Independent
Advisers WA

Investment Newsletter – November 2022

We are moving from the weird to the normal world

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WHAT A YEAR

The year 2022 is almost past us and what a year it has been! There have been hot & cold wars, surging inflation, interest rate increases not experienced in over forty years and to say that people feel financially vulnerable heading into next year would be an understatement.

The past year also flushed out non-sense business models such as Facebook which hoped that it would succeed in numbing its users' brain cells and sign them up as the citizens of its make-belief digital world of Metaverse and make lots of, well, money or crypto. Speaking of which, the crypto-mania of the past few years was a one massive and loud rave party of new generation of tech enthusiasts which proved to be both a nuisance and a distraction for considered investors. The party is now well and truly over. The notion that the core reserve currencies would soon be replaced by thousands of unruly cryptocurrencies being digitally printed & stored (whatever that meant) by a group of techies from their bedrooms was sheer fantasy and a chaotic and dangerous proposition. We look forward to the quieter years ahead.

If we could describe this year with a single statement then it would be that ***"2022 was the year of the reset".*** Just exactly what this reset is and means for investors and the economy is the subject of this newsletter.

NOT MANY PLACES TO HIDE IN 2022

Firstly, let's start with taking a global view of investment returns in 2022 across the major asset classes of stocks, bonds, commodities, and recently the cryptocurrencies - we are being generous in identifying cryptos as an asset class which are included for the purpose of illustrating relative returns.

Figure 1: Global asset classes in 2022

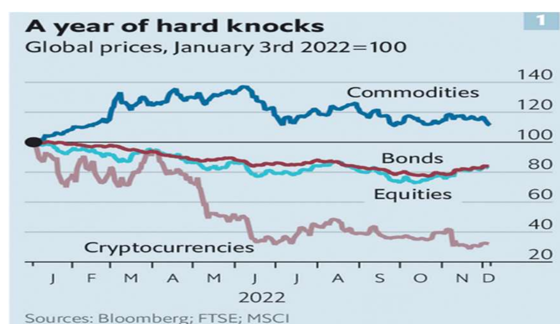


Figure 1 illustrates that both bonds and equities have had a negative year while commodities have provided some positive offset and cryptocurrencies have taught the new generation of investors an old lesson of ***'Never invest in the stuff you don't fully understand'.***

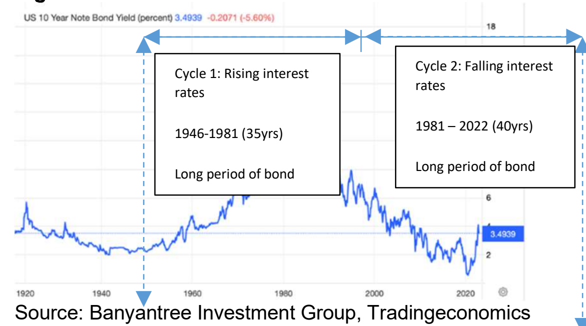
WHERE TO FROM HERE?

The future of investing will be very much about keeping whole with inflation and trying to get in front of it when possible with investment returns. So, if inflation is persistently running at 4% p.a. and your investment portfolio is returning 4% or less then that is not a great outcome. Ideally, you want to get better than 4% return. In a moderate to higher inflationary environment achieving just a positive investment return is not sufficient for sustaining your purchasing power, the ultimate goal of investing!

You might ask the question; ***isn't the Reserve Bank of Australia (RBA) telling us that they are committed to bringing inflation down to 2% and interest rates we are told will also come down to the very low levels of the past ten years?*** Not necessarily. We may just be living through the reset period for interest rates where they may well be permanently higher than the past. To understand what may lie ahead, let's take a quick look at the history of interest rates.

