Aviator Update – March 2022
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Use this Opportunity

I blinked and a quarter of the year disappeared. Quite a bit has happened so far and it's been a bumpy ride for investors.

From talking to people and scanning the financial blogosphere, it seems that the volatility has really increased the average investor's level of anxiety. Often, the investor isn't anxious about possible significant losses – instead, their concern is about where to look for sufficient returns.

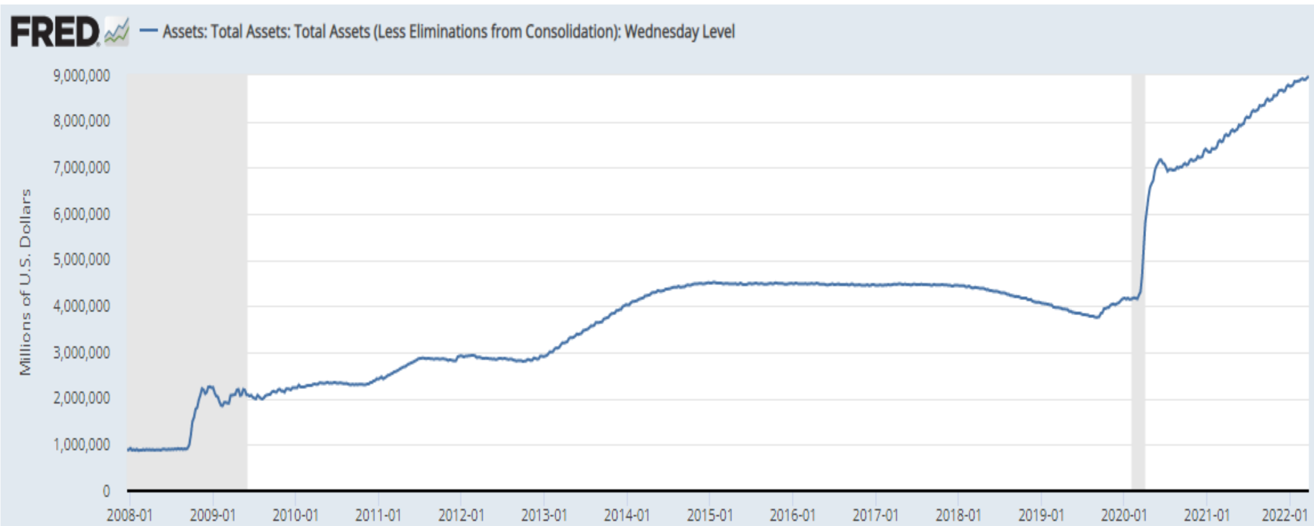
My standard response is "it's really hard right now. Really hard..." Today, I want to share some more thoughts about my current investment thesis together with some thoughts that may be of help to you.

But first, let's begin with a rather jumbled set of observations that have caught my attention and been weighing on my mind.

Inflation and Interest Rates:

Its official – the US Federal Reserve finally increased interest rates during the month – the first increase in over 3 years (granted that's not very long and a lot has occurred over that 3 years). They are now at 0.25% - might as well simply "round down" to zero…

Additionally, they put an end to their latest iteration of "Quantitative Easing". Here's what that looks like in pictures:



It will be interesting to see how the end of QE impacts investor psychology and therefore the markets. Remember, there's no direct link between bond buying and share markets.

That said, we've seen a period whereby investors have held the (incorrect) view of "Fed prints money = stocks go up". If enough truly believe this, then they surely must now believe that the key pillar of support for further gains has been removed.

More broadly, smart credit market people observe there have already been real impacts from the monetary policy shift – credit conditions have surely tightened. That's not especially ominous but credit conditions do have a major impact on the economy and financial markets.

