Aviator Update – December 2023
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AVIATOR CAPITAL

2024…

It's that time of year again… Summer has arrived in Australia. Santa is packing up his sleigh and readying the reindeer for their annual pilgrimage. And people in finance-land are embracing the "Christmas rally" whilst looking forward to what the next year might bring.

In our view, it's been a rather uneventful year. Whilst some assets are looking more attractive than a year ago, our broad views on the markets are basically unchanged. As we'll see, that's largely the case for other forecasters as well!

Before we get into looking at some 2024 predictions, let's remind ourselves that bullish optimism is mandatory on Wall Street. It's never a sensible idea to be negative on the product you're trying to sell and for Wall Street, that "product" is basically the stock market.

In terms of market outlooks, "cautiously optimistic" is probably the ideal environment for the sell-side (being brokerage houses, investment banks, investment newsletter publishers and the like).

Under this, the outlook is positive! It's a time to own risk assets. But you need to be focused – you need the expertise of your broker/adviser/analyst team to help you navigate the waters. There's scope for plentiful transactions as portfolios are re-balanced and curated. The bank's initial public offerings can be bought into with potential for instant gains.

Conversely, a negative market outlook means, for the most part, you solicit just one trade from your clients – sell. Any further trade ideas are met with "yeah I'll just wait and see for now – your strategists are saying the outlook isn't good…" You'll likely lose funds under management as clients move their money to term deposits – away from your ability to charge management fees.

Of course, there's always scope to be wrong in your optimistic outlook. The market may suffer significant falls – the kind that happen "out of the blue" every few years. The good news for strategists and most money-managers is that there's no consequence to being "wrong" in this way.

Remember, there's nothing wrong with being wrong when everyone else is wrong. Have "unexpected" events resulted in the market being down 35%? That's okay – these events occur periodically, but the markets bounce back. You can console your clients on that and how “unpredictable” it is. With any luck their portfolio is only down 30% and you can point out the out-performance you’ve delivered!

But if you say the market looks like it will fall and it doesn’t, that’s major career risk. Material underperformance will soon get you fired – directly by your clients if you’re a planner/adviser/stockbroker or by your employer if you’re a portfolio manager.

2024 from the sell-side

Plenty of investment houses have now released some commentary on the 2024 market outlook. Go find a few and read them – what you’ll find is they are all rather similar. I’d suggest “cautiously optimistic” is a common theme.

Deutsche Bank and BMO are currently offering some of the slightly more optimistic outlooks.

BMO’s chief investment strategist has the following outlook:

“*We believe 2024 will be year-2 of at least a 3 to 5-year process that will see US stocks exhibit more normal and typical performance, paced by a backdrop of normal and typical GDP and earnings growth, valuation, and bond yield ranges*.”

According to them, we’re in a new bull market. They point out that the S&P 500 usually returns about 11% in the second year of a bull market. That’s resulted in their call for a 2024 target of 5,100.

Both Deutsche Bank and BMO see the S&P 500 delivering earnings per share of $250 in the year ahead.

Deutsche Bank feels "*If earnings growth continues to recover as we forecast, valuations will remain well supported around the top of the range as is typical on the pricing in of a pickup in earnings growth*."

Interestingly, Deutsche Bank are also predicting a recession in the first half of 2024. But the good news is that although the economy will take a hit, stocks will be fine. "*Given [a recession] is widely anticipated, and expected to be mild and short, we see only a modest short-lived selloff*".

Similarly, BMO also think recession is possible however are calling a potential downturn as a "chicken little recession", noting that the continued strength of the labour market has them confident the US economy would hold up enough, meaning it would just be a "recession in name only."

