➢ Market and Economic Update – December 2024

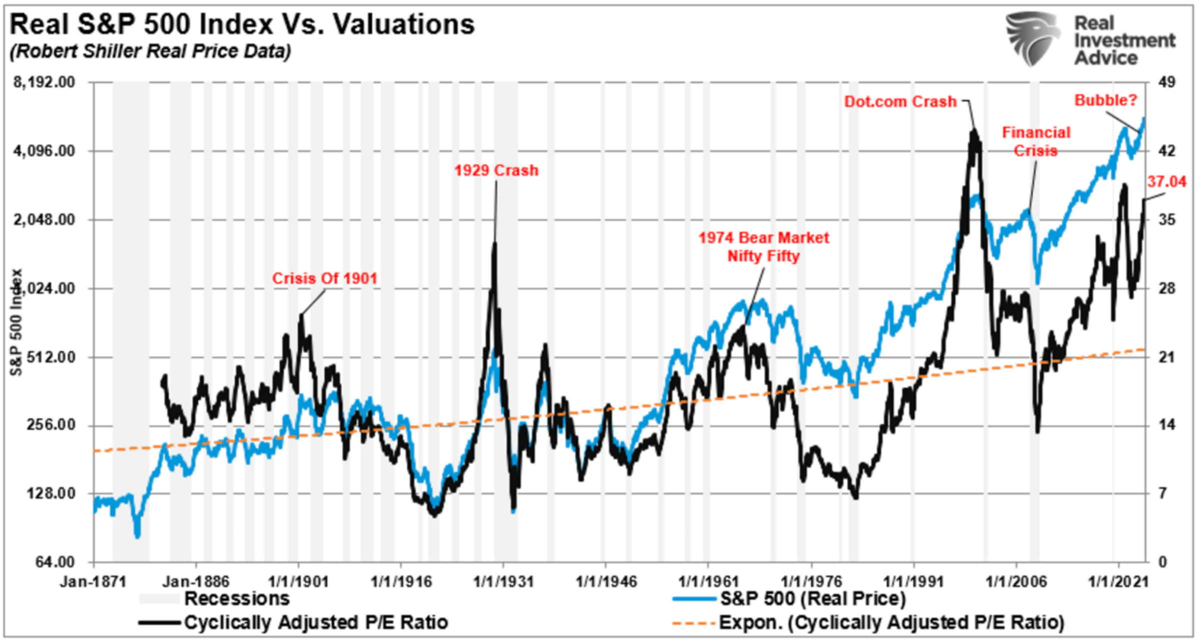
Peter Flannery CFP, FA

"People calculate too much and think too little."

-Charlie Munger

The Markets

The Share Market – has it peaked?



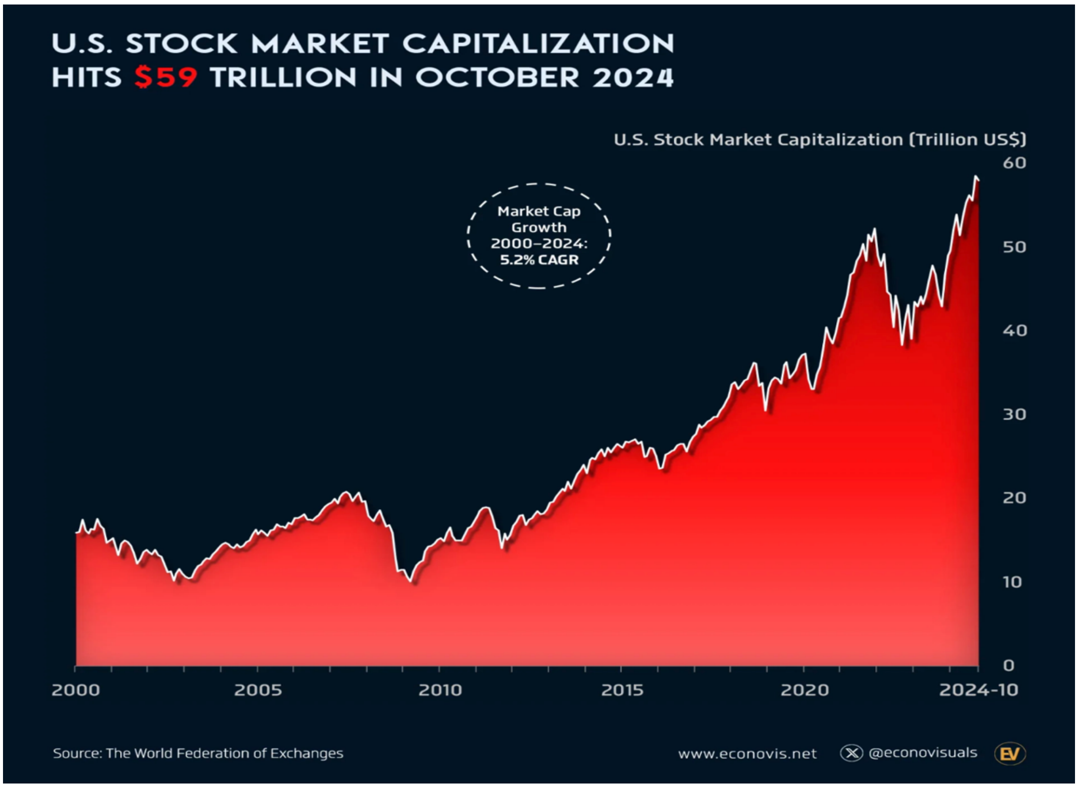
The graph above compares the cyclically adjusted P/E ratio (CAPE) with the (real, after inflation) S&P 500 index, going way back to January 1871. The cyclically adjusted P/E ratio is calculated by dividing the company's stock price by the average of the company's earnings over the last 10 years.

One of the common problems that many investors face is wanting to maximise returns but also wanting to avoid market corrections - have their cake and eat it too 😊

This can lead to some trying to time the market – bad idea. Tempting, but still a bad idea.

Better to invest in the business, let the market do its thing, and ignore the noise. That is obvious to some – apparently not easy for others. Isn't that interesting …

Has the US share market peaked?



