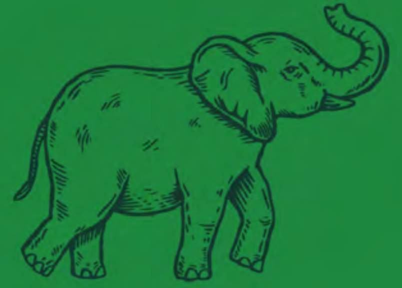
Investment Markets Report

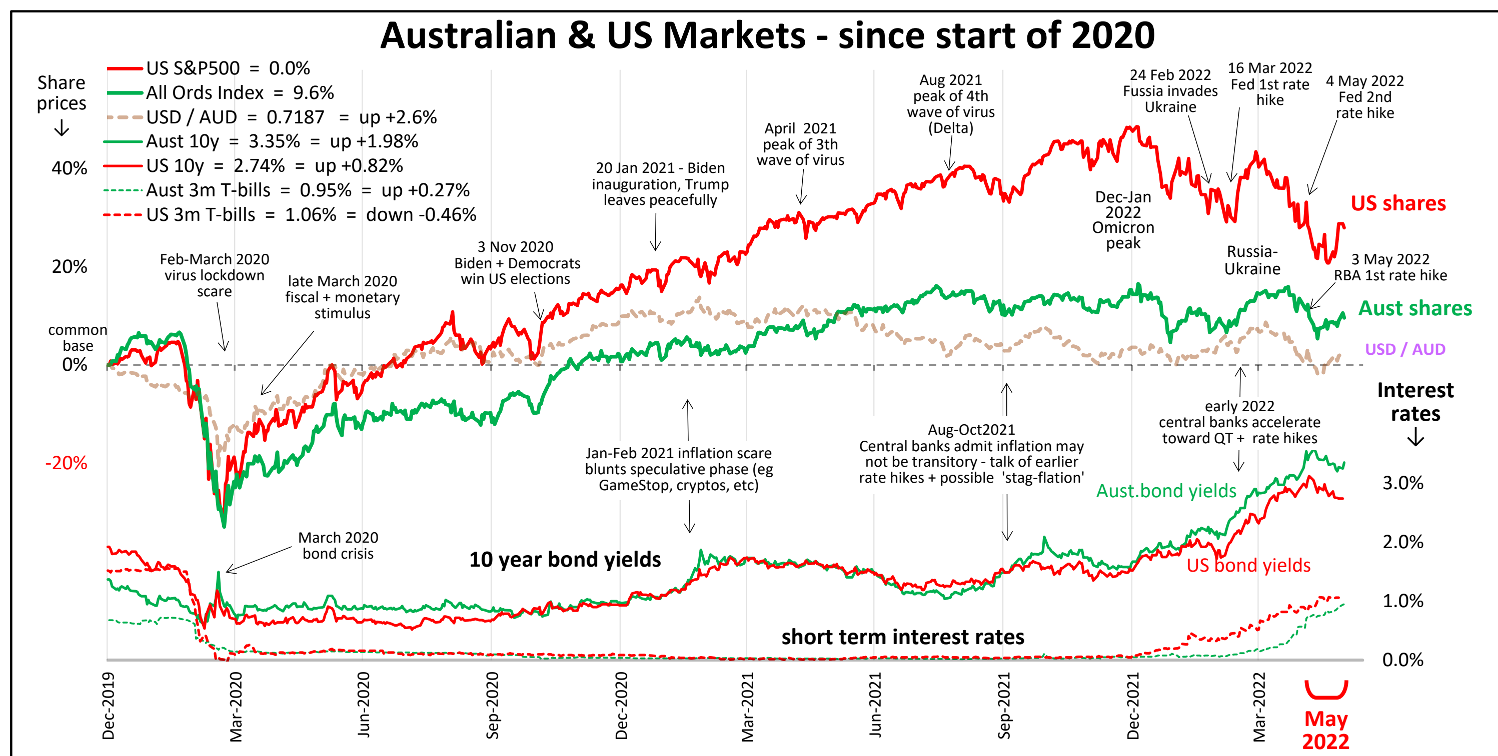


3 June 2022

StanfordBrown Private Wealth

Global financial markets snapshot

May 2022 was a month of two halves. In the first half, investors sold out of shares and bonds, and bought US dollars on fears of higher inflation and interest rate hikes. In the second half (after 11th May), investors reversed course, piling back into shares and bonds, and selling US dollars, as inflation fears turned into recession fears!



The net result of this mini-dip and mini-bounce was that global share markets ended square for the month. The main winners were oil, gas and coal producers, milking the current global energy crisis, and also banks, where rising interest rates boost margins. Offsetting these gains were falls in 'consumer discretionary' stocks (eg. Apple, Tesla, Amazon, Nike, Toyota, L'Oréal). Consumer 'staples' were also down, as rising costs eat into margins (eg. Walmart, Proctor & Gamble, Costco, Nestle). However, the Australian market ended lower in May (after holding up much better than global markets in April). Fossil fuel producers were up (except Woodside, as it absorbs the BHP deal), and retailers were down (eg. Woolworths, Coles, Wesfarmers, JB Hi-Fi, Domino's). The 'tech' sector was hit hard again - we cover this later. The big difference with the local share market was that the banks were down (except CBA), and miners were also down across the board, as lower metals prices reflected the global slowdown fears. The Aussie dollar followed the same path as shares in May, falling in the first half, then rising in the second half. The Labor win in the Federal elections on 21 May was shrugged off by local investment markets.

