➢Market and Economic Update – July 2024

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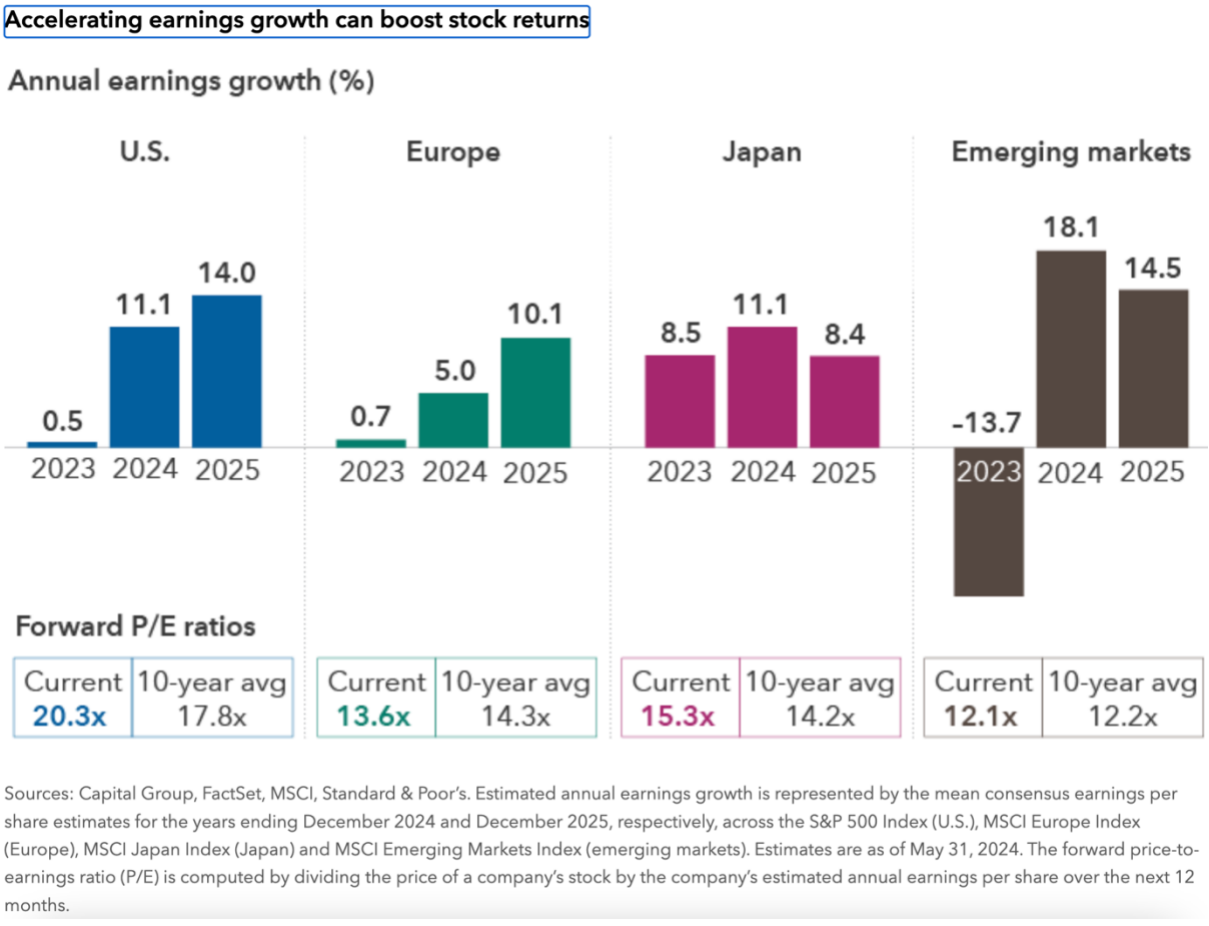
"People calculate too much and think too little."

-Charlie Munger

The Markets

Heading in the right direction



The graph above shows earnings growth rates over 2023, 2024 and 2025 across the US, Europe, Japan and Emerging Markets.

US economic growth slowed earlier this year but may still provide a suitable environment for companies across the market to grow revenue and earnings.

