Aviator Update – February 2023
Lindsey Lawrance

Shifting Narratives

It's been a rather fascinating few months in finance-land. On the surface, little has happened – economic data has been relatively 'as-expected' and the markets have been quite benign. But under the bonnet, things have shifted quite meaningfully.

We know that investor psychology plays a major role in shorter-term financial market movements. Related to this, there's generally one (or several) "narratives" ruling the investing world – it's wise for us to always understand what they are.

Think back a few years… Covid. Markets roaring higher! The general narrative was "TINA" – interest rates were zero, an incredible volume of global bonds actually had negative yields, share markets (as well as silly things such as crypto and things like "NFT's") were roaring… "There Is No Alternative". We could believe it was silly and choose not to play along. But the markets are bigger than any of us and we don't want to fight the market.

Inflation reared its head. The general narrative became "Inflation will be transitory". Oh and, "[Federal Reserve Chairman] Powell won't do anything to hurt the markets! Q.E. infinity!"

We know that 2022 wasn't kind to investors. Turned out that inflation wasn't quite as "transitory" as most expected. But despite central banks globally embarking on one of the biggest, swiftest monetary policy tightening cycles ever seen, there's still been plenty of positivity.

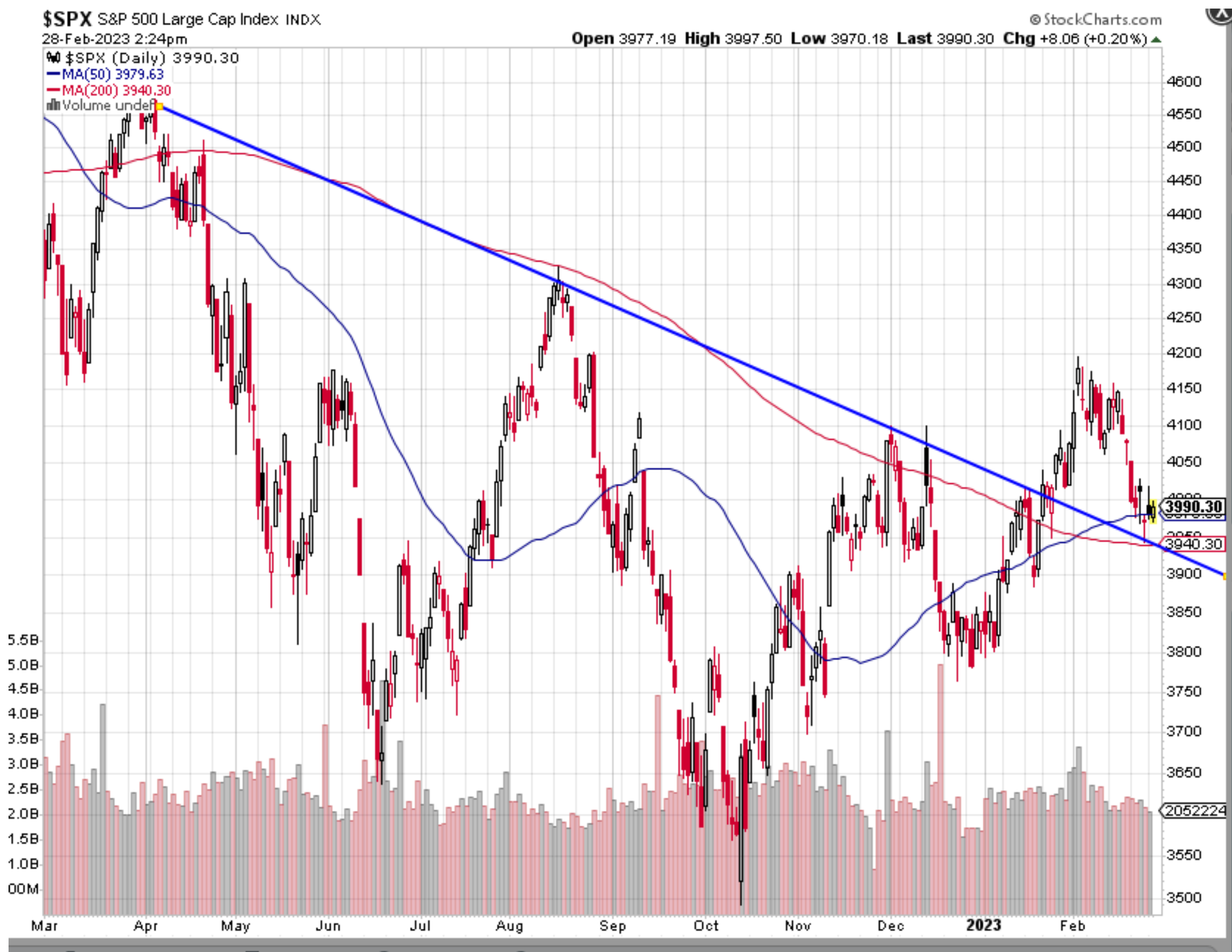
As we closed out 2022, the general narrative has in essence been that inflation is still transitory! Interest rate rises will work, inflation will fall and rates will come down. And yes, there's a high likelihood that the U.S. (and many other countries) will experience a recession. But hey, that's good! That will end inflation, rates will be cut and we'll begin a new cycle – i.e. financial markets will bottom and a glorious new bull market will be born out of the economic recovery!