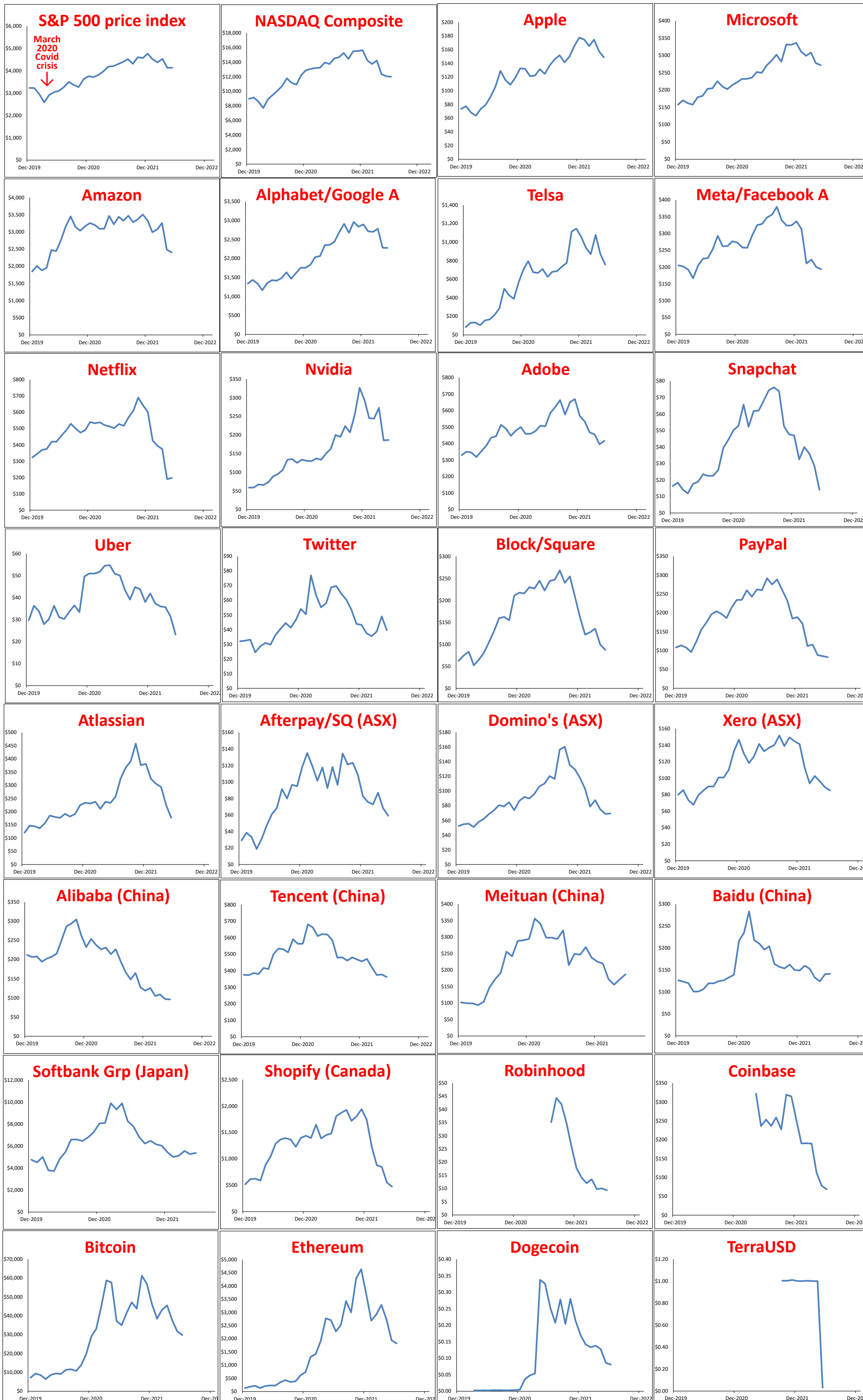
The biggest driver of global markets was once again interest rate hikes to fight inflation. In particular, whether rate hikes will go too far and trigger economic recessions, as they have done many times in the past. On 3 May, Australia's Reserve Bank raised cash rates from 0.10% to 0.35%. It was its first rate hike since 2 Nov 2010, after eighteen cuts (from 4.75% in November 2011 to 0.10% in November 2020). On 4 May, the US Federal Reserve announced its second rate hike in this cycle, and continued to lift its forecasts for rate hikes in the coming year.

Inflation continued to accelerate in most markets – eg. rising to 9% in the UK, 8.1% in the Eurozone, 6.8% in Canada, and 5.1% in Australia. The exception was the US, where inflation fell back a fraction from 8.5% to 8.3%, announced on the 11 May. With the Fed accelerating rate hikes, plus the slowdown in Europe (energy and food crises) and China (property collapse and lockdowns), that was the trigger for investors to switch from inflation fears to slowdown fears, causing the sudden turnaround in global share, bond and currency markets on the 11th.

Three big questions for investors are: (1) how much of the current inflation spike is caused by temporary supply constraints that will soon ease (covid lockdowns, Russia sanctions, port closures, food and energy shortages)?; (2) will the rate hikes needed to curb inflation tip economies into recession?; and (3) will the recent slide in share markets turn into a major collapse (ie. Is this the start of 'tech-wreck 2.0')? First, the 'tech-wreck' question.

End of speculative fever in high-priced 'hot stocks'

Here is a quick snapshot of the rise and fall (thus far) of the post-Covid tech/online fever. Below are price charts for a couple of dozen stocks since the start of 2020 – ie just prior to the February-March 2020 Covid sell-off. At the top we start with the broad US S&P 500 and NASDAQ indexes, then several US tech/online stocks, and some key stocks in other markets, including Australia. We also include some crypto's, including the terraUSD 'stable coin'.



It is important to point out that we have used no charting trickery to make price moves appear greater than they actually are. On each chart, the left scale starts at zero at the bottom, so if a price looks like it has doubled, or trebled or risen ten-fold (like Tesla & Bitcoin), or has fallen by more than half (most of them), then they have.

