarter earnings (profit) growth estimates

The bar graph above shows how 4th quarter earnings estimates declined progressively over 2023

Although difficult to see in advance, looking back, the declining earnings picture and trading price volatility with hindsight, looks obvious.

US Company revenue (turnover) and earnings (profit) overview

The bar graph above shows S&P500 revenue (the orange bars) and earnings (the green bars) declining over much of 2023.

Unsurprisingly, sales and profits have declined over 2023 but not significantly. The market however does not like the slightest hint of decline and sells off accordingly, dropping trading prices.

At the same time, the market can be forward looking. Trading prices declined over 2022 and recovered over 2023.

Anyway, projections as per the graph above show earnings and revenue increasing over 2024.

Inevitably that leads to rising trading prices, keeping in mind that markets tend to be a leading indicator (early).

Investing in businesses that grow whilst not easy, is simpler than trying to outwit a random market.

The Global Economy

By Morgan Edwards – brief bio

Dual Reserve Bank Mandate to be scrapped.

The last Economic Update of the year beckons. Here, we continue our post-election coverage with a look at our central bank and the notion of central bank independence.

The Reserve Bank of New Zealand Act 2021 provides what is referred to as the 'dual mandate'. The dual mandate refers to the Bank's two economic objectives given in section 9(1)(a) of the Act. As you can probably guess, these are:

(i) achieving and maintaining stability in the general level of prices over the medium term; and
(ii) supporting maximum sustainable employment

In the past few days, the incoming National-ACT-NZ First coalition agreement has indicated that this dual mandate will be scrapped immediately, with the 'maximum sustainable employment' target being removed from the Act.

There are two things to point out here. One is the aforementioned notion of central bank independence. The other is the relationship between 'maximum sustainable employment' and inflation.

Let's set the record straight – central banks are legislative creatures of government. They are brought into existence and mandated by legislation. Their decisions on interest rates are made by a committee, in our case the Monetary Policy Committee (MPC), but the RBNZ relies on a complex institutional tapestry to undertake its monetary policy. Namely, it relies on the issuance of bonds by the government.

Bond sales drain excess liquidity from the banking sector after government deficit spending. Australian economist Bill Mitchell noted in his 2013 paper 'Full Employment Abandoned' that '[i]f these reserves were not drained (that is, if the government did not borrow) then the spending would still occur but the overnight interest rate would plunge (due to competition by banks to rid themselves of the non-profitable reserves) and this may not be consistent with the stated intention of the central bank to maintain a particular target interest rate' (2013, p. 24).

Government bond issuance is therefore required by the central bank [RBNZ] to achieve its monetary policy targets.

In this sense, central bank interdependence is the reality, central bank 'independence' is the myth.

The inflation vs unemployment tension

On to the second point: the link between inflation and unemployment is strenuous at best, downright dangerous at worst.

The so called Non-Accelerating Inflation Rate of Unemployment (NAIRU) has influenced monetary policy for some decades now.

Papademos and Modigliani first postulated the link in the 1970s, noting that the NAIRU is 'defined as a rate such that, as long as unemployment is above it, inflation can be expected to decline - except perhaps from an initially low rate'.

The NAIRU therefore implies a 'trade-off' between 'maximum sustainable rate of employment' and inflation.

The NAIRU is always estimated and never *ever* substantiated. Even Modigliani distanced himself from this idea.

Anecdotally, it also demonstrates a lack of ideological cohesion within the economic policy world of the new Coalition Government. Ironically, the Government is removing a core tenet of 'labour market discipline' central to the very contentional macroeconomic theory it otherwise abides by.

To summarise, the rejigging of the RBNZ Act proves some very interesting points that quite clearly challenge what some consider central bank independence.

Moreover, and rather controversially I suppose, it demonstrates a real lack of critical engagement from the Coalition's economic supervisors. But when did they ever learn economic *theory* anyway?

Also – I'm certainly not complaining.

On to our whistlestop whirlwind tour of the global economy.

United States

This month in US news, we turn to US trade, with focus on US trade in economic globalisation.

The graph above depicts international trade as a percentage of GDP from 1875 to the present.

You'll note the increase of international trade as a percentage of GDP *after* the Bretton Woods Era and the 'balanced' trade of that era.

You'll also note that international trade as a percentage of GDP was steadily increasing *before* the creation of the WTO. This seriously jeopardises the intellectual and empirical quotient of my Master of International Trade where the WTO was deified as the precipitous cause of international trade.