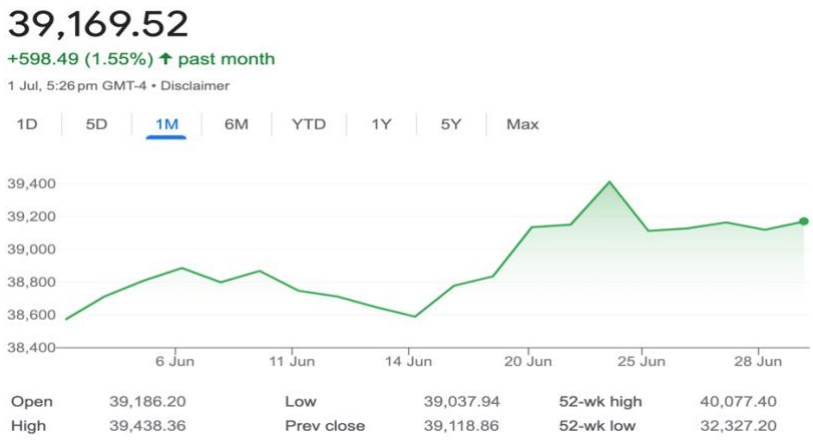
Looking at forward P/E ratios too (see the graph above), we can see that markets are generally not overly expensive by this measure (but not in bargain territory).

Global geopolitical tensions flare up from time to time, although currently, inflation and interest rates are key to market direction short term.

I am simplifying it all but generally, markets and many businesses within the market are tracking in the right direction. Stable economic growth plus interest rate cuts should help support buoyant markets in the short to medium term (all things equal).

Lower interest rates, for example, helps free up market and economic activity generally and also makes it easier for businesses to execute their expansion plans.

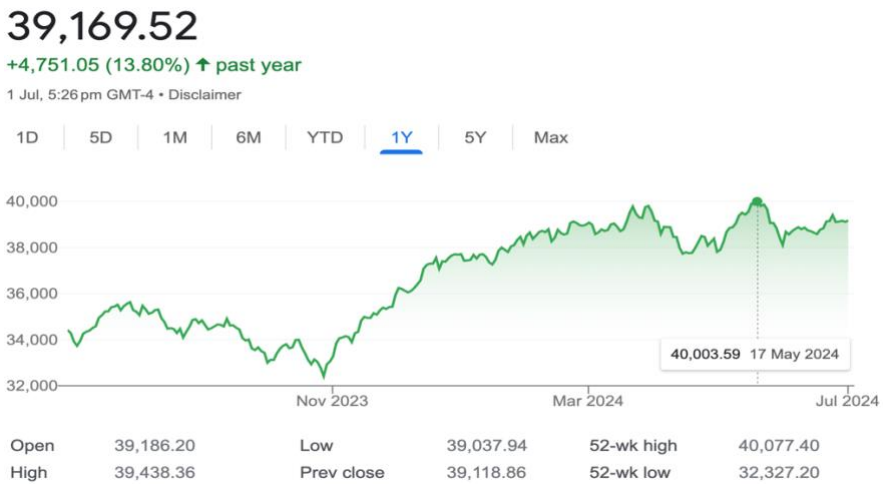
The US Share Market Over June 2024



The above graph tracks the movement in the Dow Jones Industrial Index over June 2024

Markets are up, enjoying the surge in popularity of chip manufacturing companies and AI. Hopefully, improving business fundamentals will spread more widely across other sectors and other businesses.

The US Share Market July 2023 – June 2024



The above graph tracks the movement in the Dow Jones over the last 12 month's, showing the all-time high reached May 17, 2024.

The upside volatility over June 2024.
This was how it went for the sixth month of 2024:

- The Dow Jones finished the month + 1.97%
- The S&P500 by + 4.27%
- The Nasdaq by + 7.13%

The upside volatility over May 2024.
This was how it went for the fifth month of 2024:

- The Dow Jones finished the month + 0.78%
- The S&P500 by + 3.97%
- The Nasdaq by + 6.89%

The downside volatility over April 2024.
This was how it went for the fourth month of 2024:

- The Dow Jones finished the month –3.23%
- The S&P500 by –3.60%
- The Nasdaq by –3.91%

The upside volatility over March 2024.
The third month of 2024:

- The Dow Jones finished the month + 2.08**%**
- The S&P500 by + 3.10%
- The Nasdaq by + 1.79%

The upside volatility over February 2024.
This was how it went for the second month of 2024:

- The Dow Jones finished the month + 1.84**%**
- The S&P by + 3.93%
- The Nasdaq by + 4.34%

The upside volatility over January 2024.
This was how it went for the first month of 2024:

- The Dow Jones finished the month + 1.22**%**
- The S&P by + 1.59%
- The Nasdaq by + 1.20%

The upside volatility over December 2023.
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:

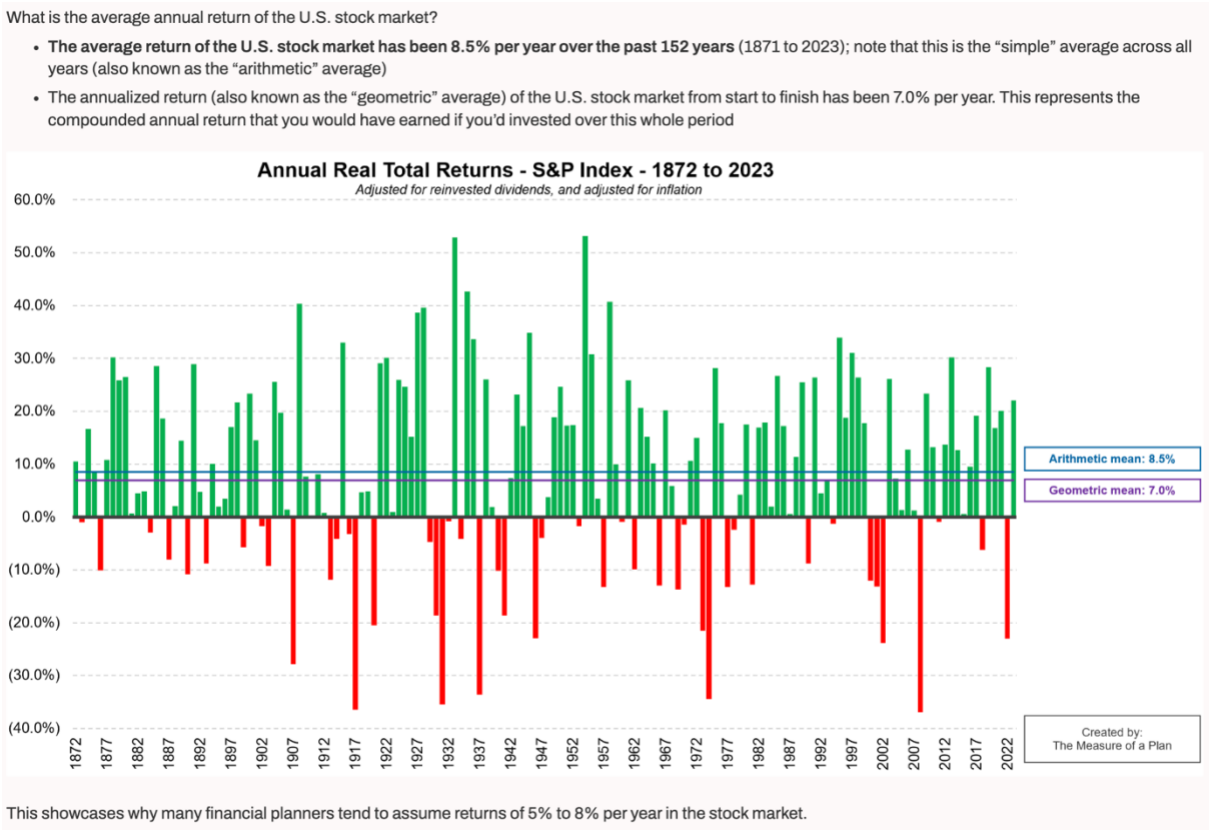
- The Dow Jones finished the month down -1.14**%**
- The S&P by -2.21%
- The Nasdaq by -3.43%

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%

From the peak of 35,630 on August 01, 2023, The Dow Jones Industrial Index declined to 32,417 by the end of October 2023. The Dow Jones currently sits at 39,169 as of July 01, 2024.

Random markets and investment returns



The graph above shows the rise or fall in the US share market (the S&P 500) each year and the 'average return' using both the arithmetic mean and the geometric mean.

Trying to make money by timing the share market can work short term, but becomes increasingly difficult, the longer you go. Markets are random.

20% per annum returns are also achievable short term, but the longer you go, the more difficult they become to repeat, at will.

Investing in quality businesses helps reduce the need to play the markets. This approach also reduces the need to continually trade, helping minimise costs and timing/pricing mistakes.

Markets and trading prices rising and falling is not the same thing as operational profit and free cash flow in a business.

The last mile and rate cuts

As mentioned last month, 'the last mile' is about getting inflation down to 2% in the US. Not easy.

The US Fed will need to continue to 'hold the line' by keeping interest rates elevated to get on top and stay on top of inflation. Markets meantime are watching closely for any signal of a rate cut.

Inflation needs to continue to decline, unemployment needs to rise in the US. We are not there yet.

Where to next?