This is not intended to be exhaustive of course, it is just to illustrate that the patterns are virtually the same in each case, regardless of the circumstances or merits of each individual company (or crypto).

As almost none of them pay dividends, half make losses, and most of the rest make only tiny profits relative to their prices, the charts reflect the rise and fall of mass hysteria – first surging in, and then fleeing.

Will the hysteria return to drive prices higher? – ie is this just a temporary 'dip' that will recover, or will the mass selling continue, or pause?

First, we need to look at the reasons for surge since the Covid sell-off, and then look at the current state of pricing (after the recent falls).

The reasons for the surge in prices are fairly simple – trillions of dollars sprayed around by governments deficit spending their way to wartime-like debts, to boost incomes, save jobs, and encourage spending.

On top of this, central banks threw away their textbooks and set about to deliberately create inflation, cutting rates to zero (negative in Europe and Japan), and resorting to straight-out money-printing, to entice people to gear up to the hilt and spend. It worked! People everywhere threw their free or ultra-cheap money at just about anything, especially online retailing, tech, renewables, 'crypto' currencies, 'NFTs', and even boring old housing.

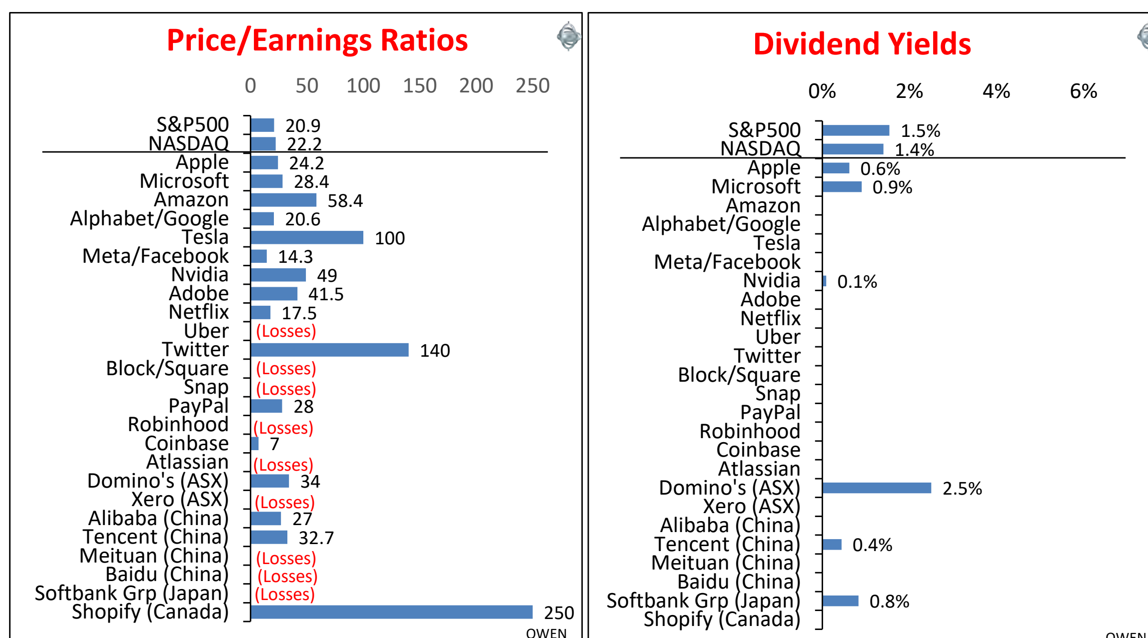
Sentiment changed in early 2022, and the reasons are also clear. It was the sudden realisation that the era of free and ultra-cheap money is over. Inflation surged (well before Russia's invasion), and central banks finally started to end 'QE' money printing, and raise interest rates back toward more 'normal' levels. There is much debate about exactly where 'normal' is for cash rates in each country, but it is certainly much higher than where they are now.

The bell at the top of the market was probably the January 2022 Superbowl, dubbed the 'crypto Superbowl', which featured slick ads showing famous movie stars spruiking cryptos as a sure way to get rich. (This is fitting, as the bell at the top of the late 1990s 'dot com' boom was the January 2000 Superbowl, dubbed the 'dot-com Superbowl'. It featured TV ads for 14 profit-less 'dot-com' start-ups that promptly crashed in the 2001-2 'tech wreck').

Will central banks suddenly switch back to rate cuts and QE? Not while inflation is running well above target, unless there is another major economic contraction (deep recession with high unemployment, like the in 2020). If that does occur, share markets would have already fallen and started to rebound by then. (We cover this later).

On the 'fiscal' (government spending and taxes) front, governments are still deficit spending, but the pace of spending increases has slowed significantly, and many programs have ended. Governments are under pressure to scale back spending, and are even talking of raising taxes (eg. tax hikes in Joe Biden's election policy agenda).

The second aspect we need to consider is the current level of pricing after this year's falls. Has the recent sell-off brought prices back down to levels that are now 'fair' or reasonable (or perhaps even cheap?). Here are the price/earnings ratios and dividend yields for the broad market and for our tech/online stars:



On the left, we can see that price/earnings ratios are a not-too-expensive 21 for the US market as a whole. (As a general rule of thumb, a 'p/e' ratio above the high teens is getting expensive, and is only justifiable if the company can generate and sustain above-market profit growth well into the future. Here we see that the p/e ratios of the tech/online stars are well above that in almost all cases. Half of them make losses, so they don't even have any 'e' (earnings) for us to calculate the 'p/e'! The current high pricing relies on assumptions of continued boom-time rates of profit growth, and many of these are going to be a lot more difficult to sustain as monetary and fiscal support is withdrawn, and as higher inflation and interest rates constrain spending, revenues, margins and profits.