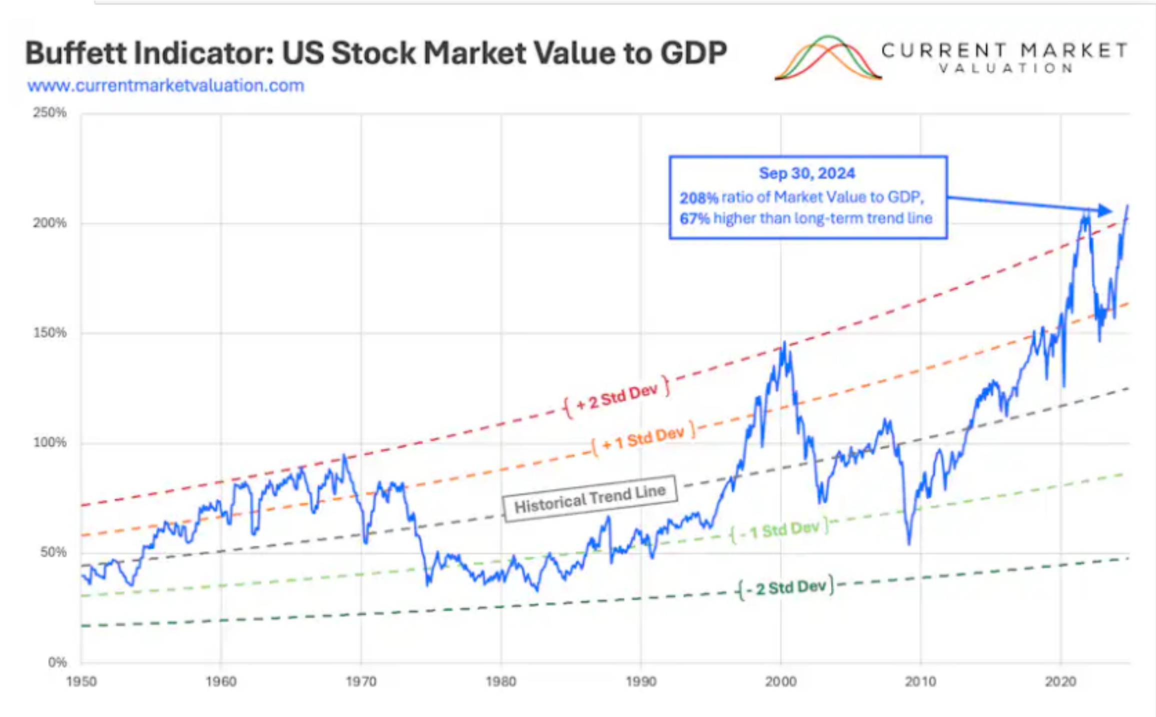
U.S. Stock (NYSE + Nasdaq - U.S.) Market Capitalization Hits $59 Trillion in October 2024.

The US share market is regularly setting new all-time highs. Has it peaked?

What we are seeing now that the US presidential elections are out of the way is the classic Bull/Bear market battle. In short, trading prices are high, but general market conditions, including the development of AI technology, suggest there might be strong growth and ongoing momentum ahead.

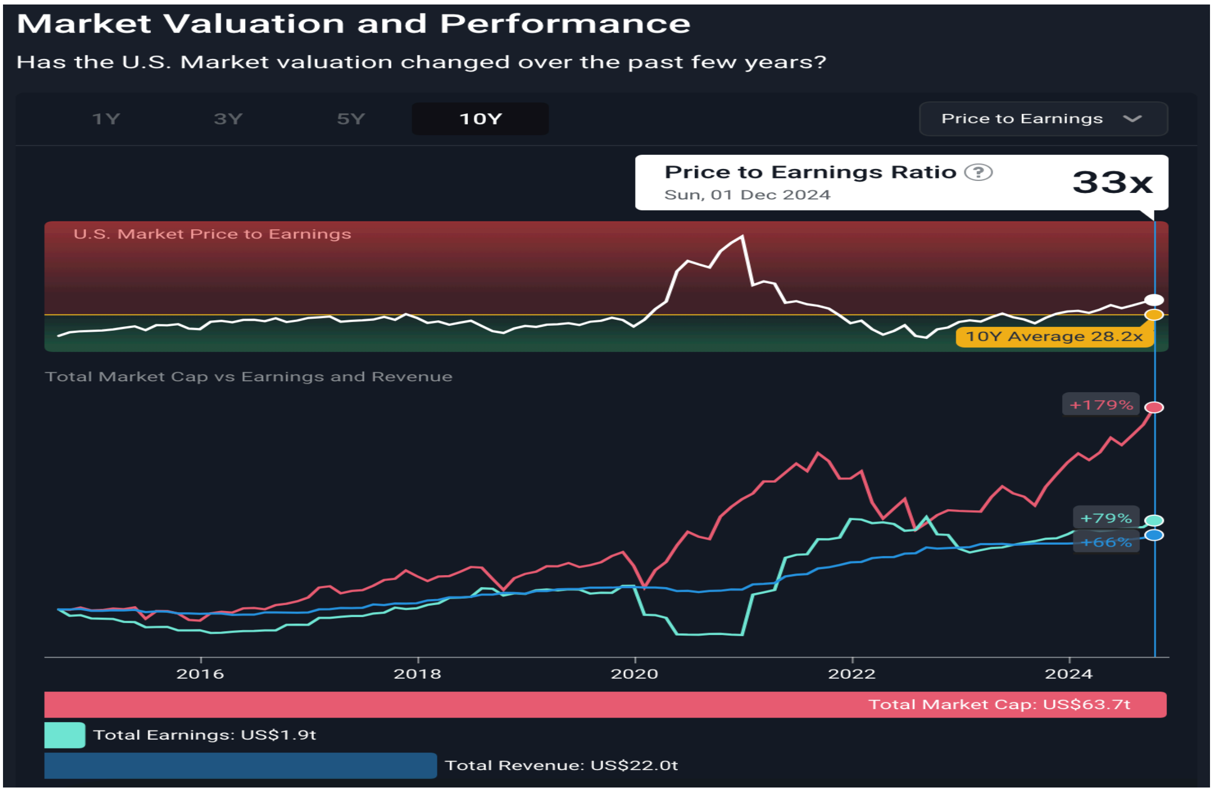
The two graphs above show pricing.

