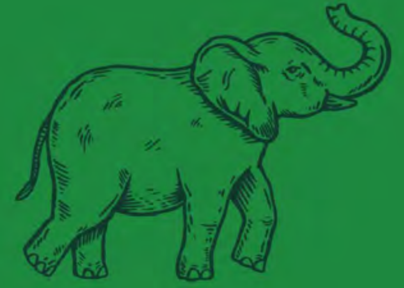
# Investment Markets Report



4 October 2022

StanfordBrown Private Wealth

Welcome to the 'Recession' edition, where we tackle some of the most pressing questions for long term investors:

- How high will interest rates go?
- How low will share markets fall?
- Will there be economic recessions?
- What about rising levels of debt?

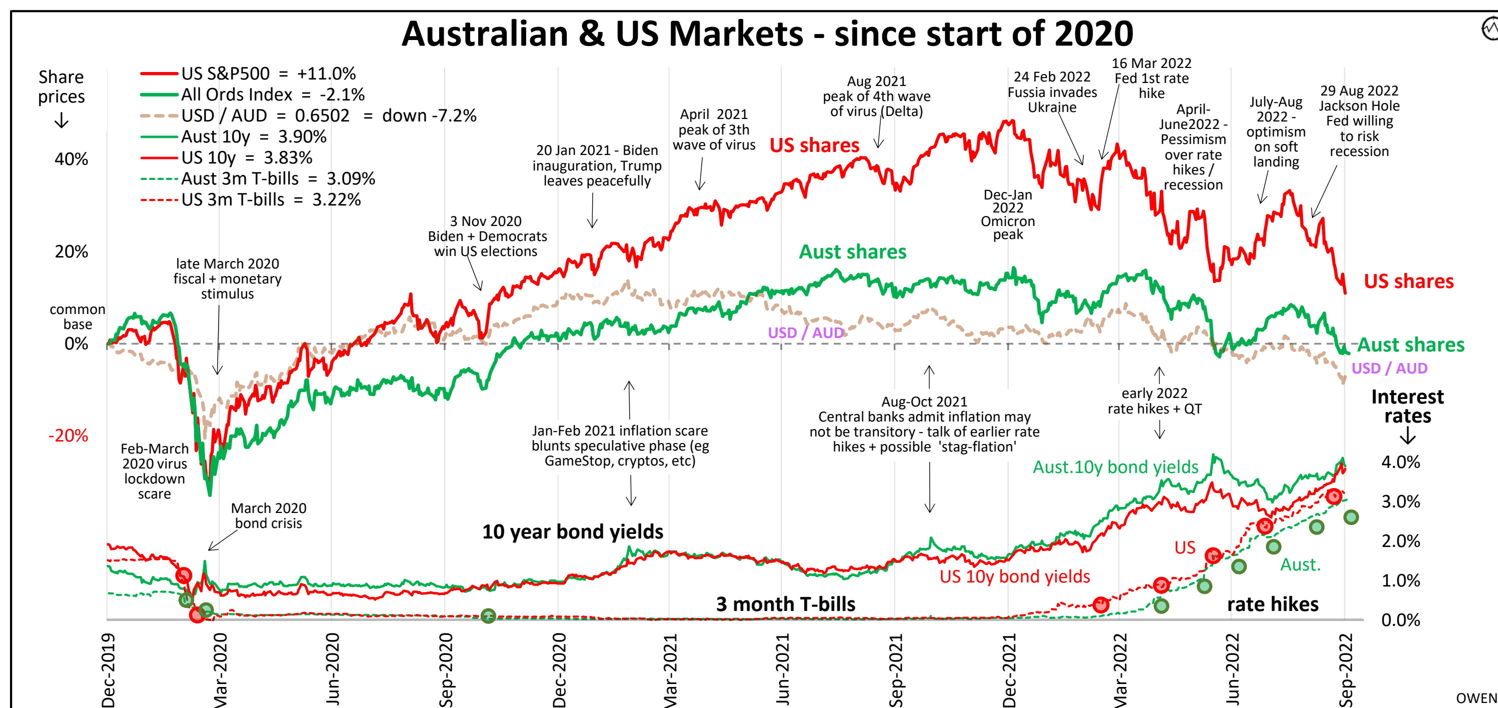
(Spoiler alert – recessions are almost always good for share markets!)

But first, a quick snapshot of where we are now.

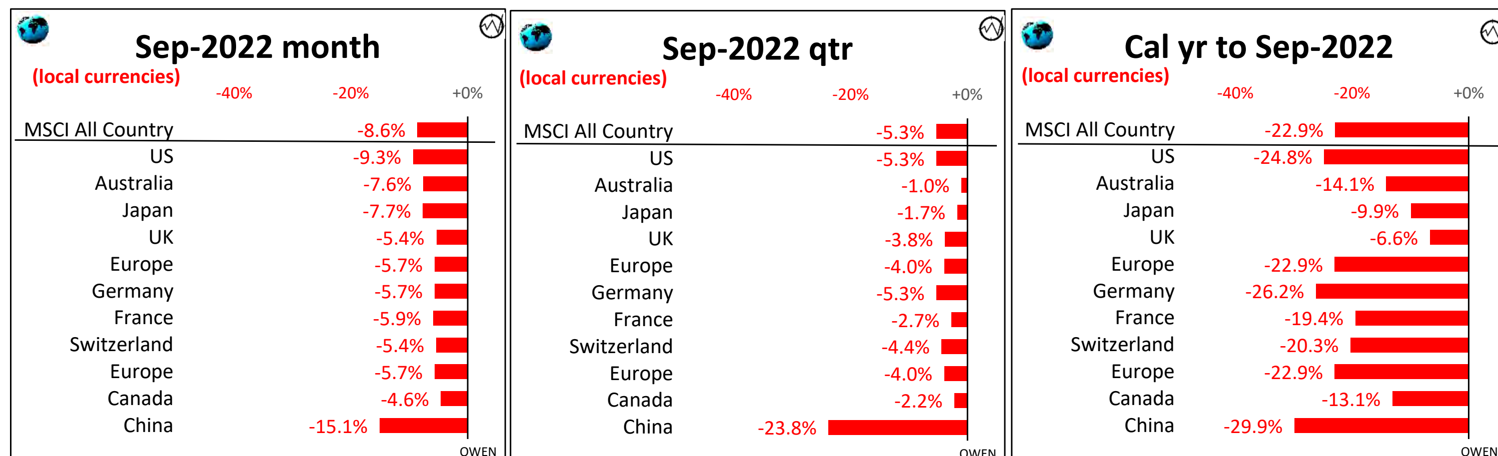
# Global financial markets snapshot

Share markets were down across the board in September as central banks kept raising interest rates to try to slow spending to bring down inflation. The exception is China, where the government is desperately trying to boost growth and spending to try to prevent the spread of the property/construction crisis (Chinese stocks have fared worst among global share markets this year).

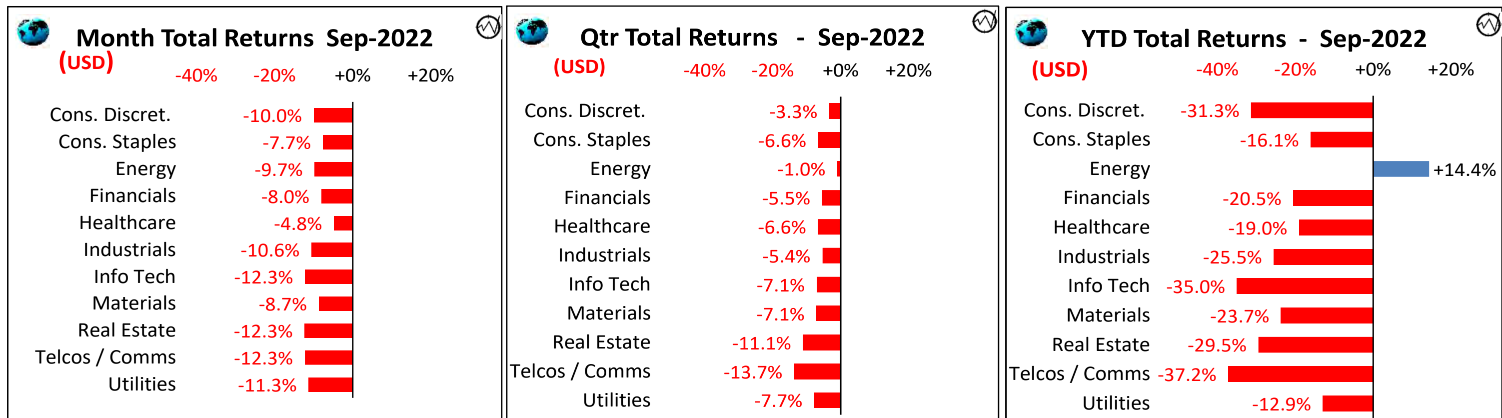
Here is our regular chart tracking progress since the start of 2020 for Australian and US markets. Share prices have been falling this year (upper section), with interest rates rising (lower section, with rate hikes marked).




The main drag on global shares markets this year has been US shares, as they were (and still are) the most over-priced (but share markets in China, Germany, Austria, Russia, Taiwan and Korea are down by more than the US).




All industry sectors were down for the September month and quarter, and all but one are down for the year to date:




The only sector up this year has been energy (oil/gas/coal producers), but oil & gas prices are now falling.

