Aviator Update – October 2023
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AVIATOR CAPITAL

Eye on the tail

It's mid-November which means we're starting to see the 2024 predictions trickle out. It's an amusing and humbling tradition where all "sell-side" analyst teams are obliged to offer up their thoughts on the year ahead. Whilst we feel absolutely no obligation to participate, I'm keen to do so this year.

However, we'll save that for next month. Today's missive is going to serve as a bit of a preamble to that.

During last month's commentary ("What's Working") I spoke about how an investment professional's need to "do stuff" every day can strongly influence markets – particularly in the short-term. I also discussed how many respected market participants believe a major change lies ahead – a fairly profound shift in "what's working". The views align fairly closely with our own core thesis, which we've comfortably been holding for some time now.

Another month has passed and no change has been forthcoming – it's been more of the same. That's not unexpected. And to repeat a statement I've made numerous times over the past 18 months "nothing has happened in the past month that changes our core thesis".

Over the past month I've continued to reflect on this idea of change. Not just in a financial markets sense but more broadly.

More specifically, I'm interested in how a lack of change can lead to an abrupt change. That "Minsky moment" sort of stuff us finance-guys like to periodically regurgitate.

A divided world

I don't know about you, but my sense is the world is a pretty bad place at the moment. A lot of unrest and hostility. There's the Israel – Palestine war, the Ukraine war and probably a few other conflicts going on that we don't really even hear of, such as a resurgence of violence in former Yugoslavia (for those of you who can still remember).

These conflicts are driving divisions among people all around the world. Even here in Australia we're seeing "pro-Palestine" rallies… "pro-Israel" rallies. People with no link to either side are drawn into picking sides.

Covid vaccines. Lockdowns. How much of a storm did that all cause? They surely severed plenty of friendships and family relationships which might never recover. Not to mention the significant increase in distrust with "the state".

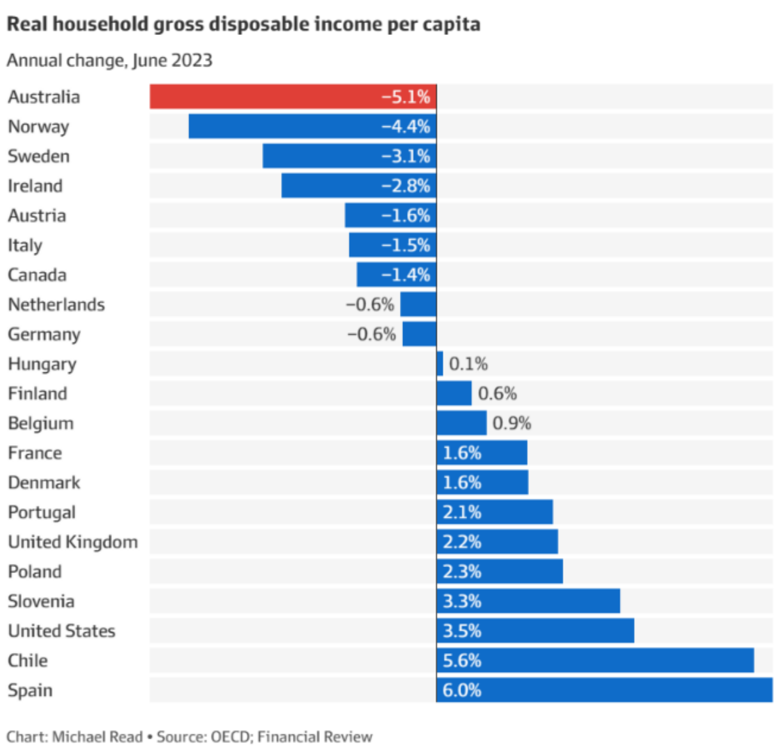
In the U.S., the dysfunctional nature of politics has been getting worse. No longer a nation of "Americans" – now a fragmented nation of "Republicans" and "Democrats". People are fine ignoring the worst indiscretions committed by "their own" whilst hypocritically attacking opponents. People reluctantly supporting political views simply because they are held by "their party".

Older folk in the U.S. are talking about being unable to recall a period of greater division. Major crime and drug problems with drastically different views on how to solve… immigration… climate "crisis"… military… income inequality… When did something as simple as "gender" become so complex and polarising?

Here in Australia, we're a pretty easy-going lot. So long as life in our own little world is going okay we tend not to get too annoyed by things. I know I'm like that. I deliberately avoid watching the news. Avoid engaging online in current affairs matters – it's all so miserable and I have a conscious stance that I don't have time or energy to devote to things that don't directly affect me.

But here in Australia, the pressures from the last few years are beginning to take a toll on many. Inflation is biting.