The next two graphs below look at value.



According to the Buffett Indicator, the share market (pricing) trades in the 4th quintile (well overvalued).

Looking at the US share market price-to-earnings ratio



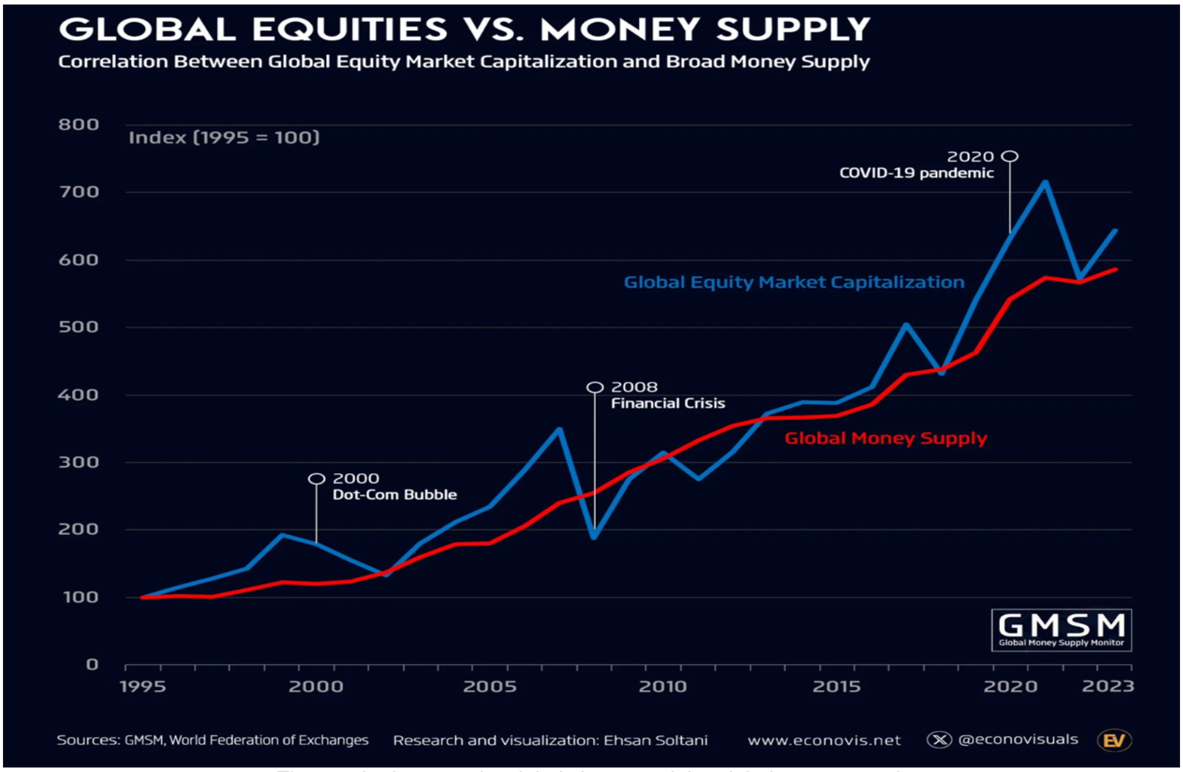
The graph above shows the change in the US price-to-earnings ratio over the last 10 years.

Ten years is not that long in investing terms. The long-term average p/e ratio is closer to 18x, so on that basis, one could reason that the 10-year average of 28.2x, whilst not far from the current 33x, is materially higher though, than the longer-term average of around 18.

Is that because of the ongoing liquidity bubble driving trading prices up, or because tech companies with lower capital costs in the recent past are more profitable than traditional 'bricks and mortar' companies and are more dominant across the market?

Capital markets have changed in many ways. The fundamentals of a company are analysed to some degree less now, with newer technology-based stock metrics more widely used. For example, growth stocks can be valued on their revenue growth or the number of new customers whilst still not making a profit. This approach can work (e.g. Xero here in NZ, Amazon in the US). However, not every rising star is as successful as Xero and Amazon. Indeed, they are in a very small club.

Liquidity, a key driver of market prices



The graph above tracks global shares and the global money supply

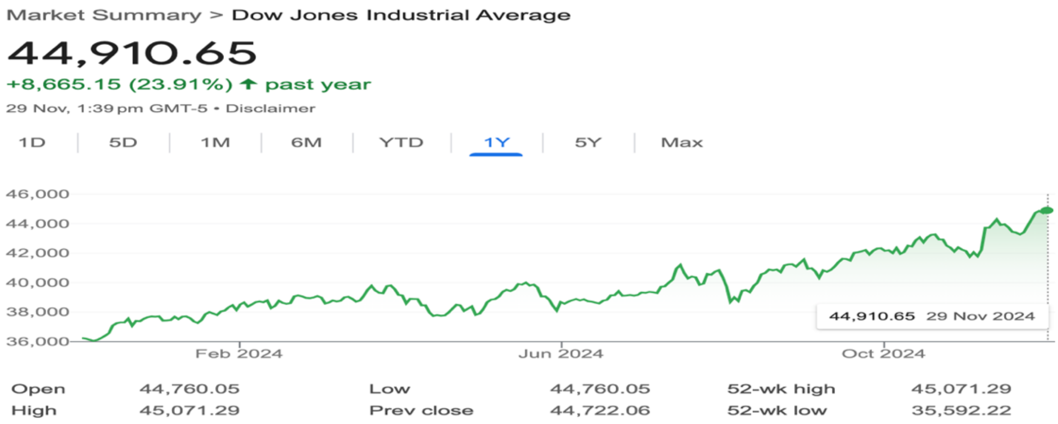
The markets respond to increased liquidity (rise) and decreased liquidity (fall). Liquidity, in some ways, is like 'oxygen' to markets. You can see why Central Banks around the world have developed many tools that control/influence liquidity.

Anyway, as I was saying, the narrative among market analysts and markets generally is just not the same as it was 20 years ago – rightly or wrongly. The way the markets analyse 'stocks' today is different than it was 20 or even 10 years ago.