History suggests that the start or end of significant wars are usually the markers for resetting inflation and interest rates. Referring to Figure 2, since the end of world war II in 1945, we have seen two great multi-decade cycles of inflation and interest rates, **Cycle 1: 1946-1981 of consistently rising interest rate** and **Cycle 2: 1981-2022 of consistently falling interest rates.**

Figure 2: US 10 Year Bond Yield 1920-2022



Source: Banyantree Investment Group, Tradingeconomics

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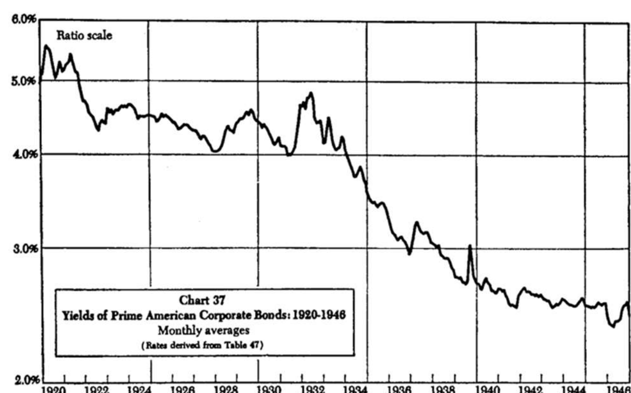
For good measure we have thrown in the below chart to stress the point that interest rates tend to move in multi-decade cycles. The following chart shows another long cycle when interest rates declined persistently over twenty-five years between 1920-1945.

Figure 3: US Corporate Bond Yields 1920-1946



Source: Homer, Sylla, 2005, A History of Interest Rates, Wiley & Sons

Anyway, referring back to Figure 2, the period from World War II to 2022 divides into two eras roughly equal in length but of marked contrast in economics and finance. Please note we are discussing the US interest rates for illustration as most advanced economies including Australia behaved in a similar way.

You often hear economists speak of interest rates declining consistently over the past forty years (Cycle 2: 1981-2022) which led to phenomenal investment returns in bonds, property, and equities. In fact, you just had to invest in any combination of these assets, never mind your risk profile, and just hold through this past multi-generational cycle of falling interest rates and you would have done more than alright. To state the obvious connection, falling interest rates led to cheaper and cheaper loans which helped households, corporates, and governments to borrow big and bid up asset prices in transactions on listed and private markets i.e. when interest rates fall asset prices rise and vice versa.

This long-term cycle 2 of the past forty years also gave rise to passive products such as ETFs which have been sold to investors on the premise that all asset classes just rise in value over the long-long term and so why pay for active managers and investment advice when you can just buy a cheap market ETF and just sit pretty and count your money at retirement. All passive products are sold on one single core premise that asset values always rise over the long term. ***As keen students of history, we are here to challenge this core assumption that asset values always rise over the long term!***

Referring to Figure 2 again and this time focusing on cycle 1 which saw persistent rise in interest rates over a 35-year period. From the war's end in 1945 through to the mid-1960's, the United States was preeminent among nations. The American economy experienced stable economic growth with progressive & steadily rising inflation, the US aided the recovery of war-torn Europe, led the Western alliance in keeping a lid on the Cold War, assisted the efforts of the less developed countries to raise their economic levels, and prepared to land humans on the moon. Talk of "the American century" was common.

Within twenty years though the mood became sombre and anxious. During the later 1960's the American century began to unravel. The remainder of the period to 1980s would be one of an unpopular Vietnam war, social dissent, political scandals, a more stagnant and unstable economy, monetary instability, large budget and trade deficits that returned the country to a debtor status internationally, sanctions with oil producing countries, and, above all, a great and protracted inflation of prices. All of these developments had profound and unprecedented effects on the interest rates. Moreover, the above is also a verbatim description for the times we are living in currently.

Consequently, the greatest of all secular bear bond market (sell-off) began in April of 1946 and ended in September 1981. It carried corporate bond yields from their lowest recorded yields to their highest. The yield index rose from 2.46% in 1946 to 15.49% in 1981 for high rated issues. The great bear market lasted some thirty-five years, by far the longest duration for a bear bond market in U.S. history.