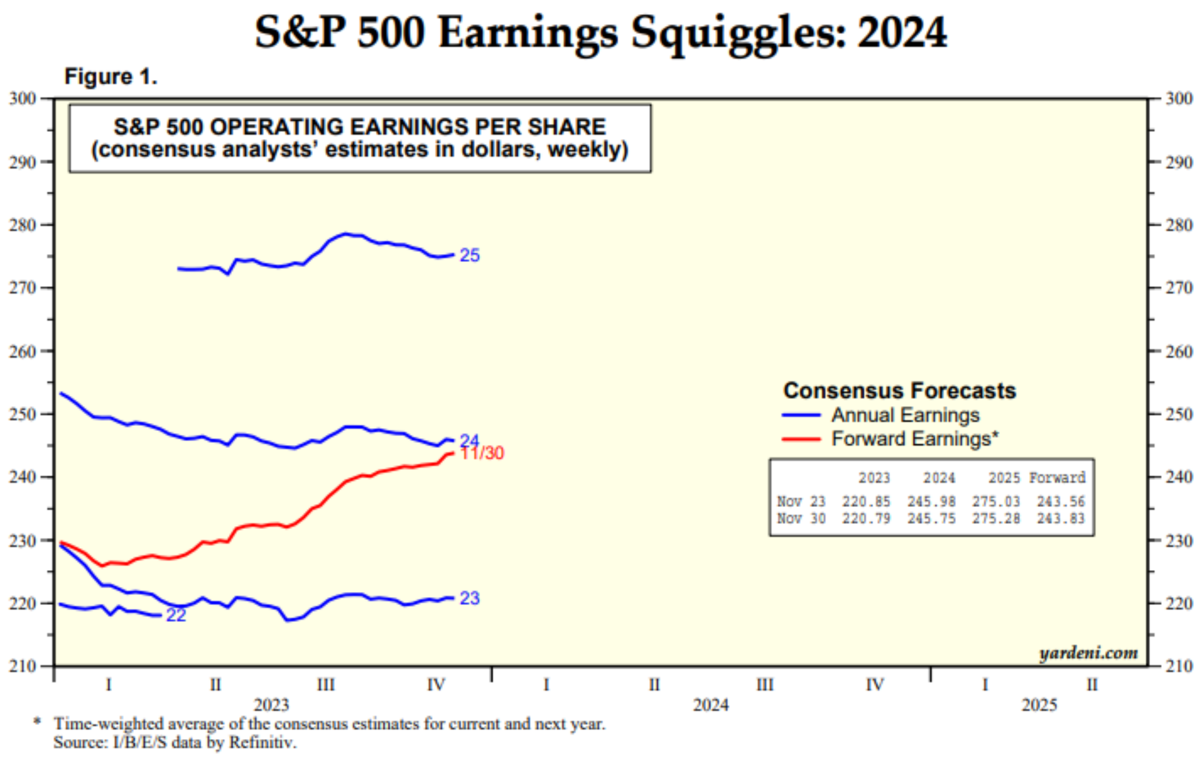
So what investment strategies should investors focus on? Well, according to BMO, "*We believe active investment strategies will be even more important next year as many of the largest stocks that drove performance within sectors are unlikely to maintain that momentum in 2024, forcing investors to search for other opportunities further down the market cap spectrum.*"

There we have it… "Cautious optimism". There's every reason to believe 2024 will be a good year for investors, but as BMO seek to highlight, you'll need the help of their team to successfully navigate the waters and maximise your returns.

Earnings Outlook:

Let's have a closer look at the earnings outlook as we head into the new year. Dr Ed Yardeni does us all a favour in tracking the consensus estimates – plotting their changes over time within charts he likes to call "earnings squiggles".

The chart below shows where the consensus earnings estimates currently sit for this year as well as 2024 and 2025.



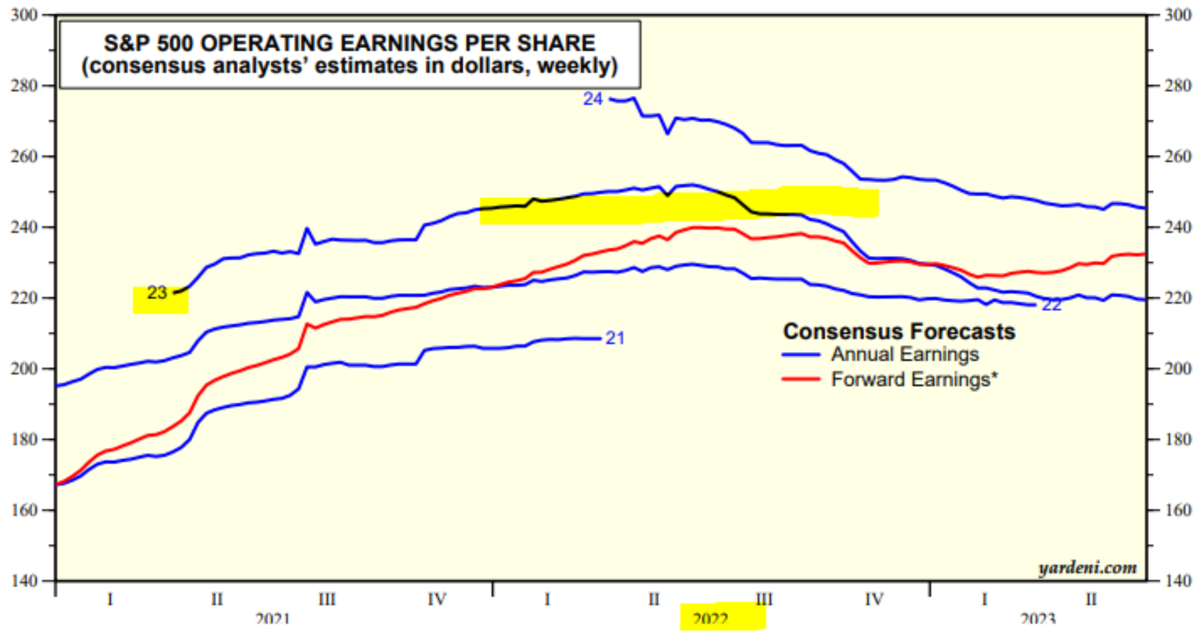
This current year (2023) is set to come in around $220 – that will be a <u>very</u> modest increase from 2022.