Suffice to say we're not really believers in this… the general chain of events is fairly sound – that's the traditional market cycle. It's the timing and starting point that I struggle with.

A recap of the last few months is in order (focusing on the U.S.)…

We started the year feeling pretty gloomy. December wasn't kind to equity markets. There was also a broad consensus that this year was going to be pretty miserable for the economy. "Recession" was the consensus call – which is incredibly unusual, given that recessions in the past have typically tended to come out of the blue (well, not really… but they were only predicted by a small percentage of professional forecasters).

January was quite kind to markets. Indeed, the technical analysts were cheering as all sorts of things began to break their downtrend lines and peek above closely-watched moving averages. Here's the U.S. S&P500:



We've had more than a few commentators quick to proclaim the new bull market has started and a run to new highs should now be targeted. We certainly can't rule out further gains although I really expect any near-term gains to be "transitory".

As we close out February, we should acknowledge that the technical backdrop remains solid – things have pulled back from recent highs but continue to look quite positive. Technicals tend to matter more when there's little news so newsflow might matter a bit more in this next few weeks and months.

Observers have noted that the run from 3900-ish to 4200-ish was due to just 8 stocks – the usual names – Google, Facebook etc. The remaining 492 members of the index stayed pretty flat. This sort of action isn't generally the stuff of durable rallies – breadth and participation are key factors and they have not been supportive.

In terms of economic data, there's been a number of important releases during January/February. We begin with the December CPI release on January 12th. It showed that inflation declined 0.1% in December with the year-over-year inflation rate declining to 6.5% from 7.1% - certainly all very positive. The January reading released February 14th showed less improvement with the year-over-year rate declining just 0.1% to 6.4%

26th January saw the release of December quarter GDP. Coming in at 2.9% annualised expansion, this was above expectations.

Finally, 3rd of February was the release of January's employment numbers. This saw nonfarm payrolls reporting to have increased by 517,000 in January with the unemployment rate remaining at an incredibly low 3.4%.

