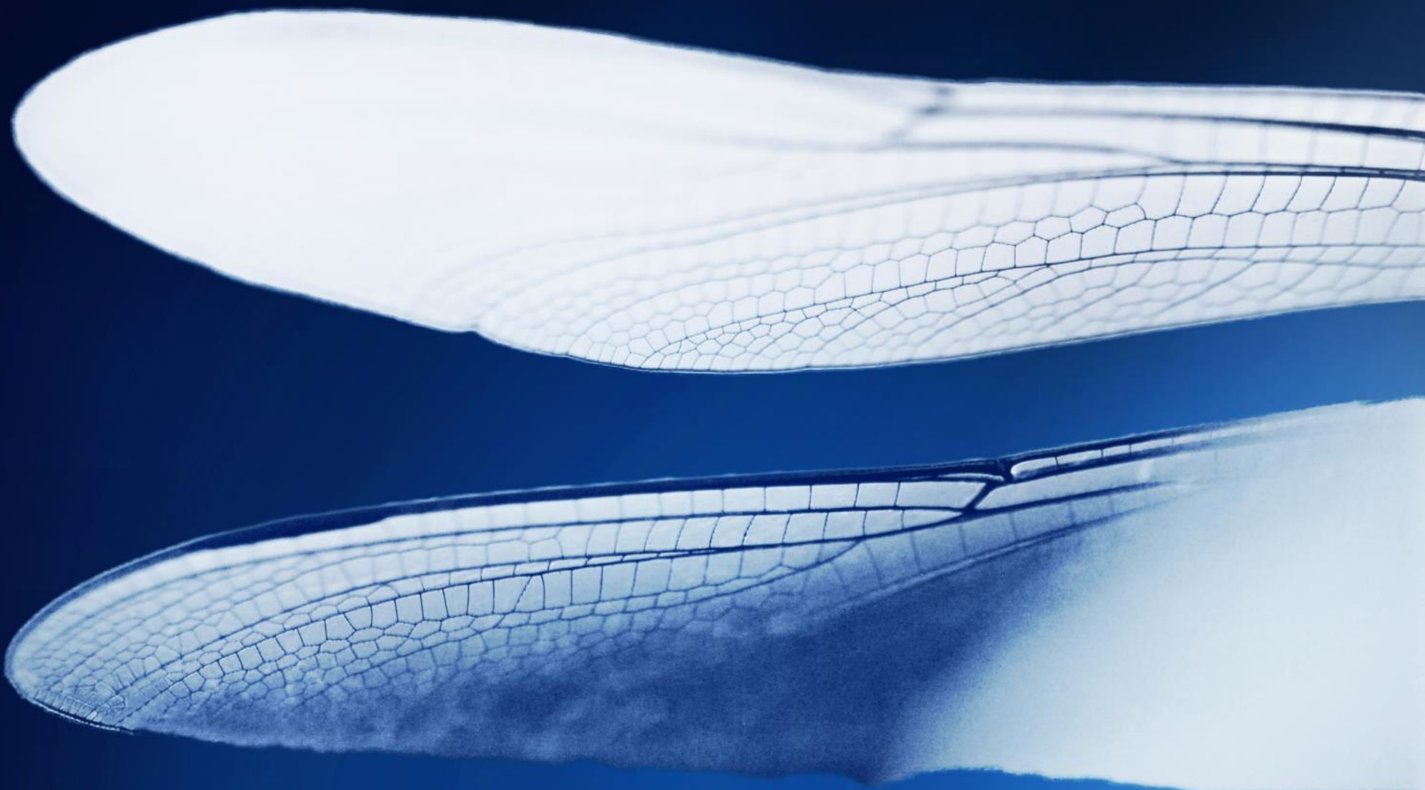
Perpetual Private | Special edition

Reflections

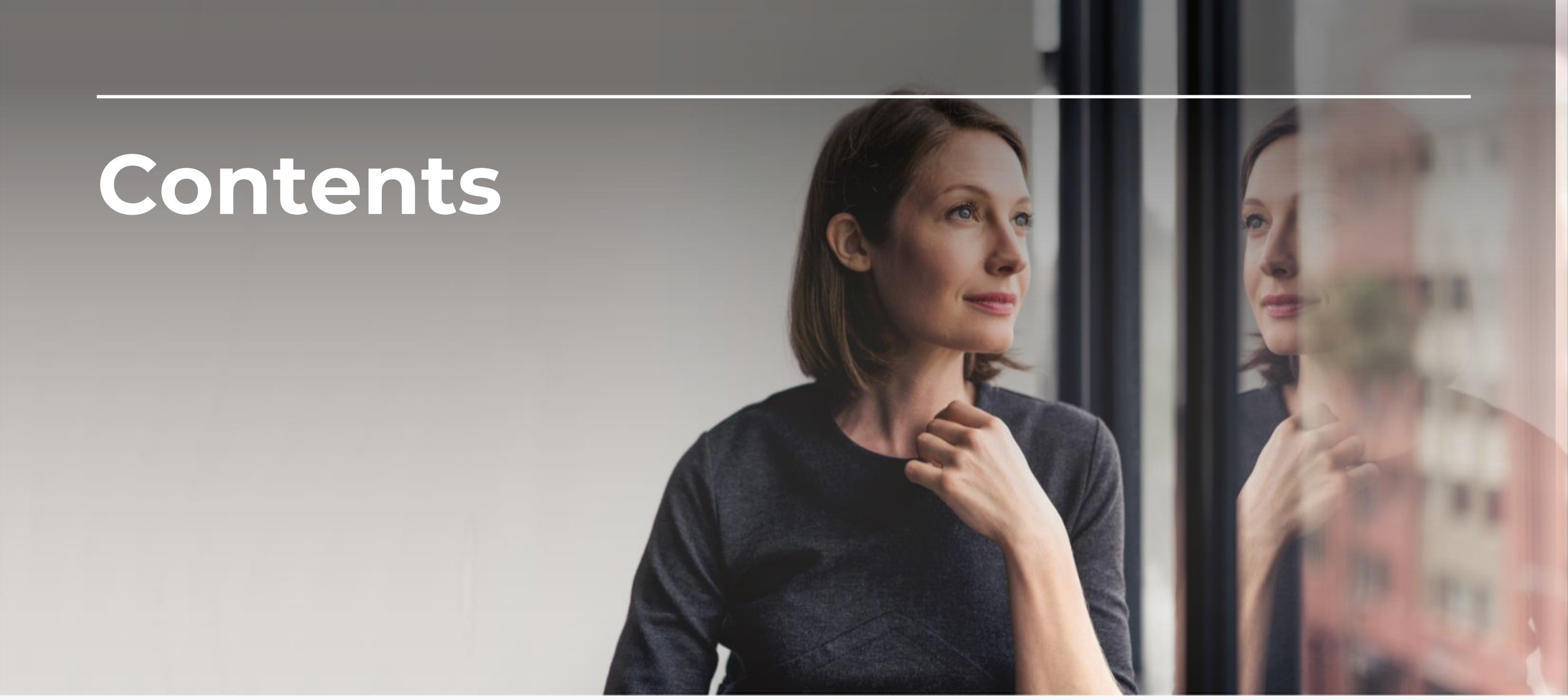
"Life can only be understood backwards; but it must be lived forwards."