Morningstar, in the recent past, has incorporated the movement in the trading price as part of the formula that determines the intrinsic value of a stock – what do you reckon are the implications of that?

My question, as usual, is …the new metrics for assessing a business are valid, however, in a liquidity-driven market, are they right?

The US Share Market December 2023 – November 2024



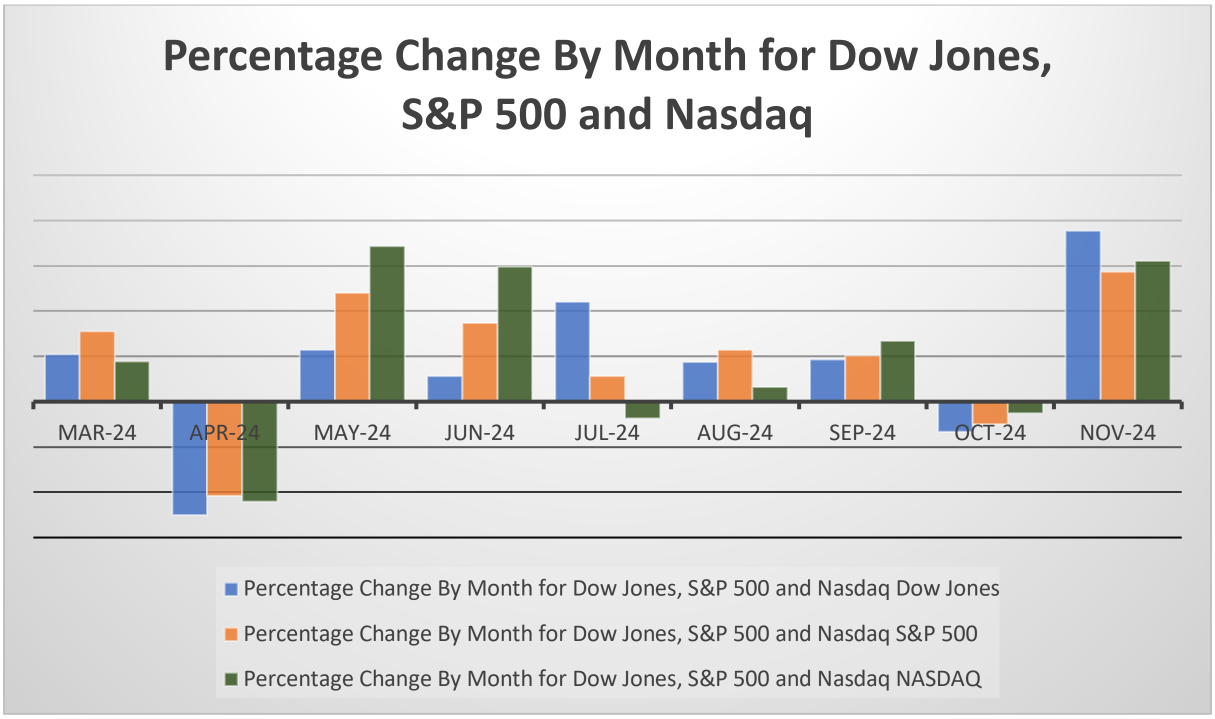
The above graph tracks the movement in the Dow Jones over the last 12 months.

The graph above is green 😊 Note the market value of the index, 44,901. Not far away from 45,000! That does mean markets are higher, sure. It also shows that the US economy has continued to grow, decade after decade (see the graph at the top). Markets, though, can get a bit excited(!), taking trading prices at times well below or well above economic growth (which trading prices are linked to in the long run) and the company's intrinsic value.

Share market index movement – USA

The volatility over November 2024.
This was how it went for the eleventh month of 2024:

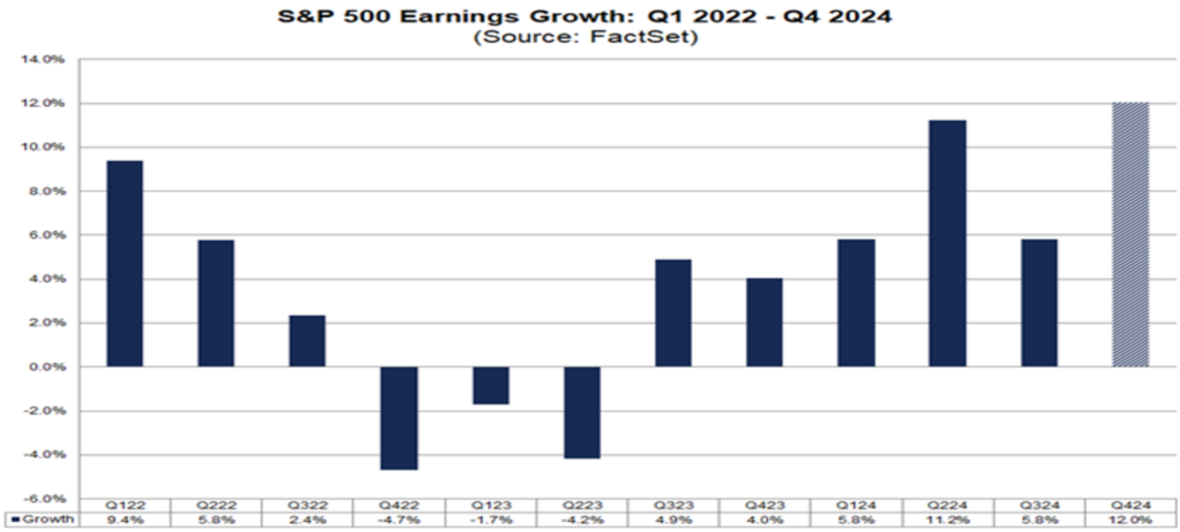
- The Dow Jones finished the month + 7.54%
- The S&P500 by + 5.73%
- The Nasdaq by + 6.21%



The graph above tracks market mood and the resulting movement across The Dow Jones, The S&P 500 and The Nasdaq.

From the peak of 35,630 on 1 August 2023, The Dow Jones Industrial Index declined to 32,417 by the end of October 2023, then reached a new all-time high of 44,910 on 29 November 2024. The Dow Jones currently sits at 44,705 as of 3 December 2024.

