➢ Market and Economic Update – January 2024

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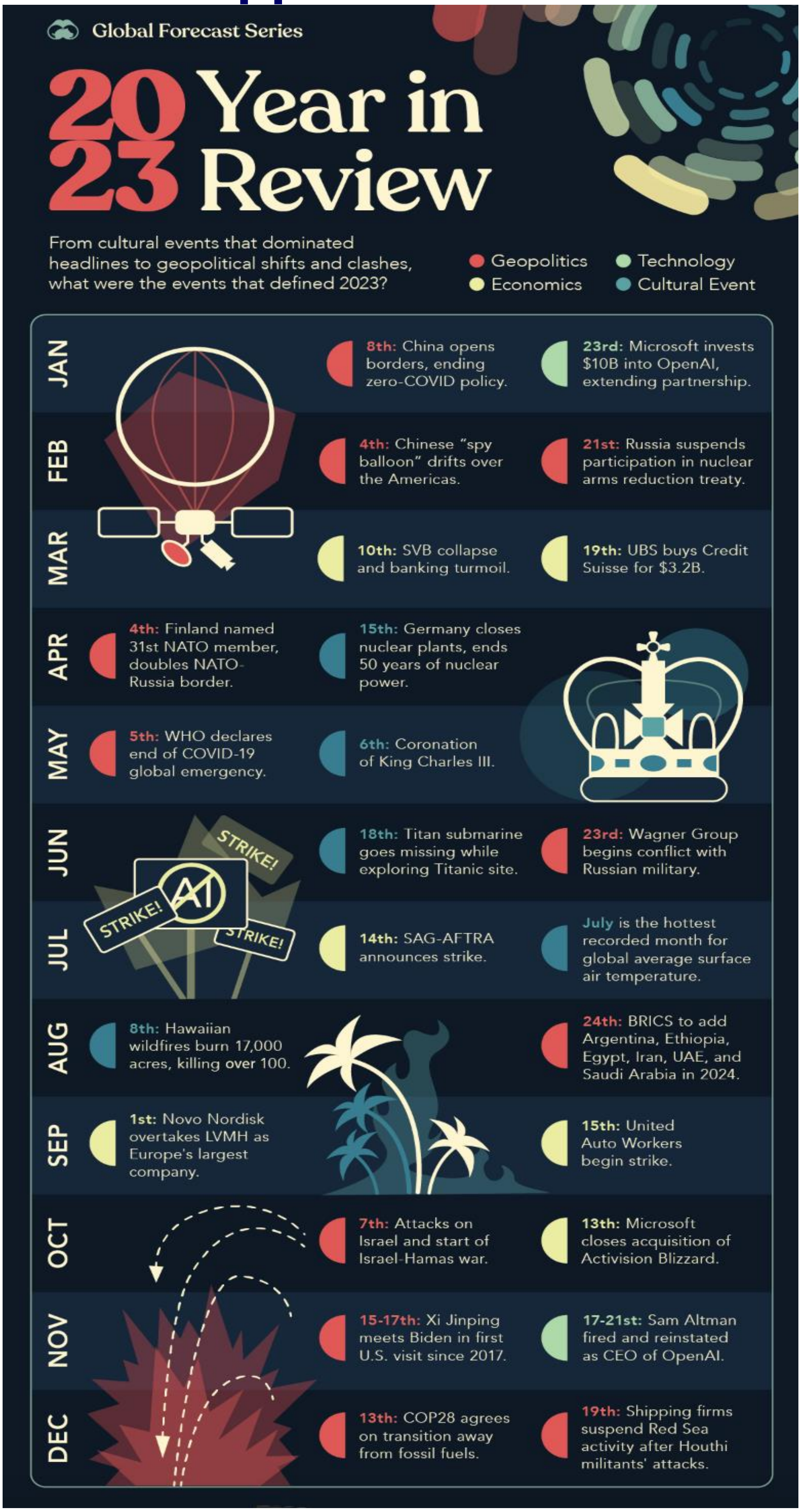
"People calculate too much and think too little."
Charlie Munger