If you held a bond ETF over that time (they didn't exist back then) and held that passive strategy over the many decades then its price would have declined from 101 in 1946 to 17 in 1981, or -83%. ***So, the passive strategy would not have worked!*** There were definitely multi-year bond rallies along the way which saw bond prices increase by 10-15% but you had to be nimble and active as otherwise the grand cycle was definitely a negative one. No one can say with certainty that interest rates will be higher or lower in the next ten years but if history is any guide we may have just turned another corner to a long road of higher interest rates.

In many ways, investment asset classes during this period of reset are shedding their excesses of the past few years and what you will see is that bonds and fixed interest asset classes will re-emerge as compelling sources of income, bank term deposits will be normal again, property will be purchased for income not speculation of doubling your money in couple of years on cheap debt, stock investing will bifurcate into companies that offer decent dividends and those that offer genuine growth or both without being shirt fronted by upstart techies with threats of imminent disruption.

Taken together, these forces will reshape investors' portfolios and alter the returns they can expect. Stay nimble and stay actively in charge of your portfolio.

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GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,284	0.43%	6.13%	1.01%	0.39%
ASX 200 Futures	AUD	7,309	0.67%	6.61%	2.87%	3.60%
Dow Jones	USD	34,590	2.18%	5.67%	4.85%	0.31%
S&P 500	USD	4,080	3.09%	5.38%	-1.26%	-10.66%
Stoxx Europe 600	EUR	440	0.63%	6.75%	-0.75%	-4.95%
FTSE 100 (UK)	GBP	7,573	0.81%	6.74%	-0.45%	7.28%
DAX (Germany)	EUR	14,397	0.29%	8.63%	0.06%	-4.66%
CAC (France)	EUR	6,739	1.04%	7.53%	4.17%	0.26%
Nikkei 225	JPY	27,969	-0.21%	1.38%	2.53%	0.53%
Emerging Markets Equities						
MSCI Emerging Markets	USD	972	2.03%	14.64%	-9.78%	-19.81%
Shanghai Composite	CNY	3,151	0.05%	8.91%	-1.10%	-11.58%
South Korea	KRW	2,473	1.61%	7.80%	-7.94%	-12.91%
Taiwan	TWD	14,880	1.16%	14.90%	-11.47%	-14.62%
Brazil	BRL	112,486	1.42%	-3.06%	1.02%	10.37%
South Africa	ZAR	68,564	2.62%	14.22%	4.79%	7.02%
Foreign Exchange						
AUDUSD	Currency	0.6788	1.50%	6.08%	-5.42%	-4.76%
AUDGBP	Currency	0.5629	0.60%	0.82%	-1.15%	5.04%
AUDEUR	Currency	0.6522	0.74%	0.74%	-2.47%	3.75%
AUDCNY	Currency	4.75	-1.51%	1.88%	-0.74%	4.17%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,478	4.12%	11.50%	-11.11%	-5.62%
LME COPPER 3MO ($)	USD/mt	8,239	2.51%	10.59%	-12.79%	-12.75%
LME NICKEL 3MO ($)	USD/mt	26,987	0.47%	23.74%	-4.95%	35.63%
SILVER FUTURE Mar23	USD/oz	21.78	1.61%	12.88%	-1.66%	-5.56%
ICE Newc Coal Fut Jan23	USD/mt	389.00	4.15%	10.35%	18.78%	244.25%
62% Import Fine Ore in USD	USD/t	96.91	0.91%	22.81%	-27.32%	2.67%
Gold Spot $/Oz	USD/oz	1,769	1.07%	8.26%	-3.75%	-0.34%
WTI Oil	USD/bbl	80.55	3.01%	-5.68%	-19.01%	29.56%
Henry Hub	USD/mmBtu	6.80	13.06%	34.81%	-19.55%	50.08%
Corn	USD/Bu	662.00	-0.56%	-4.27%	-12.14%	16.75%
Wheat	USD/Bu	771.50	1.81%	-12.55%	-29.06%	-0.29%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.53%	-0.08%	-0.23%	+0.18%	+1.84%
US	USD	3.61%	-0.14%	-0.44%	+0.76%	+2.16%
Germany	EUR	1.93%	+0.01%	-0.21%	+0.81%	+2.28%
Japan	JPY	0.25%	+0.00%	+0.01%	+0.01%	+0.20%
Italy	EUR	3.88%	+0.05%	-0.42%	+0.76%	+2.91%
Australian Rates						
Cash Rate	AUD	2.85%	+0.00%	+0.25%	+2.50%	+2.75%
90-Day BBSW	AUD	3.05%	-0.03%	-0.04%	+1.86%	+3.00%
180-Day BBSW	AUD	3.49%	-0.07%	-0.18%	+1.54%	+3.35%
CBOE Options						
CBOE VIX (Volatility Index)	Index	20.58	-5.98%	-20.48%	-21.42%	-24.31%