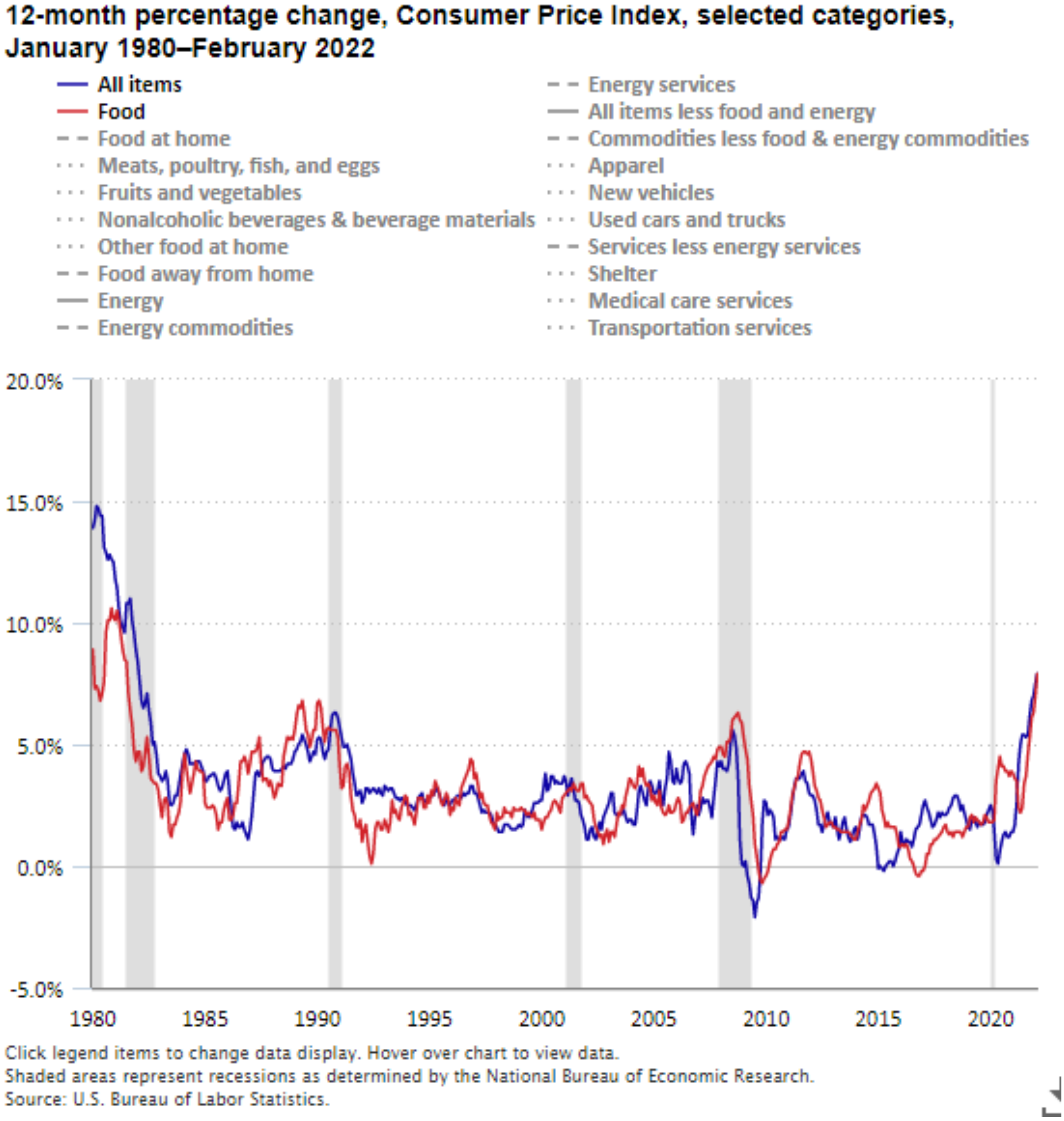
According to the Fed itself, there's quite a bit more to come in terms of interest rate rises. The board likes to release this "dot plot" – an aggregation of projected rate estimates made by each Fed board member. The average Fed member expects rates to increase to around 2% this year and closer to 3% next year.

On the inflation front, we're all aware that things are ugly out there – especially in the U.S. Commentary from the Bureau of Labour Statistics on the February inflation data included the following:

"Prices for meats, poultry, fish, and eggs increased 13.0 percent for the year ended February 2022, the largest yearly increase since July 1979. From February 2021 to February 2022, fruits and vegetables prices rose 7.6 percent, and non-alcoholic beverages and beverage materials prices rose 6.7 percent."

"Prices for new vehicles increased 12.4 percent, marking the fifth consecutive month of the largest 12-month advance since May 1975 for this commodity. From February 2021 to February 2022, prices for apparel rose 6.6 percent, while prices for shelter rose 4.7 percent."

Here's what that all looks like in pictures:



Meanwhile in Australia, the most recent quarterly CPI data (December 2021) showed a much more subdued 3.5% year-over-year change.