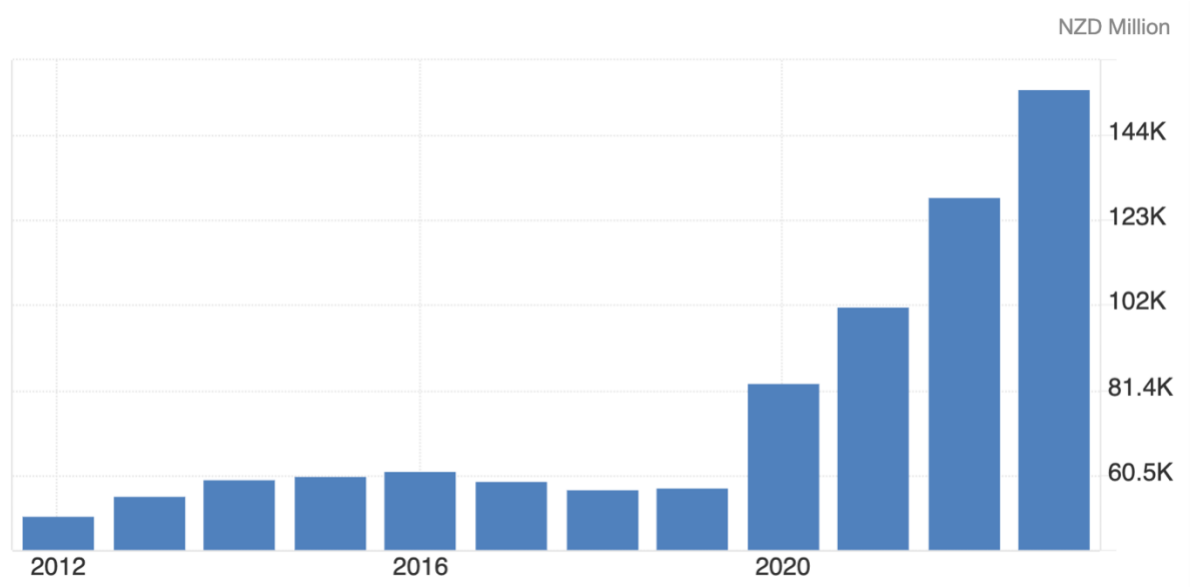
Aside from chip manufacturing and general AI excitement, we really want to see a more broadly based improvement in company fundamentals. That may mean a sustainably rising market longer term. Rising trading prices are fine although we want them to stay up there!

Hopefully there will be more volatility so we can take advantage of better pricing along the way too.

The Global Economy

By Morgan Edwards – brief bio

Government Debt - NZ



The graph above tracks government debt in New Zealand

Government debt in New Zealand increased to NZ$155.3 billion in 2023, up from NZ$128.8 billion in 2022 and a record low of NZ$405 million in 1972. Source: New Zealand Treasury.

So, What About Government Debt?

As promised in last month's economic update, this introductory section will tackle government bonds.

When we think of government bonds, we think that the government issues these to 'fund the deficit'. As we noted last month, the state is self-financing, so this can't really be the case.

So, what are the uses of government bonds?

This is a bit complicated and very different to how government 'debt' is commonly perceived, so strap yourselves in.

There are three primary uses for government bonds in a modern economy,

The first use of government bonds is 'cash-management', although this has nothing strictly to do with cash. As noted by Berkeley, Tye and Wilson in their work 'An Accounting Model of the UK Exchequer', they describe that 'the activities [issuing bonds] of the Debt Management Office [DMO] are essentially rooted in monetary policy and are concerned with managing the effect of the government's financial flows on the wider monetary system rather than representing a provisioning exercise for government'.

The brilliant paper 'the Self-Financing State', written by those same authors along with Asker Voldsgaard and Joshua Ryan-Collins of University College London's Institute for Innovation and Public Policy (IIPP), expands on this.

As described in the UCL paper, the objective of the DMO is 'to drain any reserves which have been added to the banking system on days of net spending, or to return reserves which have been removed from the banking sector on days of net revenue.

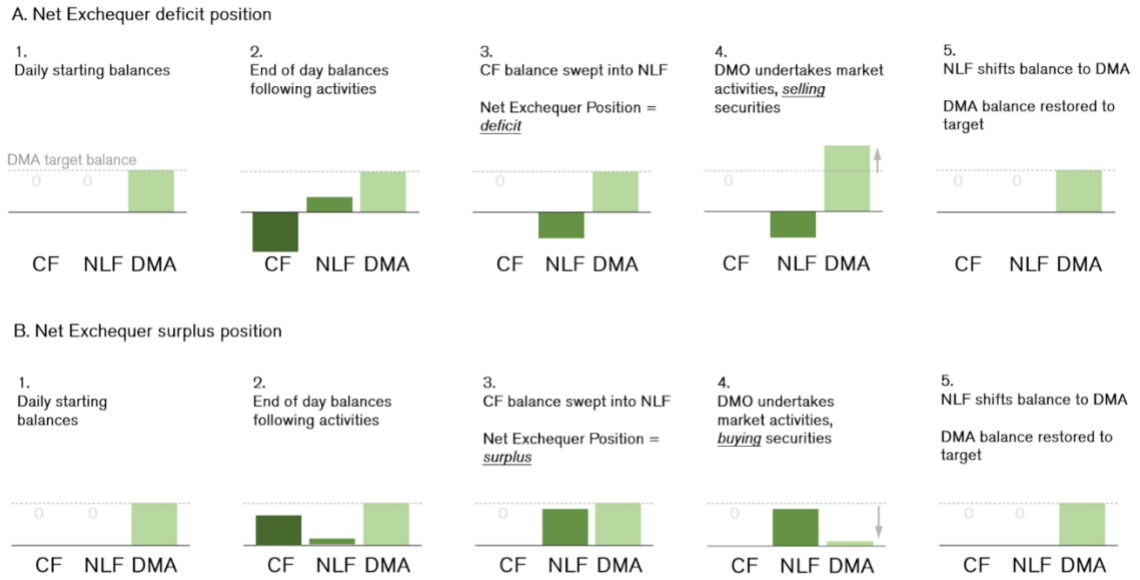
This is achieved by way of the trading of government securities in quantities which reflexively match the (anticipated) NEP [net Exchequer position].