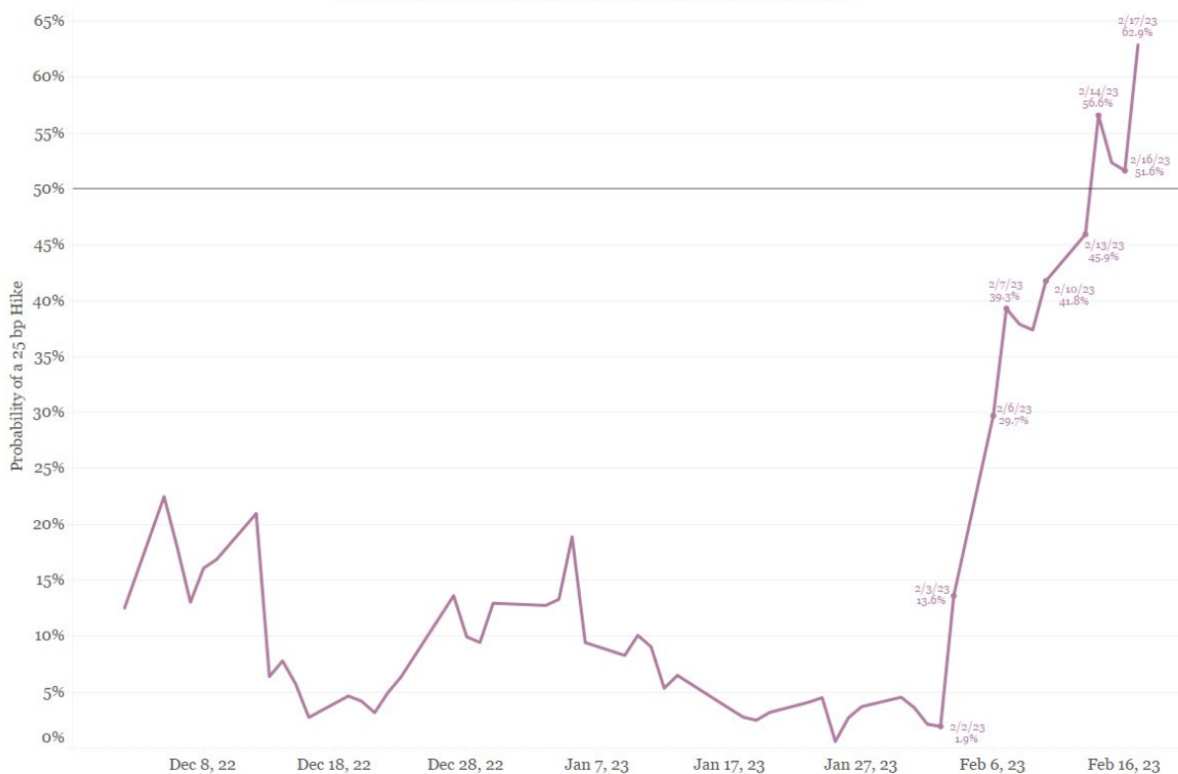
These data releases are a little problematic for the "imminent recession" narrative.

"Higher for longer"

An important part of the "recession is coming / inflation is transitory" narrative has included "we're nearly at peak interest rates".

Sure, Fed chairman Powell has been saying for months that rates will need to continue to rise (albeit at a slower pace) and will stay there possibly for quite some time. Of course, many investors don't believe him – "they'll start cutting at the first signs of economic weakness" has been the narrative.

It's therefore interesting (and significant) that interest rate markets have spent most of February increasing their expectations for further rate rises. This chart shows that prior to that February 3 employment release, the probability of a rate hike in June was seen to be very low. By mid-month, the odds had increased to over 60%. What's more, the chances of a 0.25% hike in July is now seen to be around 30%.



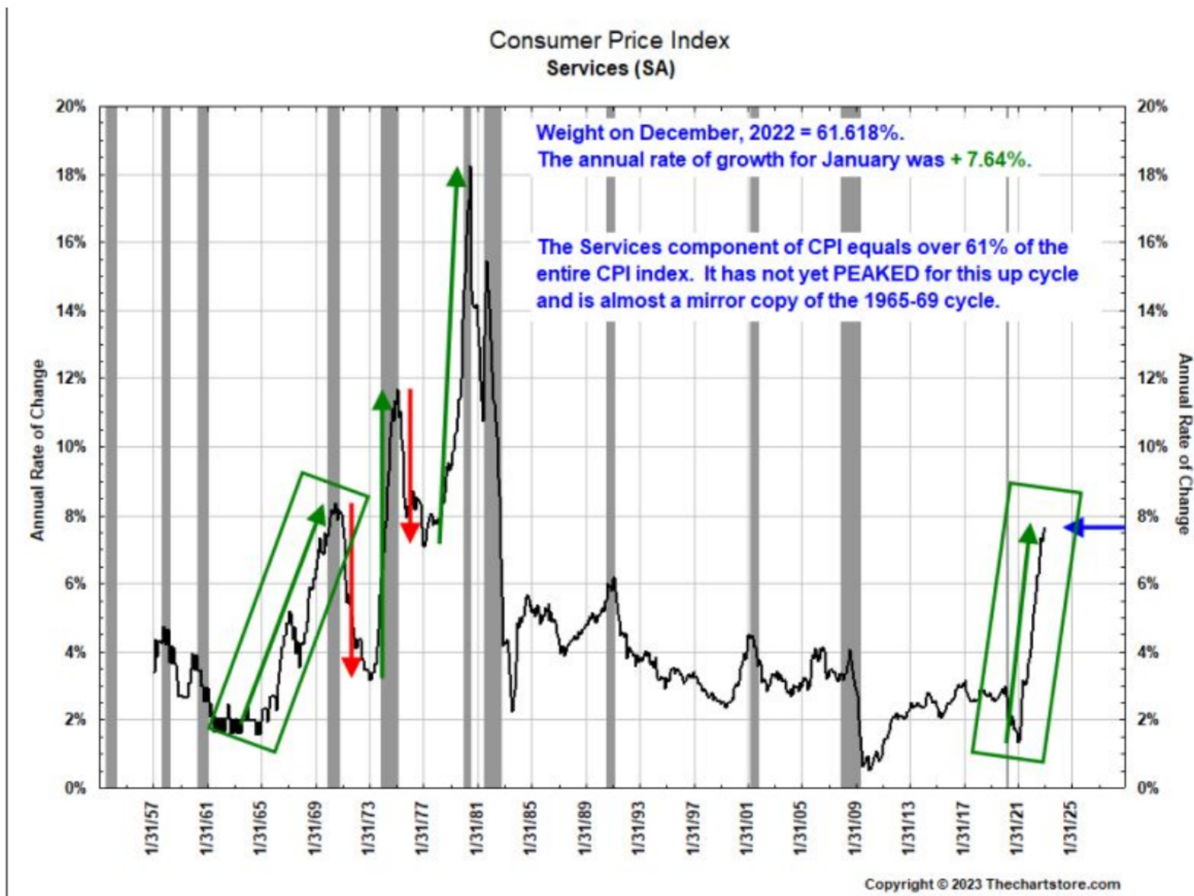
I noted late last year that the battle during this first part of the year will mostly be related to inflation and interest rates – that's certainly proving correct. The expected peak rate level is shifting higher. This is not a positive for risk assets or even less-risky assets (bonds).