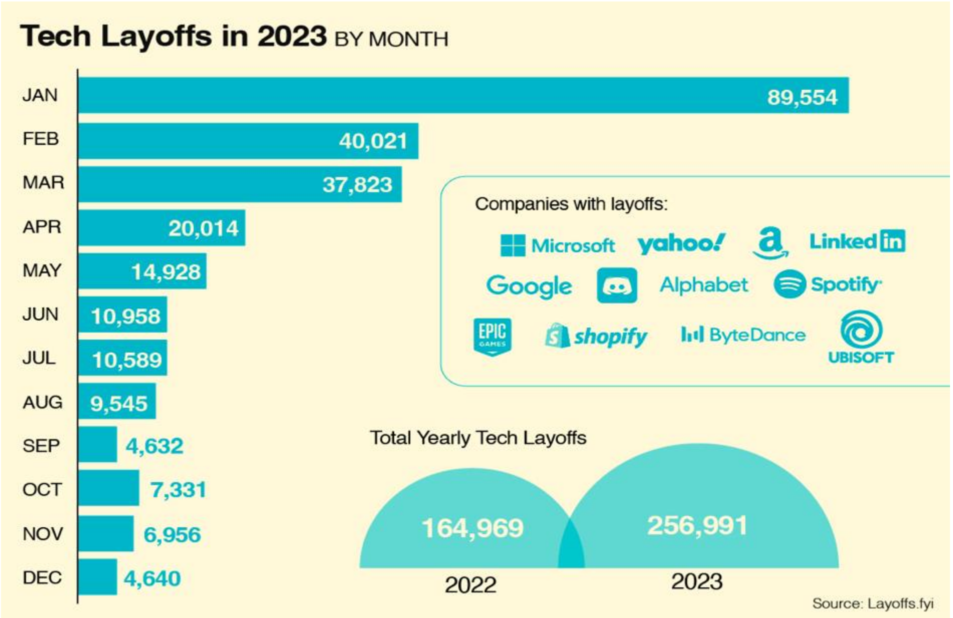
HAPPY NEW YEAR

It's not what you eat between Christmas and New year, it's what you eat between New Year and Christmas 😉

The Markets

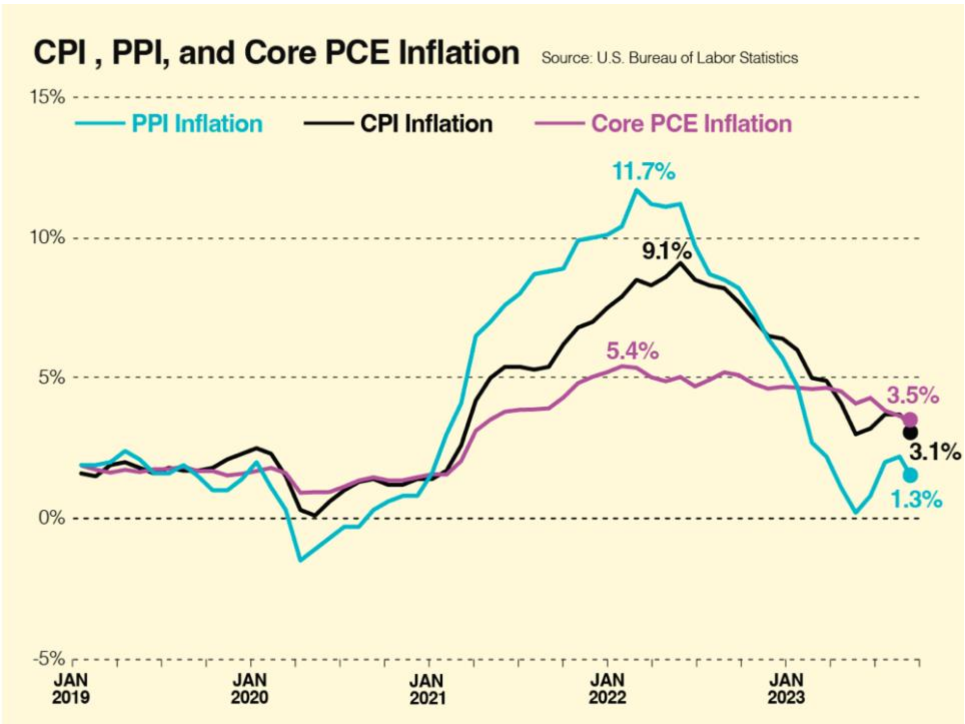
What’s happened and where to?





The diagram above shows the number of people laid off in the technology sector over 2023.

Changing market and economic conditions saw significant layoffs across the tech sector over 2023. Companies in the sector wisely adjusted their businesses to meet the post Covid environment, which became clearer as the impact of the virus reduced.



The graph above tracks three measures of inflation important to the US Fed. decision making on interest rates.