Søren Kierkegaard, Philosopher, 1844

December 2023



Trust is earned.

Perpetual



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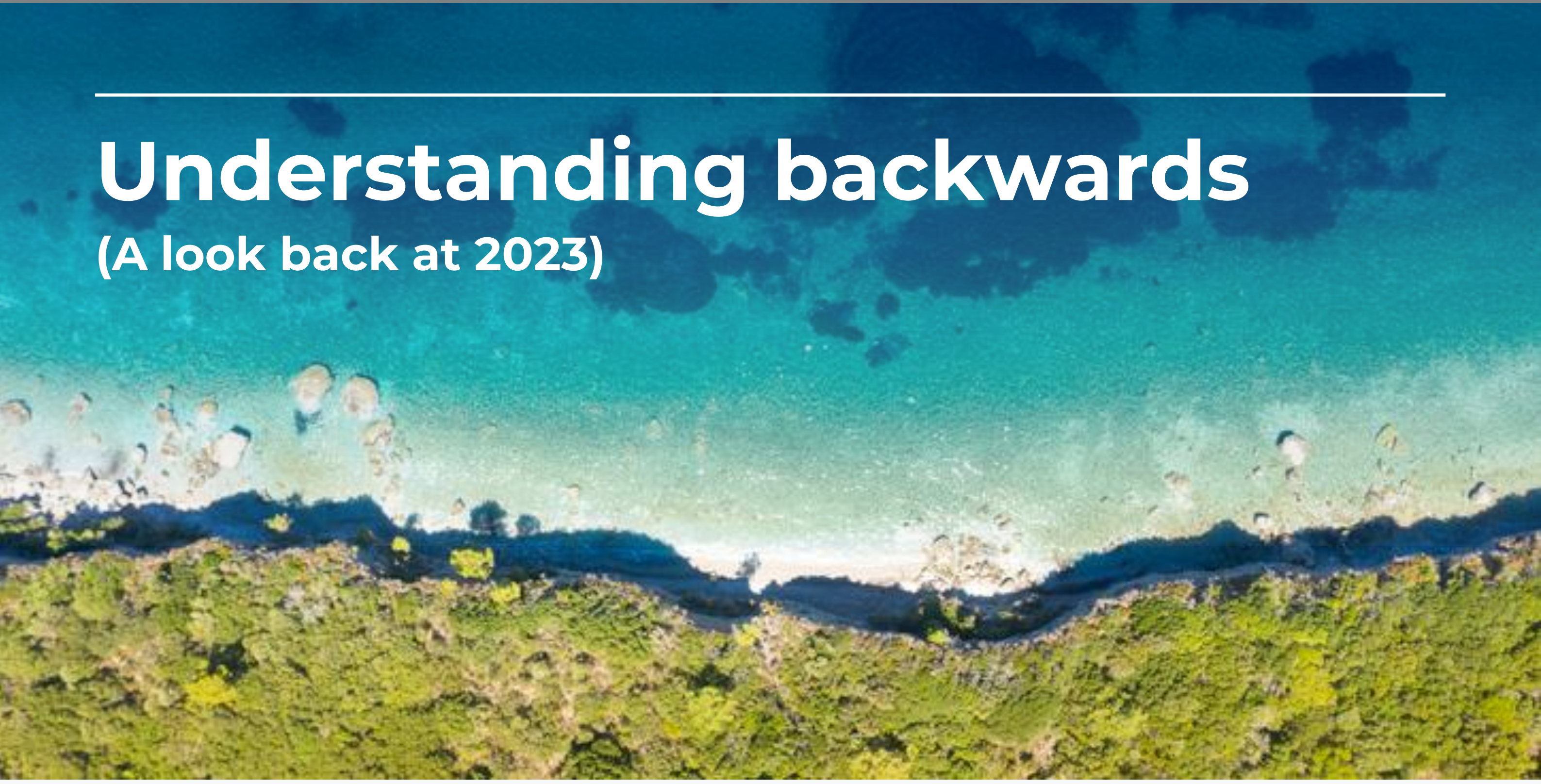
Key points