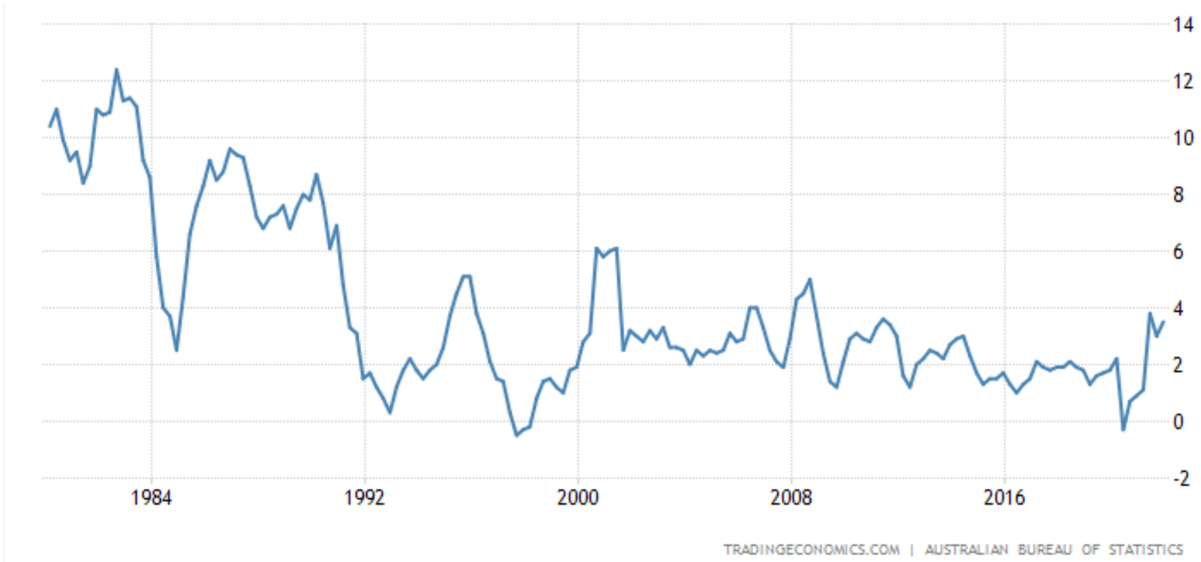
According to the Australian Bureau of Statistics;

"Annual CPI inflation increased to 3.5 per cent in the December quarter, due to higher dwelling construction costs and automotive fuel prices. Trimmed mean annual inflation, which excludes large price rises and falls, increased to 2.6 per cent, the highest since June 2014."

Further, its noted:

"Non-discretionary annual inflation is higher than the CPI and more than twice the rate of Discretionary inflation. Non-discretionary inflation includes goods and services that households are less likely to reduce their consumption of, such as food, automotive fuel, housing and health costs."

Here's Aussie inflation in pictures:



Our official interest rates remain at a record-low 0.1%. After their March meeting, our Reserve Bank governor, Phil Lowe had the following to say within their statement:

"The Board is committed to maintaining highly supportive monetary conditions to achieve its objectives of a return to full employment in Australia and inflation consistent with the target. The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. While inflation has picked up, it is too early to conclude that it is sustainably within the target range. There are uncertainties about how persistent the pick-up in inflation will be given recent developments in global energy markets and ongoing supply-side problems. At the same time, wages growth remains modest and it is likely to be some time yet before growth in labour costs is at a rate consistent with inflation being sustainably at target. The Board is prepared to be patient as it monitors how the various factors affecting inflation in Australia evolve."

So there you have it – Aussie rates stuck at zero for the foreseeable future, however, pressure on the RBA to monitor inflation.

Economic Outlook:

Beginning with Australia, my baseline view on the near-term Aussie economic outlook is "meh".

Unemployment is low. We're enjoying a significant lift in national income via booming resource prices. Interest rates should hopefully remain accommodative, supporting our bloated property sector.

As noted above, there is inflation here – particularly in non-discretionary items. This will result in a bit of "demand destruction", but if that means modestly lower imports of discretionary "stuff" this isn't an especially negative thing.

I do wonder how much of an effect the opening of borders post-Covid will affect things. Collectively, incomes went up during Covid thanks to government support. We love to travel and without this, many a household spent at least part of their travel budget on other things – fuelling domestic demand. That reverses now as Aussies take the money they would have spent on camping gear at BCF and instead spend it at a Bali resort. Hard to really put some hard numbers around this but realistically its likely small.

There are risks too – the biggest of which is probably China (see below). But realistically, things are looking pretty "meh" for our economy.