Inflation has declined and so interest rate rises in the US appear to be at an end currently. Indeed, markets are looking for a rate cut of 25 basis points in March.

The upside volatility over December.

This was how it was for the last month of 2023:

- The Dow Jones finished the month + 3.98**%**
- The S&P by + 4.40%
- The Nasdaq by + 5.90%

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% (-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 last year. The Dow Jones sits at 37,689 (as at 29 December 2023).

Although I am not making any predictions about random markets, generally, with the possibility of interest rate cuts on the way in 2024 in the US, markets may continue the (choppy) upward direction over 2024, all things equal.

The US share market – a 12 month look

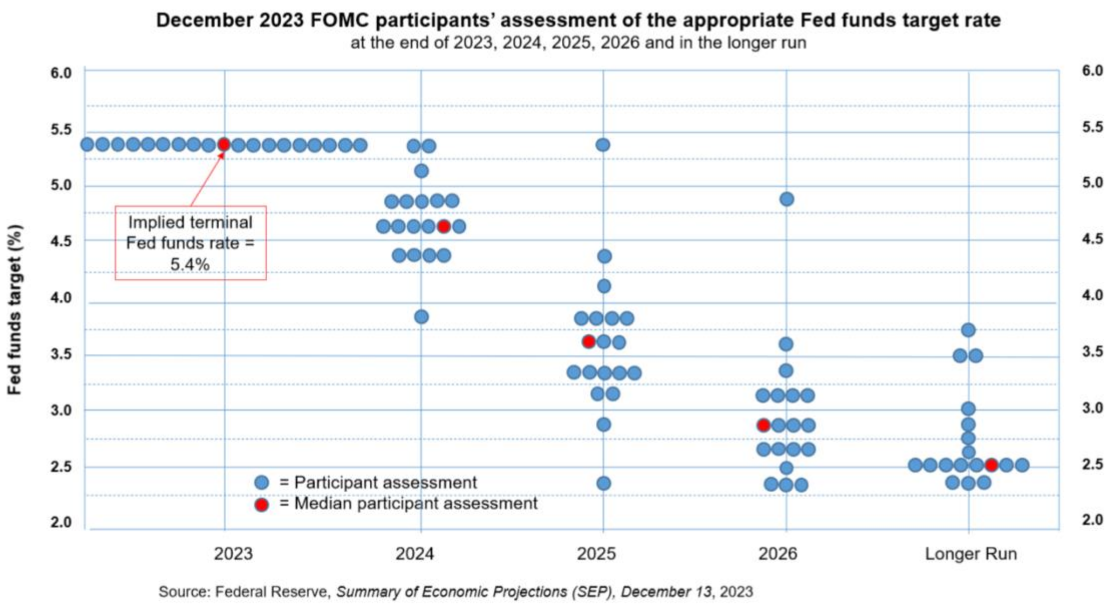
The chart above shows the US share market (the Dow Jones) over the last 12 months (to December 29 2023).

Interest rate cuts in the US will likely emerge over 2024 with some commentators suggesting a 75% probability of a 25 basis point cut in March. I was thinking later in the year but, if inflation continues to track down, then this could be a possibility.

Certainly, interest rate rises from the past are still biting across parts of the US economy (e.g. the US consumer, small business).

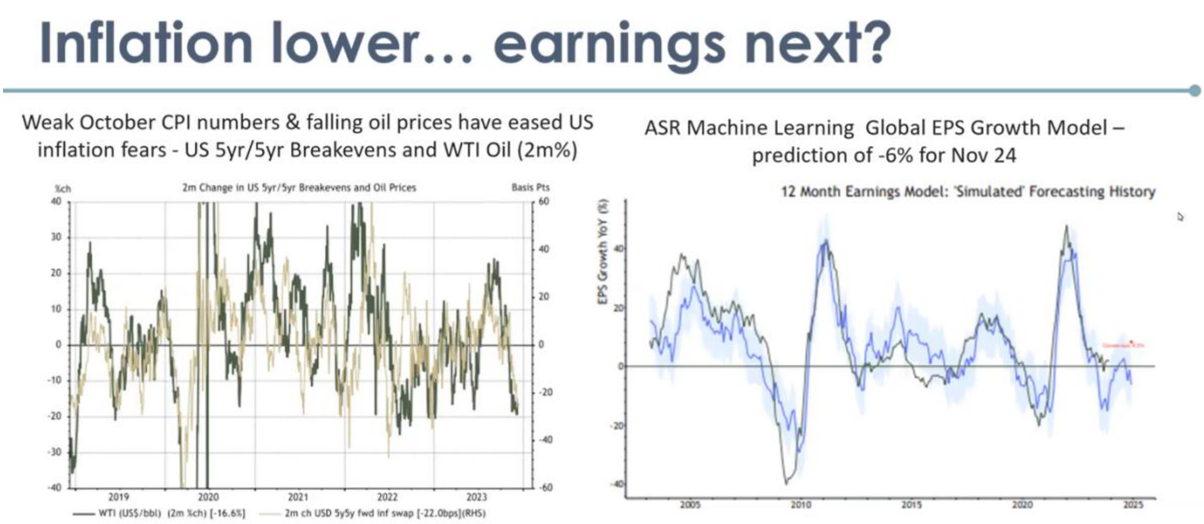
As I mentioned last month, trading prices in your portfolio may already reflect lower interest rates by the time they arrive. The point is that higher trading prices will need the support of earnings and revenue growth. Meantime, earnings and revenue growth may need to navigate recession like conditions (currently still looking like a soft landing though) and higher unemployment to some degree – little change here form last month.