2024 is projected to be around $245 – that will be around $25 increase – around 11%.

2025 is currently expected to be around $275. That represents around 12% increase to 2024.

Nice and linear – 11-ish percent annual growth. Indeed, there's valid reasoning for this – the market has delivered that kind of growth during periods of "normal" economic growth.

Taking a step back in time for a moment, the chart below shows that for much of 2022, the 2023 number was expected to be around $240! The expected outcome now around $220 is therefore quite a "miss" from earlier estimates. It's interesting to observe how these forward estimates typically get ratcheted down over time.



Quite a few commentators (myself included) feel there's quite a bit of risk to the earnings outlook. To illustrate just some of the reasons, let's apply a little financial common-sense.

Most people expect that we will see a continued moderation in inflation next year – headed back towards "reasonable".

[Digressing on this topic for a moment, for what it's worth, I don't disagree with this, although I'm very sympathetic towards the history of inflationary periods. Specifically, during previous periods of high inflation, its tended to come in "waves" – spikes and retreats. True – there's limited historical precedents in the last 100 years plus every cycle is different. It's just that the scenario of "massive spike then uninterrupted decline back to normal" would be a very unusual event.]

Anyhow… In the simplest sense, what is inflation? It is businesses raising selling prices, right? So the consensus is for a marked decline in the rate of price increases. That's not good for business revenue.

Next, we've just come through an unprecedented period of "free money". For over a decade the U.S. Federal Reserve held official interest rates at practically zero whilst also engaging in an untested and unprecedented monetary experiment known as Quantitative Easing". Here's about 70 years' worth of the Fed Funds Rate:

Since the Fed cut rates to zero during the Global Financial Crisis, lending rates available to businesses have been low. Lending rates have now "normalised". Look at the chart going back to the '50's – there's no way anyone can suggest current official interest rates are excessive – they are very much around average and that's even if we include the entire recent period of zero rates.

A lot of businesses secured a great rate on borrowings over the last 5 years. You might even recall the reports from a number of years ago about the big "debt for equity swap" being pursued by many companies – taking advantage of low interest rates by borrowing money they didn't really need then using the proceeds to buy back their own shares.

You might even have heard about the huge number of "zombie-companies" – companies that barely generate sufficient cash flow to service their debt burden.

Many of these credit facilities will fall due for refinancing in the next couple of years.

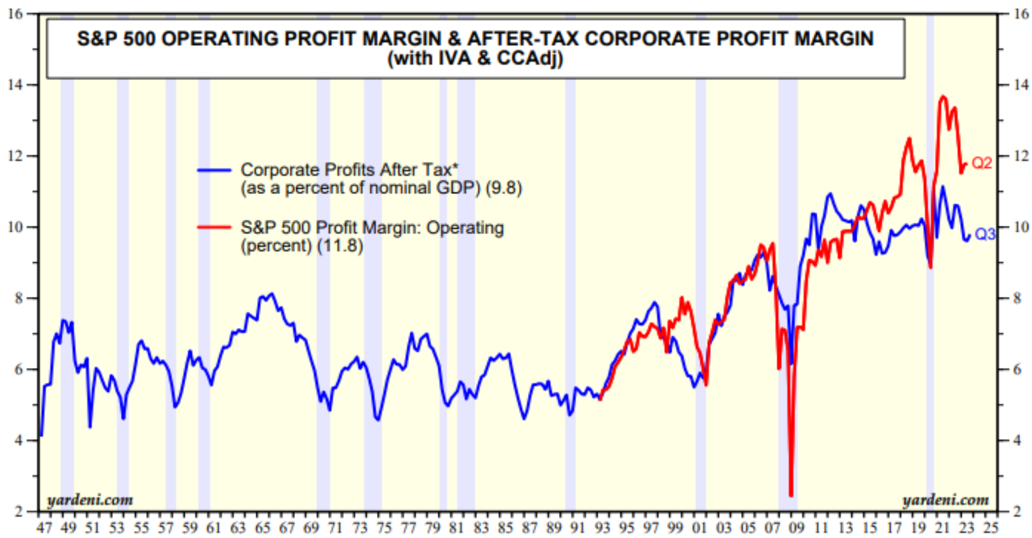
5 years ago, maybe a business was offered $500 million at 4.5%. When they come to refinance, perhaps their lender says "we'll give you $400 million at 7.5%".

That leaves you in a bit of a predicament. Your cost of funding has gone up significantly, whilst you now have a hole of $100 million you need to fill. That's going to be a major problem for some companies.

Historically-low funding costs have provided a meaningful boost to corporate profit margins over the past decade. This is now "normalising" – it should have an appreciable impact on aggregate profits.