Earnings January 2022 – December 2024



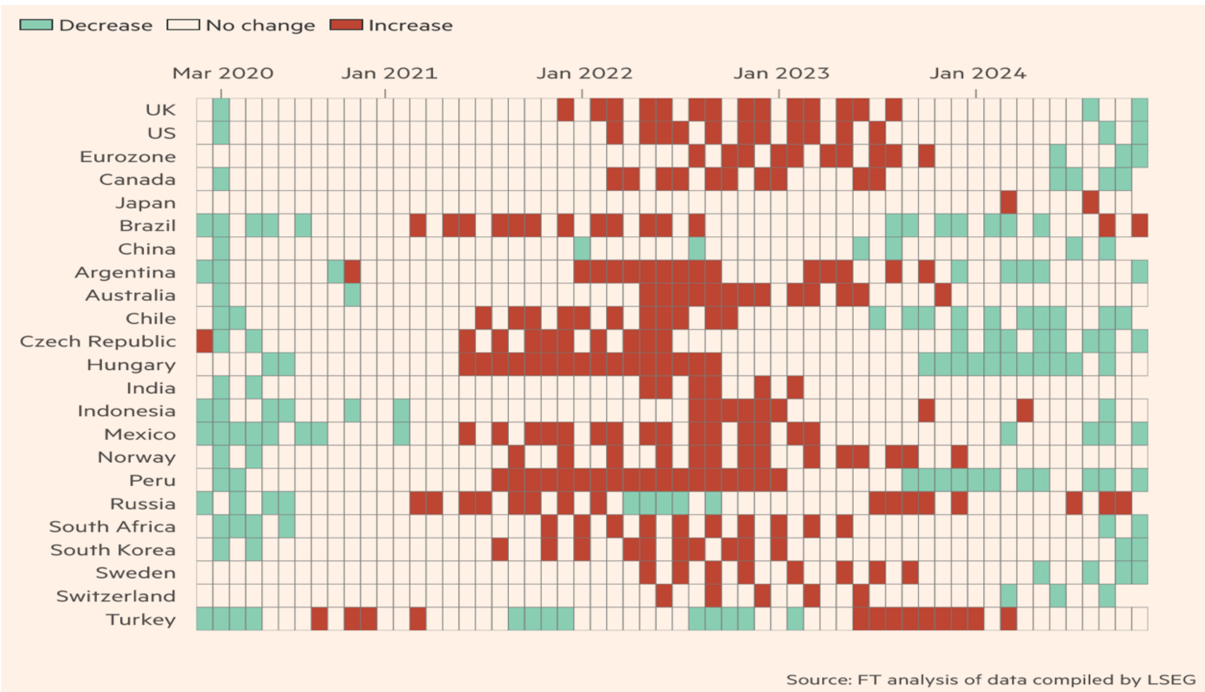
The graph above shows the change in earnings growth from January 2022 to December 2024

Earnings across the US market are mixed but generally positive. Note the impact of Covid on earnings growth in the graph above.

Global interest rates

Apart from the likes of Japan, Brazil, Australia, Norway, and Turkey, most countries are in interest rate cut mode.

As investors, we want to now be looking out over 2025 and 2026. Rate cuts might be over by then. Also, there might be other changes in market conditions to take into account.



The table above shows where many countries around the world are with their interest rate cycle.

Interest rates remain on the market's radar, as does the unemployment rate in the US.

Whilst the change in the unemployment rate spooked the market in August, since then, the unemployment rate has met the market's expectations as well as that of the US Federal Reserve. An unexpected rise in unemployment could easily unsettle the market, worried that it might mean recession is on its way.

By the way, still no recession in sight currently.

Where to next?

US Federal Reserve rate cuts continue with the recent November 25 basis point rate cut 'done and dusted'.

The next FOMC meeting is set for 17/18 December 2024. The Fed watch tool puts another rate cut of 25 basis points at around 65% probability.

There are general expectations that, whilst some Government cost-cutting could be disinflationary (job losses), there is the prospect of trade tariffs and other measures that could be inflationary that may see interest rates rise over 2026 (?).

Meantime, the expectation is that the Fed funds rate may still sit in the 4.25%-4.50% range at the end of 2024.

With rate cuts possibly ending over 2025, at WISEplanning, we are now looking ahead to 2025 and 2026, not only at market and economic data but also emerging market changes that may be driven by evolving technology.

To be clear, market corrections don't appear because trading prices are high. Markets can be happy or unhappy regardless of market prices.

When we have elevated trading prices, there is more tolerance for unexpected bad news - until there is not.

That is when sharp corrections erupt.

It is the combination of high trading prices and unexpected bad news suddenly confronting the market that can create sharp market corrections.

You know what is coming next … "*That's why we invest in the business rather than play the markets".*

The fundamentals matter, now or eventually.

By the way, to have your cake and eat it in the investing world, invest in the business (not the stock), be a business owner, hold long-term, use fundamental analysis and buy more shares in the business when the market doesn't like it. Be patient, like a business owner.

By the way, you might notice some rebuilding of cash levels as we look to position portfolios for the next 18 – 24 months and beyond.

The Global Economy

By Morgan Edwards – brief bio

Introduction: What's After the US Dollar?

As you would've picked up on in last month's Economic Update, a Trump Presidency could (most likely will) spell significant changes in the structure of the international system.

In continuing with the theme of that assessment, today, we are looking at the intricate basis of the international monetary system. Primarily, we'll be looking at what *could* come after the US dollar.

It's been reported that Donald Trump will impose 100% tariffs on BRICS+ countries if they move away from using the US dollar.

BRICS+, which stands for Brazil, Russia, India, China, South Africa and a slew of other countries (hence the plus), have been trying to move away from the US dollar as the basis of international trade and finance for some years.

In 2009, (then) People's Bank of China Governor Zhou Xiaochuan called for a reform of the international monetary system in a speech aptly titled 'Reform the International Monetary System'.

Crucially, Xiaochuan called for the IMF's Special Drawing Right (SDR) to be the basis of a reformed international monetary system, noting that 'special consideration should be given to giving the SDR a greater role [in a reformed international monetary system].