The right chart highlights that there is almost a complete absence of cash dividends. This is important for the broader market, as the top half dozen stocks on the list are not just large tech/online stocks – they are the largest companies in the US market, and the largest in the entire world, so they drive global returns. (Australia's Domino's Pizza is seen as a hot tech/online stock for some bizarre reason, but it is by far the biggest dividend payer!).

Profits need to remain strong (with inflation and interest rates not rising too high), or prices have further to fall.

‘terraUSD’ collapse – the end of crypto’s, or just a setback?

Another event that hit the headlines in the middle of May was the collapse of crypto ‘stable coin’ terraUSD, and its token ‘Luna’ on Friday 13th. US$40b was ‘lost’, plus another $300b in ‘paper losses’ in the other crypto’s that have all suffered big falls this year. (Of course, these ‘losses’ are only theoretical, as they assume every owner bought at the top. In reality, probably only the ‘late-to-the-party’ buyers bought at or near the top. Most holders – the ‘smart money’ and/or ‘pump-dump’ spruikers – probably bought much earlier at lower prices).

For the crypto sceptics, the collapse of the ‘stable coin’ was sweet *schadenfreude*, and a sign of the end of the whole crazy, speculative bubble. For the true believers it was just a minor setback in a long march. Who’s right?

First some background on terraUSD and Luna. One of the problems with Bitcoin and other crypto ‘currencies’ is that their prices are very volatile, so they are not very useful for buying and selling things in the real world. (To date they are only the currency of choice for drug dealers and cyber-hackers). To solve the problem of volatility, various groups came up with the idea of ‘stable coins’ that were pegged to a hard currency, the US dollar.

These so-called ‘stable coins’ came in two flavours:– some are backed (or claim to be backed) by actual US dollars (and/or US treasuries); and others are backed by algorithms (algo’s). TerraUSD was an algo-backed ‘stable-coin’ linked to a crypto token called Luna. The idea was that whenever the value of terraUSD drifted above USD$1, the math (the ‘code’) would automatically sell some terra (to reduce its price) and buy Luna. If terraUSD drifted below $1, the code would automatically sell some Luna to the public and use the cash to buy terra (to raise the price back to $1). In the second week of May, some big terra holders decided to sell. To keep up the price of terra, the ‘code’ sold some Luna to buy terra. As more sell orders came in for terra, the code issued more Luna tokens to sell in order to raise cash needed to keep buying terra to prop up its price. It quickly turned into a spiral. The code issued billions of Luna tokens, trashing its price, which scared even more people into selling. The ‘code’ failed. The so-called ‘stable coin’ was not just unstable, it became worthless in less than a week.

As for the so-called USD-backed ‘stable coins’, none of them can prove that they are backed 100% (or even partially) by US dollars. I would want to be able to see it in actual bank accounts in regulated, licenced, insured banks, where I can check the bank statements, and I would want to be able to check the assets and liabilities of the issuer, in financial statements verified and signed off by a regulated, licenced, insured auditor. Crypto players are, by definition, anonymous, stateless, borderless, unregulated, unlicenced, and unaudited. The largest ‘stable coin’, Tether remains at $1 today, and it claims to be backed by US dollars. But who knows? Can I verify it? Can I find it?

There were four major flaws with terraUSD/Luna, and other ‘stable coins’. (1) It relied on the assumption that the price of Luna would keep on rising forever, so they could always keep selling enough Luna to keep terra pegged to $1. (2) The ability to issue unlimited Luna tokens to support the terra price, was always going to lead to the price of Luna falling into a spiral. This is no different to Germany in 1923, Zimbabwe in 2008, or Venezuela today. (3) The whole scheme relies on public confidence to prevent a ‘run’, just like in a bank. In the real world, banks hold hard assets (loans to real home buyers, government bonds, hard currency, etc), and the depositors are guaranteed by governments. (4) The digital wallet (called ‘Anchor’) that held peoples’ terraUSD and Luna tokens, was paying ‘interest’ of 20% pa to entice people into the whole scheme. The ability to pay this interest relied on crypto prices going up forever, which is never going to happen. Obviously, anything offering 20% interest when cash rates are zero, should be an instant red flag to anyone in the real world.

But that does not mean that Bitcoin and crypto currencies, will not succeed one day. Not being backed by hard assets is not fatal. The US dollar is just a piece of paper that is not backed by any hard asset (since 1971). It is backed by a promise by the US government that it will accept the paper dollars as valid payment (eg for taxes). Because of that promise, everyone else in the world accepts the paper as valid payment for goods and services everywhere. However, we don’t even need a promise from a government to give something ‘value’. There are plenty of things that are not backed by a government that I can exchange for other goods & services, or for cash – football tickets, gift cards from retail stores, etc. Ultimately it comes down to faith that the item is not forged, and trust that it can be exchanged for something of value. If enough people believe something has value, then it does.

The crypto movement is being driven a very powerful idea - the quest for a libertarian utopia beyond the reach of governments, regulations, taxes, banks, central banks, fiat currencies, and oligopolies. The idea started with the loss of anonymity and privacy due to bank computerisation in the 1980s, accelerated with the bank bail-outs and money-printing in the GFC, and again in the Covid lockdowns, which further extended government surveillance and control, central bank money-printing and inflation. The idea is not going away, but it is early days, and many flaws need to be ironed out. In the early stages of all technological shifts, there are more losers than winners.

Why do share markets crash? Is this the 'big one'? – i) USA

Fears of inflation have been overtaken by fears of recession. However, recessions do not cause or trigger share market falls. Nor do share markets crash because, or when, they become expensive. Share markets fall when shareholders *en mass* start to expect imminent big cuts to future profits and dividends. Economic growth numbers (including 'recessions') are outcomes, not inputs or drivers of share prices. Share prices fall *before* profits fall, and well before economic recessions are announced. Conversely, shares rebound *before* profits bottom out and start to recover. In fact, share markets do best in the middle/late stages of recessions, when losses are being reported, dividends are being cut, and economies are contracting (1982-3, 1991, 2009, 2020-1, and many prior cycles).