According to OECD data, Australian household incomes have been hit particularly hard over the past 12 to 18 months:



For many, there's a need to do more with less, given interest rates have hit mortgage repayments.

"*Treasurer, inflation last quarter was a very modest 0.2% and that was mainly due to rising fuel prices. Why do the decisions OPEC nations make about oil impact how much Australians pay on their mortgage*?"

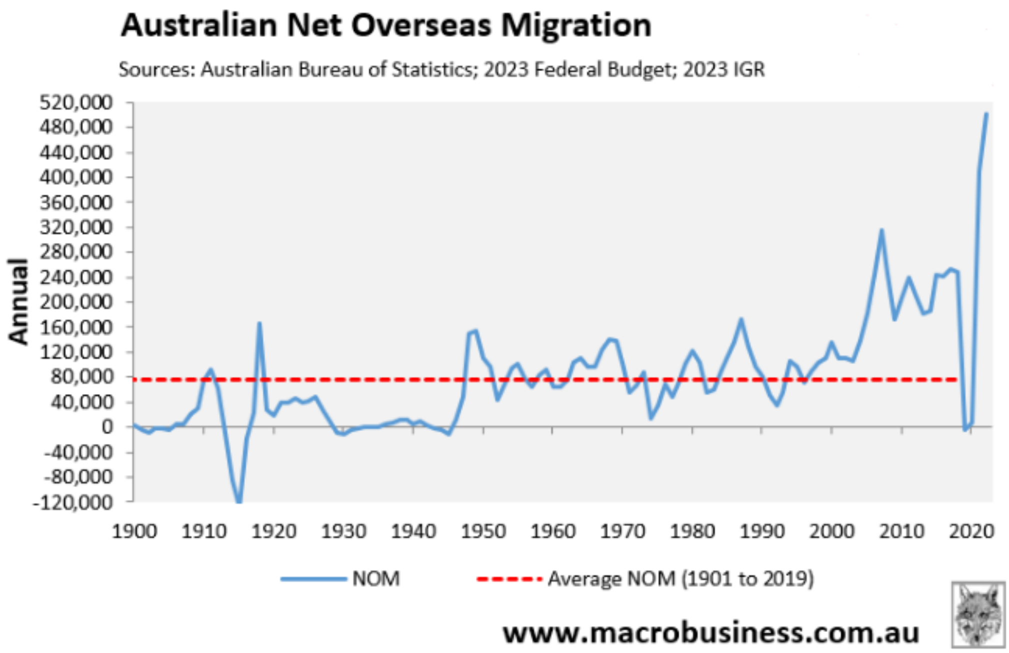
That question was put to the Australian Treasurer by the host of the "7:30 Report" after this most recent interest rate rise early this month.

The way mainstream media report on finance matters like this is equal parts "amusing" and "infuriating". It seems carefully crafted to deliberately stoke anger. If you don't know how the system is structured, you'd have been left thinking it's the government that was responsible for the rate rise. (For what its worth, they indirectly are – we'll get to that in a moment.)

Rate rises continue to be a divisive topic. For the roughly third of Aussies owning their homes outright, they are welcomed. For debt-laden families that are most affected by inflation in general, rate rises are the source of significant stress.

"Big Australia"

It's beginning to catch on that maybe there's some other reasons inflation keeps running hot. Our current federal government thinks that the way forward for Australia is more people. Immigration records have been broken this year:



Around 500,000 new Aussies. The population of my home town of Newcastle is around 500,000. So, we've added a "Newcastle" in the last year.

All these people need a place to live. They *need* to live – consuming food, electricity, water, clothing – all the normal stuff. They need to move about. They get sick and need to go to hospital. Their kids need to go to school.

Is it any wonder house prices and rents are being pressured higher? Is it any wonder why analysts are suggesting inflation might remain "stickier" here in Australia that other parts of the world?

This of course is all adding to division within our population. Property owners love the price-pressure. Younger people one day hoping to have a home in an area they would like to live are left despondent.

Our government has their heart set on continuing this sort of immigration rate into the future. A city the size of Newcastle added every year or two. Will be interesting to watch…

Unrest = unexpected

There's a well-known trait present in most of the world's most successful long-term investors – they obsess over where they could be wrong.