- 2023 was a surprisingly buoyant year for financial markets, in large part due to the AI driven boom, robust labour markets and healthy consumer spending. This confounded the expectations of a majority of economists and led to a rapid about-face for investor confidence.
- Whilst we have enjoyed much of the implications of these more optimistic conditions within our portfolios, we are not yet convinced that all of the crucial risks have become apparent. The world is indeed facing a high level of uncertainty, and anticipating what will happen next is becoming increasingly challenging.
- It's important to note that whether there is a 'soft' or 'hard' landing (no recession or recession respectively), we don't expect the structural cascade of failures that drove the worst outcomes during the 2007/08 Global Financial Crisis.
- Though we expect a world where economic growth trends lower and volatility persists, we also expect inflationary pressures to ease further and for central banks to maintain a cautious stance.
- Our primary expectations for 2024 are based around the view that we will likely experience a mild and brief recession. This view however, is simply our central expectation. There are factors that are presently not only unknown but also unknowable (i.e. the pace and velocity of the feedback loop between rising unemployment and falling consumer sentiment). As such, the environment may be conducive to a more positive outcome, it may also spiral into something more challenging.
- Moving forward our approach is to keep risk budgets tight whilst investing our time in deep fundamental research, as we wait for the balance between risk and return to become more appealing. Just as when traveling along a freeway and forward visibility is low, we keep our speed low. When investing in uncertain markets where forward visibility is low, it makes sense to keep risk exposure low.
- As we proceed through the months ahead, we remain poised to identify and capitalise on opportunities as they present themselves. This requires our focused diligence in dissecting important data points as they become known, alongside discipline in holding our line whilst waiting for circumstances that are sufficiently appealing. We are practiced and prepared to do just that and maintain a committed resolve to deliver the best possible investment outcomes.



Understanding backwards

(A look back at 2023)

There's an old joke among investors, that "economists have predicted 9 of the past 5 recessions". As it turns out, 2023 has been a year that has made this comment seem less a comic jibe and more an apt observation. Indeed, leading into the beginning of the year, two-thirds of those surveyed for the Chief Economists Outlook[1], expected a global recession before the turn of 2024.

As is now clear, global growth has remained resilient, despite a rapidly tightened monetary landscape, and what's more, investor sentiment seemingly improved much before there was clear evidence that an economic decline had been avoided.

Driving markets through the year were an array of factors – still relatively few in number – but significantly more than the binary investment decision paradigm of risk-on/risk off that dominated between 2010 and 2020. Our own observations suggest that this trend of investment fundamentals returning to the fore, will continue. The unifying force of ultra-low interest rates has gone. This has changed conditions in capital markets, businesses and households. These disparate changes across three levels of interrelated, dynamic systems, drives increases in idiosyncratic (stock specific) risk, and thus the reward available for those investors who diligently and correctly analyse the underlying and defining features of market opportunities.

As we approach the end of 2023, now is an opportune time to reflect on the year that was and plan for the year ahead.

[1] World Economic Forum's Chief Economists Outlook Survey, January 2023

Themes from the year past

The recession that never came

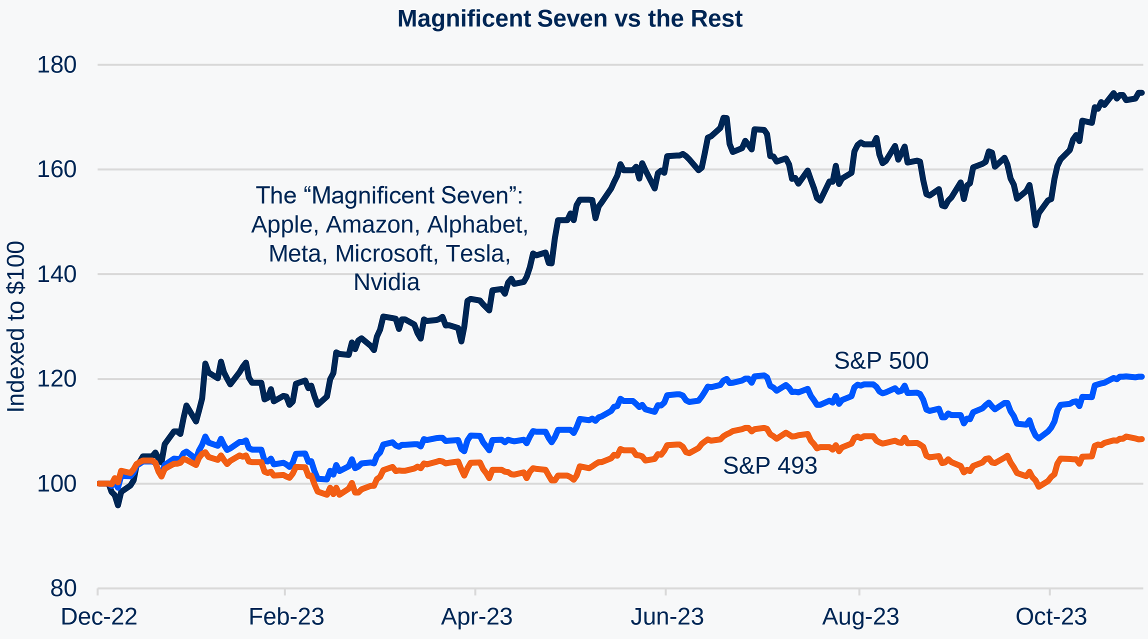
This was the year that the lagged effect of interest rate hikes by central banks was expected to finally start to bite, resulting in weaker demand and higher borrowing costs, alongside the impact of escalating living expenses – in most instances a recipe for slowing economic activity. Economic uncertainty was further complicated by the ongoing war in Ukraine and later in the year, a new and potentially volatile conflict in the Middle East, both putting pressure on global energy and food supplies.