The current share market wobbles would only turn into a big market collapse if we are facing an imminent collapse in overall profits and dividends in a broad economic contraction. In the absence of a global systemic banking crisis (like the GFC), a currency crisis (1987), or another worldwide lockdown (2020), the most likely trigger would be the combined impact on spending, demand and jobs, of sustained high inflation, and aggressive rate hikes to attack it.

To see where we are now in the cycle, these charts track the critical factors through the past five recessions. First we consider the US, as it is the largest and most influential market that affects all global markets and investors.

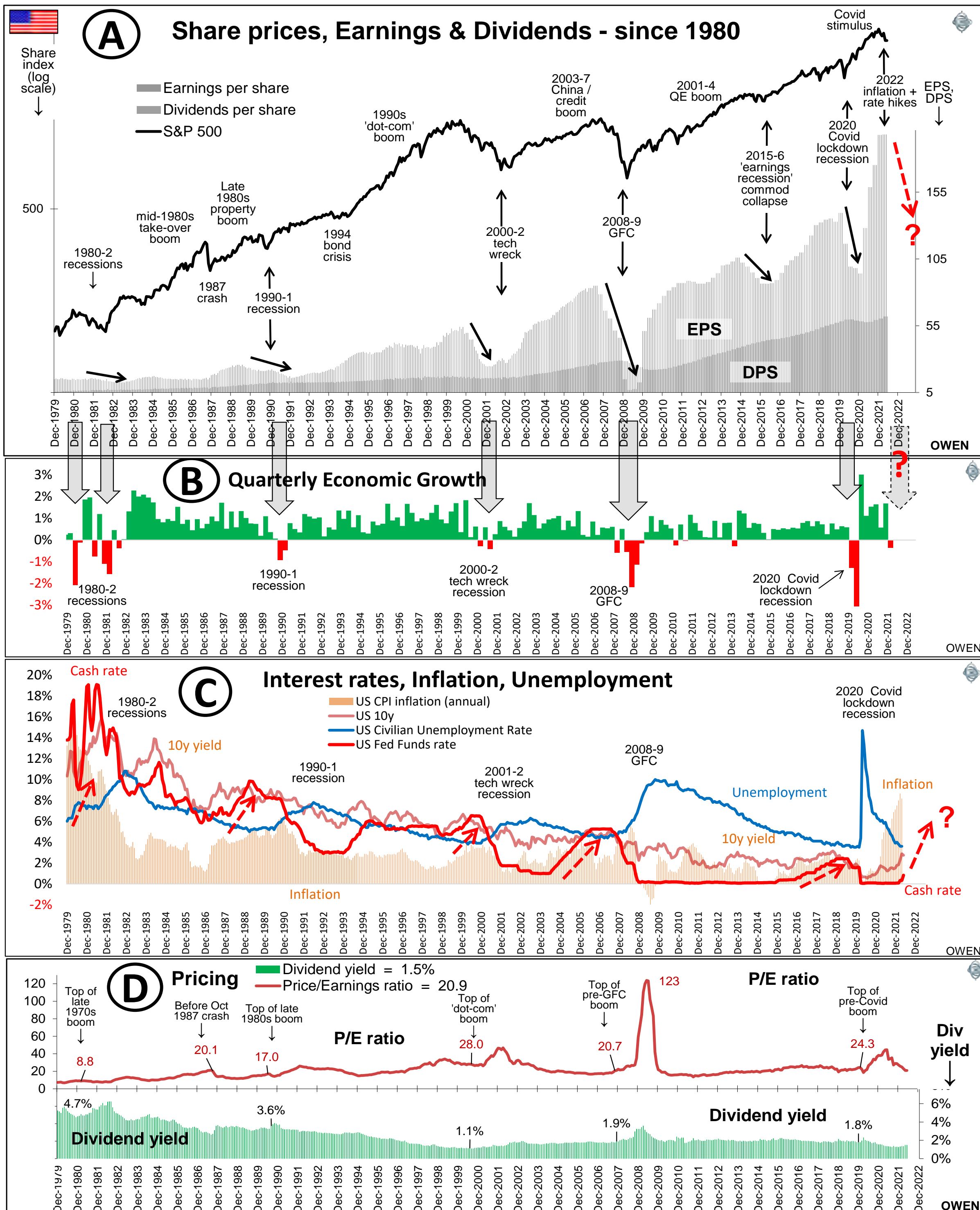


Chart A shows the US market index (S&P 500), together with grey bars in the lower section showing market-wide profits (earnings per share) and dividends. The big share market falls started *before* profits and dividends started to be cut, and the market started to rebound *before* profits and dividends started to recover.

Chart B shows quarterly economic growth rates, highlighting the major contractions and recessions, which started *after* (and partially resulting from) the cuts to profits and dividends.

Chart C shows the main 'macro factors' - inflation (orange bars), cash rates (red line), bond yields (orange line), and unemployment (blue line). Each economic recession occurred after periods of rising inflation and interest rates. In most cases, inflation and interest rates had been rising for some time, and it was the late stage rate hikes that triggered the collapses in share prices, spending/revenue, profits, and economic growth (in that order).

Chart D shows two common measures of stock market pricing: 'price/earnings' ratios (top) and dividend yields (bottom). These are not as important as many people think. Share markets can crash when pricing is expensive or cheap. The current overall market price/earnings ratio of 21 times earnings is lower than it was prior to four out of the past five crashes that preceded recessions, and also lower than it was prior to the October 1987 crash, but the 'moderate' pricing did not stop the market from collapsing. Dividend yields are probably a better measure of value (as dividends are hard cash, whereas reported 'profits' are very rubbery and easy to fudge, especially in booms when most investors seem more interested in rising share prices than boring financial reports, and whether reported 'profits' are real or sustainable). The current dividend yield of 1.5% for the aggregate US market is very low historically, and lower than it was before prior to every crash except the 'tech-wreck'. This makes the market more vulnerable to fall further when it does fall, as almost all crashes were accompanied by cash rate hikes, making low dividend yields less attractive as cash rates rise.