Moreover, the BRICS countries' *eThekwini Declaration* in 2013 noted that 'we welcome the discussion about the role of the SDR in the existing international monetary system'.

But what is the SDR?

The Special Drawing Right (SDR) is an international reserve asset created in the 1960s. The SDR is a basket of the world's most used currencies. Its value is derived from the weightings of these currencies and is posted every day on the IMF's website.

Currency	Weights determined in the 2022 review
US dollar	43.38
Euro	29.31
Chinese Renminbi	12.28
Japanese Yen	7.59
Pound Sterling	7.44

The table above shows the currencies that make up the SDR and their weightings in the SDR basket.

Crucially, Article 8 Section 7 of the IMF Articles of Agreement (signed by all members of the IMF) stipulates the cooperation between member countries in 'making the special drawing right the principal reserve asset in the international monetary system'.

At the moment, the principal reserve asset of the international monetary system is the US dollar.

The irony of BRICS+ pushing for wider use of the SDR is that the US dollar is the central determinant in the pricing of the SDR.

Of course, the other thing the BRICS+ countries have been pushing for is an expansion of the SDR basket. However, the US basically has a veto on these decisions. The other irony of the SDR story, from the United States perspective, is that the SDR is intended to overtake the role of the US dollar in the international system anyway.

However, the US dollar is by far and away the most widely used currency in international trade and, crucially, the most widely used currency in the international financial system. For this reason, I don't see the international monetary system moving away from the dollar anytime soon, despite concerted efforts from BRICS+ countries to do so.

Many (if not all) international holdings of the US dollar and it's use, would have to switch from the US dollar to the SDR. Most of the external holdings of US dollars are in the Euro Area, so they are pivotal in this. However, I don't see the Europeans moving that far away from the Americans anytime soon.

So, at this present point in time, it seems that the US dollar will reign supreme for the foreseeable future.

With that, on to our monthly trip around the world economy.

United States

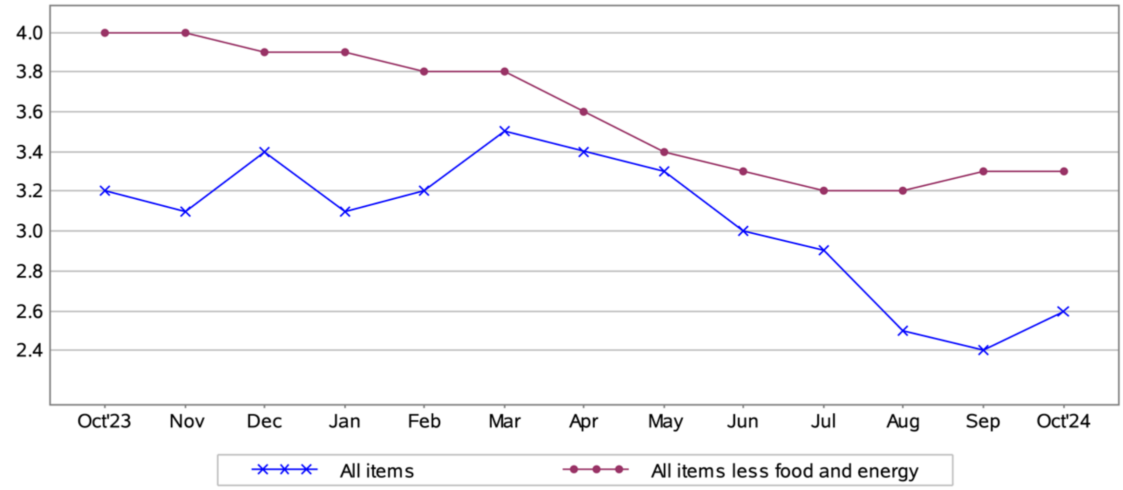
Unless you've been living under a rock, you will have heard that a second Trump Presidency will begin in January 2025.

There's a lot of talk on tariffs, including comments that the US Government will impose high tariffs on Canada, China and Mexico.

It is too early to offer any meaningful opinion or analysis on what this could mean. Until we get some more concrete information, we'll stick to inflation this month (at least).

The latest CPI data indicated that US inflation had a slight uptick. This has led to one US Federal Reserve official saying that the battle against inflation may be 'stalling'.

Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Oct. 2023 - Oct. 2024
Percent change



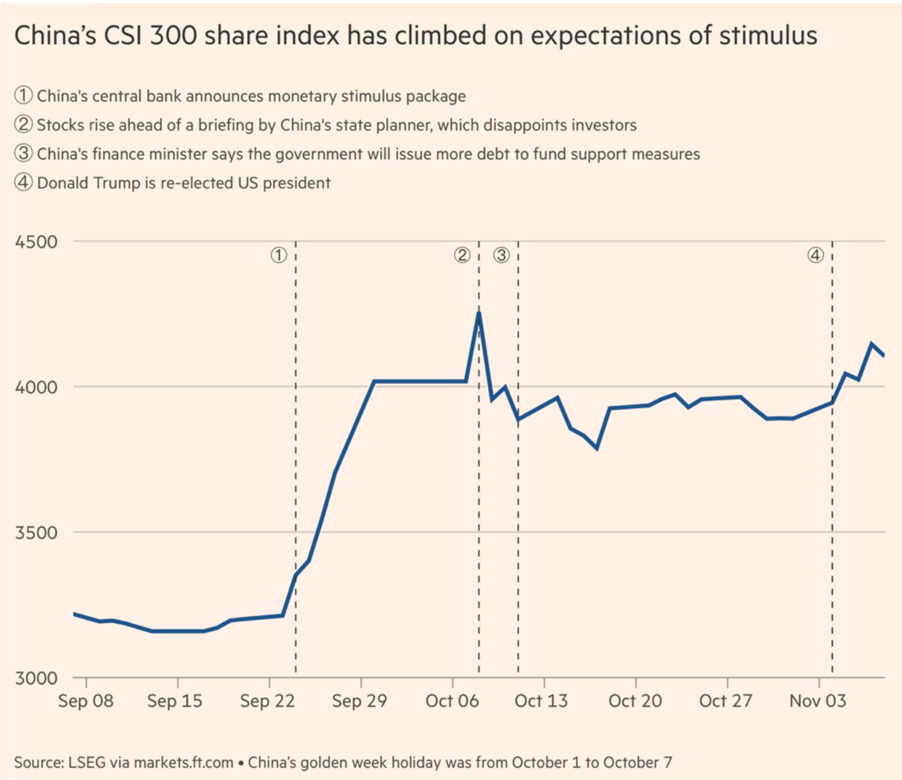
The graph above shows US CPI inflation data between October 2023 and October 2024.