The US Fed – interest rate direction



The graph above is 'the fed dot plot'. It shows the consensus thinking about interest rate direction in the US by the US Federal Reserve Open Market Committee (FOMC).

The red dots on the graph above suggest the Fed Funds Rate could decline to 4.6% this year and 3.6% in 2025. Certainly, the interest rate rises over that last couple of years are still biting so, the 'higher for longer' mantra around interest rates looks to be running out of steam.



The graph to the left tracks the US 5 year breakeven (see explanation below) and oil prices. The graph to the right shows possible earnings direction (rising or declining) based on modelling by ASR using their machine learning earnings growth model.

Markets sometimes use the US TIPS / Treasury Breakeven rate to project where inflation is heading over the next 5 years on average. The 5 year breakeven rate is calculated as the difference between the 5 year treasury rate and the 5 year treasury inflation indexed security rate – the gold line on the left side graph.

So, the left side graph above suggests current US Fed interest rate policy is tight, supported by the graph to the right showing that earnings growth looks sluggish, possibly declining near term.

The question here is whether lower inflation might lead to recession which in turn might result in negative earnings growth?

This all seems to point to interest rate cuts by the US Federal Reserve. Policy settings are tight and there is room for them to be loosened.

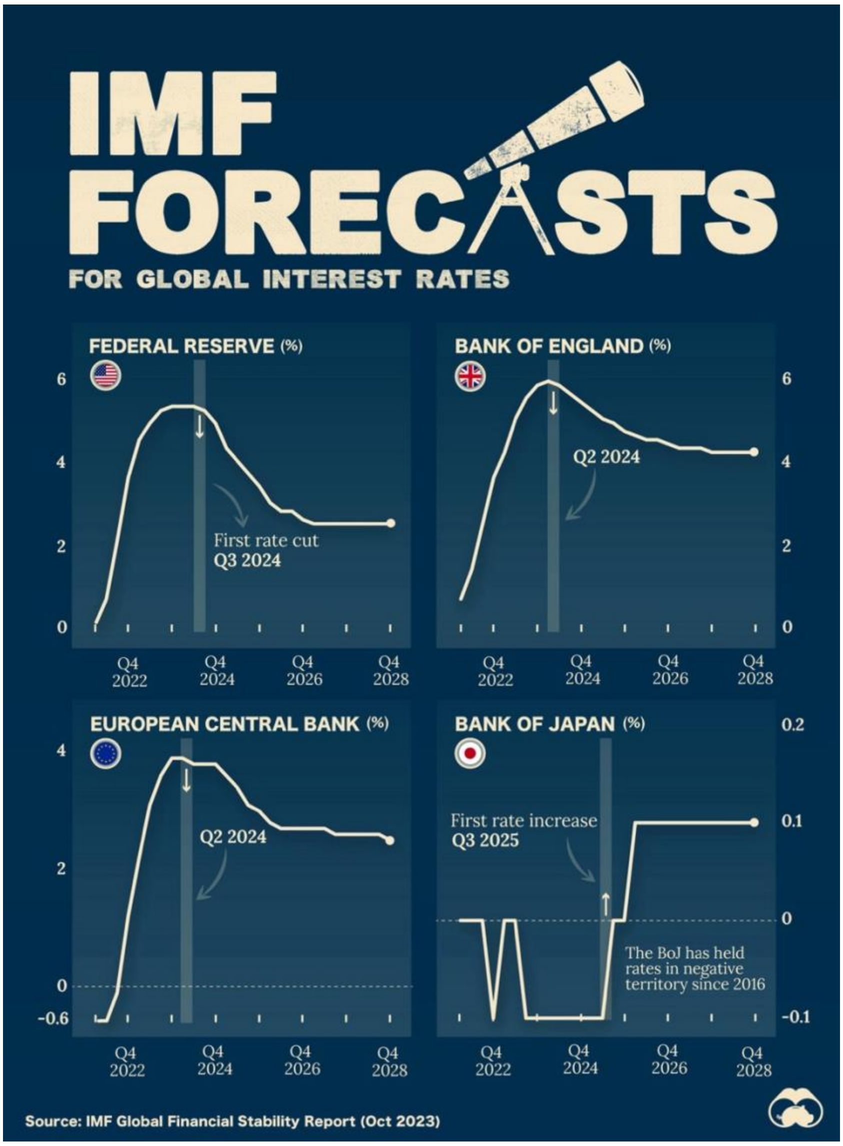
The Global Economy

By Morgan Edwards – brief bio

The beginning of another year signals yet more excitement in the world of international economics.