Data as of 30 November 2022

ECONOMIC NEWS

• **In Australia** the Reserve Bank of Australia (RBA) downshifted to smaller rate hikes, increasing cash rate by +0.25% to 2.85% (and raised further in early December to 3.1%) , the highest level since April 2013 with minutes from RBA's November policy meeting revealing, the bank is prepared to pause its tightening cycle or return to larger interest-rate increases if the economy requires it.

Consumer sentiment tumbled to the lowest level in 2.5 years in November with pessimists greatly outnumbering optimists as expected inflation rate, which measures consumer inflation expectations over next 12-months, rose to a 4-month high of 6%. Job market remained hot with wages rising +3.1% p.a. in September quarter, the fastest pace since March 2013.

• **Global growth outlook.** OECD announced the world's central banks must keep raising interest rates to fight soaring and pervasive inflation, even as the global economy sinks into a significant slowdown, as it upgraded 2022 world GDP growth to +3.1% (Australia downgraded to 4%, U.S. to 1.8%, Euro area to 3.3%, U.K. to 4.4%, Japan unchanged at 1.6%, China to 3.3% and India down to 6.6%) while keeping 2023 forecast unchanged at 2.2% (Australia 1.9%, U.S. 0.5%, Euro area 0.5%, U.K. -0.4%, Japan 1.8%, China 4.6% and India unchanged at 5.7%), announcing it isn't currently forecasting a recession in 2023, and forecasting 2024 economic growth (GDP) growth of 2.7% (Australia 1.6%, U.S. 1%, Euro area 1.4%, U.K. 0.2%, Japan 0.9%, China 4.1% and India 6.9%).

• **In the US -** Consumer confidence fell in November to a four-month low with a gauge of current conditions decreasing to the lowest since April 2021, amid the double blow of rising interest rates and persistent inflation with the inflation expectations increasing in the short and long run with 1-yr and 5-yr expectations highest in 4-months and 5-months, respectively. Job market remained hot with employers adding more jobs than forecast in November with nonfarm payrolls increasing 263k which combined with decline in participation rate to a 4-month low led to unemployment rate staying steady at 3.7%, and wages surging by the most in nearly a year with average hourly earnings increasing +5.1% p.a. Manufacturing contracted in November for the first time since May 2020 as output weakened in the face of a third-straight month of shrinking orders, however, inflation showed signs of easing with input prices shrinking at the fastest pace since May 2020.

• **China.** Economic activity contracted further in November with official manufacturing Purchasing Managers' Index (PMI) falling to the lowest since April and both manufacturing and non-manufacturing PMI staying in contraction territory. Total debt as a percentage of GDP climbed to new record high of 272.1% in September quarter 2022.

• **Europe. European Central Bank (**ECB) President Christine Lagarde said that borrowing costs will continue to rise even as economic activity slows down in the face of record inflation, announcing she'd be surprised if euro-zone inflation had peaked, despite data revealing euro-zone inflation slowed for the first time in 1.5 years in November with CPI rising +10% p.a. and declining -0.1% over the month and consumer sentiment rose to a five-month high in the month.

• **India.** Economy grew at a slower pace in September Quarter 2022 with economy (GDP) growing +6.3% p.a., with Reserve Bank of India (RBI) forecasting the economy to remain on track to expand by ~7% in 2022-23, as supply responses gain strength, demand improves amid easing inflation and the banking system returns to health.