While the CPI isn't the Fed's preferred inflation metric, it still shows inflation (for all items) below that crucial 3% barrier.

China

As reported last month, China's top legislative body (the Standing Committee) approved a USD $1.4 trillion spending package designed to help local government 'hidden debt'.

As noted last month, the announcement was likely to garner a bit of stock market excitement. This has come to fruition.



The graph above, from the Financial Times, shows the CSI300 (the top 300 stocks traded in China) since September 8, 2024.

It is worth noting that 'the market' (i.e. businesses, commentators) was expecting a bigger response in light of the election of Donald Trump in the United States. This may create the need for further stimulus in the near to medium term, but that is something of a wait-and-see type of situation.

Euro Area

The European Central Bank released the results from its Consumer Expectations Survey on November 29.

The graph above depicts the economic growth expectations of survey participants.

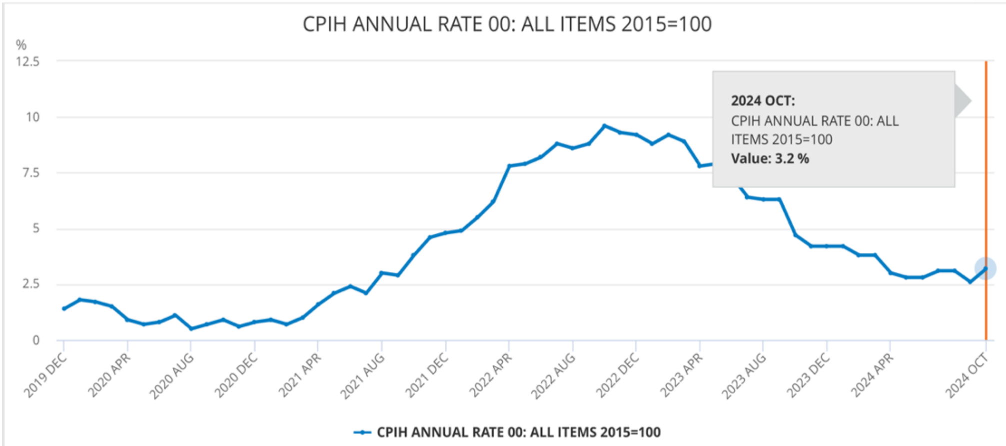
Basically, the graph above shows that 39.8% of survey respondents expect the economy to shrink over the next 12 months. 33.8% expect it to remain the same, while 26.5% expect it to grow.

I'd probably put myself in the 'expect it to stay the same' camp. France's budget troubles might also impede Euro Area economic growth, but we'll wait and see about that, too.

United Kingdom

Inflation, as measured through the CPIH (where H stands for household costs) in the UK, has ticked slightly above the Bank of England's target range at 3,2% in the October 2023 to October 2024 period.

The benchmark CPI index rose 2.3% during the same period. This follows an interest rate cut on 7 November from 5% to 4.75%



The graph above depicts monthly inflation from December 2019 to October 2024.

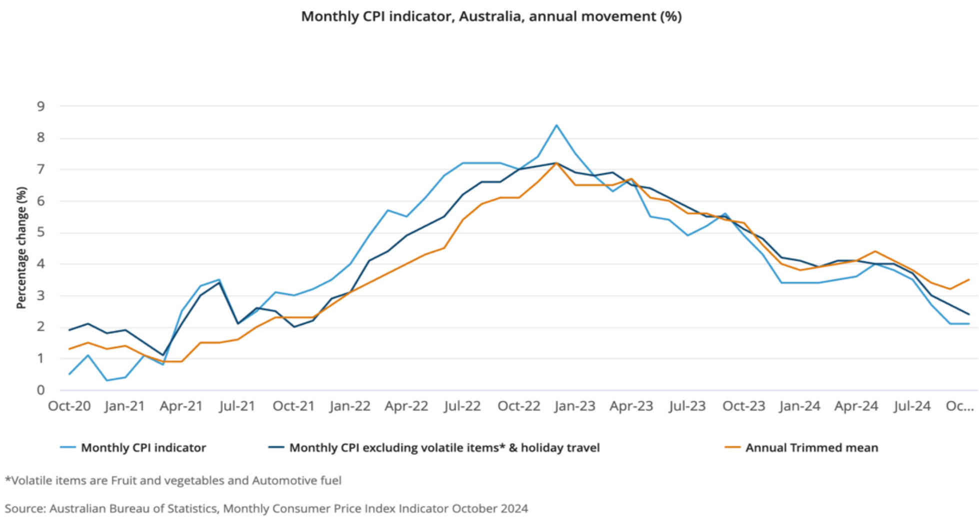
This has scuppered hopes for further interest rate cuts in the near future. However, as reported by the Office for National Statistics (ONS), 'the largest upward contribution to the monthly change in both CPIH and CPI annual rates came from housing and household services, mainly because of electricity and gas prices'.

Australia

The Reserve Bank of Australia held the Cash Rate Target (their OCR) at 4.35%.

This confirms what I have been writing about for some time – that the RBA is absorbed in its own *ideological* fear of inflation. Their rationale for keeping interest rates unchanged reflects the belief that 'aggregate demand remains above the economy's supply capacity, evidenced by the persistence of underlying inflation, surveys of business conditions and ongoing strength in the labour market'.

Contrast this with declining consumer sentiment (as covered last month), stagnant GDP, and a weakening labour market.



The graph above shows the monthly CPI indicator between October 2020 and October 2024.