Understandably, it will take a little time to flow through. This year there seems to be a view that the global economy is "digesting" the substantial interest rate rises with ease. But it's a little too early to say that.

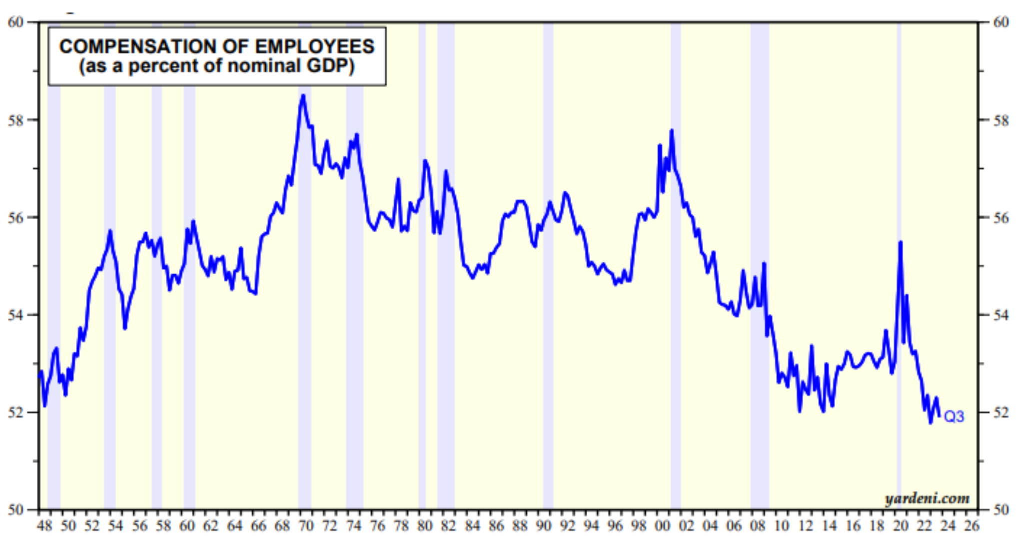
In terms of profit margins, it's been widely discussed that margins in recent years have been abnormally high:



Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
* Profits after tax with IVA and CCAdj.
Source: Standard & Poor's, I/B/E/S data by Refinitiv, and Bureau of Economic Analysis.

Again, a significant decline in debt servicing costs has helped.

There's another factor that's seen to be very relevant – wage growth:



Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: US Department of Commerce, Bureau of Economic Analysis.

For varying complex reasons, wages growth has been suppressed over the past decade. Lower compensation to employees means more profit for companies and thus higher profit margins.

But have you noticed that workers are fighting back? Have you noticed how much strike action is going on around the world? Do a little research – there's a lot.

As workers win meaningful pay increases, companies will be faced with a choice – attempt to pass it on via higher selling prices (= inflation pressure) or wear it (= lower profits).

Neither of these options is a positive for share prices.

Recession obsession

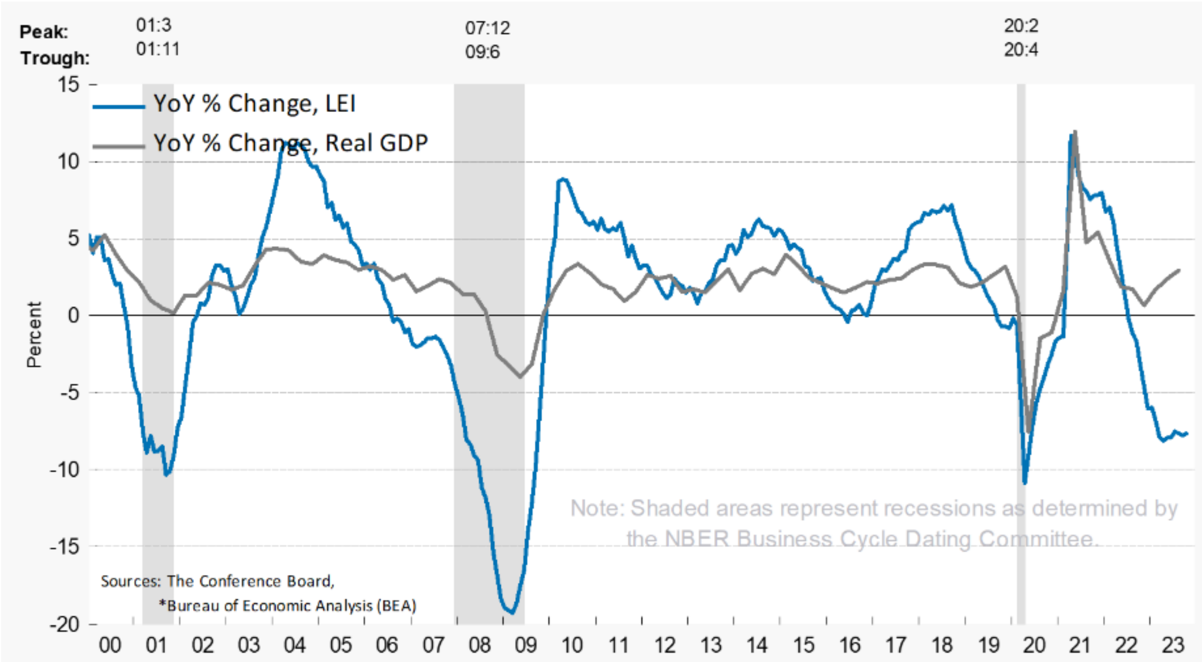
If you recall, this time last year it was universally accepted that 2023 would see a recession in the U.S. economy – it was to be the most widely-predicted recession ever.