The big tech/online stocks are all down heavily this year. They are spread across three sectors:

- 'Tech' sector: Apple (US, down -22% this year, Microsoft (US, -31%), Intel (US, -50%), Nvidia (US, -59%), Samsung Electronic (Korea, -32%), Taiwan Semiconductor (Taiwan, -31%)
- 'Consumer Discretionary' sector: Amazon (US, -32%), Tesla (US, -25%), Alibaba (China, -33%)
- 'Telco/Comms' sector: Meta/Facebook (US, -60%), Alphabet/Google (US, -34%), Tencent (China, -42%)

Australian shares have fared better than most world markets for two main reasons. The first is the assistance from the falling Aussie dollar, although the UK and Japanese markets have held up even better, assisted by even larger declines in the Pound and Yen. The second reason is our industry mix – a very small local tech/online sector, and relatively large fossil fuel sector, plus iron ore miners, which benefited from the windfall spike in iron ore prices.

Although all share markets have fallen heavily this year, the main chart on the prior page shows that the US market is still 11% above 'pre-covid' levels (start of 2020), while Australia is back to square. Later in this report we discuss the outlook for share markets in much more detail, given the outlooks for inflation, interest rates and recessions.

Bond markets had another negative month in September, with bond yields rising by half a percentage point or more in most countries, driven by rising inflationary fears despite increasing risk of recessions. Global bond markets are having their worst year since the post WW1 inflation spike in 1921. In Australia, the bond market is down by almost as much as the share market this year: -10.5% total return from 'risk-free' government bonds, compared to -10.8% for the broad share market. (The worst ever return for Australian bonds was -12% in the three months to July 1931, when Australia defaulted and restructured its entire stock of domestic bonds. The day of the restructure was the very day the share market started to rebound, right in the middle of the 1930s depression. A theme of this report is how share market rebounds start in the midst of doom & gloom, despair & default!)

Last week, the Bank of England was forced to intervene in the UK bond market, and start buying up bonds again to prevent a major crisis. Britain's inflationary mini-budget caused UK bond yields to shoot up, and UK pension funds could not meet margin calls on their geared-up bond holdings. (Yes, not only do UK pension funds hold stacks of government bonds, they also gear up on them! Crazy on both counts!). Almost all long term/pension funds in Australia and around the world are stacked with fixed rate bonds (most are required to either by law, or by their own internal rules), but we have very little in our diversified client portfolios. Instead, we hold most of our bond allocations in high grade floating rate notes, which <u>increase</u> their returns as interest rates rise.

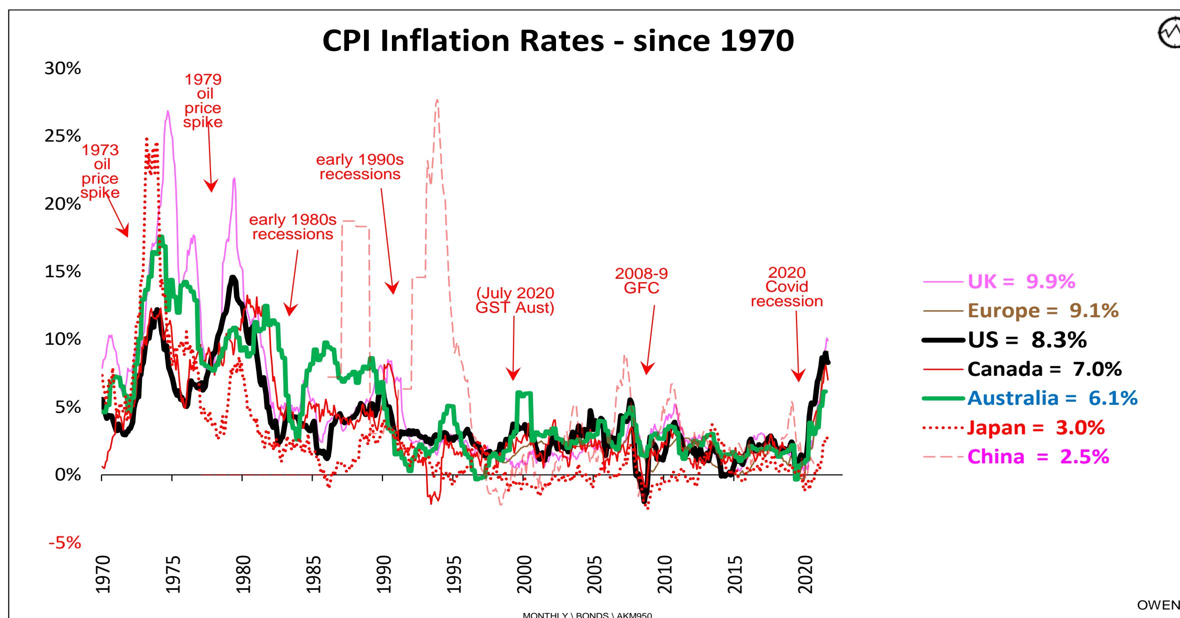
The Australian dollar fell 6% against the US dollar in September, but it was more a case of the US dollar rising as a 'safe haven' against all other currencies, especially the Yen and Pound. The falling AUD acted as a partial hedge/ cushion against falling global share markets, as half of our international share exposures are un-hedged.

Commodities prices were mostly down in September, reflecting expectations of slower global growth ahead. Oil, gas, iron ore, and most industrial metals were down, but coal prices edged up further in the global energy crisis.

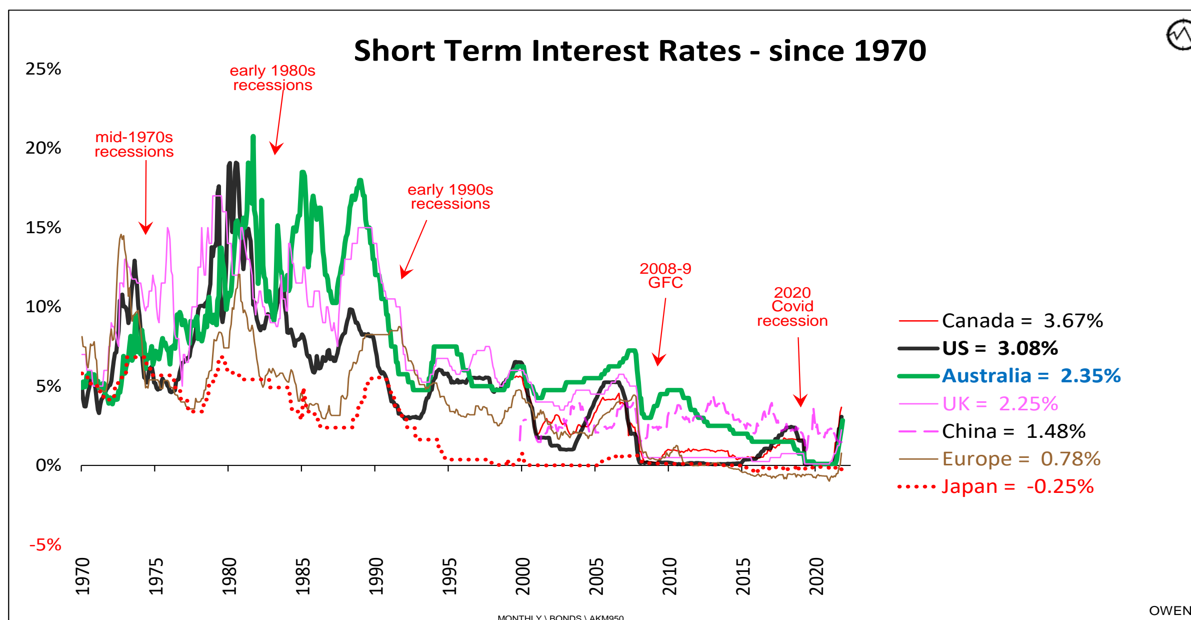
Now back to the questions on how high will inflation and interest rates go, and whether they will result in recessions. Much will depend on central bank resolve, and their willingness to withstand political pressures and keep on raising rates despite causing widespread job losses and corporate failures in order to bring down demand and spending.

# Inflation & Interest Rates – how high will rates go?

The answer to the question: 'How high will interest rates go?' will be different in each country, and impossible to tell in advance, of course. However, we can answer the question: 'Are we there yet?' with: 'Certainly not!' The next two charts provide some context. The first shows inflation rates in Australia and key countries since 1970:




While inflation is currently running at levels not seen since the 1970s and 1980s, on the next chart of short term interest rates we can see that even after the raft of rate hikes this year, interest rates are still barely a fraction of the levels they were when fighting the 1970s and 1980s inflation. They will need to go higher, but how far?




Much of the current inflation is temporary, resulting from covid lockdowns, Russian invasion disruptions, and unrelated weather events. Also temporary is the current consumer spending boom funded by the massive global build-up of household savings from covid stimulus programs. These temporary factors will ease the inflationary pressure over time as restrictions are lifted, as alternate supply sources are found, and as household savings are run down. However, governments are still pouring fuel on the inflationary fire by running big deficits. With politics fracturing everywhere, it is extremely difficult for elected governments to cut spending and raise taxes. This leaves the heavy lifting to unelected central bankers, and their main inflation-fighting tool is rate hikes. Even if inflation were to be brought back to say 3-4%, it would mean cash rates of at least 5% to contain inflation from there.

The key to global markets is the US Fed, and Jay Powell has been clear since the end of August 'Jackson Hole' meeting that he is committed to keep on raising rates to bring down inflation, even at the risk of a deep recession to reduce spending and jobs. This brings us to the prospect of recession, and likely impacts on share markets.