Digressing slightly for a moment, I was perusing a research note from a prominent Aussie retail brokerage firm the other day. My eyebrows were raised by their commentary about the Aussie dollar being significantly below their fair-value model of around USD0.94!

The key variable in their model appears to be commodity prices. Fair enough – strong commodities = strong current account = "dollar-positive. I'm sceptical about the AUD getting close to this any time soon but if it comes close there's some pretty profound investment implications which we'll touch on a bit more later.

U.S.A.

An increasing number of smart and respected economic commentators are convinced the U.S. is on the verge of a recession. It's certainly not a consensus expectation. Most commentators – particularly those from the "sell side" (investment banks and others that are required to be perennially optimistic) – are projecting growth to remain positive.

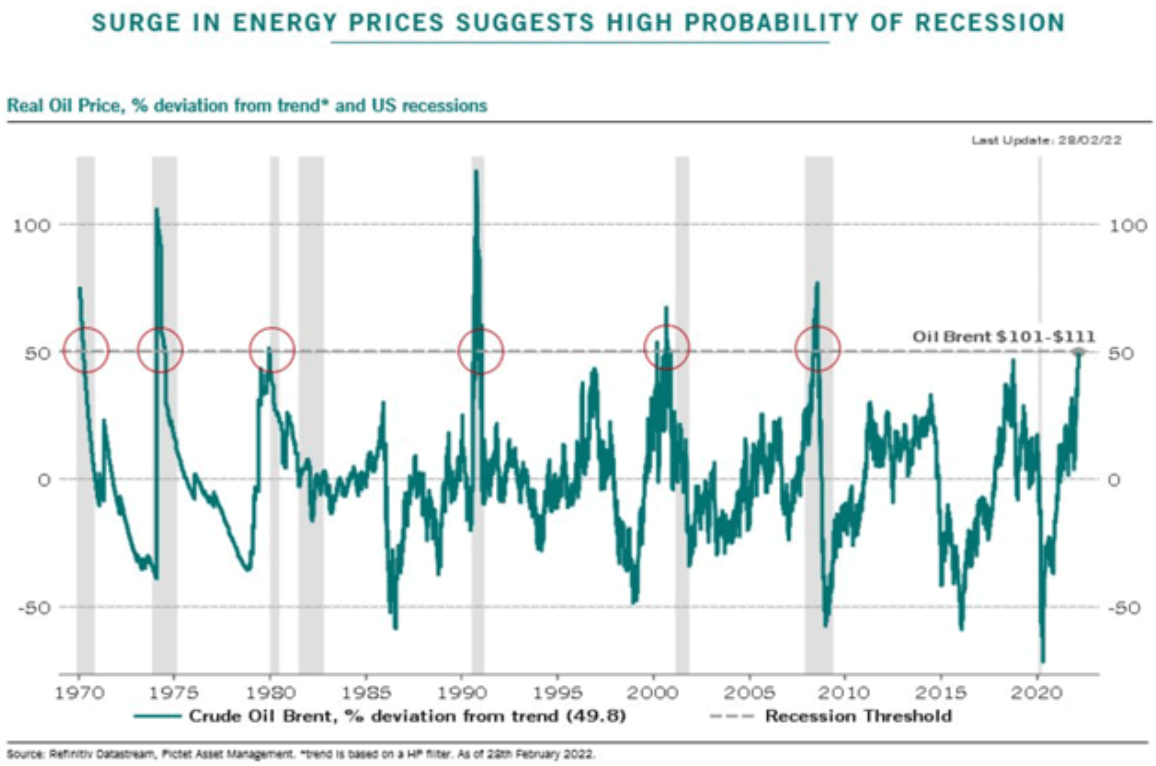
So what's the "recession thesis"? Trying to keep it simple, the recession thesis is largely based around:

The economy being barely "stall-speed" to begin with;

Significant economic disruption caused by the Ukraine war coupled with a global economy already dealing with the massive disruptions caused by Covid;

Then throw in an interest rate tightening cycle commencing at the same time…

We could go on for pages with observations supporting the “recession is coming” thesis. Here’s just one interesting observation - noting that a surge in energy prices has been an uncannily good predictor of upcoming recession:



Source: Pictet Asset Management

I find the arguments for looming recession in the U.S. pretty compelling. How bad will it be and what are the broader ramifications on investment markets? That’s an even harder question to answer…

Circling back to inflation, have another look at that chart of U.S. inflation above. What tends to happen when the economy enters recession (represented by the grey shaded bars)? A recession could be a very good thing with respect to their inflation problem!