GLOBAL MARKETS

US markets. US markets were stronger in the month, with the Dow Jones up +5.7% and S&P500 up +5.4%, as data which revealed US inflation cooling in October by more than forecast, sparked bets the Fed can downshift its aggressive rate-hike path.

Long-dated US treasury yields were lower, however, remained inverted with the 2-Yr yield at 4.3% and 10-Yr yield at 3.6%, with global bonds also joining U.S. peers in signalling a recession, with a gauge measuring the worldwide yield curve inverting for the first time in at least two decades.

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Australian Share Market. The ASX200 gained +6.1%.

Commodities. Over the month, WTI oil price declined -5.7% to US$80.55/bbl, as OPEC+ reduced its forecasts for global oil demand again, lowering estimates for the amount of crude it will need to pump in December Quarter 2022 by 520k barrels a day. Iron Ore Price grew over 20% over the month to US$111 per tonne as investors became positive on China reopening its economy after signs its abandoning its zero Covid-19 policy.

THE LONG READ

STICKY & DANGEROUS

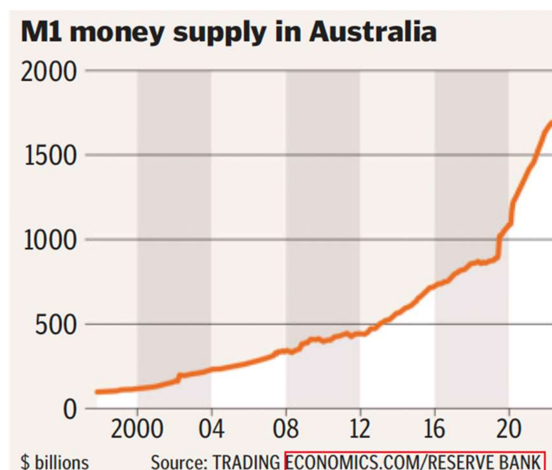
The inflation print for the September quarter was 7.3% a year, a significant jump from the previous quarter's 6.1%. It feels very much as if this episode of high consumer price inflation is going to stick around for some time to come, something we have been warning about since earlier this year.

The inflation genie seems to be out of the bottle and despite the well-intentioned, but misplaced, efforts of the central banks to control inflation, this one is going to run its course, which could mean years. You will only get a confirmation of this prediction when it is blatantly obvious that higher inflation is not going away.

With higher inflation proving to be sticky, how should investors position themselves in this economic environment?

Firstly, consumer price inflation essentially means the prices of goods and services are rising. Inflation can come from demand exceeding supply (also known as a demand shock), which is just an eloquent way of saying that consumers have more cash to spend on goods and services than the available supply. So, when Johnnys are competing with Pauls to buy the next electric vehicle or splash on holidays and airfares, it is the Johnnys with deeper pockets and their unwillingness to wait in the months-long order queue for the delivery of their car or confirmation of their next holiday who are proving to be one of the causes of rising prices.

To fund these price rises, Johnnys must have plenty of cash to splurge. In fact, that is exactly the case in our economy right now. There is a lot of money moving around the Australian economy after 10 years of a record property boom and profligate money printing by our central bank during Covid-19 lockdowns.



The graph above illustrates this point clearly by showing just how much currency (money) supply there is in the economy (held in bank accounts as defined by M1 Money Stock) and how quickly it has grown since 2020 – M1 grew a whopping 82% between 2020 and 2022. Also sustaining the demand shock is historically low unemployment and wages growth, which is starting to take off.

The other side of the inflation equation is the supply-side shock. When you have manufacturing capacity, shipping and ports capacity, labour, and energy reduced in their availability for whatever reason, but particularly due to wars (Russia-Ukraine) or other synchronised global events, such as lockdowns and trade sanctions, then ongoing disruptions in, or reductions of, supply capacity will lead to a rise in prices of end products. And there is not much central banks can do about supply-side shocks other than to hope and pray that they sort themselves out. In fact, Jerome Powell, the chairman of the Federal Reserve in the US said exactly that recently: "It's not the Fed's job to stop supply-side inflation."