# Recessions are Good for Share Markets – A: Timing is Key

Nothing scares investors like talk of a 'recession'. Indeed, most of the largest share market falls have been related to economic 'recessions' and 'depressions'. However, history has shown that economic contractions have been mostly good for share prices. The Australian share market actually rose during the great majority of economic recessions in Australia. (The same is also true for the US share market during US recessions.)

How is this possible? The key is timing. What causes share prices to fall is the fear of impending recession, not the recession itself if, or when it finally arrives. Share markets have almost always rebounded out of the middle of recessions, while the economy is still contracting, while profits and dividends are still being cut, and while news headlines are full of gloom and doom, rising unemployment, corporate layoffs and bankruptcies. As a result, the broad share market index in Australia has actually risen during the vast majority of economic recessions.

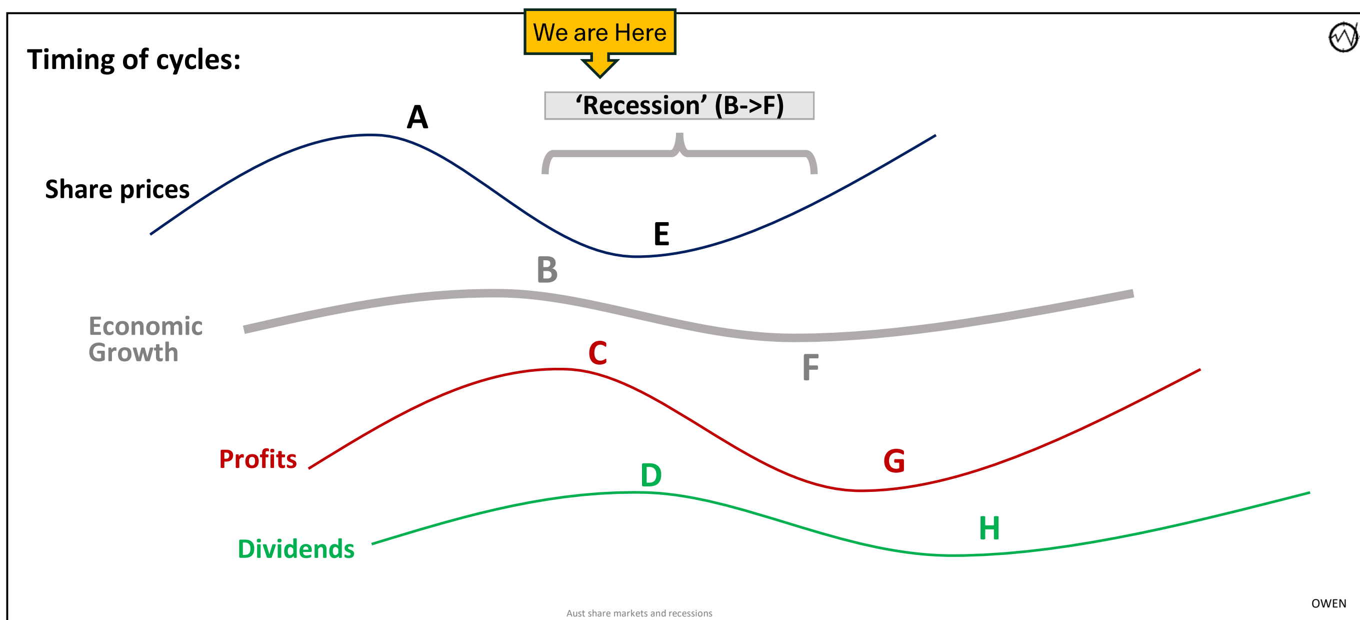
'Recessions' and 'Depressions'

First, some definitions. An economic 'recession' is generally, but not always, defined as two or more consecutive quarters of negative economic growth. There are exceptions – for example, in the 2008-9 'Global Financial Crisis', the Australian economy only had one calendar quarter of negative growth (-0.5% in the December quarter 2008), but many people regard it as a 'recession' as it certainly was a broad and deep economic and financial crisis - unemployment rose sharply, the All Ordinaries index fell by -51%, aggregate earnings per share fell by -40%, aggregate dividends per share fell by -38%, there were widespread bankruptcies across several industry sectors, and two of the 'big-4' banks had to borrow emergency funds from the US Fed's 'lender of last resort' funding facility. Another exception to the 'two consecutive quarters of negative real growth' definition of a 'recession' was the 2020 Covid lockdown recession, when the US National Bureau of Economic Research (the body that calls US recessions), declared a 'recession' in the US lasting just two months (February-March 2020).

Before the 1940s, every economic slowdown was called a 'depression', but now the term is reserved for much deeper and longer economic contractions than mere 'recessions', accompanied by very high unemployment (say 20% or more), significant and sustained declines in aggregate incomes, commodities prices, trade and credit. In Australia, the main economic 'depressions' were in the 1930s, 1890s, and 1840s, which were all global crises.

Timing is everything

Share prices generally fall before economic contractions start, and then start rebounding while economies are still contracting. This chart illustrates how the cycles work:




The timing of each part of the cycle almost always follows the following order:

**A**. Share prices start falling in anticipation of profits falling in an upcoming economic slowdown, but while aggregate company profits and dividends are still rising.

**B**. Economic activity starts contracting (ie negative growth in real GDP) – usually well after share prices start falling (A). Because of delays in reporting national economic numbers, by the time negative economic growth is reported, the share market has already been falling for several months in most cases. Even in the very short, sharp 2020 Covid recession, when the March quarter economic contraction in Australia was announced in May, the share market had already started to rebound strongly from late March.

**C**. Aggregate company profits start falling (due to slower revenues and often rising interest rates), usually well after share prices have started falling (A), and also usually after economic activity starts contracting (B). Often, company profits are still surging well into economic contraction – eg profits were still surging in 2008, a year after share prices started to fall. Aggregate company profits fall by much more than the reduction in economic output because companies have operational and financial leverage, and narrow profit margins, so 'bottom-line' profits are greatly affected by even very small changes in 'top-line' revenues and interest rates. For example, in a serious recession, GDP might fall by say -3%, but aggregate profits and share prices might fall by 30-40% or more.

**D**. Dividends start falling, after profits start falling (C). Cutting dividends is usually the last resort of company boards in a crisis. Generally, companies try to maintain dividends in order to retain investor confidence and support the share price, even though profits have fallen. The fall in aggregate dividends is always less than the fall in aggregate profits. For example, aggregate profits might fall by -40-50%, but aggregate dividends would fall by say 20-30%.

**E**. Share prices start rebounding – usually while economic activity is still contracting in the middle of 'recession', while profits and dividends are being cut. Share prices start to rise in anticipation of future rebounds in profits (G) and dividends (H) in the year ahead.

**F**. The economy starts growing again – well after the start of the rebound in share prices (E). Share prices start rebounding while the economy is still contracting – even in the 1930s Great Depression. As a result, in most cases, by the time the economy starts growing again, share prices have more than recovered their falls during the actual recession itself. As a result, the actual periods of 'recessions' (when economic growth is contracting, from points B to F), share prices actually rose in the vast majority of cycles.

**G**. Aggregate company profits rebound, well after start of rebounds in share prices (E) and economic growth (F).

**H**. Dividends are finally raised, as balance sheets and profitability are restored – well after the start of rebounds in share prices (E), economic growth (F) and profits (G).

The net result of this consistent pattern is that the share market has risen during the vast majority of economic recessions (point B to point F on the chart). We detail every recession in the past 150 years later in this report.

Where are we now?

The most important markets for Australian investors are the US (which drives all global markets), and Australia. Both are probably around point B on the chart. Share prices have already fallen in anticipation of rate hikes cutting into consumer spending, leading to lower corporate profits and dividends, job losses and economic contractions. Whether or not there is a 'recession' is not as important as the fear of significantly lower profits and dividends.

Although the US economy actually contracted in the first two quarters of 2022, the National Bureau of Economic Research is not yet calling it a 'recession' as household spending and jobs remain very strong. Also, corporate profits and dividends are still rising, albeit at slower rates than in 2021. Australia also has strong jobs, spending, profits and dividends. Even in Europe and the UK, economies are probably already contracting, but jobs, spending, profits and dividends remain strong. China is also contracting, but for us the key markets are the US and Australia.

Where to for share markets?

Share markets have already sold off in anticipation of lower profits and dividends, and the share price falls are probably not over yet, because large sections of the US share market in particular are still over-priced, although the Australian market is probably now around 'fair value'. When economic recessions do arrive, they will be marked by mass job losses and bankruptcies, as in numerous previous cycles. When share markets rebound, it will be when doom and gloom is greatest, unemployment and corporate failures are rising, and companies are posting big cuts to profits and dividends. Rebounds have always been faster and stronger than investors expect, and they start when fear and uncertainly are greatest (when there is 'blood in the streets', says Warren Buffett).

# Recessions Good for Shares – B: 21 recessions in 150 years

Australia has had 21 economic recessions since the 1880s (based on the conventional definition of at least two consecutive quarters of negative growth in real GDP). These include two ‘depressions’ – in the 1890s and 1930s.