What can we expect from 2024 in the world of economics?

I suspect that – besides austerity - one of the core macroeconomic occurrences of the year will be the growing antagonism between interest rates and the rate of inflation. In other words, will central bankers stay the course on holding interest rates at current levels (if not higher) despite declining rates of inflation.



The graph above, sourced from Visual Capitalist, depicts expected interest rate movements for four internationally important central banks. These are the predictions of the International Monetary Fund (IMF).

I want to draw your attention to the graph on the bottom right. Despite ‘inflationary pressure’ and ‘the markets’, the Bank of Japan (BoJ) has maintained their negative interest rate policy.

Japan has always proven itself to be an extremely interesting case study in modern macroeconomics. In recent years, while the rest of the advanced world has engaged in ‘monetary tightening’ (i.e interest rate rises), Japan has stayed the course with a high degree of success. While we can’t compare apples and oranges (Japan’s economic history over the past three or four decades makes it a very different beast), the same monetary dynamics are present.

It is also worth noting that the interest rate policy of the BoJ doesn’t so much represent monetary stimulus, but instead represents the reality that interest rates don't work as many might think they would.

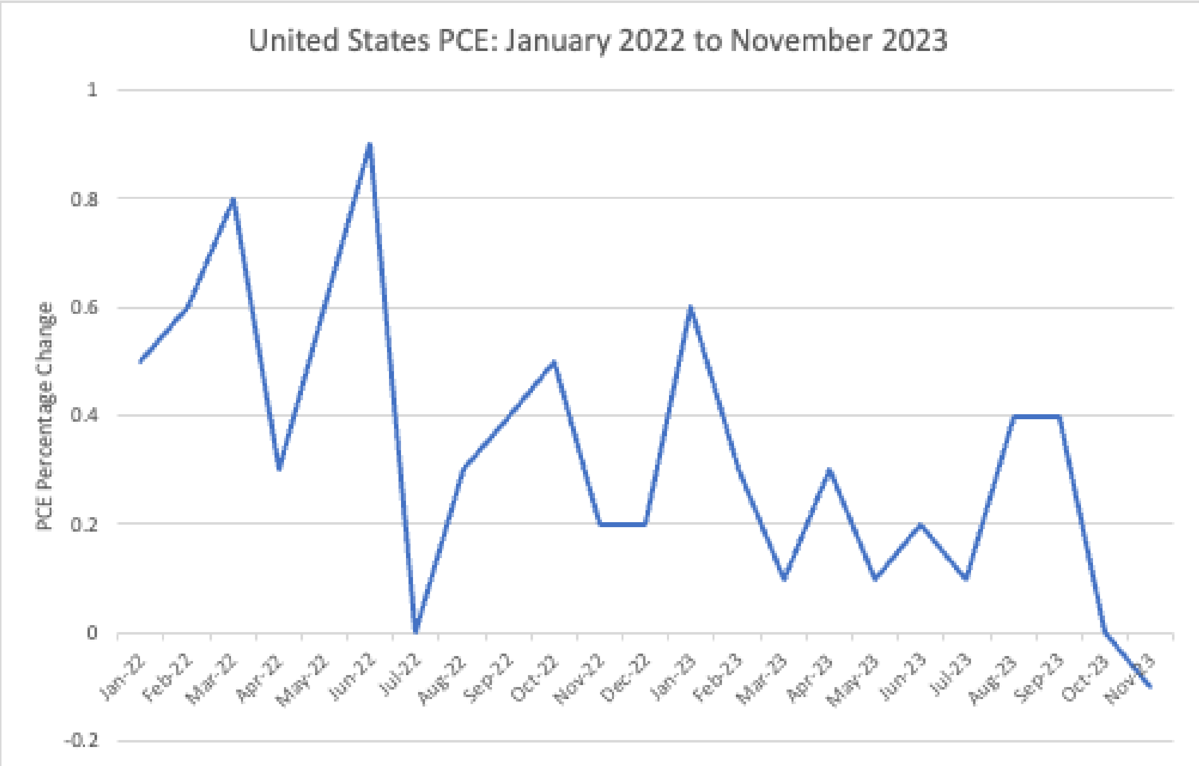
I’m referring to the fact that interest rate policy is really implemented through government bond issuance and open market operations designed to meet target interest rates. The Japanese have done this well, especially over the past 10 years.