Where are we now?

At the far right of Chart A we see that aggregate profits and dividends have rebounded strongly from their big falls in the Covid lockdown recession - thanks to extraordinarily generous and inflationary fiscal stimulus (government deficit spending, running up wartime-like debts handing out money left, right and centre), plus extraordinarily generous and inflationary monetary stimulus (zero interest rates and straight-out money-printing). All of this free and/or ultra-cheap money has - surprise, surprise – resulted in inflation. Even before the Russian invasion, US CPI inflation was running at 7.5%, and the Fed's preferred measure, Personal Consumption Expenditure (PCE) excluding food & energy, was 5.1%. Then the Russian sanctions and disruptions accelerated inflation even further.

The key question for investors is:- are we now at the cusp of the next big collapse in aggregate profits and dividends – indicated by the potential red arrow on the right side of Chart A? Just like the conditions leading up to most collapses in profits and economic recessions in the past, rising inflation and interest rates are both eating into consumer spending. It is highly likely that rate hikes will be the trigger for the next big fall in share prices, profits and economic slowdown (in that order). But are we nearing that point now?

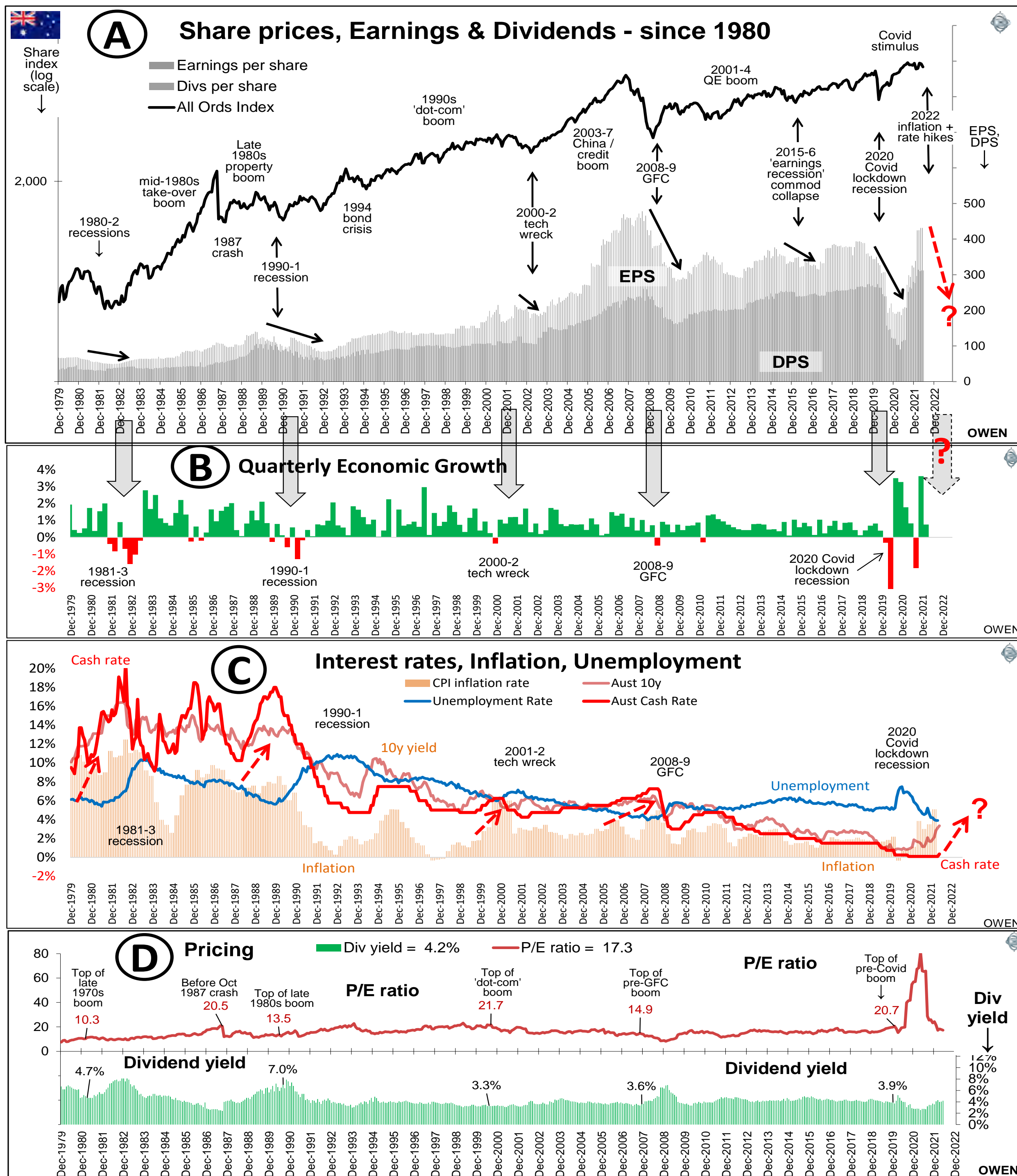
There is a chance that the Federal Reserve may not need to raise rates much further (eg beyond say 3-4% or so) to contain US inflation, and avoid a major collapse in spending and profits. Consider the following:

- rapidly rising prices for food and energy are already constraining consumer spending on other items;
- mortgage repayments (which in the US are tied to 30 year bond yields) have been rising since the middle of 2020, and are already back to pre-Covid repayment levels, reducing overall spending; and
- many of the temporary supply disruptions will be cleared in time, with borders re-opening, alternative suppliers coming on stream, etc.