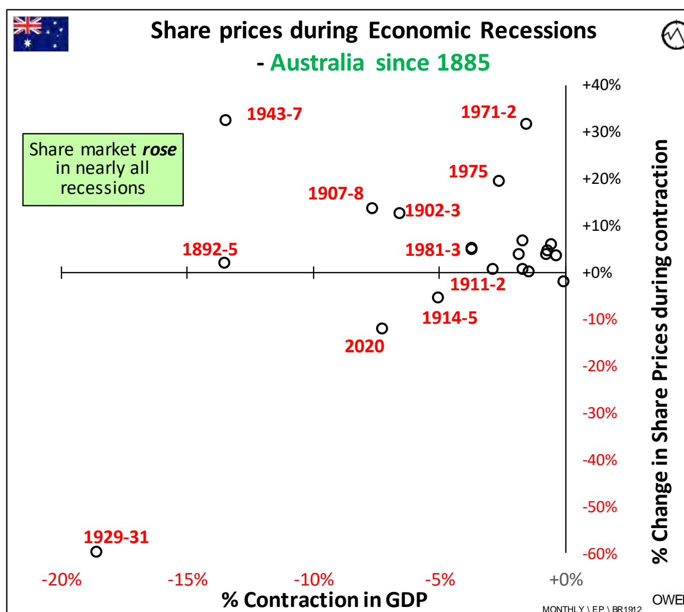
The chart below shows changes in the share index during each of the recessions since the 1880s in Australia. Almost all are in the upper sector of the chart – the broad share market rose during the recessions. In summary:

- The broad share market index rose during 17 (81%) of the 21 recessions in Australia since the 1880s.
- Aside from the very short, sharp 2020 Covid sell-off, share prices rose during each of Australia’s previous nine recessions, since the 1938-9 recession, when share prices fell by just -1.8%.
- In the recent well-known recessions – share markets rose during each of them. These included: Keating’s 1990-1 ‘recession we had to have’, the long 1981-3 recession, the 1975 Whitlam inflation recession, and the 1971-2 mining collapse recession.

## Recessions (contractions 2q or longer)

Australia since 1885

| | Start | | End | | Qtrs / yrs | | Real GDP fall | Share prices |
|---|---|---|---|---|---|---|---|---|
| 1 | Dec 1891 | | Dec 1895 | | 4 | yr | -13.5% | +2.2% |
| 2 | Jun-1900 | | Jun-1901 | | 1 | yr | -1.7% | +1.0% |
| 3 | Jun-1902 | | Jun-1903 | | 1 | yr | -6.5% | +12.9% |
| 4 | Jun-1904 | | Jun-1905 | | 1 | yr | -1.7% | +7.0% |
| 5 | Jun-1907 | | Jun-1908 | | 1 | yr | -7.6% | +13.9% |
| 6 | Jun-1911 | | Jun-1912 | | 1 | yr | -2.9% | +0.9% |
| 7 | Jun-1914 | | Jun-1915 | | 1 | yr | -5.0% | -5.1% |
| 8 | Jun-1916 | | Jun-1918 | | 2 | yr | -3.7% | +5.3% |
| 9 | Jun-1927 | | Jun-1928 | | 1 | yr | -0.5% | +6.2% |
| 10 | Jun-1929 | | Jun-1931 | | 2 | yr | -18.6% | -59.6% |
| 11 | Jun-1938 | | Jun-1939 | | 1 | yr | -0.0% | -1.8% |
| 12 | Jun-1943 | | Jun-1947 | | 4 | yr | -13.5% | +32.8% |
| 13 | Jun-1952 | | Jun-1953 | | 1 | yr | -0.7% | +4.7% |
| 14 | Jun-1961 | qtr | Sep-1961 | qtr | 2 | qtrs | -1.8% | +4.0% |
| 15 | Sep-1965 | qtr | Mar-1966 | qtr | 3 | qtrs | -0.3% | +3.8% |
| 16 | Dec-1971 | qtr | Mar-1972 | qtr | 2 | qtrs | -1.5% | +31.9% |
| 17 | Sep-1975 | qtr | Dec-1975 | qtr | 2 | qtrs | -2.6% | +19.7% |
| 18 | Sep-1977 | qtr | Dec-1977 | qtr | 2 | qtrs | -0.7% | +4.1% |
| 19 | Dec-1981 | qtr | Jun-1983 | qtr | 7 | qtrs | -3.7% | +5.2% |
| 20 | Sep-1990 | qtr | Jun-1991 | qtr | 4 | qtrs | -1.4% | +0.4% |
| 21 | Mar-2020 | qtr | Jun-2020 | qtr | 2 | qtrs | -7.2% | -11.8% |
| | | | | | | count: | 21 | 21 |
| | | | | | | median | -2.6% | +4.1% |
| | | | | | | % Positive for shares: | | 81% |




Aside from a couple of very minor share price falls during the 1938-9 recession and the 1914-5 WW1 recession, the only recession or depression in Australia that was accompanied by big share price falls during the period of economic contraction was the 1929-31 depression – when shares fell by 60% during the period of contraction.

In the 2020 Covid recession, shares fell by 11% while the economy was contracting, but shares then rebounded quickly, starting from the early part of the recession. In that case the economy contracted in the March and June quarters 2020, but the share market started rebounding strongly from the last week of March, and the share rebound continued through the June quarter contraction.

Share prices fall in anticipation of bad news – especially the fear of big cuts to corporate profits and dividends. Just as share prices tend to over-shoot on the upside during booms, prices generally also over-shoot on the downside as well, and then recover when the actual losses are announced, when people realise it is not actually the end of the world after all. In nearly all cycles, share prices start their rebound while the economy is contracting, while earnings and dividends are being cut. By the time profits bottom, share markets are well into their rebounds.

In fact, some of the best years for shares are when the economy was contracting or still weak – including 1983, the best ever calendar year for Australian shares (up +60%), during the 1981-3 recession.

This is a reminder to ignore media scare mongering. In particular, by the time the recession hits, most of the share market fall is probably already in the past. The great share market surges start when the media headlines are full of doom and gloom, rising jobless rates, corporate bankruptcies, losses, and dividend cuts. For readers interested in more detail, we outline every recession and share market sell-off in the past 150 years at the end of this report.

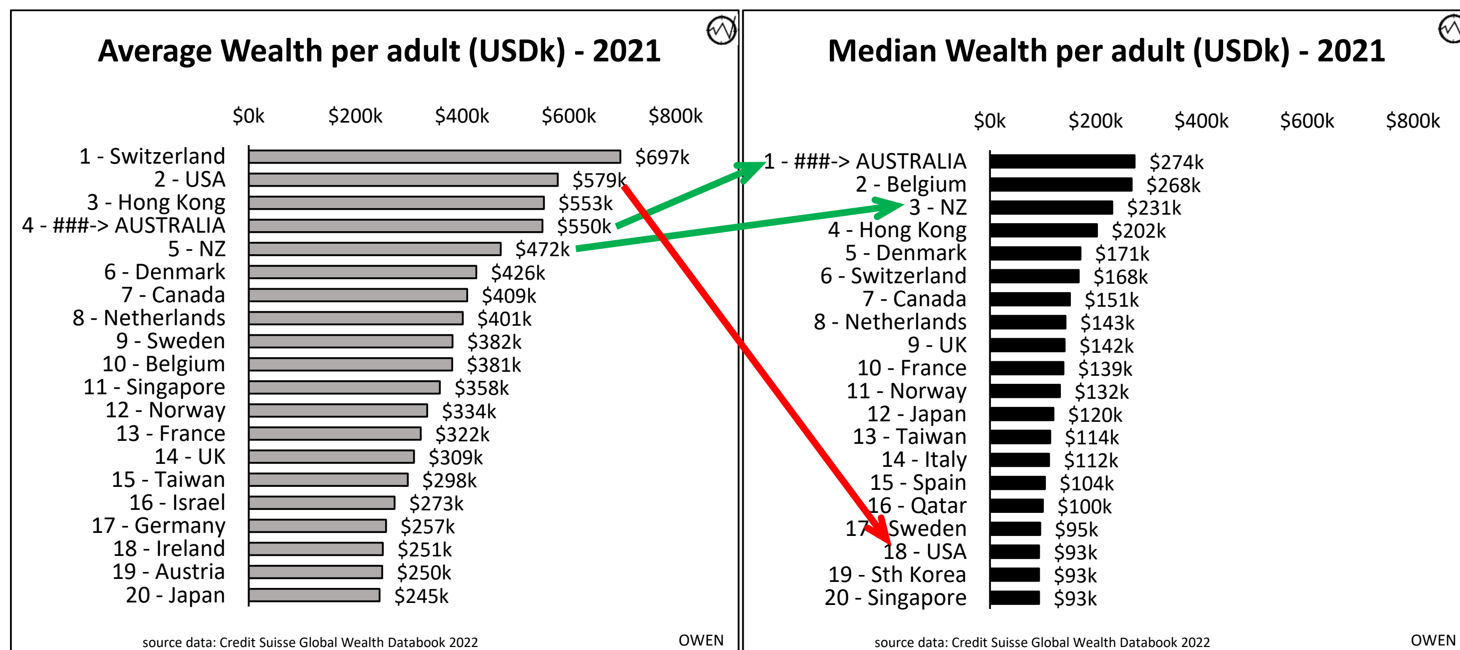
# Australians are Wealthiest in the World - still

With media headlines full of doom & gloom – including inflation, interest rate hikes, recession, war, and price falls in just about every type of investment asset in every country – it is good to pause for a moment to consider just how lucky we are here in this part of the world. Last week, Credit Suisse published its annual 'Global Wealth Report', on household wealth in 170+ countries. It shows that Australia retained its top spot as the wealthiest nation on earth.