Out of interest (no puns intended), it will be worth keeping an eye on Japanese economic activity over the coming months.

Now, on to our first economic tour of the year.

America

Inflation has continued to cool in the United States, with inflation as measured through personal core expenditure (PCE) declining -0.1 on a monthly basis.

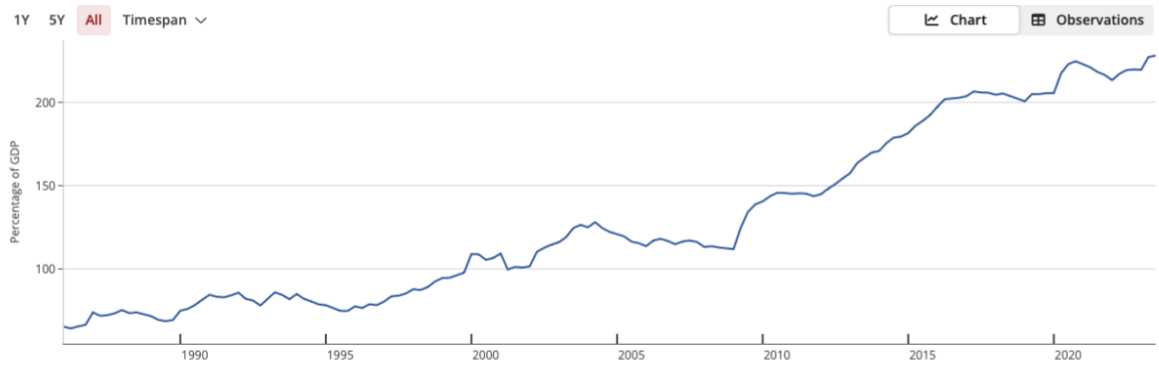


The graph above depicts PCE on a monthly basis since January 2022.

On an annual basis, inflation is up 3.2% on November 2022. This signals a positive movement in inflation that central bankers – namely the Fed – will be happy about. However, this is no surprise given that supply factors critical in causing the inflation in the first place have abated significantly over the past year or so.

China

Interesting piece (it is paywalled, but can be found here: https://www.ft.com/content/b809c735-5ae7-433f-964d-f12ca7320538) detailing the 'sidelining' of the People's Bank of China (PBoC), a once crucial player in international economic affairs. During the halcyon days of the PBoCs reign, it led China's domestic financial liberalisation, accession of the Yuan into the IMF's basket of currencies (the SDR), and the post-2008 recovery.