If anything, the RBA is contributing to the persistence of inflation by keeping interest rates higher in the first place. This has flow-on effects on business costs (higher interest payments on debt) and rental accommodation (higher interest rates on mortgages). It is pretty clear from the graph above that CPI inflation (minus volatile items) is still trending lower.

New Zealand

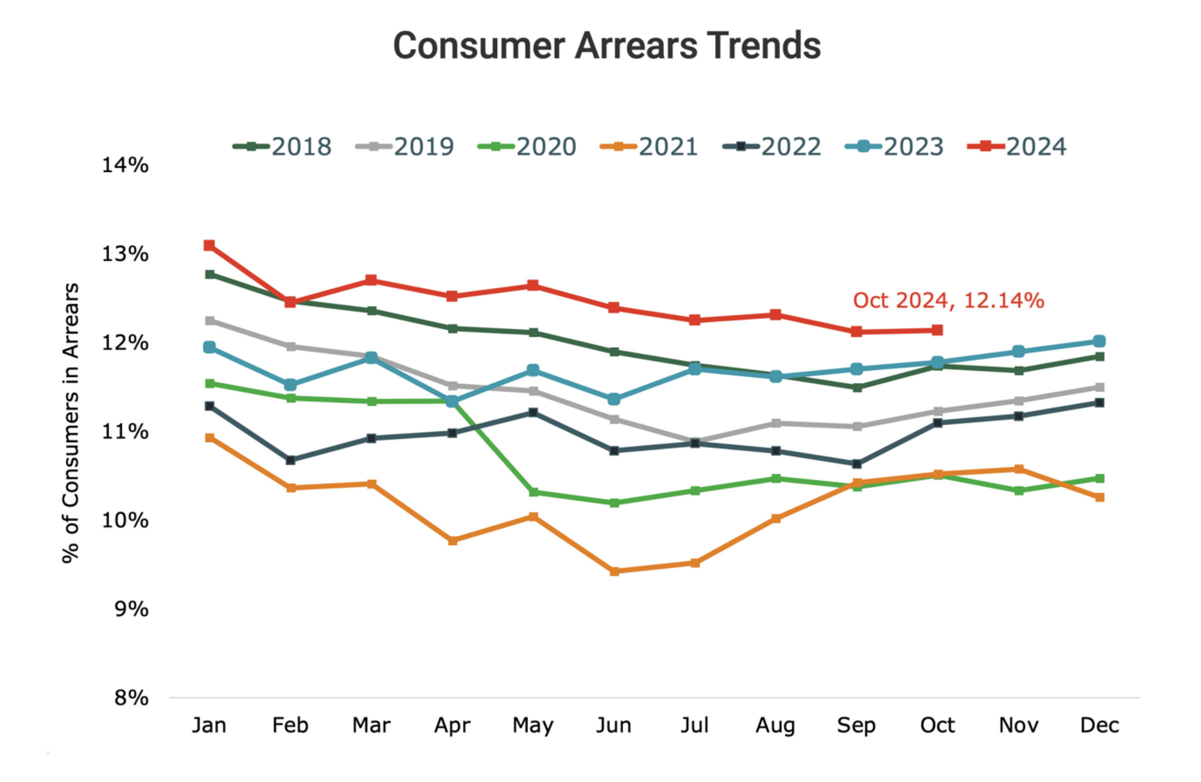
It is another story on our side of the ditch.

The RBNZ has lowered interest rates by 50 basis points from 4.75% to 4.25%. This is the second 50-basis point cut in a row. Context is important here, too. As reported in September by the Treasury's Chief Economic Advisor Dominic Stephens, the Government's spending cuts are the deepest in modern New Zealand history.

Expenditure is income, and if there is no spending to fill the spending gap created by the Government, then your economic activity suffers.

The RBNZ is lowering interest rates to stimulate economic activity in a context of declining Government spending (as discussed), but also in an environment of already high private debt.

Moreover, it appears that more of the 'credit active population' is having trouble keeping up with their debt payments.



The graph above, from Centrix, shows trends in consumer arrears.

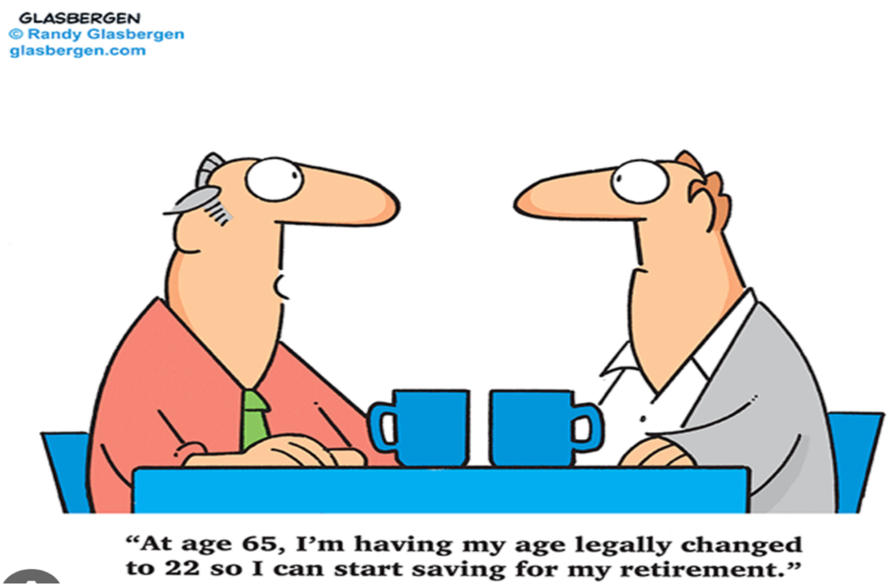
The number of customers in arrears is higher than in previous years. This indicates, amongst other things, difficulties in employment and keeping up with living costs.

As you'll see in the graph, there are more people in arrears now than in previous years. It's not a sign of a healthy economy at all.

Conclusion

2025 is going to hold many twists and turns for economic activity in the international economy. It is looking like it'll be inflation down, tariffs and uncertainty up. We will wait and see.

Until next year!


GLASBERGEN
© Randy Glasbergen
glasbergen.com
“At age 65, I’m having my age legally changed to 22 so I can start saving for my retirement.”