To simplify, if there is too much money sloshing around within the banking system as a result of a government deficit at the end of the day, the DMO trades bonds with the banking sector, either to drain (if there is a surplus)

or inject (if there's a deficit) the amount of reserves that would offset the spending impact of the net Exchequer (Treasury) position.

This is shown in steps four and five of the figure below.

Figure 6: Cash management with daily fiscal deficit and surplus



Note: All balances reflect each entity's position vis-à-vis the Bank of England. CF: Consolidated Fund. NLF: National Loans Fund. DMA: Debt Management Account controlled by the Debt Management Office (DMO).

The figure above shows the process described in the previous paragraph. Note that I haven't explained the whole process – it is a wee bit too long to relegate to a few paragraphs. For more, read this: https://www.ucl.ac.uk/bartlett/public-purpose/publications/2022/may/self-financing-state-institutional-analysis

While of course this is in the context of the UK economy, the same process *can be assumed* to occur in the same way in New Zealand. The only difference would be the accounting structures between the UK government and the NZ government.

Of course, the other two purposes of government 'debt' include interest rate control and the use of government bonds as a safe investment asset.

Interest rate control was demonstrated through quantitative easing (QE), where central banks marked up the reserve accounts of commercial banks at the central bank in exchange for their holdings of government bonds.

In turn, this would ease the quantity of bonds in circulation (hence the term quantitative easing), thus raising the price and lowering the interest rate on the bond. Note that this does *not* in any way increase the ability of the bank to lend. Government bonds are a safe investment asset because, well, the government can't go broke.

While this is a complicated (as promised last month) departure from how we conventionally see government bonds, the reality is much more interesting. Moreover, this allows us to really understand what is going on when the government issues bonds.

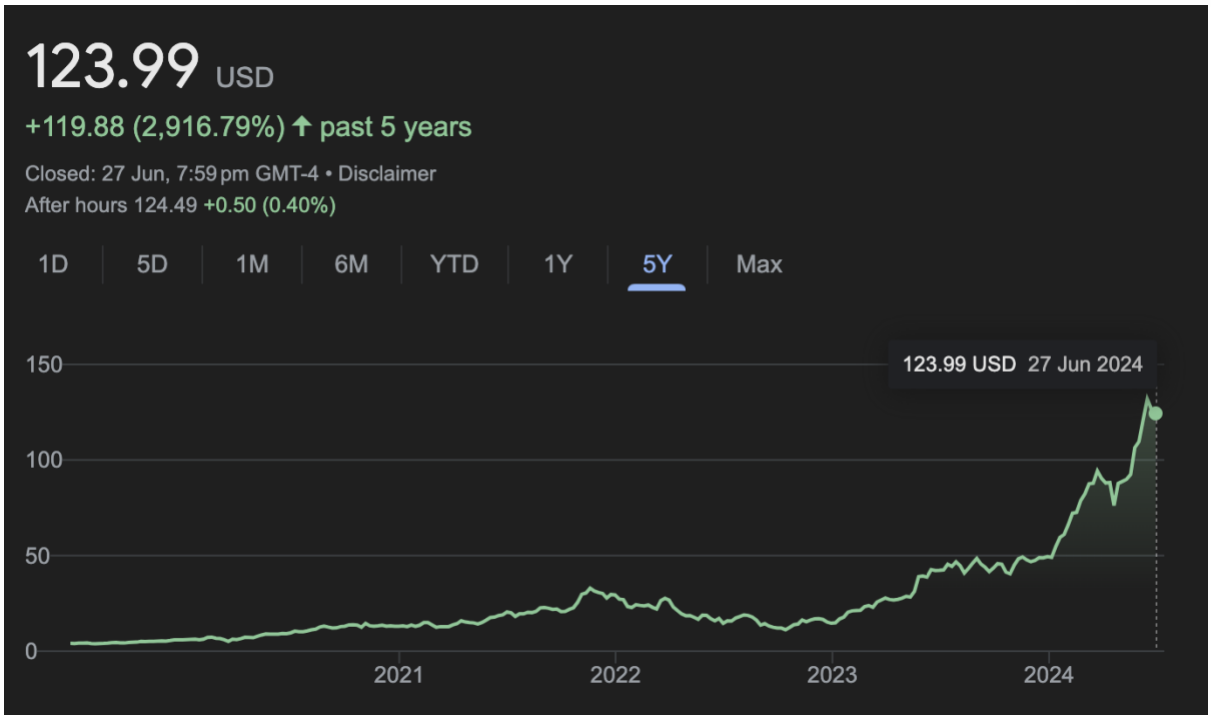
With that, let's begin our monthly trip around the global economy.