However, the widely anticipated recession failed to materialise. Several factors contributed to the resilience of the global economy and asset prices, including strong consumer spending, a resilient labour market, and the ability of businesses to adapt to the changing economic environment.

The Artificial Intelligence (AI) boost

It would be remiss to talk about 2023 without mentioning the emergence of artificial intelligence (AI) into the global consciousness, particularly OpenAI's ChatGPT, which gained one million users in its first week after launch in late 2022. It garnered widespread attention for its ability to generate human-quality text and it had a meaningfully positive impact on market sentiment. As investors grew excited about the possibilities associated with AI and its potential to drive productivity growth in a broad number of ways, the tech sector – and particularly a narrow group of seven stocks dubbed the 'magnificent seven' – enjoyed a significant rise in market value. As shown in figure 1, without the boost of these seven stocks, the U.S. equity market would have experienced a ~8% increase from the beginning of the year to the end of November (orange line) rather than the ~20% markets have enjoyed (light blue). One can imagine that the tone of this note, and consumer confidence would be very different if it weren't for these seven stocks contribution to markets this year – directly, and by way of improving investor expectations they heralded.

Figure 1. The ‘Magnificent Seven’

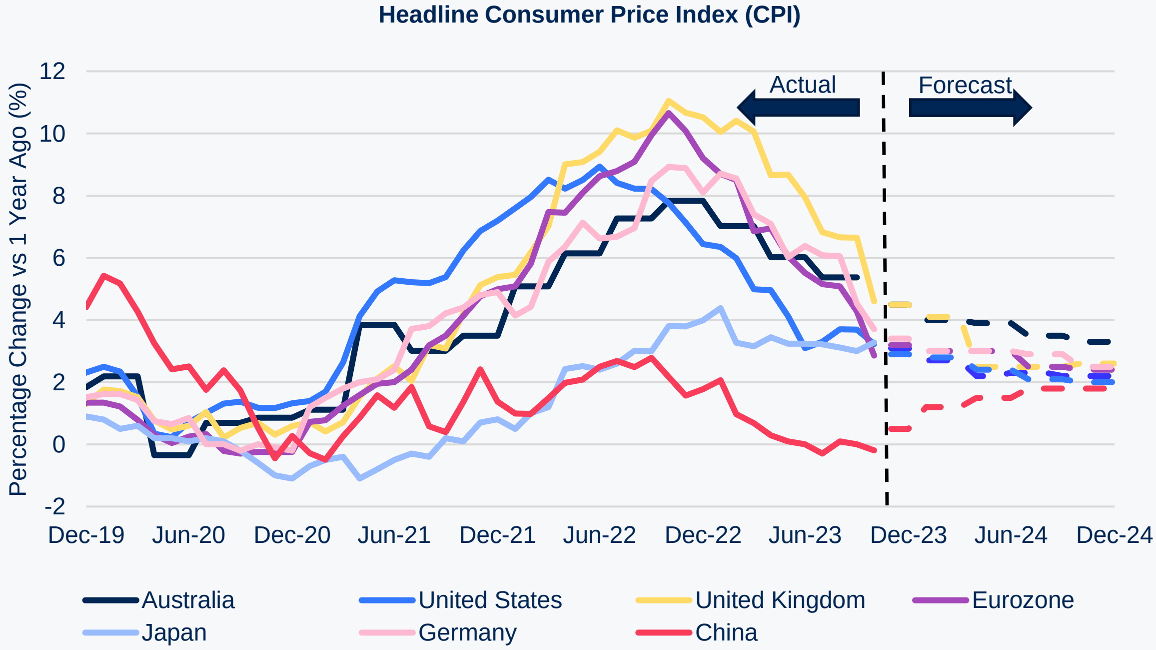


Source: FactSet, Data as of 29th November 2023

Inflation: Retreating but not resolved

As it was in 2022, inflation continued to be top of mind for market participants and a persistent challenge for central bankers. Although inflation remained stubbornly high, well above 3% throughout the first half of the year, it showed promising signs of cooling towards the latter half. This was attributed to the lagged impact of higher interest rates on the economy, positive tailwinds as a result of the “base effect”, supply chain disruptions continuing to ease, and energy prices stabilising. However, as shown in figure 2, inflation remains above central bank targets, and concerns about how ‘sticky’ it will be remain a primary concern for our monetary authorities.