The '2022' report is a snapshot at the end of 2021, but things have changed since then of course. So far this year we have seen price falls in shares, bonds, crypto, and even housing, with the rate hikes and Russia's war on Ukraine. However, despite these falls, Australia would still retain its number one ranking this year because our share market has held up better than most, thanks to our heavier weighting of commodities producers.

The charts below show the top 20 countries ranked by wealth per adult. 'Wealth' includes 'financial assets' (shares, managed funds, bonds, pension/super funds, etc), plus 'non-financial assets' (mainly housing), minus debts (mainly housing debts). It includes only individuals, not companies or governments (we cover these later).

The left chart shows 'average' wealth per adult, and the right chart shows 'median' wealth per adult (both are expressed in US dollars to allow international comparisons).




For each country, 'average' wealth (left) is much larger than 'median' wealth (right) – why is this? The 'average' (or 'mean') wealth is the total wealth for a country divided by the number of adults. The 'median' wealth is the wealth of the person in the middle of the pack - with an equal number of adults richer and poorer. In the case of Australia, there are 13.8 million adults, so the 'median' adult is the person in the middle, with 6.9 million people with more wealth, and 6.9 million with less. The 'average' wealth is skewed by the billionaires and ultra-wealthy, which boost the 'average', but don't affect the 'median' at all. If Gina Rinehart is suddenly 'worth' $5 billion more because iron ore prices rise, it lifts the mathematical 'average', but makes no difference to the 'median' or the ordinary worker.

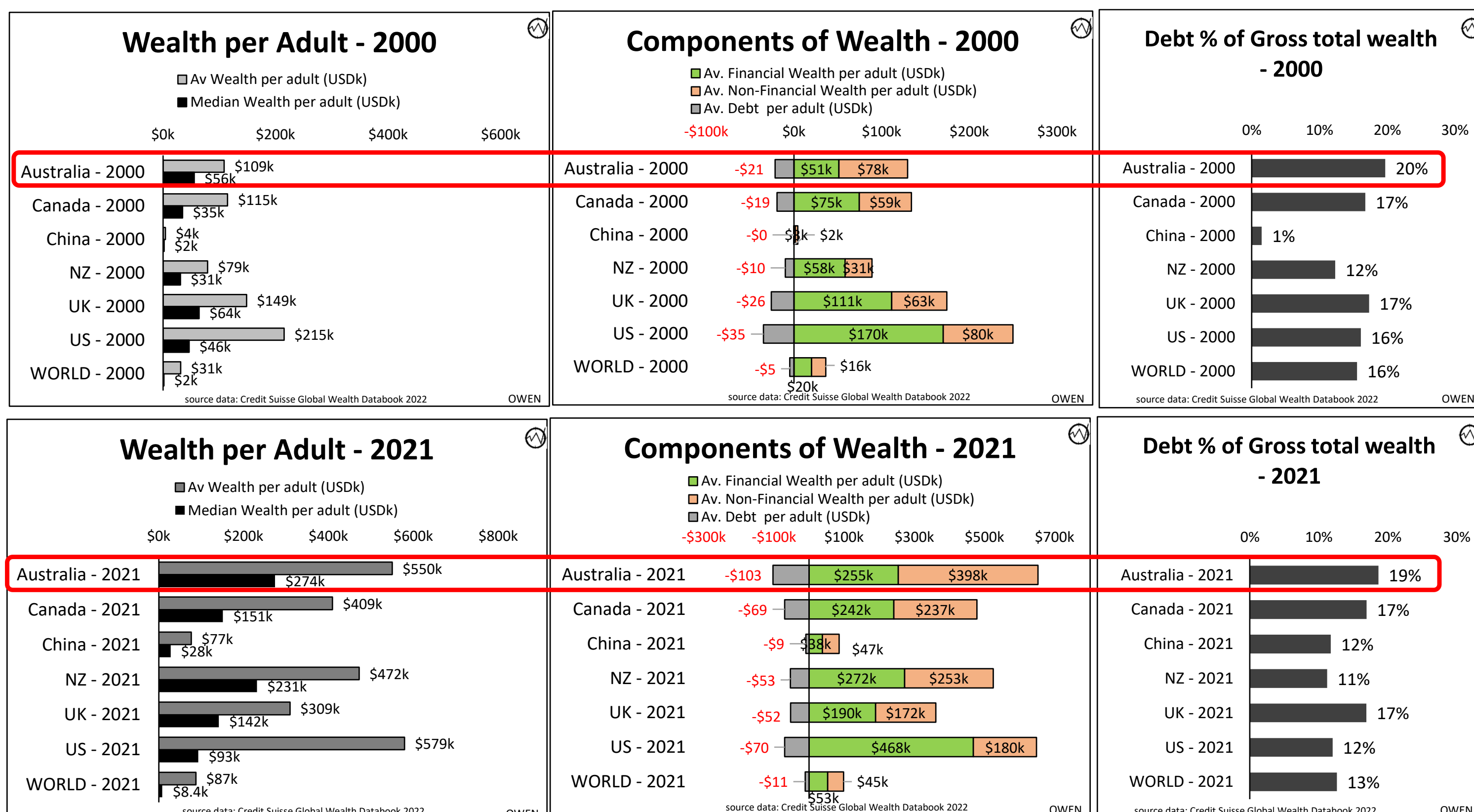
The 'median' wealth per adult is a much better measure of the general wealth of a society, as the 'median' adult in any given country represents the typical, ordinary workers. The median Australian is an ordinary worker with 'non-financial assets' (mainly housing) worth around US$200k, plus 'financial assets' (mainly super and shares) worth around US$120k, and debts (mainly housing debt) of around US$50k. Although these numbers may appear rather low, 'ordinary' Australians are in fact the wealthiest people in the world, and NZ is not far behind, in third place.

The difference in ranking between 'average' and 'median' wealth for a country is a function of the degree of inequality of wealth within the country. USA ranks 2nd on 'average' wealth because it has by far the most billionaires and ultra-wealthy (defined as US$50m+), but it ranks a rather low 18th on 'median' wealth because of its relatively unequal distribution of wealth. The median ordinary Aussie has three times the US dollar net wealth of the median ordinary American. Australia, NZ (and most of Western/Northern Europe) are far more equal in wealth distribution across society, and so they rank higher on 'median' wealth than on 'average' wealth.

# Heavy Reliance on Housing & Debt - still

Australia has consistently ranked at or near the top of the table on average and median wealth in the world, since first gaining top spot in 1890 (no, that is not a typo. 1890, not 1980!). However, it is useful to dig a little deeper into the numbers to understand some of the risks and vulnerabilities involved.

In the next set of charts, we highlight a few selected countries for comparison (including China, and World totals). The left charts show 'average' and 'median' wealth per adult in each country (as explained in the previous story). The middle charts show the components of this wealth – separated into 'financial assets' (ie. shares, managed funds, bonds, pension/super funds, etc), plus 'non-financial assets' (mainly housing), minus debts (mainly housing debts). The right charts show the level of debt relative to total wealth. The upper set of charts show the position in 2000 – before the start of the long China/commodities boom. The lower set of charts show the most recent position, at the end of 2021, as per the 'Global Wealth Report 2022'.




Apart from sizeable increases in all numbers between 2000 and 2021 (mainly due to inflation), most of the other features have not changed significantly. One exception has been the tremendous rise of household wealth in China over the past 20 years, albeit from a very low base of relative poverty at the start, to moderate wealth today.

In the middle charts we can see that housing (orange bars) makes up the bulk of wealth for Australians, and this has not changed in the past 20 years. Despite the increasing role of superannuation over the period, Australia still has the highest reliance on housing, at 72% of total household wealth, and this is the same as it was in 2000.