United States

An important question for the future of the global economy is what the role of artificial intelligence (AI) will be.

While the jury is still kind of out, there is no doubt that AI will aid in performing really laborious tasks.

We have already seen this with the shift from the London Interbank Offered Rate (LIBOR) to the Interbank Offered Rate (IBOR), where AI saved hundreds of thousands of man hours by allowing banks to 'get through documents in efficient fashion'.



The graph above shows NVIDIA's share price over the past five years.

During the course of the past two or so years, AI technology has accelerated immensely. This has been shown in recent years, and especially over the past week, by NVIDIA.

NVIDIA's processors dominate the AI market for the moment. In June (on June 19, to be exact), NVIDIA briefly became the world's most valuable company with a value of $3.33 trillion USD.

As AI improves more, and thus becomes even more widely used in our devices, there will be numerous opportunities for investors to gain from companies pursuing AI. These opportunities are likely to emanate from the United States.

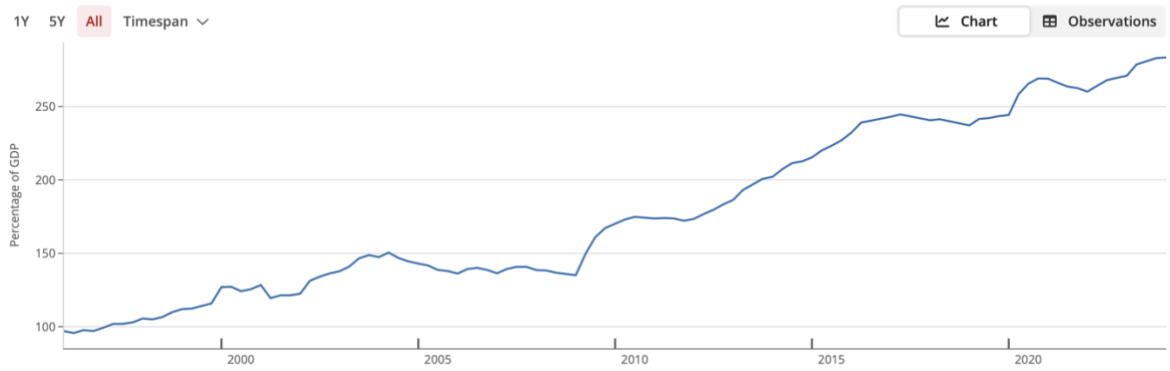
China

In China, look at the latest total credit to the non-financial sector data released by the Bank for International Settlements.

Remember that this graph shows *total* credit, which is in fact debt.

Credit is the flow (represented as the annual change of debt), and debt is the stock (the total cumulative credit that must be repaid). This data serves as important bellwether for the Chinese economy (and others, of course).

China - Credit from All sectors to Non financial sector at Market value, Percentage of GDP, Adjusted for breaks



The graph above depicts credit to the non-financial sector in China between Q4 1995 and Q4 2023

As you can see, credit(debt) in China remained on a broadly increasing trajectory, implying that demand is stable (for now). I always point this out – look at the rise in China's credit(debt) in 2008.

Like the economic rise of Japan in the 1980s, this is what has helped to secure their economic rise during the post-2008 Global Financial Crisis era.