Anyway…

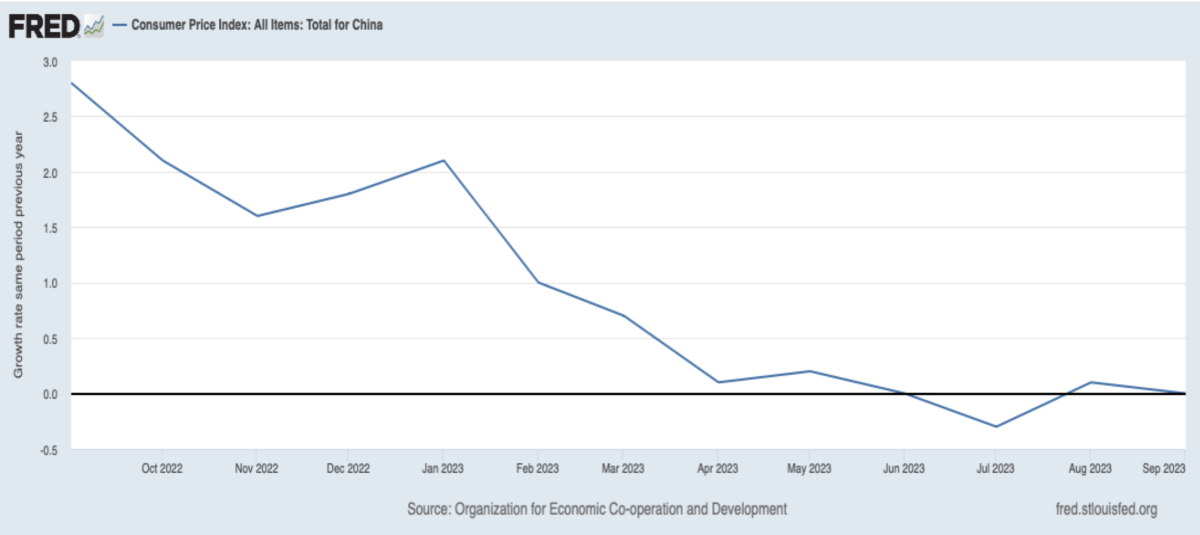
The Financial Times article I've borrowed this figure from (linked here) makes the case that trade protectionism has not been as prevalent as assumed. This insight is corroborated by the IMF.

It also makes another claim that reflects prior insight I've given in prior MAEUs on the structure of the global economy with the US at its centre. Namely, *'the Nixon Shock ended the original Bretton Woods settlement, introducing fiat currency. But it was designed to maintain the purpose of Bretton Woods: international dollarisation. Nixon changed the means, not the ends'.*

In other words, despite the seemed prevalence of trade protectionism, international trade remains robust. Moreover, and reflective of the aforementioned quote, the US remains at the centre of international trade.

China

Latest inflation data from China, dated to September 2023, indicates that monthly changes in the rate of inflation have declined precipitously.

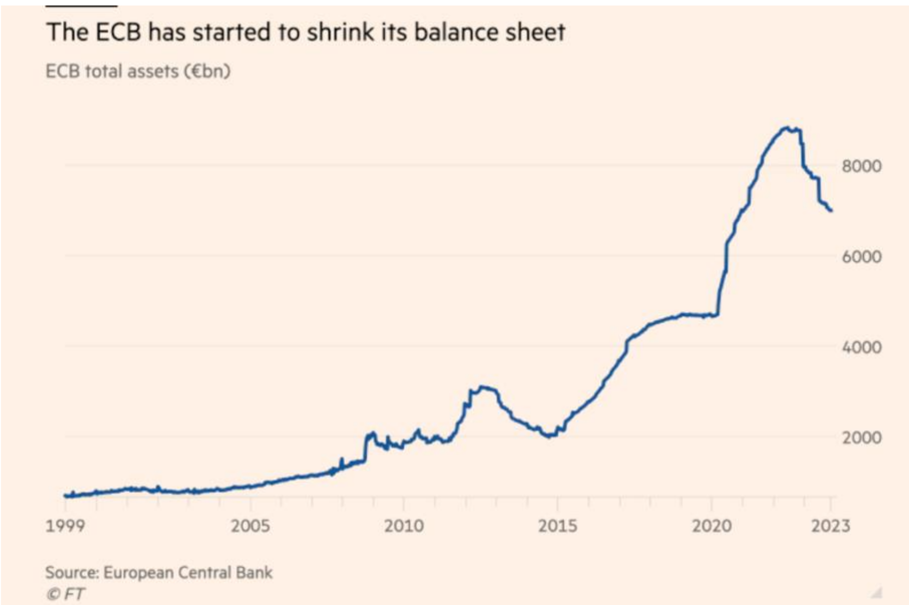


The graph above depicts monthly inflation from September 2022 to September 2023.