The world economy is suffering from a series of unrelenting short-term and long-term supply shocks. Starting with oil, it would be naive of us to think that the producing countries are not reading the same writing on the wall as the rest of us: the world is fast switching to renewable energy, and oil, gas, and coal will be forced into obscurity.

Compounding the problem for countries producing oil and gas is that they are largely autocracies with no other significant industries to fall back on. Some of these countries will literally need hundreds of billions of new funds to help diversify their economies away from dependence on fossil fuel, in addition to the cost of running their existing annual budgets. These expenditures will not be possible at oil prices below $US75 a barrel, according to the Carnegie Foundation's estimates. So, oil prices will have to be much higher to help fund the energy transition for OPEC countries.

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The other supply-side shock we keep hearing about is labour shortages. This exodus was second only to the situation in World War I when servicemen left to fight in the war. The departure of workers in 2020-21 left a gaping hole in the domestic economy for supply of staff. It is easy for people to exit the country, but the process for re-entry for non-residents involves manual assessment of paperwork by immigration officials and the staffing in the immigration department would be inadequate to deal with the surge of people and workers trying to get back into Australia. We have heard of anecdotes where average processing times have moved out from four months to 18 months for certain visa applications. This will take some time to work through in our opinion.

Sanctions on the supply of oil and gas coming out of Russia are another supply-side shock. This is causing unprecedented increases in the prices of power and gas all over the world, adding to the cost of goods and services. This shock is likely to get worse before it gets better.

The rising risk of decoupling of trade between China and the US-led group of advanced economies is another supply shock. This is an increasing risk in our opinion and one that would lead to shortages of, and/or higher prices for, certain high-tech products used to make consumer and defence products.

More broadly, over the past three decades China has contributed immensely to lowering the prices of consumer products through cheap manufacturing and labour. That tailwind for low consumer prices and inflation is unlikely to be present in the next three decades given the cold war that has just begun between the US and China. And even if China is to remain engaged in global trade, it has an ageing demographic, which will take people out of the labour force and push up wages and prices.

So, the macro dynamic at play right now is one of central banks raising interest rates to reduce demand and avoid pressing against tight capacity, causing inflation. But equally, the supply side is responding with reductions in capacity to keep prices high, ranging from oil production cuts to reducing gas supplies, while labour shortages are starting to cause higher wage inflation. That all adds up to inflation remaining sticky and high.

Inflation can be an accelerating kind, increasing from 4%, 5%, 6% to 7% and so on over successive measurement periods; it can be steady in a range, say, of 4%-5% from one period to the next; or it can be disinflation, for example, 7%, 6%, 5%, 4% and so on.

The most dangerous kind of inflation is the accelerating one and that's when the panic buttons go off and almost all asset classes come under selling pressure. Australia is currently experiencing this dangerous kind of inflation.

Where inflation is range bound, even though it may be in a moderately higher range of 4%-5% or even 5%-6%, that is not a problem and will be a good thing for our overly financially leveraged economy.

Disinflation can also be dangerous when it is being aggressively engineered by central banks forcing up interest rates to unaffordable levels. If done aggressively over a short time, the damage can translate into unemployment spiking to levels not seen in a long time while many businesses are pushed over the financial edge due to demand destruction.

The happy medium for central banks would be to accept a higher range of inflation and get away from the obsession of bringing it down to 2%-3% as if it is some magical range for ensuring prosperity. It is not. In fact, the 2%-3% range started out as a passing statement in a speech made in 1992 by Bernie Fraser, who was the Reserve Bank governor at the time. There is no science behind this ad hoc number.

Investing over the next few years will be about ensuring your returns keep you ahead of inflation or at least hold with it. Investors will focus on cashflow-based returns. Investments that are yielding negative real income will be brought under a microscope and likely show more price volatility. Growth will be difficult to come by for the next few years as consumers will be focused on making their financial ends meet and keeping on top of their bills. We are in for a prolonged period of stagflation: stagnant growth and persistently high inflation.

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