Figure 2. Headline Inflation



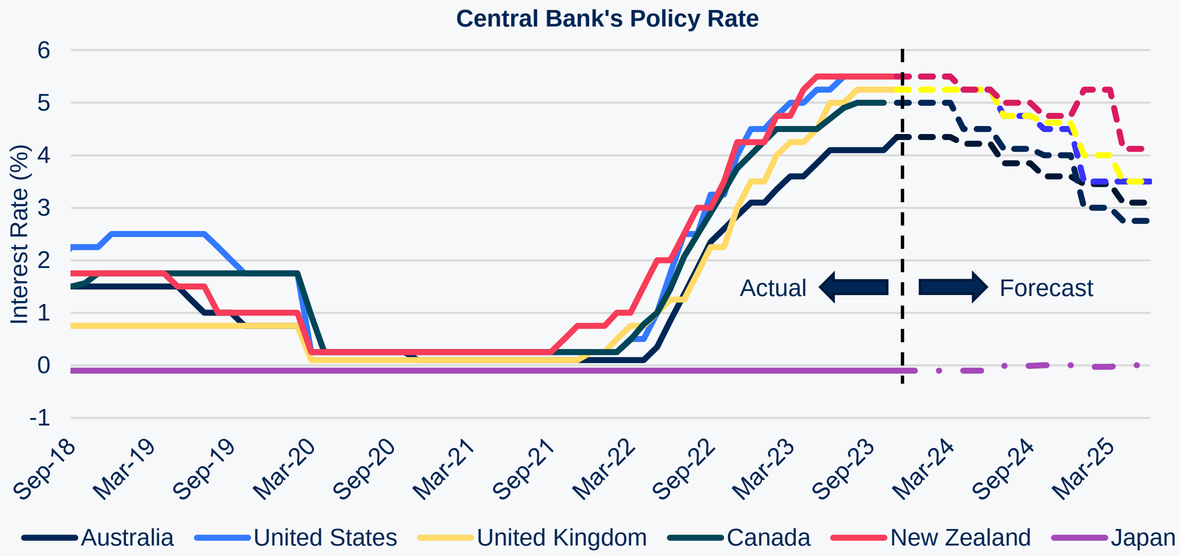
Source: FactSet, Data as of 30th November 2023

Central bankers have been criticised for failing to predict inflation breaching their upper targets, labelling it 'transitory', thus delaying hiking interest rates. Of course, hindsight is 20/20, and what the likes of Jerome Powell of the U.S. Federal Reserve (Fed) and (former RBA Governor) Phillip Lowe weren't to know was that Russia would invade Ukraine, leading to disruptions in commodities markets. Nor was it obvious that China's post pandemic reopening would prove to be so tepid. Nonetheless, they were ultimately forced into rapidly increasing interest rates in an effort to avoid inflation expectations becoming entrenched.

With inflation now receding, unemployment still at relatively low levels, and robust growth, there is building optimism that central banks' policy actions will deliver a 'soft landing'. This means that economic growth will decelerate, unemployment will increase to a manageable level, and inflation will fall to around central bank's target range, all without triggering a recession.

Since March 2022, the Fed has increased the Fed Funds Rate eleven times to 5.25%-5.50%, its highest level in 22 years. The Reserve Bank of Australia (RBA), and many other central banks across the globe, have adopted a similar tactic, with the RBA having raised the 'overnight cash rate' to 4.35%. Fed Chair, Jerome Powell has recently said that the strength of economic growth and the labour market *"could justify further tightening of monetary policy."* However, he seems in no rush to increase the benchmark interest rate, and the recent easing of some inflationary pressures supports the case for rates to stay around their current levels for a time.

Figure 3. Interest rates



Source: FactSet, Data as of 30th November 2023

Globally, central banks remain committed to bringing inflation back under control, but they face a delicate balancing act. Raising interest rates too much could tip their respective economies into a recession, whilst cutting rates too early could result in embedded inflation expectations. They also have to deal with the added difficulty that interest rates generally impact the economy with a 12-24 month lag. Therefore, it is likely to be a 2024 story as to whether they've tightened monetary policy too much, as the full brunt of these interest rate hikes are felt by the broader economy, or whether they have got it just right (i.e. a 'goldilocks' scenario).

Labour markets

Despite the economic uncertainty, labour markets remained remarkably robust throughout 2023. Unemployment rates remained low, and wage growth picked up, reflecting strong demand for workers in many industries. This resilience was a key factor in preventing the feared recession from materialising. The strength of the labour market was partly attributed to the continued recovery from the COVID-19 pandemic, as businesses reopened and expanded their operations. Additionally, demographic factors, such as an ageing population and declining labour force participation, contributed to the tight labour market conditions.

It was these conditions which enabled consumers to continue spending in the face of higher cost of living pressures, and helped support economic resilience.

Geopolitics

In 2023, the global geopolitical landscape remained volatile with tensions between Russia and Ukraine continuing to escalate and draw international attention. The conflict in the Middle East has also resulted in significant human and economic costs, initially having a significant impact on oil prices before subsiding. Additionally, tensions between the incumbent superpower, the U.S., and heir apparent, China; have not receded, despite President Biden's more diplomatic approach to the tensions between the two countries. Indeed, China has proven to be more assertive on the world stage and has made clear efforts to reinforce stated long term strategic goals, such as reintegrating Taiwan. Additionally, ongoing trade disputes (a hangover from the Trump presidency but notably not reversed under Biden) and strategic rivalry between the world's two largest economies added to uncertainty and risk, impacting global trade, investment, and supply chains, complicating the efforts of economies to re-emerge and rebalance in the aftermath of the pandemic.