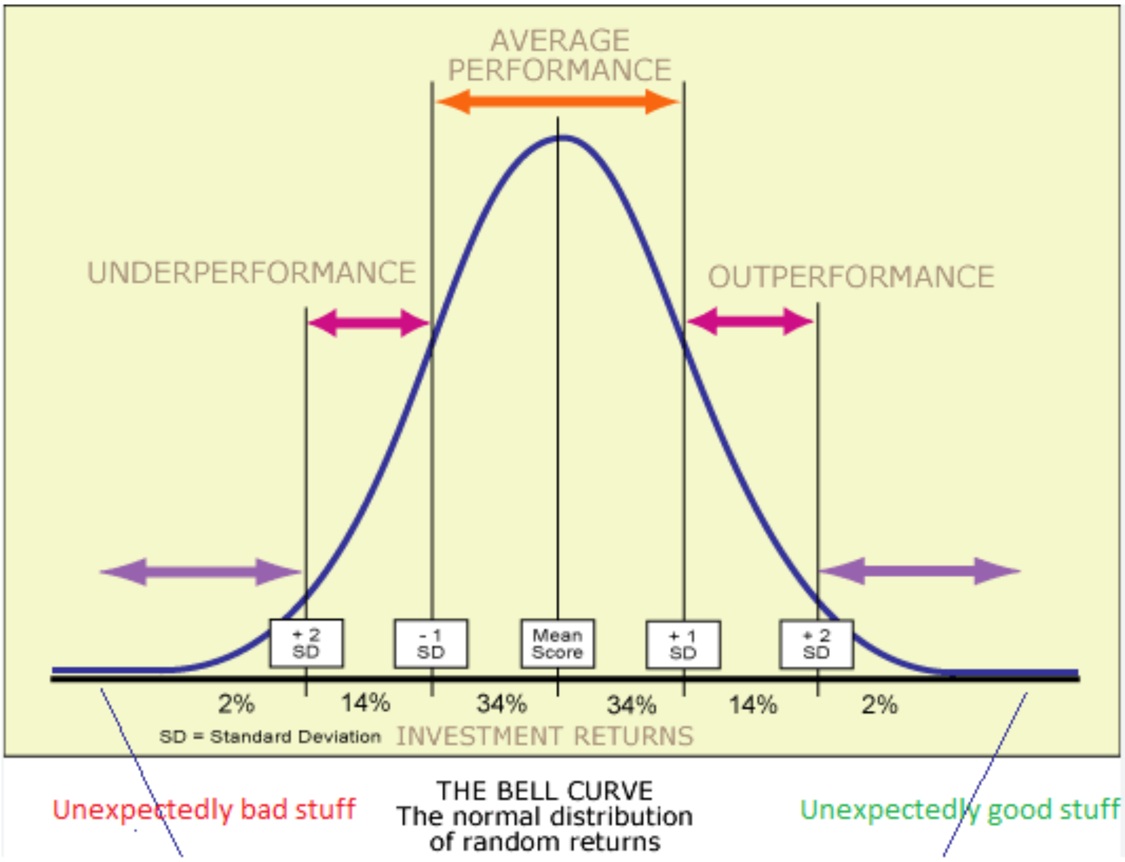
It sounds like a negative character trait… something that needs bashing out of someone via successive rounds of business/personal coaching. "Think positive"… "the power of positive thinking" – we frequently encounter people telling us how important these things are in order to be able to take risks and make things happen for ourselves in life.

This doesn't apply to investing. It's the job of an investment manager to identify a set of possible outcomes and assign a perceived probability on each. Again, successful managers have a tendency to focus heavily on possible negative outcomes. Their thinking can have a major impact on their investment decisions – geographical areas, asset classes, sectors, down to individual securities/instruments.

Importantly, it's not about being "negative". It's about being realistic. Perhaps that's the valuable trait of a successful investor – the ability to truly see things as they are…

As we enter 2024, given the state of the world at present, it's more important than usual for investors to focus on the unexpected.

In finance-land we call it "tail risks". That is, the possibility of an event occurring that falls outside of the "expected" set of outcomes, according to a normal probability distribution:



It's my view that, in terms of share market returns, we might currently be in a "fat tail" situation. That is, a "higher than normal" probability of negative things happening that impact share market returns.

Here's one (or several related) examples…

Say the Chinese economy continues to splutter and demand for raw materials plummets. This "unexpected" scenario would put major pressure on resources prices and likely result in a major decline in some of our major resources companies including BHP, RIO and Fortescue.

Take it a step further. Say the spluttering economy leads to widespread social unrest, requiring the Chinese government to… how do we put it… "use a heavy hand" to control protests.

Separately, what if China makes a move on Taiwan?

It's likely that these latter two scenarios would result in the U.S. calling for trade sanctions on China.

Sanctions… on our biggest trading partner…

If there's any whiff of that possibility, rest assured our major mining companies will be hit for 35% before you can say "what do you think this might mean for Australia?" All your fundamental research will mean nothing – earnings-per-share growth and RoE's don't much matter where there's powerful global political forces asking you to shun your biggest customer.

To reiterate something I'm conscious to often state, we're optimistic about what the future holds – for investors and humans more generally. As I plan to share next time, there's a lot of exciting opportunities emerging for investors. But simultaneously, it's a time where we need to focus intently on <u>all</u> possible outcomes.