Consistent with the economy and markets not doing what they're supposed to, the recession didn't arrive.

Consistent with forecasts such as those earlier from BMO and Deutsche, recession is still seen to be a real chance in 2024. The consensus has shifted however – 2023's resilience has many giving up on a recession.

Leading indicators such as the Conference Board's Leading Economic Index (LEI) have a decent track record of foretelling an upcoming recession. The trend over this past year has not been favourable – readings historically associated with recession. However, it's very fair to point out that this last 4 years has been unprecedented and there's been unprecedented impacts on the economy.

The LEI chart (below) offers a graphical representation of the enthusiasm towards a "soft landing" – all year its delivered readings consistent with imminent recession yet the economy chugs along.



There's barely a couple of precedents in the data (at least in the last 20 years) – if the economy has shrugged off "weakness" so far, maybe the worst is behind us? If the LEI can bounce back from these depths then it's a good chance the economy will strengthen.

With that in mind, it's worth noting what have been some of the strongest components in the index. One in particular – stock prices.

That's right – stock prices have earned themselves a place in many leading economic indicator models, including the widely-followed Conference Board's. There's a reason for this – stock prices have an admirable record of predicting recessions.

Yes, I know… there's the old saying that goes "the stock market has successfully predicted 15 of the last 3 recessions!" But nevertheless, the stock market generally goes down ahead of a recession.

It is an interesting juncture. A buoyant stock market has helped support (weak) leading economic indicators – they would have been worse with stock market weakness.

Appreciable stock market weakness in the near-future will likely send the leading indicators lower… to levels that would be very likely associated with recession. Said differently, appreciable stock market weakness in the near-future would be *very* a strong indicator of impending recession.

"Leading indicator" remains the key phrase here. The scenario I'm describing is a market selloff being a valuable warning of recession and further meaningful market weakness. But just like previous occasions, the Wall Street crowd won't have that – "healthy pullback… Fed pivot… soft landing… buy the dip…" That's what we'll hear…

In terms of recession expectations, for what its worth, respected economic forecasters are currently noting that it remains a time to be on “recession-watch”. Economic data suggests the economy is on the brink of recession, however it’s still too early to call.

Our humble opinion is that there’s a decent chance of a recession in the U.S. in the next 12 to 18 months. Will it be a “recession in name only” or something more serious? I don’t know. I’ll simply highlight that the consensus expectation prior to *every* recession is it will be brief and shallow.