China – Australia's largest trading partner

Heading into this year, many investors believed that China's COVID-19 re-opening after a prolonged lockdown would help boost global growth and provide support to financial markets. However, as we know, the Chinese economy underwhelmed in 2023 and faced several significant challenges through the year, including a real estate bubble that threatened to destabilise its housing market and weak economic growth. There were also signs of a weakening consumer market, raising questions about whether the country could continue to grow at the same pace that it has done for the last two decades. These challenges highlighted China's reliance on debt-fuelled growth and its vulnerability to external shocks. Addressing these issues will be crucial for China's long-term economic stability and its ability to maintain its position as a major driver of global growth.

Banking crisis – U.S. & Switzerland

The U.S. financial sector experienced a period of turbulence, with several banks, including Silicon Valley Bank (SVB), facing financial difficulties. The banking crisis highlighted the interconnectedness of the financial system and the potential risks associated with banks having concentrated exposures to specific sectors. The financial difficulties faced by SVB and other banks raised concerns about the stability of the U.S. financial system, especially during a rate hiking cycle that hasn't been seen to this magnitude for several decades. In response, the U.S. Federal Reserve provided liquidity support to the banking sector, and the government implemented measures to protect depositors and taxpayers – all steps that helped prevent a wider financial crisis ensuing.

In the wake of U.S. banking turmoil, the Swiss banking sector also faced significant challenges. Credit Suisse, the second-largest bank in Switzerland, collapsed in March 2023. The bank had been plagued by a series of scandals, management shifts, and significant losses in recent years. To prevent a full collapse that might have devastated the global financial system, Swiss bank UBS Group AG bought Credit Suisse for 3 billion CHF (~ $3.3 billion USD).

Living forwards

(Driving forces for 2024)

Just as 2023 confounded expectations, we have little doubt that 2024 will also exhibit its own fair share of surprises. This, simply, is the nature of markets and something we are used to navigating. Namely, decision making under uncertainty. That we don't have a clear picture of the path ahead however, does not mean that we shouldn't contemplate the obvious and likely influences on market outcomes. Despite our recognition that 'no plan survives first contact' we also adhere to the understanding that a failure to plan is akin to planning to fail. As such, below, we explore the key themes we believe will continue into next year, as well as those that will possibly emerge.

Likely new themes for the year ahead

Inflation and interest rates

Despite being significantly down from its peak in 2022, inflation remains stubborn and significantly above the target of most major central banks' (circa 2%). Although, the resilience of inflation is unsurprising: the sharp rise between 2021 and 2022 was driven not only by COVID-19 and energy price shocks, but also by excessive liquidity in the system following the lingering impacts of monetary policy largesse, some of which remains today.

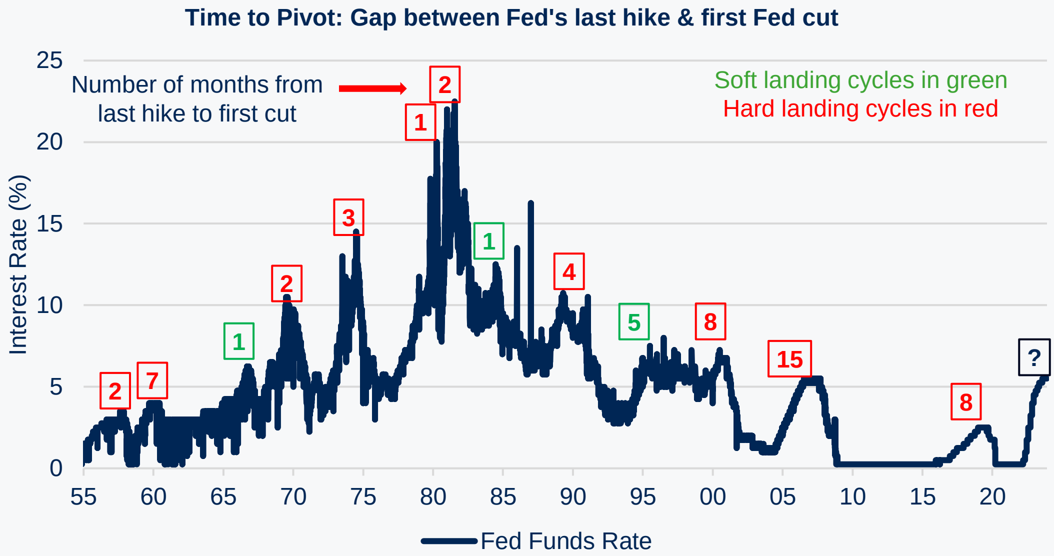
There are also longer-term supply side shocks that are contributing to structurally higher inflation over the long-term. The first is deglobalisation or, more precisely, the fact that trade as a share of global gross domestic product (GDP) is trending down, because of greater on-shoring or near-shoring of supply chains amongst other factors. The massive push to decarbonise many industries and a structurally tighter labour market due to demographic changes are also factors.

Looking at previous episodes of high inflation it can take several years for inflation to fall back to desirable levels, largely due to second-round effects, such as wage-price spirals.