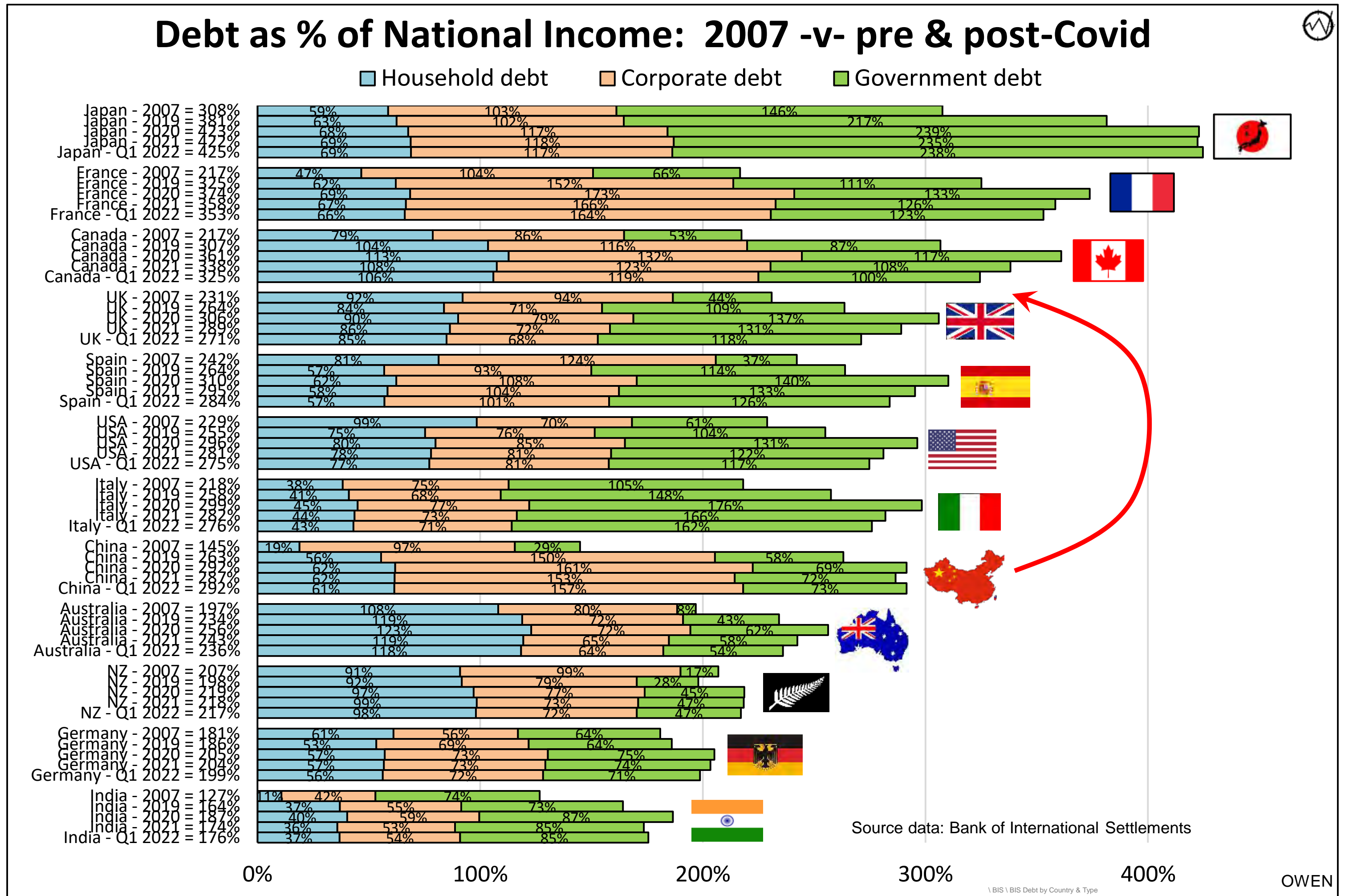
Hand-in-hand with Australia's heavy reliance on housing, the right charts show the level of household debt (mainly housing debt). Australia has the highest debt levels – in terms of debt relative to assets, and also in absolute dollar terms. Only Switzerland, Luxembourg and Norway have higher levels of household debt per adult than Australia.

Australia is more vulnerable to the effects of interest rate hikes than most other countries for two reasons: the first is the sheer level of household debt, and the second is the fact that most of it is variable rate debt, tied to short term interest rates. Each time the RBA raises cash rates, the banks raise their rates on variable rate mortgages within hours or even minutes. In contrast, US household debt levels are some 40% lower per person, and the majority of US mortgages are at fixed rates, tied to 30 year treasury bond rates, which change much more gradually than cash rates. As a result, Australian households carrying debt are much more sensitive to mortgage stress and household spending pressures from the interest rate hikes to fight inflation.

# Debt Olympics

In the last story we looked at household debts in various countries, but household debt makes up only one quarter of total debt in the world. The rest is a combination of corporate debt and government debt. With interest rates rising rapidly, it is time to update on our regular chart on the global Debt Olympics to see how we are faring.

This chart shows debts as a percentage of national income (GDP) for the main countries. Each country has five bars. The top bar is the position in 2007 (just before the Global Financial Crisis), then in 2019 (just before the Covid crisis), 2020 (height of the Covid crisis), 2021, and finally the most recent data (end of March 2022). Each bar has three sections for the main types of debt – household (blue), corporate (pink), and government (green).




In terms of total debt loads, Japan retains the wooden spoon by a big margin. Japan is locked in a death spiral due to its ever-increasing welfare bills for its declining & aging population.

If the lesson from the GFC was to avoid excessive debt, nobody was listening. Far from 'de-leveraging' after the shock of the GFC, households, companies and governments in every country loaded up on cheap debt in the post-GFC years. Then, in the 2020 covid crisis, debt levels rose rapidly with the deficit spending sprees, ultra-low interest rates, and cheap lending programs specifically designed to encourage even more debt! The good news is that every country except Japan and China has managed to reduce its debt load since the 2020 peak debt levels. This is mainly via economic growth, rather than reducing actual debts. New Zealand is also a laggard here, with its total debt load remaining flat since 2020.

The big mover in recent years has been China, which has jumped up the table to 4th highest debt load, now ahead of UK, Spain, USA, and Italy. Although most of the debt in China is labelled 'corporate', in reality much of this is state-controlled entities, propped up by endless rounds of refinancing into the never-never by state-controlled banks, terrified of the social unrest that may be unleashed if unprofitable 'zombie' companies were to collapse.

Australia still ranks very well compared to its peers (although still behind NZ). Government and corporate debt levels remain relatively low (although it had virtually no government debt going into the GFC). The main problem for Australia is household debt (blue bars), which remain the highest in the world.

# What Lies Ahead?

This month's report covered a lot of territory – we tackled the most pressing questions facing long term investors:

- How high will inflation and interest rates go?
- How low will share markets fall?
- Will there be economic recessions?
- What about rising levels of debt?

Definitive answers (forecasts) are impossible, but we hope we provided some context. On the inflation front – there are early signs of headline inflation numbers coming down (mainly from lower energy prices). Although many of the temporary inflationary forces will ease in time, there are several factors pointing to inflation persisting above target levels for many years. Central banks are looking increasingly likely to press on with rate hikes despite (and indeed, to bring on) slowdowns that cause business contractions, lay-offs, and collapses. These are almost certain.

For share markets – much, or perhaps even most, of the falls are probably already behind us. Several sectors are still fundamentally over-priced (notably tech/online sectors, mainly in the US), and these probably have further to fall. However, in most other sectors, this year's share price falls assume not only big cuts to profits and dividends next year, but they also assume that the cuts to aggregate profits and dividends will be permanent, which of course they will not. Although there is certainly plenty of gloom & doom in the news at the moment, we are probably not yet at the stage of abject despair, which is when the big share market rebounds start. In every one of the many cycles we have studied, the rebound is always stronger, quicker, and more broad-based than expected.

If central bankers go soft and pause rate hikes at the first sign of economic stress, share markets may rebound, at least for a while. But if central bankers stick to their guns and engineer deep recessions to slow demand and spending sufficient to bring inflation back to target ranges, then share markets will fall further. However, even in that 'worst case' scenario, share market rebounds will start while economies are contracting, while unemployment and corporate failures are rising, and companies are posting big cuts to profits and dividends. Watch this space!

Bond markets are likely to remain under pressure if inflation remains above target, but bonds will probably rally in price (bond yields falling back, if only temporarily) in the event of deep recessions. We are steering clear for now.

For commodities - although there are supply/demand differences within each commodity market, commodities prices broadly reflect changes in sentiment on the outlook for global growth. Most industrial commodities are weakening – oil is back below $80/barrel, natural gas below $7/MMBtu, iron ore below $100/t, copper below $8,000/t. Most will probably rebound with economic recoveries next year. The hot sectors like 'battery metals' (lithium, copper, nickel, cobalt, graphite, manganese) will continue to suffer wild bouts of over-enthusiasm, over-investment, then over-supply. We have covered commodities markets at some length in recent reports.

We have also covered housing markets in recent reports. House prices will continue to fall with further rate hikes and credit rationing by the banks, which will reduce loan sizes, and therefore reduce purchase prices.

The 'wild card' is Putin and his nuclear option, adding to the doom & gloom for investors. Last month we covered the impact of military attacks, nuclear crises, wars, and even World Wars on share markets. The results surprised most readers. Even the most serious crises including world wars are actually hard to find on share price charts.

During this year we made several portfolio adjustments to further diversify risks, and to increase resilience in the event of broad recessions. We are about to undertake our regular quarterly review, and will keep you informed of any further changes to portfolios to protect capital and capitalise on opportunities where warranted.

For readers interested in more detail on every share market cycle and recession over the past 150 years, we have included a Supplementary Report below.

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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# Supplementary report:

# Share markets and Recessions – the last 150 years

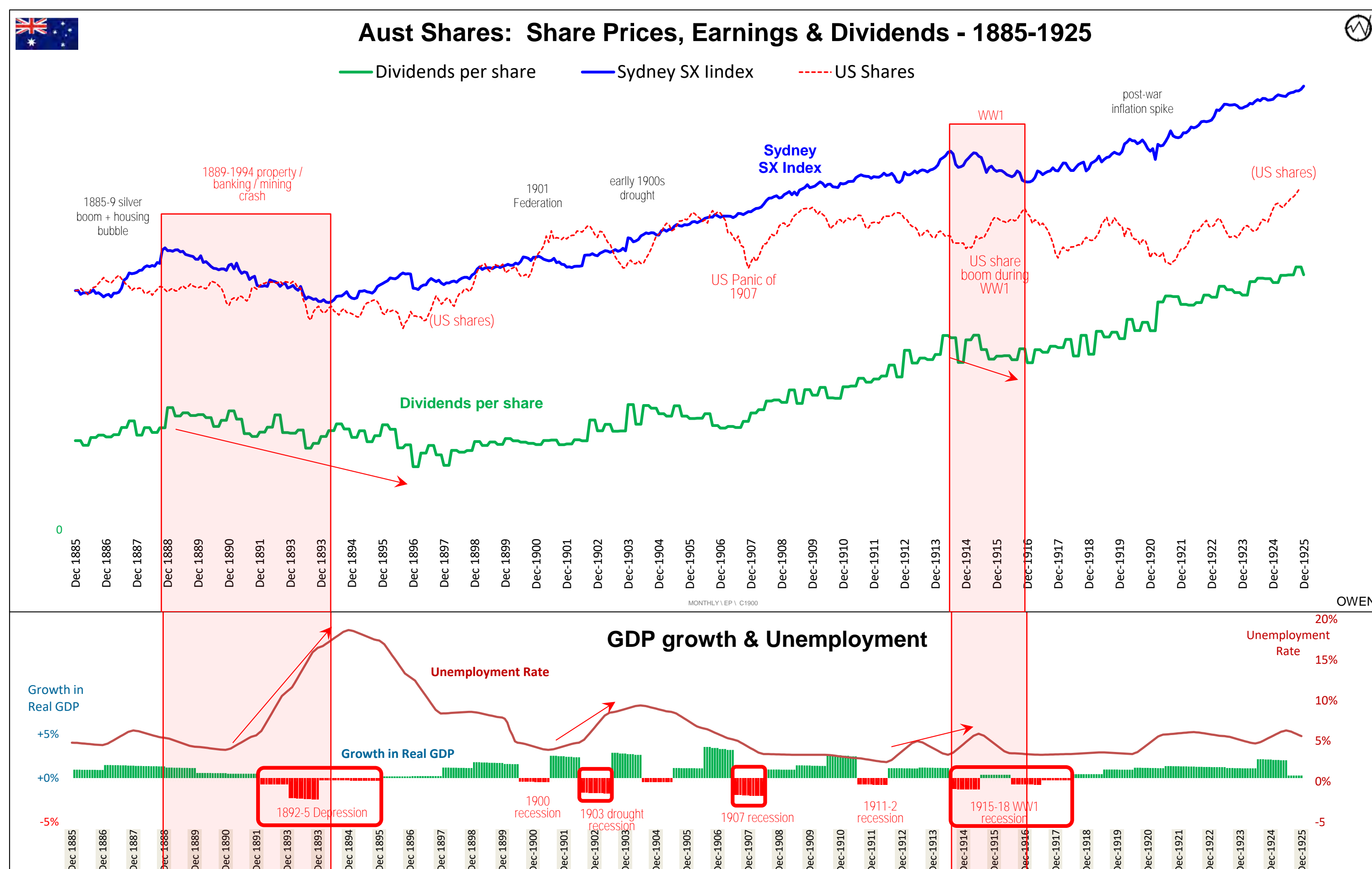
In the following sections we look at each of the share market cycles and recessions in Australia over the past 150 years to illustrate how, in almost all cases, they followed the same pattern. Share prices start falling well before the start of recession, then rebound during the recession itself, while the economy is still contracting, while profits and dividends are still being cut, and unemployment is rising. As a result, share markets generally rise during the period of economic contraction, with very few exceptions.

On the charts, the pink boxes highlight the significant falls in share markets, while the thick red boxes in the lower section highlight the periods of economic contractions (recessions and depressions). In almost all cases, share prices fall before economic contractions, and rebound during the recessions, well before the start of economic recovery.

In addition, the upper charts show the broad US share price index, illustrating how the Australian market has almost always followed the US market closely, because capital flows are global.

# Share markets and Recessions – 1885 to 1925

Between 1885 and 1925, there were two major share market sell-offs in Australia. The first was in the lead-up to the 1890s depression, when the 1880s mining boom and property development boom collapsed (triggered by falling metals prices, collapses in agricultural prices and trade, and the sudden withdrawal of British capital). The second major share market fall was during the First World War.




## 1890s Depression

Real GDP in the Australian colonies fell by -13.5% (the deepest contraction aside from the 1929-31 Depression) and the contraction lasted four years - calendar 1892 through to calendar 1895 inclusive. (Prior to 1900 we have only calendar year data for economic aggregates).

As with other major recessions, it the 1890s depression was a global phenomenon. Whereas the 1930s depression was milder in Australia than the US, the 1890s depression was worse in Australia. In the US, the economy contracted by -8% and lasted only two years. The US (which at that time was an agriculture-based, capital-importing, 'emerging market') also experienced a collapse in farm commodities prices and incomes, and a sudden withdrawal of capital from the UK. Australia (also a resources-based, capital-importing emerging market) had the collapse of a mining boom, wool & wheat prices, but also had the collapse of a massive speculative housing construction and land development boom, especially in Melbourne. The sudden withdrawal of capital from the UK also triggered an existential banking crisis involving widespread bank closures and half of all bank deposits in Australia being frozen for more than a decade. This was much more severe than in the US.

The share market started falling from the start of 1889, three years before the economy started contracting (the start of 1892), and four years before the 1893 banking crisis.

After the market fell by -36%, the share rebound started in March 1894, which was right in the middle of the economic depression, and nearly two years before the economy started growing again (from early 1896). When the share rebound started, dividends were still being cut, and unemployment was rising sharply to 16% and still rising. Although the share market fall was large, most of it was before the economy started contracting. During the period of Depression itself, the share index actually rose by +2% (excluding dividends).

WW1 recession

Real GDP in Australia fell by -7.2% in a contraction that lasted from the June 1914 through to the end of the June 1917 year. (Between 1900 and 1959 we have only June financial year data for economic aggregates, so that is all we can use to measure recessions). Share markets started at the same time as the economic contraction, because of the sudden outbreak of War. Over the whole four year period, the broad share index fell by -14.7%, as imports and exports were severely disadvantaged by shipping disruptions. However, the share market did start to rebound from the start of 1917, some 18 months before the end of the economic contraction. (The shipping disruptions in WW1 spurred a major policy shift toward import replacement manufacturing behind high protection barriers. These policies were a significant drag on national growth rates until they were finally disbanded in the 1980s reforms).

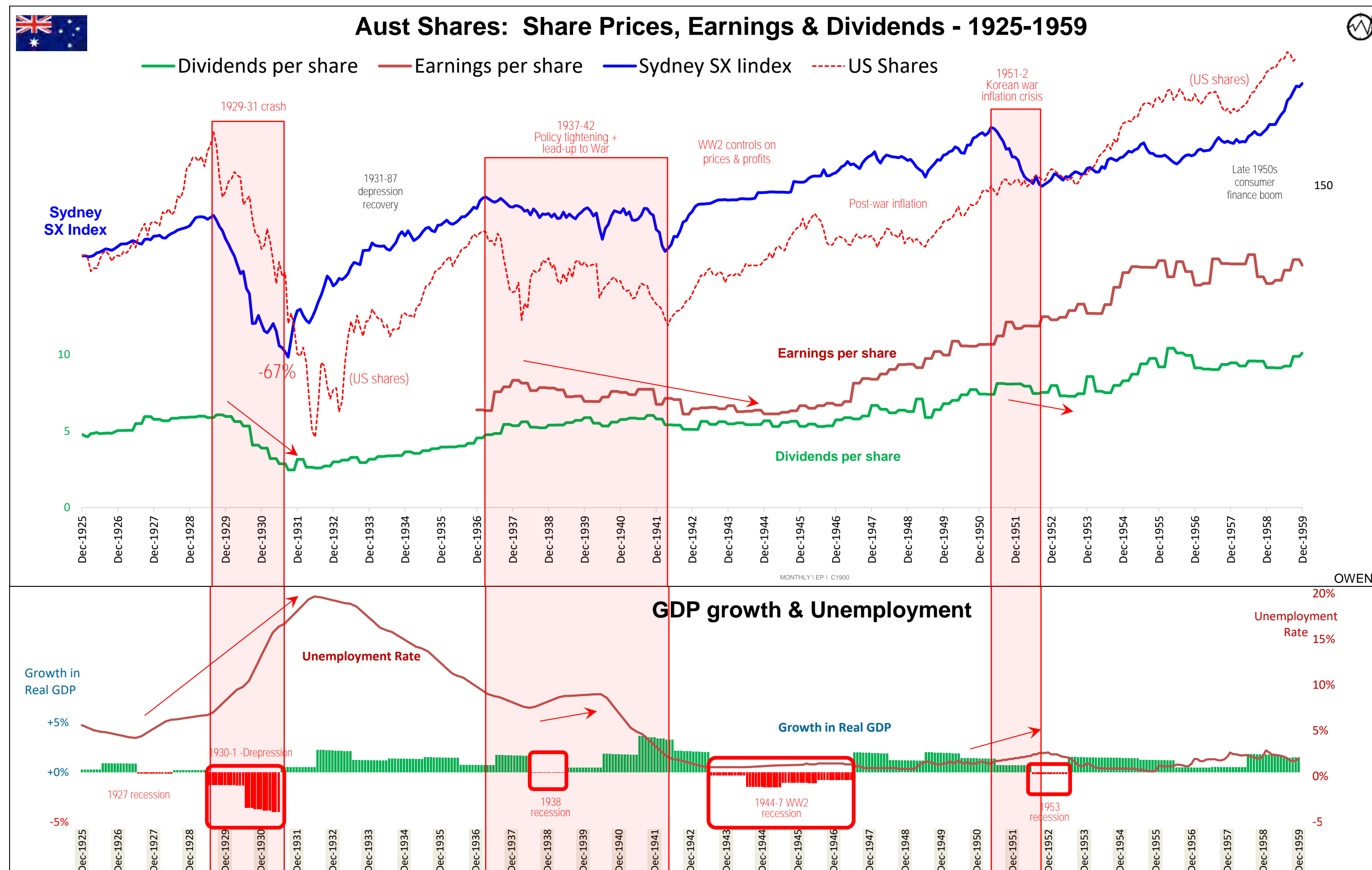
In addition to the 1890s depression and WW1, there were five additional shorter economic recessions during this period. Each lasted for one year (based on the limited June financial year economic data).