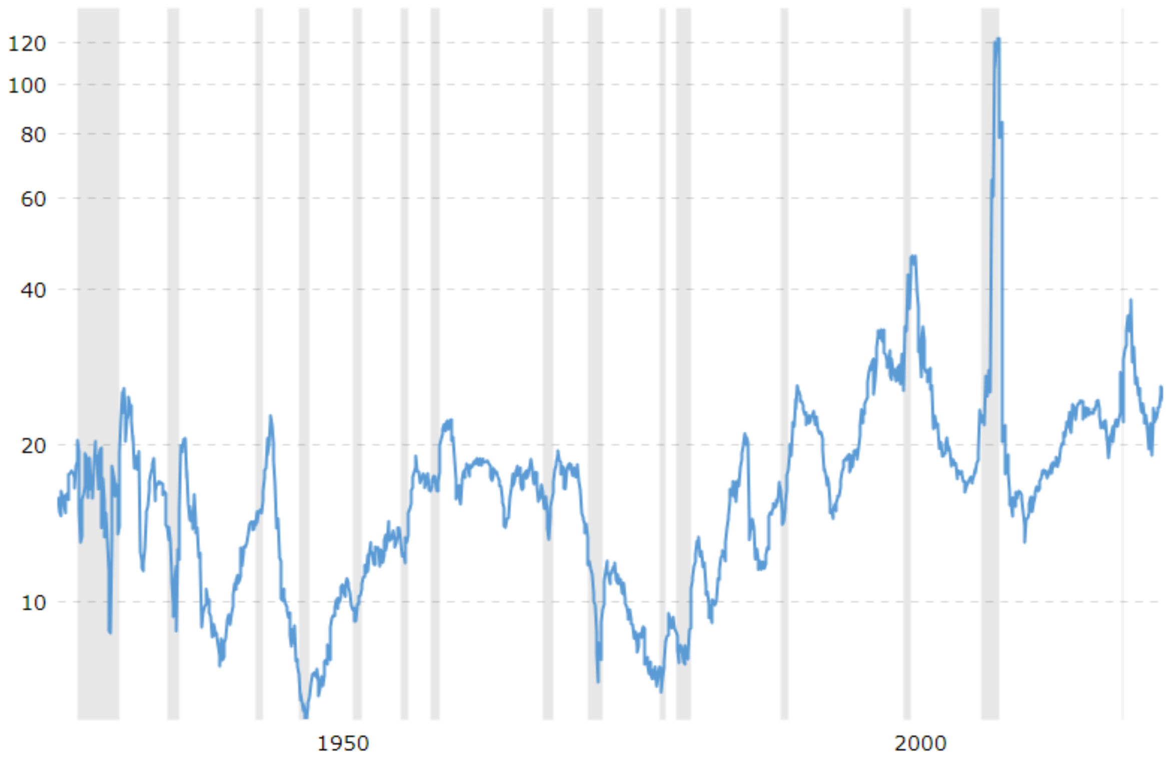
Valuation Update

Before we review some “meaningful” valuation metrics, let’s take a moment to review some “meaningless” valuation metrics.

Referring back to that S&P 500 earnings data, 2023 is expected to end with around $220 in earnings. If we divide that into the market price of 4,550, we arrive at a P/E ratio of about 21.

How does that stack up to history?

S&P 500 trailing 12-month P/E:



The long-term average is closer to 16. We sure can’t say 21 is “cheap”!

Oh, if you're interested, look up where the PE sits on some of those favoured tech stocks like NVDIA and Google. 30-something or higher. They need to deliver some incredible growth in earnings to justify current valuations – I sure hope this "AI" stuff isn't just hype!

If we look out to 2024, earnings are projected to be $245. "Forward P/E" around 19 – a little better.

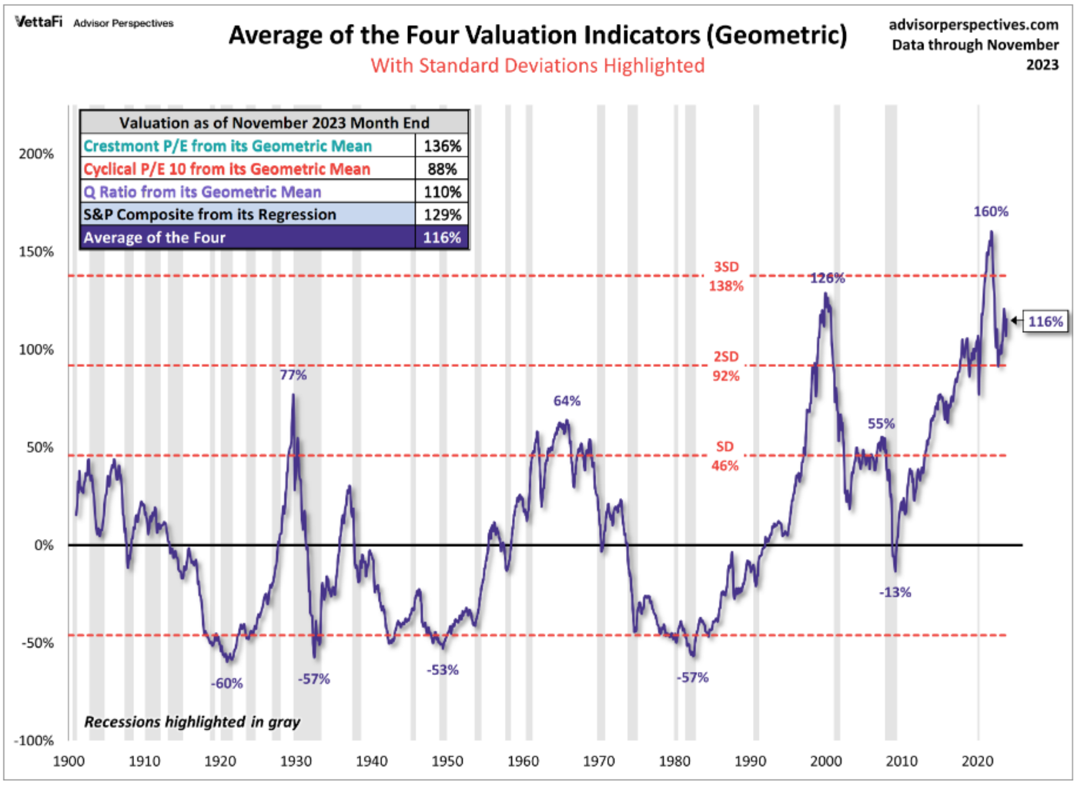
These metrics are the most commonly-cited valuation metrics. They are nice and simple. The reason I refer to them as "meaningless" is that they have demonstrated very little predictive power.