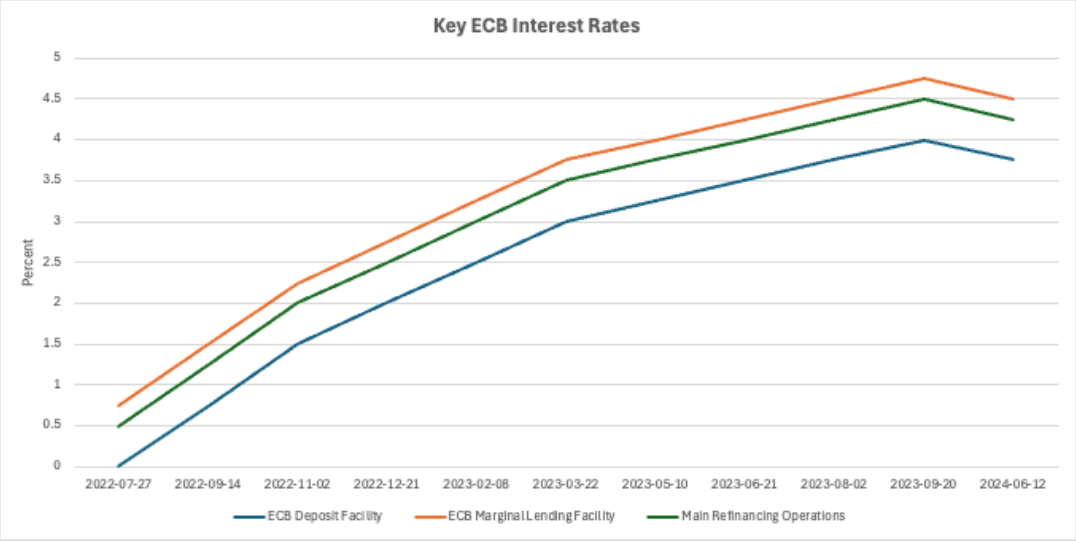
Slightly elevated debt to GDP (from 282.9% to 283.4%) indicates that credit is still expanding relative to GDP, indicating demand for credit(debt). If this continues to grow, then the end might not be nigh for China's miracle.

Euro Area

As expected, the European Central Bank (ECB) lowered their key interest rates by 25 basis points each.

The ECB Monetary Policy Committee noted that 'Since the Governing Council meeting in September 2023, inflation has fallen by more than 2.5 percentage points and the inflation outlook has improved markedly.

Underlying inflation has also eased, reinforcing the signs that price pressures have weakened, and inflation expectations have declined at all horizons'.



The graph above shows the three key ECB interest rates at the date they were changed.

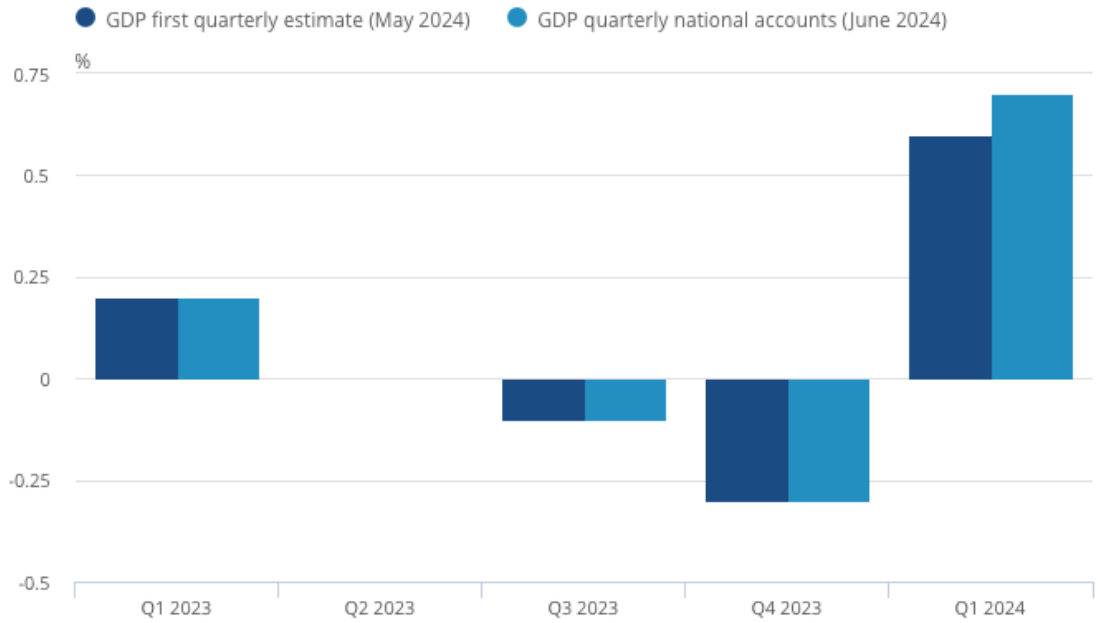
While this may not be the beginning of every central bank's 'loosening cycle' (as central bankers possess a more ideological belief that interest rates quell inflation, which may stop others like ours from lowering as quickly), the ECB's decision to cut interest rates does mark something of a turning point in the 'war against inflation'. Although, note that interest rates aren't the reason inflation is coming down…

United Kingdom

The UK economy picked up slightly in Q12024. However, according to Reuters, this has come too late for a Conservative Party election boost. The Office for National Statistics (ONS) reported that GDP lifted 0.7% from the previous December quarter (Q4).