China

China is a bit of a running joke amongst many hedge funds.

An economic model based around mercantilist export policies combined with an investment boom fuelled by debt. Respected analysts feel that the investment side probably hit its "best before date" a decade ago. From then on, capital investment projects – being investment in all sorts of things like residential/commercial property, train networks, factories etc – have become increasingly "un-economic". Their delivery – the actual building – employs people, creates GDP growth and consumes significant amounts of raw materials (great for Australia), but when the assets are really not needed, they don't stand to provide anywhere near enough cash flow or economic benefit to cover the debt burden created.

Debt is going up at a much higher rate than GDP whilst a good chunk of the GDP is, to use Chinese president Xi Jinping's own term, "fictional growth".

What can't go on forever won't go on forever. Yet still it continues. Many a hedge fund has had their fingers burned betting on a dramatic slowing in Chinese investment!

Respected China-commentators are very comfortable calling Chinese real estate a "bubble". It is evident that the market has had a major stumble since the Evergrande saga began last year. That's very troubling given the property industry is a significant part of their economy.

Their central government is doing what they normally do in response. They've wandered into their control room and surveyed the control panel.

The "residential property" indicator is flashing red.

The "stimulate residential property" lever isn't working.

The "make stuff and export it to the world" indicator is looking good. Aside from disruptions caused by aggressively shutting down large parts of the economy in order to fight Covid, exports remain very solid – little additional stimulus is possible from this area.

Surveying their (few) other options, they reach for the "stimulate infrastructure development" lever and give it a big yank.

That's an apt visualisation of what's occurred. In response to a faltering residential property market, they are actively encouraging regional and local governments to ramp up infrastructure spending.

Will this work in terms of softening the blow inflicted by a deflating property market? Probably. Most of the projects will be uneconomic and all will be funded by new debt. It's therefore a continuation of these same unsustainable practices they have done for years now. It will matter one day but perhaps not today.

There's another very interesting risk facing China – this one really does intrigue me. The U.S. is battling an inflationary environment whilst China is battling a potentially-deflationary property bust. Monetary policies are thus on divergent paths.

A meaningful rise in U.S. interest rates will potentially unleash some very powerful destabilising forces on emerging market economies. Modern financial history provides some good precedents in this area – if you're interested, you can start by brushing up on some aspects of the 1997 Asian Financial Crisis.

Essentially, a 2 or 3% rise in U.S. interest rates stands to have a significant impact on capital flows and investment decisions. We know that trends tend to feed on themselves. These sorts of events are potentially significant as they can break (or at least clog) the global "financial plumbing".

I'm surely not bullish on China. But I'm not presently lining up to be the next to get their fingers burned betting on their (unsustainable) economic model breaking.

Ukraine:

As alluded to already, the economic disruptions caused by the Ukraine situation could be quite significant for a world already economically strained. Some of them are "self-inflicted"…

It's probable that Russians were surprised by the response from "The West". There was probably a sense that The West wouldn't really do much. They're on the decline. They left Afghanistan. Busy fighting Covid, inflation… They have all become more interested in themselves.

Yet the Ukraine situation brought The West together. What surely surprised Russia is the co-ordinated response with measures in terms of sanctions that stand to actually hurt western nations.

China will surely have noticed this. Manufacturing and exporting "stuff" is a big part of their economy - they run a significant trade surplus. If, for some reason, The West wanted to inflict economic damage on China, they could. Significant damage.

Investment Outlook – what do we do?

My first draft of this particular section ended up a long and winding saga about all sorts of things – asset classes, investment horizons, skill sets, cognitive biases… I've decided to spare you from that and try to get my message across a lot more succinctly:

- With respect to investment markets and economic outlook, what do you believe?

- What risks are you willing to take?

This isn't a test – there's no right or wrong. It's about your belief?