I mean, the P/E was lower than now prior to the 2008/2009 GFC. That didn't stop the market falling 48%. The P/E was much lower in the early '70's ahead of a bear market that saw the S&P loose over 50%.

A useful valuation model is one that has a decent track record of predicting the future –one that has a high correlation to subsequent market returns.

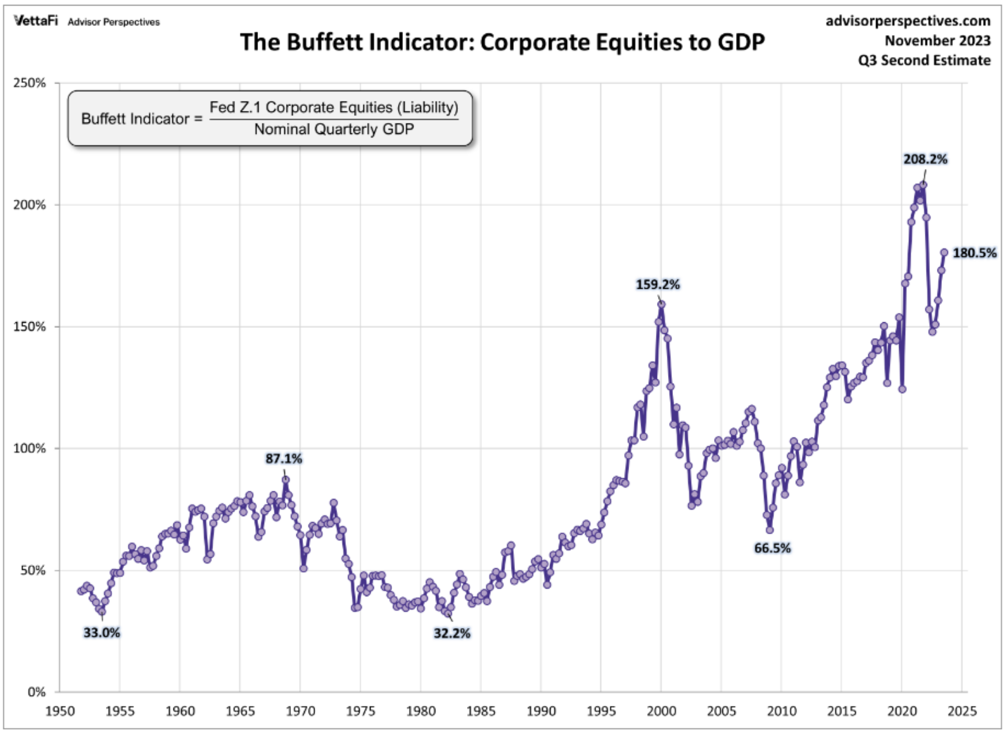
Unfortunately, it takes a little more brain-power and effort to both come up with such a model and also to understand and apply it. Fortunately for us, when it comes to the U.S. markets, quite a number of smart people have done the hard work for us.

The team at Advisor Perspectives maintain and track a number of valuation models that have proven to be reliable indicators of subsequent market returns. The chart below is an average of four models they track:



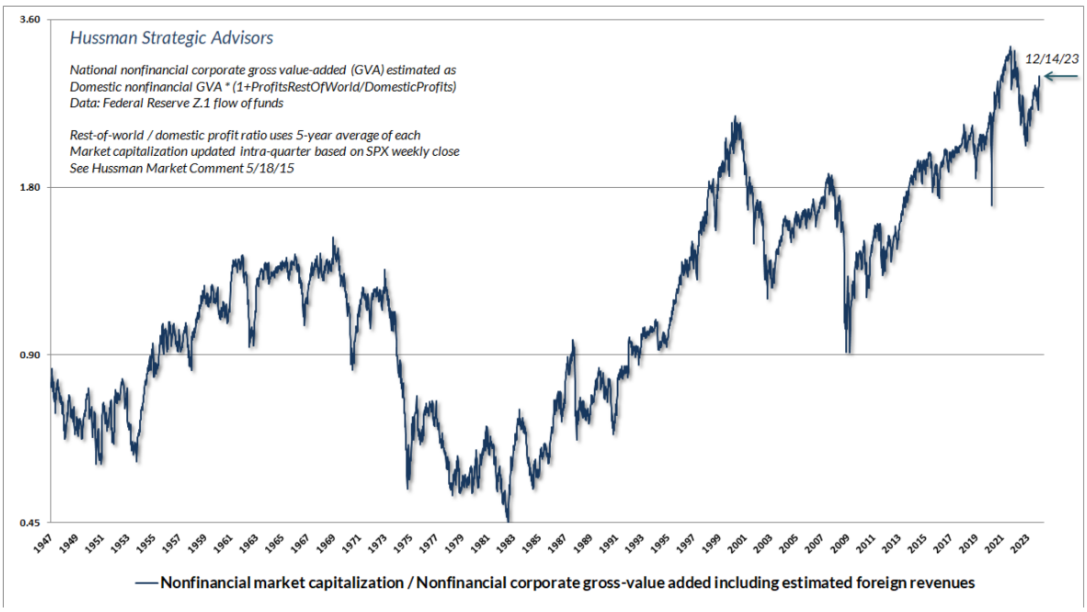
According to these models, valuations have only been higher a small number of times including prior to the 2000 market peak and the 2021 market peak.