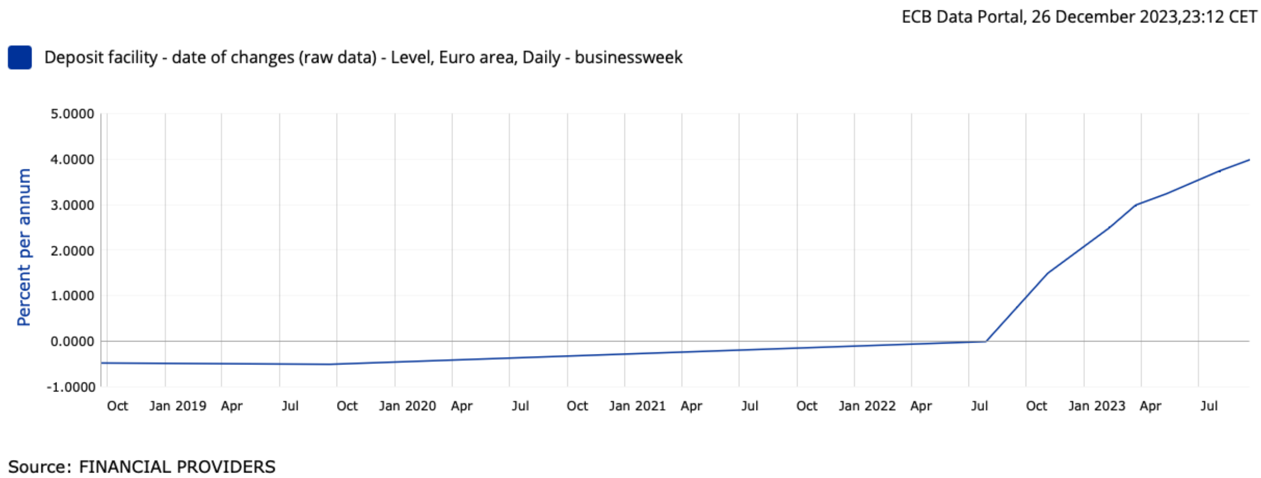
The graph above depicts one of my very favourite datasets – credit to the private non-financial sector in China.

You can very clearly see the near vertical increase in credit to the private non-financial sector in the aftermath of the 2008 GFC. Therefore, you can imagine that there is less capacity to engage with such a rampant credit growth in more recent times. China's internal ructions, as ever, will be an interesting thing to keep our eyes on over the coming months.

Euro Area

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

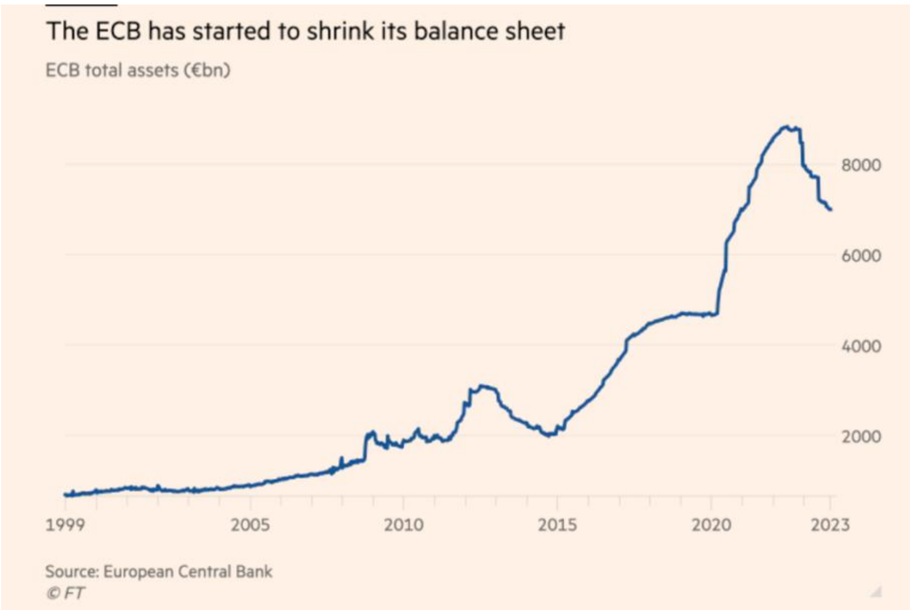
The ECB kept interest rates steady at its meeting in December 2023. The ECB noted that there is scope for inflation and thus interest rates to increase over 2024. Moreover, the Governing Council noted their determination to keep "sufficiently restrictive levels for as long as necessary".



The graph above depicts the deposit facility over the past five years. This rate is one of the three interest rates decided at the meeting of the Governing Council.

While this is exciting news for inflation hawks, there is still uncertainty about external impacts (i.e., the War in Ukraine) on supply in the Euro Area, although the economy appears rather resilient to these impacts now.

However, some members of the ECB's Governing Council point to elevated wages as a continued concern for inflation. More continued ideological dogma here. A real concern is the coming austerity push, owing to the restrictive fiscal rules of the Stability and Growth Pact (SGP) in the Euro Area.