Against this backdrop, we question whether markets are correct in pricing in no more rate hikes by major central banks and significant rate cuts starting in mid-2024. Perhaps this consensus reflects the expectation that higher productivity growth, driven by artificial intelligence, could help lower inflation. These advances might lift aggregate supply in the world economy and thereby – potentially – help bring down inflation. The jury is still out, however. So far, productivity growth numbers are not showing signs of a structural increase. Additionally, whilst productivity growth can be supported by technological innovation, it can also be held back by factors like misallocation of capital and the prolonged fallout following the burst of credit bubbles or wars.

While inflation remains above target, interest rates will remain elevated. Indeed, even once inflation returns to desired levels, should other economic conditions such as employment and economic activity remain strong, it is unlikely that central banks will see the need to reduce rates. We suspect that the inherent expectation of a hasty return to the low levels of official interest rates we saw during the pandemic, is misplaced. As shown in figure 4, it is true that the U.S. Fed and other central banks have historically cut interest rates very shortly after they have finished tightening. However, pre-1990's it was often clear soon after the end of a tightening cycle that the economy faced a recession. Post-1990's there has been longer gaps between the end of the Fed hiking cycle and the start of the Fed cutting rates – a trend we expect to continue in 2024.

Figure 4. Last hike, first cut



Source: FactSet, Minack Advisors

Indeed, with globalisation retreating, there is likely to be a higher floor placed under inflation moving forward. As such (and remembering that extremely low levels of inflation is what enabled central banks to bring interest rates so low), we suspect that the inclination of central banks to open the easy-money spigot every time economies are challenged will fade.

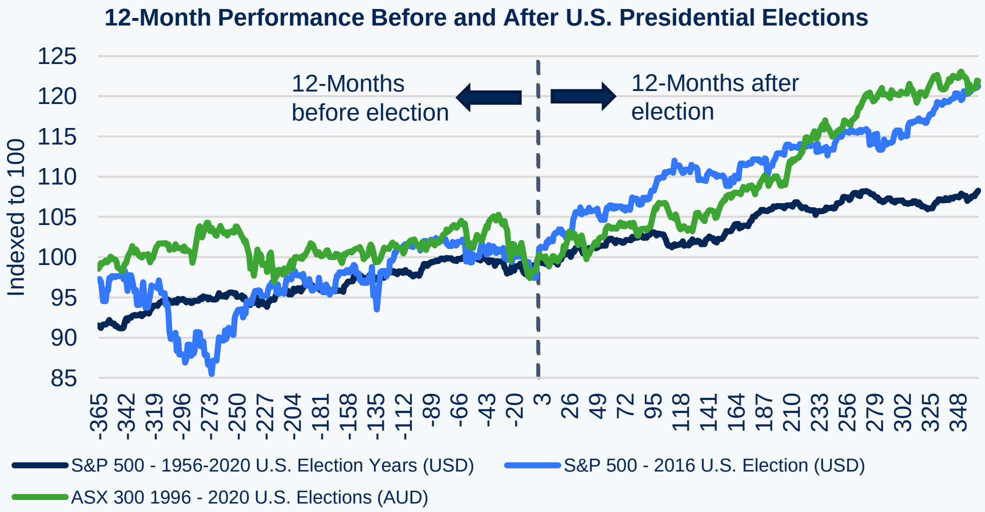
Geopolitics

The world is currently facing a high level of geopolitical risk, which has compounded economic uncertainty. The ongoing war in Ukraine, the humanitarian disaster in the Middle East, and rising tensions between China and the West are just a few examples of the many geopolitical issues that are impacting businesses and investors. As a result, executives and investors can no longer assume a placid geopolitical backdrop when making decisions.

Whilst predicting the course of any single geopolitical crisis is difficult, the global trajectory is toward more frequent conflicts of increasing consequence. Navigating the evolving geopolitical landscape will likely require access to deep wells of expertise, as geopolitical issues that could have been ignored in the past now stand to directly impact companies' supply chains and customer bases.

Next year, the 2024 U.S. election will take place, where neither candidate is truly popular among their electorate. Historically, investment markets have experienced higher volatility in election years. This was particularly the case in 2016, when Trump edged out Clinton to take the top position. Although, in the 17 election years since 1950, stocks have been positive 82% of the time in presidential election years, as shown by the dark blue line in figure 5. Investors should brace themselves for higher volatility as each party ramps up their election campaign and the candidates exchange barbs.

Figure 5: U.S. Election years



Source: FactSet

On a more positive note, more than half of the people on the planet live in countries that will hold nationwide elections in 2024, marking the first time this milestone has been reached. Whilst a significant moment for democracy, democratic elections across the developing world have become increasingly less free in recent years, particularly due to the recent rise of a more partisan populist flavour of politics.

El Niño

With the Bureau of Meteorology declaring Australia to be in an El Niño weather pattern as of September 2023, we can expect certain (mostly dry) weather conditions to impact economies whilst also increasing the risk of bush fires locally. With unseasonably warm and dry weather expected around the globe, there are clear impacts that can be anticipated. Most notably that food prices could be squeezed. This has led to conflict in the past. Especially in developing nations. The last time this occurred, it resulted in the Arab spring, where a number of countries saw popular uprisings and a false hope for the emergence of young democracies across the region. Although we don't necessarily expect such an impact this time around, it would be negligent for us not to monitor this situation closely.