As you can see, monthly changes in prices have hovered around 0% since April 2023. In fact, the rate of change between August and September 2023 *was* 0%. This looks a bit deflationary.

Euro Area

The European Central Bank is planning to limit reinvestments in its COVID era bond purchase programme.



The graph above depicts the ECB's balance sheet since its inception in 1999. Here, you can clearly see the rather large increase in 2020.

In 2015, Jens Weidmann noted the bargain between Mephistopheles and the emperor from Goethe's Faust. Weidmann was chanelling (the rather Germanic) anti-inflationary stance, essentially insinuating that Mario Draghi (ECB President at the time) would send Europe into some kind of hell. That didn't eventuate – Europe still exists.

Through bond purchases, the ECB has managed to keep Euro Area governments solvent while also keeping interest rates low at longer maturities on the yield curve. Yes, it may have circumvented law, but the Euro has not collapsed – yet.

United Kingdom

Continuing on our previous themes of erroneous data, the Office of National Statistics (ONS) has released a new labour force survey.

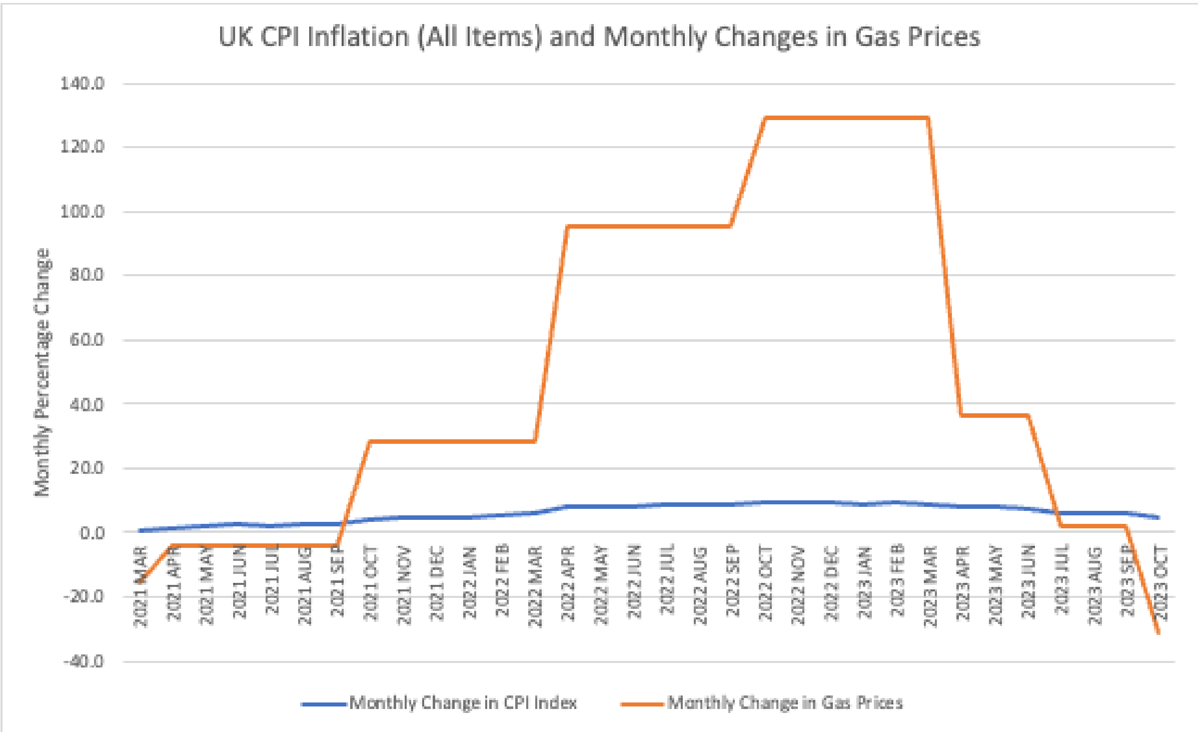
This is the aptly titled Transformed Labour Force Survey (TLFS).

Primarily, the TLFS aims to achieve better responses and a larger sample size than the current labour force survey.