Inflation Peaked?

Recapping those recent U.S. CPI results, headline rates have come down which is surely welcome news (and also as-expected given the consensus narrative that inflation will continue to fall precipitously back towards 2%).

But when you dig a little deeper, there's plenty of reasons to believe that the road to lower inflation will at least be a little bit bumpy.

Here's some interesting observations on how inflation in the services sector is yet to peak:



We've described our "best guess" in relation to inflation several times over the past few months. There's a very strong chance that we've seen the peak of inflation on a "headline" basis. But what matters more is what happens after that. The consensus narrative has been a consistent fall back towards 2%. We're not so sure. It will probably be a bit choppier than many expect and there's a good chance that it might stall for periods well above this comfort-zone. A 4 or 5% rate is uncomfortably high for the Federal Reserve.

The narrative is shifting. More people are abandoning the "transitory" narrative and shifting to the "higher for longer" stance. "Higher for longer" in terms of inflation and also interest rates.

Consumer "tapped out"?

We've discussed fairly extensively the distortions most economies have endured owing to Covid. Less-developed nations with minimal "safety nets" suffered the most as the global economy was shut down. For nations including Australia and the U.S., the "safety net" was boosted by historic proportions as mountains of government stimulus was unleashed.

It sure did the job (in a crude, poorly-targeted way). But we're now on the other side. The chart below shows the U.S. personal savings rate (red) together with revolving credit (credit card debt):

Notice the massive rise in "savings" during the pandemic. This matches the government deficits – a deficit in one sector shows up as a surplus in other sectors - the accounting identities of course hold true!

The surplus is now gone. Further, it's evident that households are needing to rely on things like credit cards to meet the rising cost of living.

Of course, things like this don't have a natural "floor"or "ceiling" – the trend could continue. But it's a case of what can't go on forever won't go on forever. This needs to end at some point.

Inflation and Earnings

As we've described in recent months, there must be a logical connection between inflation and earnings. A reduction in the rate of inflation basically means a reduction in the rate of price increases. Inflation has been kind to many companies – they have managed to grow their profits via increasing their prices beyond the rate of increase in their input costs.

I like to follow commentary from a number of U.S. small-cap value managers. They do things properly thus they follow companies closely – all that tedious stuff like listening in on all the quarterly earnings conference calls.

They report a distinct trend across all sorts of companies. Revenues (and to a lesser extent profits) have been increasing owing to increasing prices. Sales volumes in many cases have actually been falling.

Many still report input cost pressures. Many are confident about passing this on in higher prices although they caution that it might be more difficult to raise prices when demand is clearly declining.

