Aviator Update – January 2023
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Information Overload

It's been a rather quiet month in the markets to kick off the year. Although the markets might have been pretty quiet, January is always a busy month in terms of absorbing information.

Most commentators feel an obligation to present some thoughts on the year ahead as well as report on the year that was. A lot of insightful commentary has been produced and it's valuable to read a lot of them – both the opinions we agree with and ones we don't.

I frequently cite Aviator's unofficial motto as making sensible financial decisions based on a deep understanding of financial history and financial market operations. I also often talk about the role cognitive bias has in investment decisions – how we are invariably drawn to views and opinion that mirror our own. Seeking out opposing views (and actually thinking about them) is important.

I laid out some of our thinking last month. Repeating what I reported most months of last year, nothing has transpired in the previous month to change our core thesis. My readings over the past month has however stimulated much thought and a few ideas.

Today, I want to reflect on some of the opinions I've absorbed and how they fit with our own views.

China Reopening

There's a lot of excitement and anticipation related to China stepping away from the "zero covid" policy they have been running since the covid outbreak began. I see comments and data showing that "long China" is a very crowded trade at the moment. Crowded trades make me apprehensive – riding a wave of excessive enthusiasm can be great, but you need to keep a close eye on the exit.

According to many, it's going to be great for at least three reasons:

Firstly, the consumption side of their economy is supposedly still very depressed. Many anticipate a significant uptick in the consumer side and believe this will be a huge boost for the global economy.

It’s true that there’s some (relatively reliable) data showing consumption being depressed from pre-covid levels. But a major problem China has is that – even with 1.4 billion people – the consumption side of their economy really isn’t that important. By global standards, it’s an absurdly low percentage of their economy. That’s an outcome of the economic policies China has pursued for the last 30 years. And it’s not about to change.

From the commentary I’ve reviewed, what does catch my interest is the extent to which areas such as air travel remains depressed from pre-covid levels. A “normalisation” of those economic areas will mean significantly increased demand for at least one thing… oil…

The price of oil is notoriously hard to predict. I am persuaded by the arguments in favour of higher-priced oil in the future. There are at least four reasons cited for this:

Demand stands to increase despite the world’s efforts to transition away from oil.

Investment in oil exploration and production has been insufficient in the last decade or so – in part owing to the world’s efforts to transition away from oil.

The cost of doing business has increased. There’s still plenty of “easily extracted” oil, but supplies are reducing – it’s becoming costlier to extract oil. Further to this, inflationary pressures are lifting costs of production such as wages.

Supply from some important producers (i.e. Russia) is reducing.

I do see a time when oil will be quite significantly higher than it is now. Very difficult to say when, but I do think it’s a matter of “when” and not “if”.

There’s some inflationary implications of a doubling in the oil price that need to be kept in the back of your mind.

There’s also a lot of enthusiasm about what the China-reopening means for resources more broadly. More activity is expected to mean more building of “stuff”, which many believe will put upwards pressure on things like iron ore and copper.

I’m far less enthused on this compared with oil. My main concern relates to the incredible amount resources China consumes already. As we’ve covered in detail before, China’s economy is very (dangerously) unbalanced towards “building stuff”. The Chinese themselves know this and would like to find a way to transition away from the reliance on this sector. It’s really hard to do. But it will inevitably happen one day because it simply cannot go on growing forever – their economy will get to a point where it simply can’t absorb any more debt-fuelled investment and it will stop. Not necessarily imminent, but inevitable.

Volume and value of resources consumed by China is a massive number. If demand reduces by a small percentage, that’s still a massive number. In other words, a small shift in demand

might be all it takes to throw these resources markets into supply surplus and sink the prices in the process.

Again, this isn't necessarily imminent but it's an area I'm wary about playing in. The way I see it, simply living in Australia naturally makes me "long resources" given they are a large part of our economy.

The final area where commentators are excited about China reopening is in relation to inflation. There seems to be this view that as the economy opens up fully, factories will be back to full capacity and back to "exporting deflation" in the form of abundant goods.

In this respect, I think it's foolish to expect China to simply revert back to pre-covid conditions. Like covid has forever changed western nations, we should expect it to have had some lasting changes on China as well.

Don't believe that all those massive protests in China a few months ago were all to do with covid lockdowns.

Valuations

As regular readers know, I'm highly critical towards a lot of the "valuation" analysis our industry uses. That's because much of it is quite useless.

What information do you expect a valuation model to provide you? If I said, "valuations are around historically-average", what do you think this should mean? Is it fair to say that you'd expect to feel confident in the medium-term outlook? That provided the economy performs "historically average", shares should reliably deliver a "historically average" return.

If that valuation model is useful, it should have some reliable predictive powers, right? Said differently, there should be a high correlation between the "signal" it provides and subsequent market returns.

One of the most common and popular valuation tools is the good old "PE ratio". For U.S. investors in particular, the "forward operating PE" is most often cited.

This ratio compares the current price level to the estimate of earnings for the coming 12 months. For example, if the S&P 500 constituents are expected to collectively earn $2.25 per share, it would make the forward PE around 18 with the index trading at 4000.

The trouble with this sort of analysis is it's meaningless! It offers very little insight into likely future returns – there's very little correlation between any given year's "forward PE" ratio and subsequent returns.

I frequently cite a number of different valuation models that are shown to have a very high correlation to subsequent market returns (often greater than 90%). These currently show that U.S. markets are close to being as richly valued as they have ever been.