This is the Fed's 'soft landing' scenario. Unfortunately, the Fed does not have a good record on engineering 'soft landings', as evidenced by the charts of the past 40 years (nor in the 70 years prior to that). It is safe to say that the chances of the Fed engineering a soft landing are low. We *will* get a big fall in share prices, profits and dividends (and jobs, etc) eventually, but it may not be just yet. The market has already priced in at least another half a dozen rate hikes in the coming year, and that gives the Fed a fair amount of headroom. (It took rate hikes to 6% to finally trigger the last 'tech wreck'). Early signs of easing inflation may be enough to convince the Fed to even under-shoot on rate hikes, or at least not over-shoot this time, and this would support share prices.

Why do share markets crash? Is this the 'big one'? – ii) Australia

The simple answer is that the Australian share market crashes (and rebounds) because, and when, the US market does. (The main exceptions were 1907 and 1951). Below are the same charts for Australia. The cycles and causes were the same. The difference is in the extent of the booms & busts in each cycle. Australia had bigger 1980s take-over and property booms, so we had a bigger 1987 crash and 1990-1 recession. The US had a bigger '1990s 'dot-com' boom, and a bigger '2001-2' tech-wreck'. Australia had a bigger 2003-7 China/credit boom, and a bigger GFC bust. In the current cycle, the US had a bigger 'tech/online' boom, and is destined for a bigger bust. But when?



Where are we now? Profits and dividends in Australia have also rebounded from their big falls in the Covid lockdown recession, although not as strongly as in the US. Current market price/earnings ratios are not high, and dividend yields are above 4%, which is the historical average. However, this moderate pricing does not mean share prices will not fall. Our inflation is lower than the US, but our rate hikes have been slower so far.

Regardless of local conditions, when the US market does collapse, our market will fall at the same time, but by less. First, we have a much smaller tech/online sector; and second, we have a much larger resources sector. This is being supported by strong commodities demand and prices, driven by structural (ie non-cyclical) global spending on infrastructure, military, and the shift to renewables, electric power and battery storage.

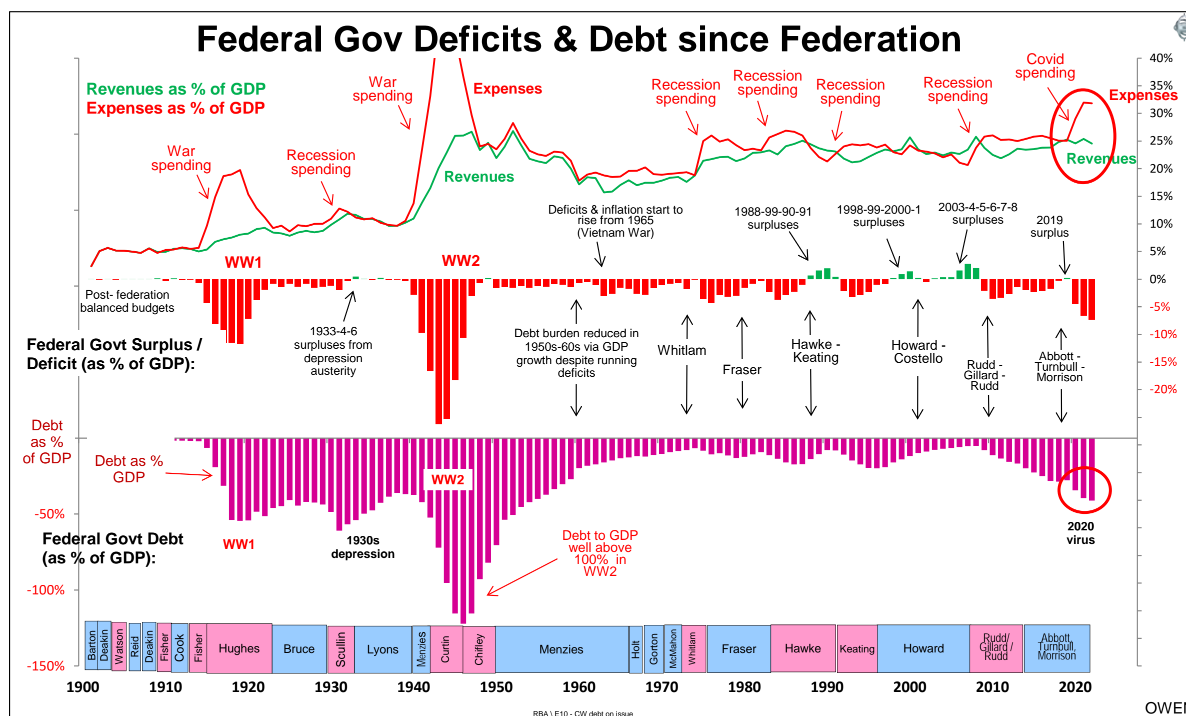
A trillion dollars of debt – how do we pay it off?

In last month's report, prior to the Federal election, we looked at the history of government debt in Australia, to find out which side of politics had a better record on deficits and debts. We concluded:

> *Clearly 'left' governments have run deficits more often, and have run larger deficits, however the main reason was that Labor happened to be in power during the two big war-time build-ups, where the deficits and debts were bi-partisan. On the other hand, 'left' governments also contributed to the largest increases (improvements) in budget balances – ie reducing deficits, mainly after the big war-time build-ups. Equal points to both sides. Top marks for voters for electing governments that maintained stable institutions.*

We also noted that inflation was the secret weapon governments used to reduce the real size of debts every time in the past. Apart from relying on windfall commodities booms, or resorting to politically suicidal spending cuts and/or tax hikes, the only other way to reduce the real size of debts is inflation. Last month we showed how each of the past bouts of high government deficits and debts was followed by double-digit inflation (fuelled largely by the deficit spending sprees, and also by supply constraints). This is clearly the case again this time with the RBA letting inflation run up again, then dragging its heels in scaling out of QE, and finally starting to raise interest rates.