However, the data is still 'experimental' and should be taken with a grain of salt.

If the data is right, it may demonstrate that the labour market is more resilient to higher interest rates than previously thought.

On the ever present topic of inflation, here's gas prices and monthly CPI data.



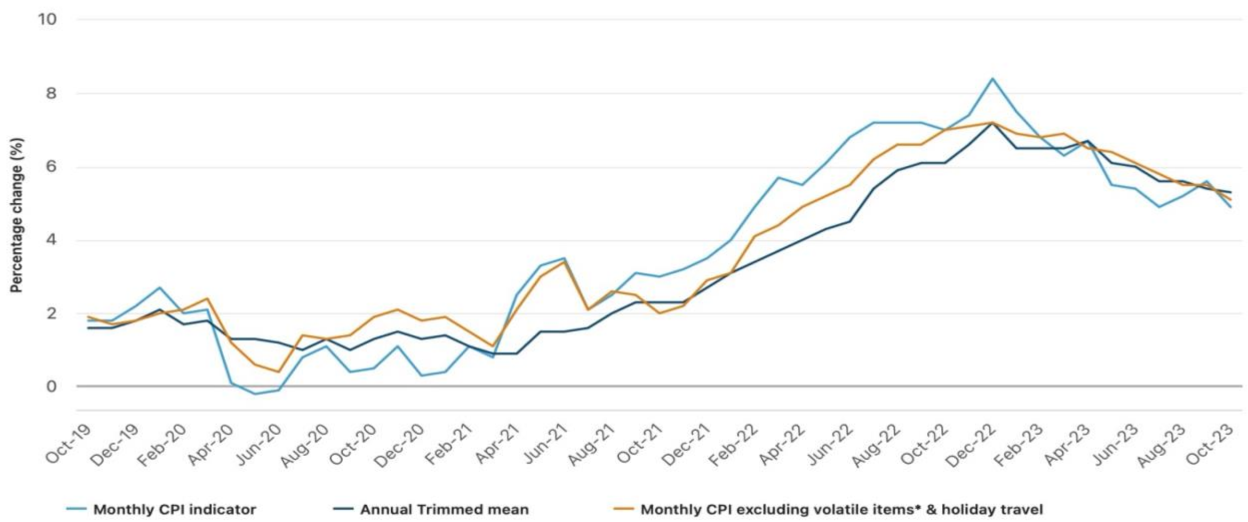
The graph above depicts monthly CPI and gas price data within the UK. Because of the way the graph is layed out, the blue line (inflation) looks somewhat flat but, look closely and you can see inflation is up materially.

Guess what – there is a 0.86 correlation coefficient between these two datasets. That means, in english, that there is a statistically significant correlation between rising and declining gas prices and inflation. I hope you aren't surprised.

Australia

Let's take another look at Australia's monthly inflation data.

Monthly CPI indicator, Australia, annual movement (%)



Source: Australian Bureau of Statistics, Monthly Consumer Price Index Indicator October 2023

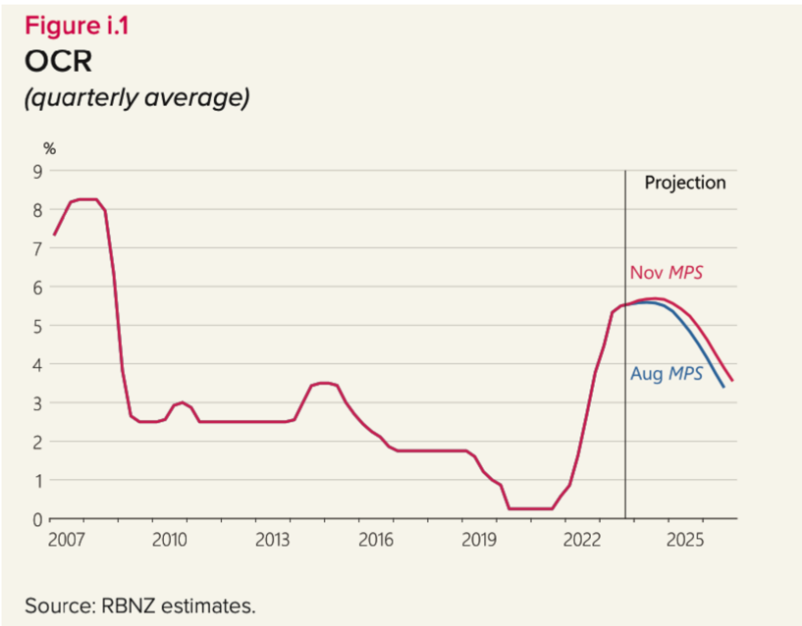
The graph above depicts annual changes in inflation for all items in Australia.