Importantly, valuation doesn't tell us very much about short-term returns. It tells us that, from this point, the returns that will reliably be earned by investors over the medium/long-term (around 10 years) will be well "below average".

Having said all that, I've seen several commentators discuss valuations in the context of traditional unreliable metrics. To paraphrase what a number of commentators have said;

"A forward PE of 18 for the S&P 500 is very up there. And that uses an earnings estimate that many of us believe is overly optimistic and subject to being revised lower as the year progresses. Allowing for this, the forward PE is probably in fact beyond 20. This is one of the more extreme readings ever seen."

As much as anything, I find it interesting that historically-<u>un</u>reliable and historically-reliable valuation metrics are telling the same story – it's difficult to make a case for further market gains on a valuation basis. I haven't read any cases for this.

But again, valuations don't tell us too much about the near-term.

Inflation and GDP and Earnings

I've read a number of very interesting discussions about the relationship between inflation and GDP. Remember that inflation is in the simplest sense the change in the price of things. The price of things produced and sold is a key input into GDP.

We're all excited about the prospect of the rate of inflation reducing. Remember however, this doesn't mean the price of things falling… it simply means a reduction in the rate of increases.

Digressing for a moment, I've held the view for a while that the true impact of inflation is yet to be seen – I still very much believe that. Let's say that a basket of goods you consume starts at $100 before experiencing 10% inflation, reducing to 5% inflation.

After year-1 the basket costs $110

After year-2, it costs $115.50

Inflation has come down dramatically yet that basket of goods now costs 15.5% more than 2 years ago.

For many of us, this is simply annoying. But for many individuals, it's incredibly painful. That pain takes time to manifest – people don't really "feel" a 2% quarterly change… but people sure feel a 15.5% 2-year change!

Average wage growth has not gone anywhere near offsetting inflation. Therefore, a lot of purchasing power has been lost over the past 12 months and more will be lost in the next 12 months, even if inflation cools. This is yet to fully show up in people's spending decisions. This is the case in Australia as well as the U.S. along with many other nations.

Back to inflation, earnings and GDP… A reduction in inflation means a reduction in the increase in sales prices. This should mean a reduction in economic activity – in GDP. Or to be more accurate, a reduction in the rate of increase in GDP. That's not necessarily too meaningful. And "real" (inflation-adjusted) GDP might be just fine.

But there's more… Sales prices equals revenue for businesses. I've seen a few commentators note that a good number of businesses have produced solid earnings growth over the last few years solely as a result of inflation. Sales volumes didn't change. Operating expenses were pressured upwards by employees demanding more and input costs rising. They were simply able to raise their prices more than their costs increased.

Businesses everywhere continue to crave this – input costs, wages costs continue to press higher and they would love to pass all this on via higher prices.

The general consensus remains for a precipitous, straight-line fall in inflation back to around 2%. The assertion we have discussed previously is that this might not be realistic. The "top" is likely in, but there's a strong case that it might get stuck somewhere higher than 2%. Maybe 4 or 5… And what if (or I suspect "when") we see an unexpected uptick on quarterly CPI in the U.S.? I'm not sure investors are prepared for that.

Ponzi

"Ponzi scheme" is a term frequently thrown around. Named after the Italian-American businessman Charles Ponzi, the scheme at its heart is pretty simple – returns are paid to earlier investors from funds contributed by newer investors.

I've read a number of pieces describing how a decade of zero interest rate "easy money policy" from central banks facilitated an explosion in Ponzi schemes. Companies – even entire industries – where earlier investors have been delivered gains by later investors' willingness to buy in at a higher price.

Of course, we're talking mostly about crypto and tech startups as well as SPACs. Some of these companies have become household names, yet have never been able to turn a profit. They still exist because of the generosity of investors – willing to stump up more and more capital, often at higher and higher company valuations despite never yielding a profit.

What's more, many of these companies and industries have grown to employ millions of workers.

Investors including sophisticated venture capital and private equity shops were happy to fund these ventures in the TINA ("there is no alternative"), FOMO ("fear of missing out") world of zero interest rates. But with cost of capital now much higher, all these things look much less appealing.

It's a little difficult to gauge what an unwinding of the excesses in these areas means to the economy and markets. It's clearly underway – many tech companies are announcing layoffs. In doing this, many are (unintentionally) highlighting how ridiculously bloated their workforces have become.

Recession is coming

That's the consensus for the U.S. – if not the world. I too feel that it's very probable.

Yet at the moment smart commentators note that, objectively looking at the current data, we can't yet say this is inevitable.

As many point out, a standard feature of a recession is rising unemployment. So far, various measures of forward-looking employment data have not shifted in a way that would indicate imminent recession.

Acknowledging this, other smart commentators talk about the upcoming recession being quite a bit different to others – a recession where the employment market remains strong. It's an interesting idea. It's hard to gauge exactly what it means for the economy and corporate profits. Arguably, it's a scenario that fit's the "soft landing" many investors are hoping for – a weakening of inflation and economic forces without anything really breaking.

With valuations as stretched as they are, I'm really not especially concerned about whether a recession unfolds and how it looks. It will be interesting, but extreme valuations should be investors' most pressing concern.

Many commentators (myself included) think this year will at very least be interesting for investors. Here's hoping we can all lock in some profits along the way.

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