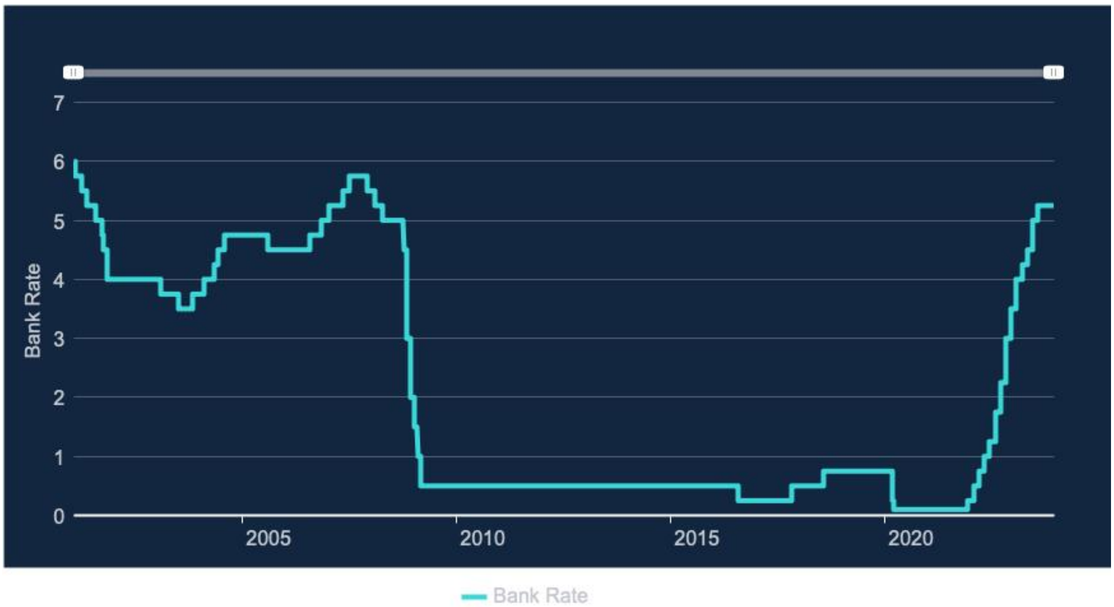
The graph above depicts the ECB's balance sheet since its inception in 1999. Here, you can clearly see the rather large increase in 2020.

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 Eruo has not collapsed – yet.

United Kingdom

At its December 14 meeting, the Bank of England left interest rates unchanged at 5.25%.



The graph above depicts the path of interest rates in the UK since 2001.

It will be interesting to see how the BoE deals to inflation over 2024, especially as the inflation rate continues to fall. Fuel and food prices are both lower, contributing to an annual inflation rate of 3.9%.

Australia

In Australia, inflation remains strong – apparently. The Reserve Bank of Australia (RBA) decided to maintain interest rates at 4.35%.

The graph above depicts the cash rate target (i.e., the official cash rate) between 1990 and the present day.

The RBA note that the risk of inflation remains higher for longer and this may necessitate higher interest rates in the coming months. However, 'the monthly CPI indicator for October suggested that inflation is continuing to moderate, driven by the goods sector; the inflation update did not, however, provide much more information on services inflation'.

Given the flow through effects of interest rates into the services industry (i.e., interest costs are key input costs), it is safe to assume that elevated service costs are a direct result of elevated interest rates.

New Zealand

SO many interesting things look set to happen in New Zealand over the coming 12 months. From the coming austerity and the resulting impacts on economic, social and financial conditions, Three Waters reform, to the Annual Fiscal Statement (the 'budget') in May, the year will be jam packed with interesting events.

Already, the redirection of the Interislander project and the continued warnings about 'fiscal cliffs' warn us of an impending austerity push from this government.

Enough of all that. Let's begin the year with New Zealanders' favourite economic topic – house prices. The latest QV house price data for all of New Zealand (as measured at 1 November 2023) indicates a -3.3% decline in the average house price on the year prior.

The graph above depicts the average house price in New Zealand since November 2018.

Here, you can see the impact of monetary loosening, namely the *portfolio rebalancing effects of quantitative easing,* on New Zealand house prices. However, note that house prices have increased steadily since ~Q2 2023 despite increased interest rates. While this doesn't necessarily have any implications for interest rate setting by the RBNZ, it does indicate the resilience of the housing market to elevated interest rates and investors' preference for holding onto houses.

In Conclusion

2024 is shaping up to be a very interesting year macroeconomically. As well as interest rate movements over the next 12 months, I can assure you that there will be far more important economic happenings.

I suspect that these economic outcomes may determine political occurrences (i.e., elections) and create further price increases (i.e., rates as a result the infrastructure crisis in New Zealand) for many people. Time will tell.

Until next time!

Cartoon by Inkcinct.com.au

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