Sport diplomacy

The sporting calendar for 2024 is particularly full, featuring the African Cup of Nations (soccer), Copa America (soccer), the World T20 and the Paris Olympics. Whilst such events have a mixed record of diplomatic outcomes, they do provide world leaders an opportunity to engage in a less formal environment. Given the recent fractious geopolitical environment, such events may serve as timely pressure-release points through the year.

AI

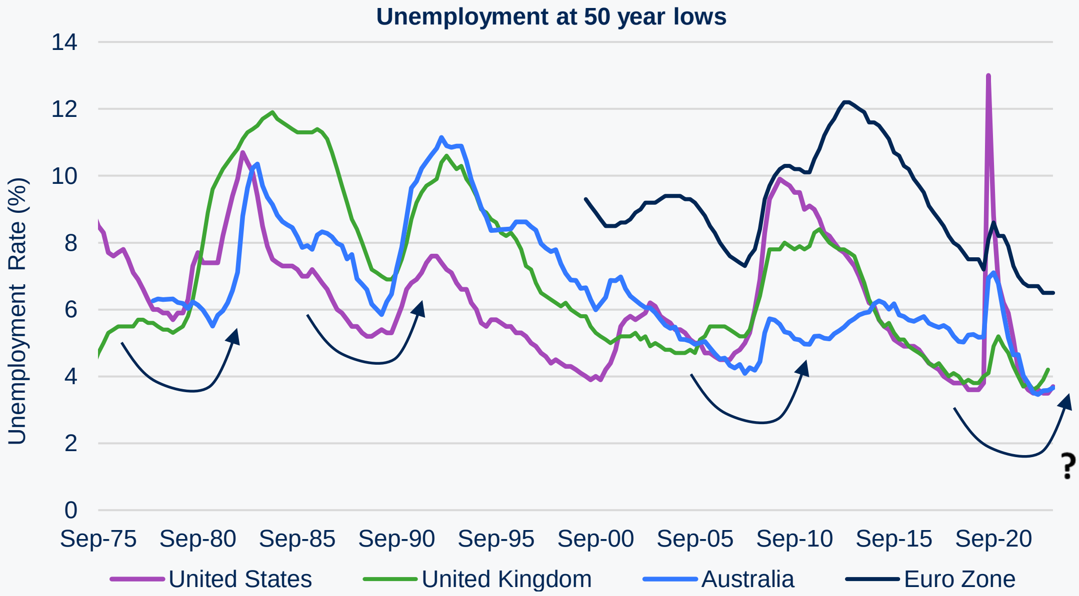
Following its emergence in 2023, we expect the market thematic of 'AI' to fade during 2024. That isn't to say it's not going to be an important technology moving forward however, expectations for the companies along the AI supply chain have expanded rapidly and are beginning to find their limits. As such, we expect AI to slowly recede from the market's primary perspective, but quietly build from a productivity/economic point of view, as it is integrated into working practices.

Labour markets and the consumer

Despite displaying an impressive resistance to the imposition of higher interest rates, it seems reasonable to expect labour markets to soften through 2024. Hope that this may be avoided is just that, hope. Labour markets continue to be tight against historic standards and it seems unlikely that demand will fall to a sufficient degree that it can resolve inflationary pressures without an increase in unemployment. Historically, employers are unlikely to let go of workers when earnings are increasing. As we approach the end of 2023, the driving forces behind earnings have started to soften, suggesting that cost savings via reduced staffing levels might be one of the few levers left to company management to improve earnings outcomes.

As figure 6 demonstrates, in most periods when unemployment does begin to increase, it tends to move in a meaningful way. When we look at the root causes of this phenomena, indications suggest that this is the combination of worker layoffs broadly being resisted until macroeconomic conditions effectively force it (impacting most companies in a similar manner and therefore occurring in broad trends), alongside the feedback loop that emerges as spending behaviour is curtailed due to consumers feeling less secure in their jobs. This curtailment of spending further weighs on corporate earnings, which then encourages a further drive to reduce staffing costs.

Figure 6: Labour market



Source: FactSet, Data as of 29th September 2023

The path of least resistance

Final conclusion

Though we do not know how 2024 will play out, there are some elements that we can be confident of. The key example of this is inflation. Just as inflation was less important in 2023 than it was in 2022, it was still the most important individual determinant of market conditions. In 2024 we expect this trend to continue as central banks fine tune monetary policy. As they have been at pains to make clear, monetary authorities are laser focused on addressing inflation. This is clear. Consequently, as inflationary forces begin to ebb away, central bankers will still need to encourage the right balance of economic conditions. Here, considerations such as full employment and economic activity will begin to move to the fore. As such, we expect that inflation will remain one of the most important factors, but not as dominant as it has been since 2022. This will progress to a situation where it is just one, of a multitude, of key considerations for determining investment positioning. The progression to a new economic phase creates disruptions in risk and return dynamics both across and within asset classes. These disruptions present opportunities as well as threats.

Ultimately, we expect that the path ahead will become increasingly clear as we move forward. That there will be surprises along the way is almost certain. We know from experience, the best approach to moments like this, is to invest our time in studiously following economic and market developments. We reflect on the truism that 'knowledge is power'. As the environment graduates from threat rich to opportunity rich, we seek to amass as much of that power as possible. Acting on it when the time is right.

We wish you and your family a delightful holiday period and look forward to reflecting on 2024, and how closely it matches our expectations, next December.

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