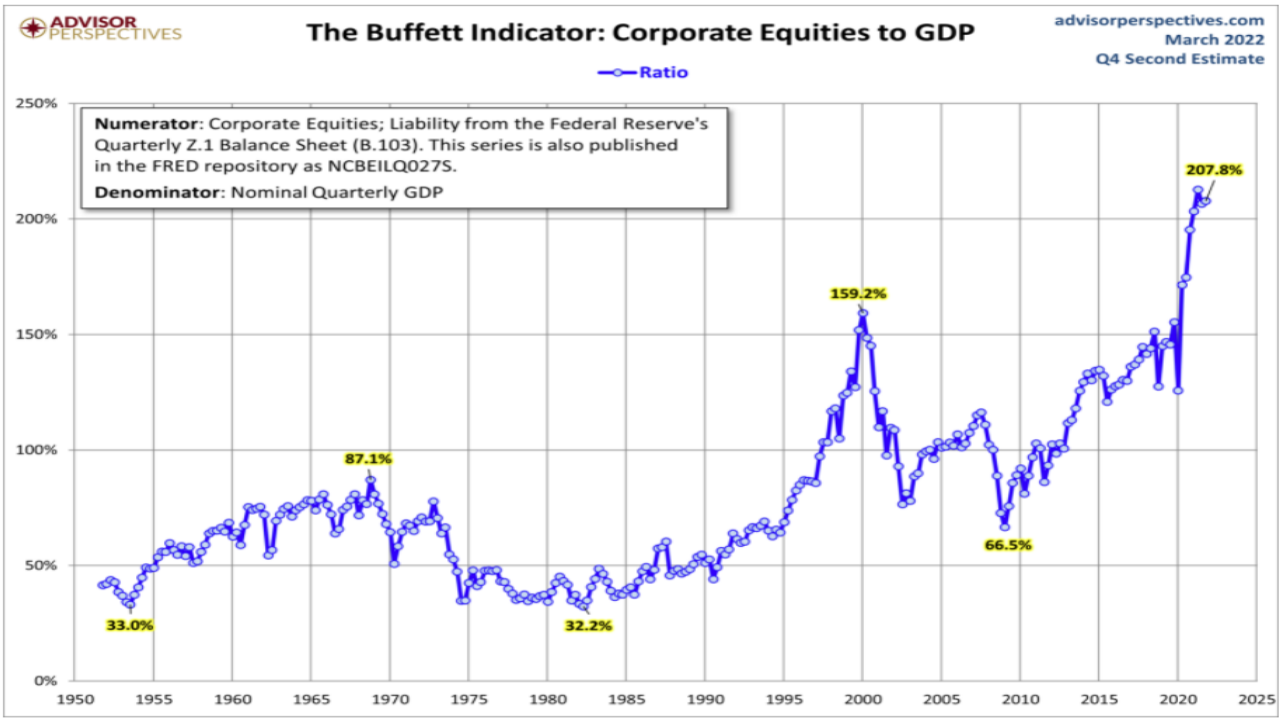
If you believe our learned colleagues, the Aussie dollar could hit 90-something to the U.S., this has pretty profound implications on international investment positions.

Do you think the markets are at risk of a meaningful fall?

Are you willing to forego potential near-term gains to protect capital?

Are you so uncomfortable being in zero-yielding cash that you are willing to take a risk to offset inflation?

Nothing has occurred in the prior month or two that materially affects my current investment thesis. The core of my thesis is based around charts like the following:



The total market capitalisation to GDP ratio has become known as the "Buffett Indicator". It comes from 2001 commentary co-authored by Buffett where he discusses this ratio and comments "…it is probably the best single measure of where valuations stand at any given moment."

I frequently cite other valuation models that have proven historically-reliable.

All these reliable valuation models show that U.S. equities are about as richly-valued as they have ever been. To be more blunt, **I'm comfortable calling U.S. equities "a bubble".**

My core investment thesis is that valuations will move back towards long-term averages – that has been the historical precedent - whenever valuations have become significantly stretched (in either direction) they have ended up reverting back towards trend.

This is a polite way of saying I think U.S. markets are in for a significant decline at some point. At least 30%, probably more.

I believe that, irrespective of economic conditions, if the U.S. falls meaningfully, it will drag the Australian market (and most global markets) with it.

I am willing to take the risk of foregoing further gains via not being invested in shares at this point.

I am even willing to risk the prospect of modest losses from betting against U.S. shares (via small, carefully-managed short positions).

I am frustrated that cash earns zero, but I'm unwilling to take the risk of moving out the risk spectrum in search of a return. I don't want to tie up capital in other things and I really don't think it will be too long before opportunities emerge and I do not believe inflation will destroy the value of my capital in 2 or 3 years.

I believe that this recent recovery in the markets has provided another opportunity for investors to carefully re-consider what they believe, how they are positioned, and whether any changes are desirable.

Over to you… Whilst we never know what lurks around the corner, I encourage you not to waste this opportunity to review positioning. What do you believe? Are you comfortable with what you own?