Let's check in with the "Buffett Indicator" – corporate equities to GDP, which Warren Buffett has described as probably the single best indicator of where valuations stand at any point:



A similar picture, although under this model valuations currently surpass the 2000 market peak.

Finally, let's have a look at John Hussman's market cap-to-gross value-added model which has a correlation in the high-90's with subsequent market returns:



As over-valued as it's ever been aside from a few months surrounding the 2021 market peak.

All these models suggest the U.S. share market is 50% (or more) over-valued compared to long-term "norms".

As usual, these valuation models come with an important caveat – they provide a reliable forecast of future market returns over the medium to long-term but are not a reliable indication of short-term returns.

The fact that markets are very over-valued relative to history doesn't mean they "must" fall in the near-term. Indeed, the only way for the markets to reach strenuous valuation extremes is for them to shrug off and push through lower extremes.

U.S. share market investors can expect a very, very modest average annual return on their share portfolio over the coming 5 to 10-year period. But "average" is the key – it's not likely to be a nice, neat 1% per year. History shows that periods of similarly extreme valuations have "resolved" with an abrupt retreat in valuations. Said differently, markets have tended to experience a significant fall. That's the historical precedent – no guarantees this cycle will be the same.

Along for the ride…

For several years now, "flippant" probably best describes my stance on the Australian markets and economy. As Australian-based asset managers, of course we have a view. As it stands at the moment, our Australian economic views are mostly reflected in our property portfolio activity.

Presently, our views on the Australia share market are a reflection of our views on the U.S. share markets. There's a bunch of good companies here in Australia. Consistent track record of growing their earnings. Paying good dividends and coming with valuable franking credits (especially valuable within superannuation funds).

Simply, we're a believer in history that says the Australian market is largely beholden to the U.S. If the U.S. falls 50%, anticipate Australia will follow suit. Sure, you can say it will come back – pointing to how it always does. But suffering a major drawdown doesn't sit well with us – that's a function of what we believe (more on this below).

2024…

With valuations significantly extended, it's our view that a lot needs to go "right" next year:

- Recession needs to remain elusive.

- Profit margins need to stay at historical highs. Corporates need to be able to refinance all the debt they need.
- Inflation needs to continue to subside.
- Consumer spending needs to remain buoyant.

Also, as mentioned in last month's commentary, nothing "unexpected" needs to happen:
- No imploding of the Chinese economy.
- No currency crises.
- No sovereign debt crises.
- No oil price shocks.
- No invasions…

Most importantly, investors need to remain "greedy".

A swing from "greed" to "fear" is basically the single biggest reason markets have those periodical major falls. When investors collectively decide they want to get out of shareholdings, the question becomes who's going to buy them? Equilibrium must prevail – for every seller there needs to be a buyer. When fear is in the air, typically large price adjustments (lower) are needed to lure a willing buyer.

This is especially the case when the market is as over-valued as it currently is. Over-valued markets tend to "correct" lower – that's what they do, that's what history demonstrates.

As we survey the investment landscape today, it's striking how little has changed this year, although I guess that's probably the situation many years. Sure, things have happened this year (delivering some interesting investment opportunities that we might explore in some more detail in the coming months). But in terms of share markets, it's been a rather uneventful year.

One of my main messages during this last year has been challenging everyone to reflect on what you believe in. Your investment philosophy. How you're going to go about navigating what, in our view, is an extraordinary time in investment markets history and one of the most challenging times.

Just to recap, here's a little of what we believe:

We're out in search of that illusive "absolute return" – we don't much care about how the market fares – we seek to do the best we can regardless of market direction.

With that, we're comfortable in being "wrong on our own".

We believe opportunities are much easier to make up than losses.

We believe in market history.

We believe in market cycles.

We don’t believe in the average sell-side view that 2024 should be just fine, although we are very respectful this may well be the outcome.

We believe that, as we enter 2024, share markets are in a particularly high-risk state.

We believe that this environment offers some captivating opportunities as the market cycle completes.

We believe that patience is essential whilst impatience for returns will likely prove costly.

Above all, we’re optimistic about the future. We believe its going to be a bumpy ride and we’re confident we have the ability to navigate our way through the turbulence.

Best wishes everyone for the new year. I hope you have a good year with regards to all the important things in life (not money)…