Figure 1: Real GDP is estimated to have increased by 0.7% in Quarter 1 (Jan to Mar) 2024, revised up from the first estimate

UK, Quarter 1 2023 to Quarter 1 2024



Source: GDP quarterly national accounts from the Office for National Statistics

The graph above shows the estimate and final result for GDP data in the UK.

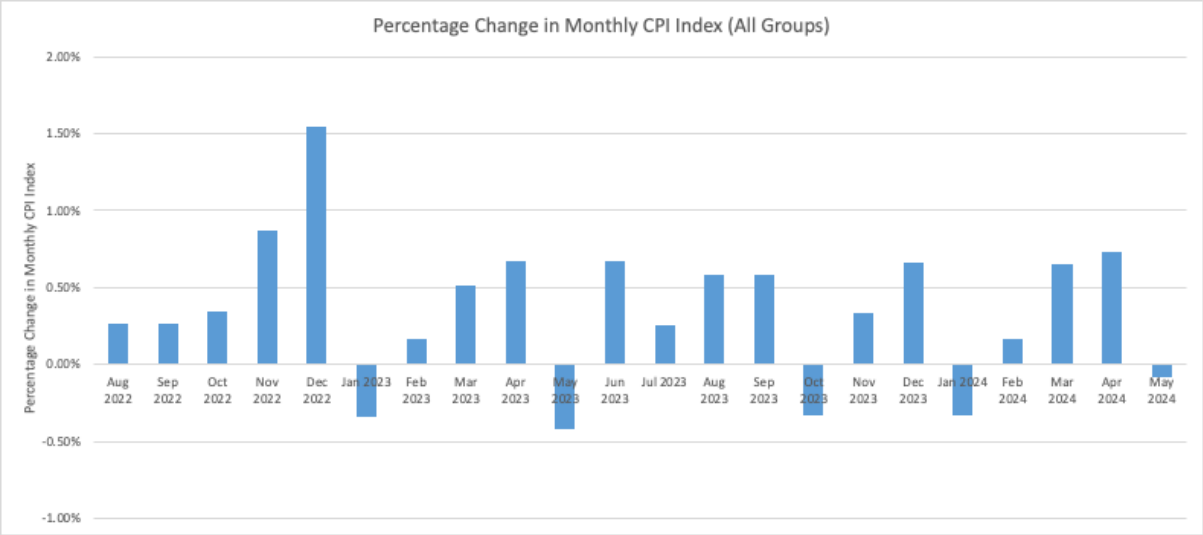
Importantly, the ONS reported that 'in expenditure terms, there were increases in the volume of net trade and household spending, partially offset by falls in gross capital formation and government consumption'.

Further, in output terms, 'services grew by 0.8% on the quarter with widespread growth across the sector; elsewhere the production sector grew by 0.6% while the construction sector fell by 0.6%'.

With the UK election days away (at the time of writing), it will be interesting to see what the first few post-election weeks hold for UK economic news.

Australia

The monthly CPI indicator in Australia rose 4.1% on an annual (May 2023 to May 2024) basis. While this is higher than pundits were anticipating, there is slightly more to be seen under the hood.



The graph above shows the percentage change in the CPI Index (All Groups) between August 2022 and May 2024.

As you can see in the graph, there was a slight *decline* in the all groups (including health, transport, electricity etc) monthly CPI index.

Of course, this implies that 'elevated inflation' in Australia isn't all its cracked up to be. The next Monetary Policy Committee meeting isn't until August, so it will be interesting to see the 'official line' from the Reserve Bank of Australia's take on this.

New Zealand

New Zealand is out of a recession, according to the latest GDP data from Stats New Zealand.

While this was celebrated, the decline in GDP per capita was lamented.

However, we turn to our friends at QV for some house price data.

The graph above shows the average house price in New Zealand from May 2019 to May 2024.

Here, it is clear as day to see the impact of low interest rates and the portfolio rebalancing channel of QE.

What's that I hear you ask? The portfolio rebalancing channel is where investors rebalance their portfolios away from assets like government bonds (i.e., interest bearing assets) and towards other investment assets – such as housing.

I suspect that it is no coincidence that as the QE programme (or large-scale asset purchase programme as the RBNZ called it) wound down, the average house price started to decline.

Presently, house prices appear relatively stable, but markedly lower than what they were a few years ago. I'd expect the house price to edge up slightly from now on.

It's also worth noting, as indicated from the same BIS data quoted earlier, that credit(debt) to the non-financial sector increased slightly in Q4 2023. This coincides with the uptick in average house prices in January 2024.

Conclusion

It seems to be that inflation continues to trend down across the developed world.

The antagonism between declining inflation and elevated interest rates seems to be continuing.

However, with the ECB first off the mark in lowering interest rates, it may only be a matter of months before other central banks follow their lead.

Until next month!