This month we look at deficits, by separating its two components – revenues and spending. In this month's chart, the upper section shows annual government revenues (green line) and spending (red line), which produce a net result each year: either a surplus (green bar) or deficit (red bar) in the middle section. The lower section shows the resultant level of debt over time. All amounts are expressed as a per cent of national income (GDP):



The overall upward trajectory of the red line (spending) indicates how government spending has been increasing over time as a share of total national income since Federation. There have been several great surges in spending (red line) that caused big deficits (red bars) and big increases in debts (pink bars) - in WW1 and WW2, and also smaller surges in spending in each recession – notably in the mid-1970s, early 1980s, early 1990s, in the 2008-9 GFC, and in the 2020 Covid lockdown recession. After each recession-induced bout of spending and deficits, spending was reduced gradually, allowing the deficits to fade and eventually turn into small surpluses (green bars in the middle section) at the tops of booms right before the next slowdown. It is notable that revenues (green line) have remained more or less stable in the post WW2 era. It has been the spending line that is much more volatile.

For investors – deficit spending, and resultant build-up of debts (in recessions, wars, and Covid), are generally good for share prices as the extra spending ends up directly or indirectly in corporate revenues, profits and dividends. Conversely, once the deficit spending-fuelled boom has grown the economic pie, it inevitably leads to inflation that has to be countered with spending cuts and interest rate hikes. Central banks nearly always go too late and too hard with rate hikes, triggering recessions, and the whole cycle starts again. We are at that point now.

What Lies Ahead?

Investment markets are going to be driven primarily by how central bankers manage rising inflation, part of which is due to temporary supply disruptions that will be resolved in time, and part of which is probably 'baked in'. Looking beyond the short term gyrations, we are probably heading into a world of higher government spending, deficits and debts, higher inflation, and therefore higher interest rates than we have enjoyed over the past thirty years since the early 1990s recession, and especially in the past dozen years since the GFC.

With this medium term outlook for higher inflation and interest rates, and our asset allocation in portfolios reflects our historical observation through many cycles that, in conditions of rising inflation, shares have done best, then commercial property, then housing in the middle, then bonds, cash and precious metals at the bottom with the lowest real total returns.

Another outcome from rising inflation and interest rates is that portfolio income (dividends from shares, rents from real estate, interest from bonds and cash) will be higher than it has been in the post-GFC era. As our portfolios are designed primarily for people aiming to generate income in the future (eg for retirement), we try to look through the noise of short term volatility, and focus instead on the underlying earnings generation of companies that are best placed to survive and prosper through a variety of conditions in the future, rather than making speculative bets for short term gains.

Unemployment remains low, but is built on a huge pile of debt that must be serviced, refinanced, and perhaps even repaid one day. In the case of Australia, $1 trillion of debt buys a lot of jobs, so the unemployment rate should be low or even zero! The Federal government racking up $1 trillion in debt is the equivalent of handing out $100k to each and every one of the 10 million households in Australia. Did you get your $100k? No? Neither did I! But it went somewhere. Wherever it landed, it was either spent or deposited in banks. If it was spent, it leads to jobs and more spending. If the money was deposited, the bank lent it out to borrowers, who circulated it again, and so on. Much of this extra cash went directly or indirectly into company revenues, which was paid out to staff, suppliers and dividends, all of which were re-circulated again via spending or bank deposits. Along the way, the higher company profits and dividends propped up share prices.

Aside from rising inflation and interest rates threatening company profits, another major risk is China. Politically, Xi Jinping cannot admit that the Chinese vaccines are inferior to other global alternatives, so he has stuck to his zero-Covid policy. The harsh lockdowns are crippling output, and exacerbating the already severe slowdown in housing and construction. Several more stimulus measures were announced in May, but it's difficult to see evidence of these working yet. Part of this may be difficulties in implementation, and part may just be in the time lags between policy announcement, action and outcomes. Continued infrastructure and construction investment in China is critical for Australia's mining companies, but also our tax revenues and therefore government spending. Our base case is that commodities demand, prices, volumes, revenues, profits and taxes are likely to remain relatively strong in the medium term. Global spending on infrastructure, military and carbon transitions are important, but continued Chinese demand remains a very important component.

House prices – media stories are full of dire predictions that rising interest rates might trigger house prices falling in the order of 10-20% in the coming year. That sounds scary, but that would only take prices back to where they were a year ago. Price falls only affect people who bought at the top with high debt levels, and are at risk of losing their incomes. Aside from a small proportion of highly leveraged recent buyers, the bigger risk to banks and non-bank lenders is residential property developers and builders. We have seen several collapses over the past year, and there are likely to be many more as rising interest rates and materials costs, plus falling prices, place them under even more pressure.

As always, we remain vigilant and willing to make further adjustments to portfolios to protect capital and capitalise on opportunities where warranted. In April, after our end of March quarter review, we opted not to 're-balance' portfolios, and this meant we did not 'top up' as share prices fell further . We will keep you informed of any changes.

Ashley Owen, CFA

Chief Investment Officer

Ashley Owen

Chief Investment Officer

CFA, LLM, BA, Grad. Dip Applied Finance

Ashley is one of Australia's leading portfolio managers of diversified investment funds for long term investors. His mission is to manage portfolios that provide investors with confidence that their investments will generate the wealth they need to live the life they wish to lead for the rest of their lives – for themselves, their families and as a legacy for future generations.

His primary focus is protecting investors from losses and risks, rather than chasing high returns from the latest hot funds or fads.

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