These trends don't paint a positive picture for corporate profits. Corporate profits that were already juiced by mountains of stimulus during Covid.

Remember that it always takes some time to see the full effects of interest rate changes throughout the economy. The changes to date haven't been fully realised and yet rates keep rising.

It's understandable so many believe in the "the Fed won't let bad things happen to the economy" narrative… that they will "blink" at the first signs of weakness.

But they say they are committed to beating inflation and I think they might be serious. I sure don't think they care about investors' portfolios as much as many investors think.

Meanwhile in Australia…

I caught up with some old school friends the other week. Guys that (mostly) live within 15 minutes of me although despite classifying them as my best friends, we see each other barely every few years due to the commitments of our families (and a good degree of laziness).

None of them are finance guys – teachers and engineers turned out to be popular vocations among our group. All of us have fairly "normal" incomes and fairly "normal" financial circumstances.

There was some discussion about the economy and interest rates. Those with mortgages complained about rising interest rates – there was a clear sense of concern. But we still happily bought rounds of (over-priced) beers at the trendy pub that's packed on a late Saturday afternoon with others doing the same.

For those of us in finance-land, we see commentary about the dangers of rising interest rates to the economy. We understand the logic. We know it takes some time to properly flow through the economy. We all hear stories about more and more people doing it tough. Yet I think for most of us, we don't seem to see any of it.

That's really the key to economic forecasting. There's always people doing it tough – struggling to afford rising costs… losing jobs… suffering a business downturn… falling behind on mortgage payments… forced to sell their home or investment property… The real key is the extent to which it is happening.

Weakness begets further weakness – what's often called "pro-cyclical forces". If things deteriorate, that deterioration causes things to deteriorate some more.

One of my friends made some disparaging comments about how he kept hearing about the major banks reporting record profits. I had to explain that the level of interest rates actually doesn't have much to do with bank profits. Banks are largely about selling one product – debt! And they sure have found a wonderful place to sell their wares here in Australia. We can proudly boast to having one of the highest levels of household debt (mostly mortgages) in the world! That's why the banks keep declaring record profits – because they keep selling more debt!

So in conclusion…

I better wrap this collection of somewhat disjointed observations into something more succinct and perhaps useful…

I've been describing the market conditions as "challenging" and "really hard" for some time now – several years in fact. It became hard when U.S. markets (around 60% of total global market cap) became historically very over-valued based on reliable long-term valuation models. As I frequently emphasise, valuations don't tell us much about the shorter-term but they do tell us a lot about the longer-term. High valuations mean low expected returns over a longer period of time.

This remains the case today. Despite the falls in 2022, U.S. markets remain more over-valued than almost any other point over the past 100 years – low returns can be expected looking out over a 5, 7, and 10-year horizon.

History shows that markets have tended to reconcile elevated valuations via an abrupt decline in valuations back towards "normal". This is another way of saying over-valued markets have tended to fall a lot in a short space of time after which returns have actually been quite reasonable. The subsequent "recovery" results in an interesting journey to nowhere…

The U.S. corporate earnings outlook appears very poor at present. Consensus estimates for earnings growth during this year seem "optimistic". The economy is in the final stages of absorbing the stimulus thrown at it during Covid whilst the predictable effects of inflation and interest rate rises are beginning to show via a reduction in consumption. Corporate funding costs are shifting higher as business need to re-finance, further pressuring cash flow and profits.

Current leading economic indicators suggest the economy is weakening towards recession although employment data is quite strong and not supportive of imminent recession (not uncommon at this point in the cycle). An inverted bond yield curve is also pointing towards recession – and it has a perfect record over the past 50 years or so.

This all makes investing, well… really hard right now.

To be a little more blunt, I expect we will see falls from here in excess of 25% in the major U.S. indices before a durable low point is reached. But don't worry, it will probably play out quite a bit like 2022 where stomach-churning selloffs turn in to face-ripping rallies – something for everyone!

Here in Australia, I've noted in recent months that I don't have any strong opinions. This remains the case. Our economy has proven incredibly resilient over the past 20 years or so – not due to the skilled stewardship of our political leaders but simply because we're "the lucky country".

So in conclusion… don't overlook a 4% term deposit for some of your capital at the moment – looking back in a year or two I think there's a reasonable chance you might be fairly pleased with that return! But don't lock it up for too long as there's probably some good opportunities to deploy capital waiting around the corner.

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