We can see that inflation (measured on an annual basis) is continually trending down. However, owing to the belief that interest rates can bring down inflation if they remain at these levels, the RBA is still posturing towards rate hikes. Wait and see on this one.

New Zealand

Turning to New Zealand, the RBNZ left the Official Cash Rate unchanged at 5.5%.

However, they did note that 'inflation remains too high, and the Committee remains wary of ongoing inflationary pressures'.



The graph above depicts the quarterly average OCR from 2007 to its estimates for the future OCR beyond 2023.

As you can see, the 'dot-plot' (or expected path of interest rates) remains slightly higher for slightly longer than previously anticipated (the red line vs the blue line).

As you'll remember from previous MAEUs, the fight against inflation is largely an emotional one. Or, perhaps a bit more fairly, a fight that is based off of an erroneous logical link between interest rates and inflation.

In Conclusion

As we wrap up the year, many of the underlying dynamics remain roughly the same.

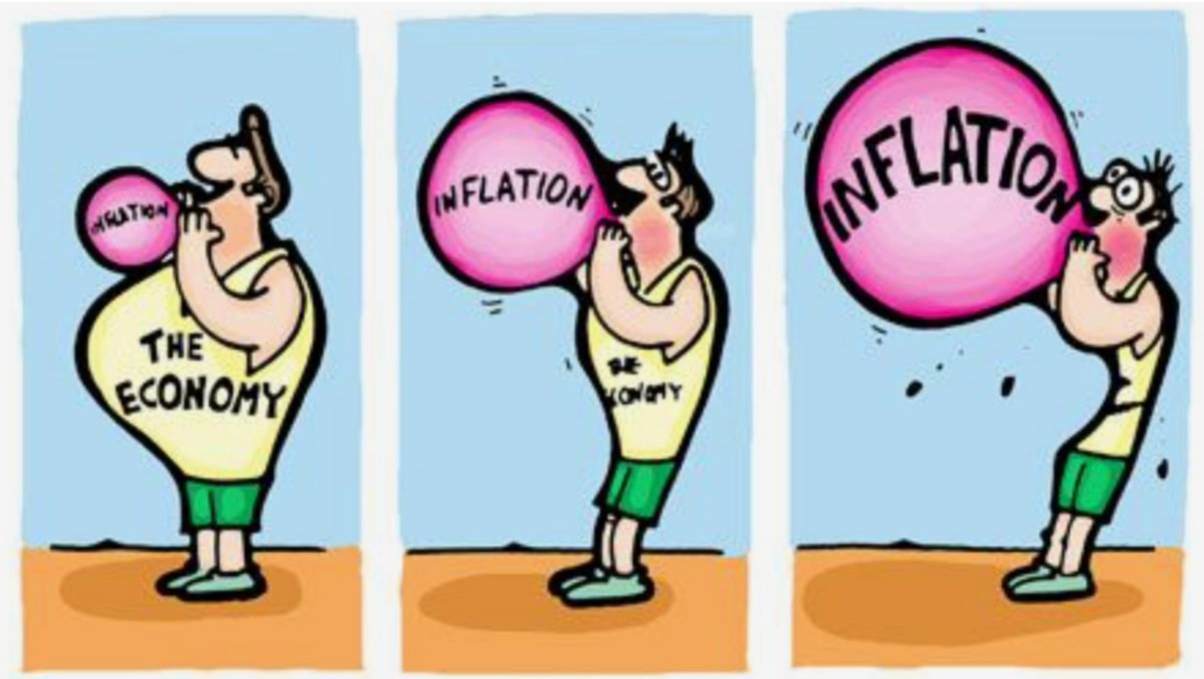
While central banks are fighting inflation (at least they think they are), inflationary pressures seem to be abating. Though we shouldn't give credit to increased interest rates.

Throughout next year, it will be interesting to see how central banks deal with elevated prices (largely due to increased interest costs), and to see how far they overreact.

As we can see in the UK, inflationary pressures are driven by non-monetary factors (i.e., input costs such as gas).

Couple this with interesting fiscal policy decisions (recall the sectoral balances – we'll be seeing those more and more next year) and we are in for very interesting economic times indeed.

Until next year – Merry Christmas!



Cartoon by Inkcinct.com.au