During each of these recessions, the broad share market rose, without a significant hiccup.

- In the 1900/1 recession (1900/1 June year), GDP fell by -1.7%, but the share market rose by +1.0%.
- In the 1902/3 recession (drought), GDP fell by -6.5%, but shares rose by +12.9%.
- In the 1904/5 recession (drought), GDP fell by -1.7%, but shares rose by+7%.
- In the 1907/8 recession (commodities collapse following the US 'Panic of 1907'), GDP fell by -7.6%, but shares rose by +13.9%. (The 'Panic of 1907' is one of the very few US share market collapses that was not echoed in Australia.)
- In the 1911/12 recession, GDP fell by -2.9%, but shares rose by +0.9%.

# Share markets and Recessions – 1925 to 1959

Between 1925 and 1959, there were three major share market sell-offs in Australia, only one of which was primarily driven by economic factors (the 1930s Depression). The other two were driven by the wars. (Between 1901 and 1959, aggregate GDP data was only available for June financial years, so that is all we can use to measure recessions. Quarterly economic data only became available from 1959).




## 1930s depression

In the 1930s depression, the Australian economy contracted by -19%, and lasted two years: the 1929/30 June year and the 1930-1 June year. Our Depression was significantly shorter and shallower than in the US, where the economy contracted by -33% and lasted 3 years there. The US share market fall was also much deeper and longer than here. The main reasons were that Australia did not have a speculative 1920s boom, and we avoided a banking crisis in the 1930s, although both economies were greatly affected by the severe global slump in commodities prices and trade.

The 1930s depression was a very rare case in which share prices started falling more or less at the same time as the start of the economic contraction, and then shares also started to rebound when the economy started to rebound. It was also a rare instance of Australian shares leading the US share rebound, by nine months, mainly because Australia devalued the local currency much earlier than the US, and this greatly boosted commodities prices and export revenues.

However, other aspects of the usual lagged shares-recession pattern were present. When the share rebound started, profits and dividends were still being cut, and the unemployment rate was still rising.

## Second World War

In contrast to WW1, when the local economy and share market were severely affected by shipping lane closures, WW2 was much more favourable to the protected local manufacturing economy and share market.

However, the share market still suffered a significant and sustained decline, falling by -33% from March 1937 to March 1942. The main fall was from October 1941 with Japanese advances, including through the fall of Singapore, bombing of Pearl Harbour, and Japanese bombing raids across Australia. The economy grew strongly during this period, while share prices fell.

The WW2 recession saw GDP contract by -13.5% over 4 years from July 1943 to June 1947, but the share market rose strongly, up by +31% during the recession. It would have been even better if share price moves were not capped by war-time share price controls designed to limit profiteering from the war.

1952-3 Recession

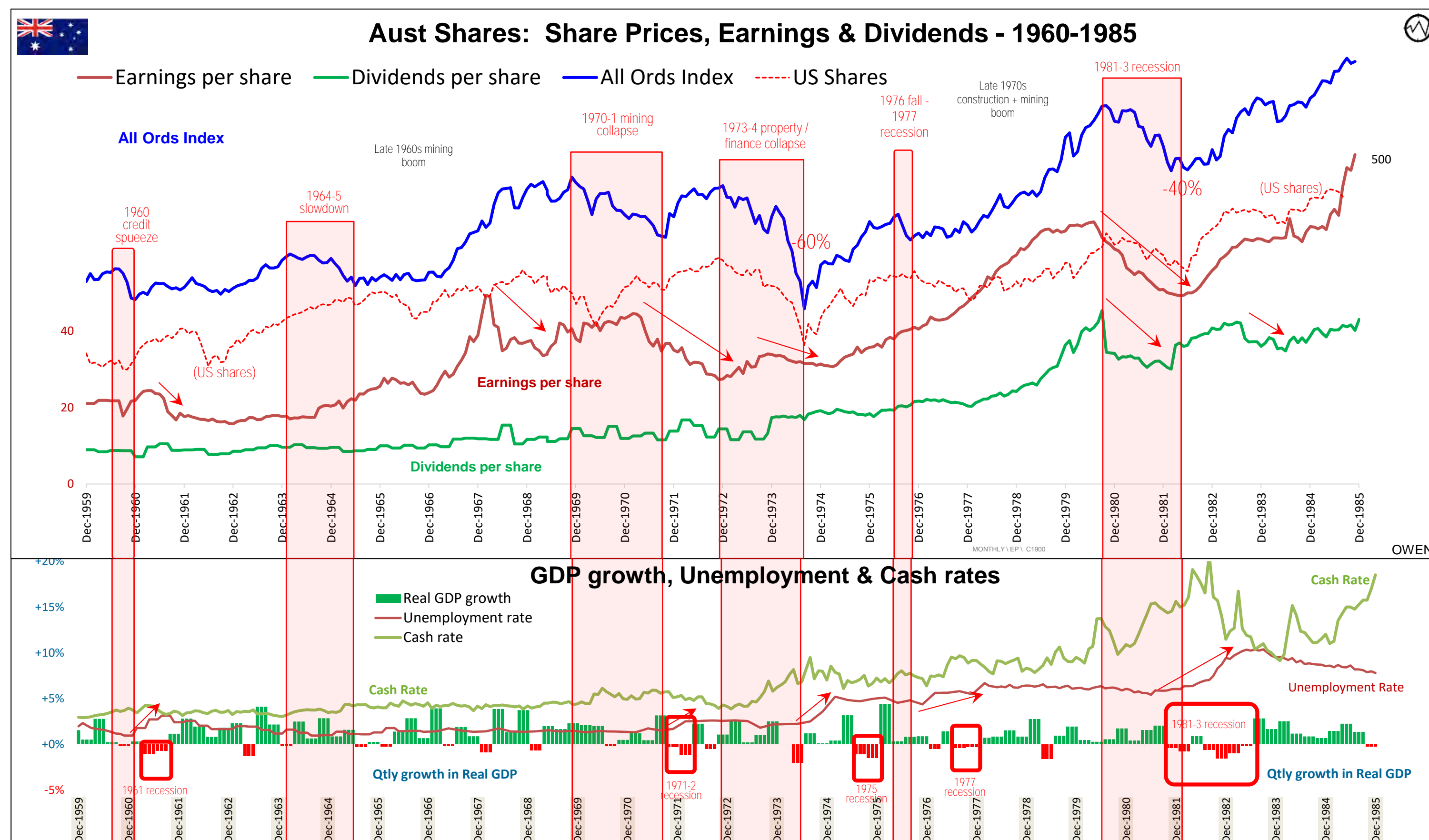
This recession was a result of the harsh tax hikes introduced to stem the 20% inflation spike during the Korean War. The main causes of inflation included an extraordinary war-time wool boom, and also price surges (food, rents, fuel, and many household items) following the delayed lifting of WW2 war-time price controls. GDP contracted by 0.7% in the 1952/3 June year. The share market fell heavily from May 1951 to October 1952. However, as per the usual pattern, most of the share market fall was before the start of the recession. During the recession itself, the share market rose by +4.7%.

It followed the usual pattern – share prices fell well before the recession, while profits and dividends were rising, and then the share market started to rebound in the middle of the recession, while earnings and dividends were still falling, and while unemployment was rising, resulting in shares rising during the period of recession itself.

The 1951-2 Korean War inflation share market fall was one of the very rare examples of a major fall on the local Australian market that did not follow a fall on Wall Street.

# Share markets and Recessions – 1960 to 1985

The recessions in this period also mostly followed the traditional pattern, where share prices fall before the economic recession starts, then shares rebound out of the middle of recession, while the economy is still contracting and while profits and dividends are being cut, and unemployment is rising.




## 1961 recession

The share market fell sharply in the last four months of 1960 as the government imposed a credit squeeze, including hiking sales taxes and interest rates, to slow inflation from the late-1950s consumer finance boom. Share prices then rebounded strongly from the start of 1961 while the economy contracted in the second and third quarters of 1961, and unemployment rose while aggregate profits and dividends were being cut.

## 1970s recessions

Likewise with the 1971-2 recession. The wild, late 1960s speculative mining share boom collapsed from the start of 1970 to late 1971, while interest rates were rising, and well before the economic contractions in fourth quarter 1971 and first quarter 1972. Again, the share market surged back during the recession, while profits and dividends were being cut in 1972.

The 1975 recession followed a similar pattern. The government's severe credit squeeze hit the share market from the start of 1973 through to the end of September 1974 at the bottom of the property finance collapse (including the June quarter 1974 single quarter economic contraction). Share prices then rebounded from the start of October 1974, and kept rising right through the recession in the second half of 1975, while unemployment was still rising and profits were still being cut.

In the 1977 recession, share prices fell in late 1976 but rebounded through the actual recession in the third and fourth quarters 1977.

## 1981-3 recession

In the US, this was Paul Volcker's big inflation-busting double-dip recession that killed off the 1970s US inflation. In Australia it was also a serious recession that ended the late 1970s property boom, but it was not severe enough to kill off inflation here. Australia still suffered high rates of inflation through the 1980s until Paul Keating's inflation-

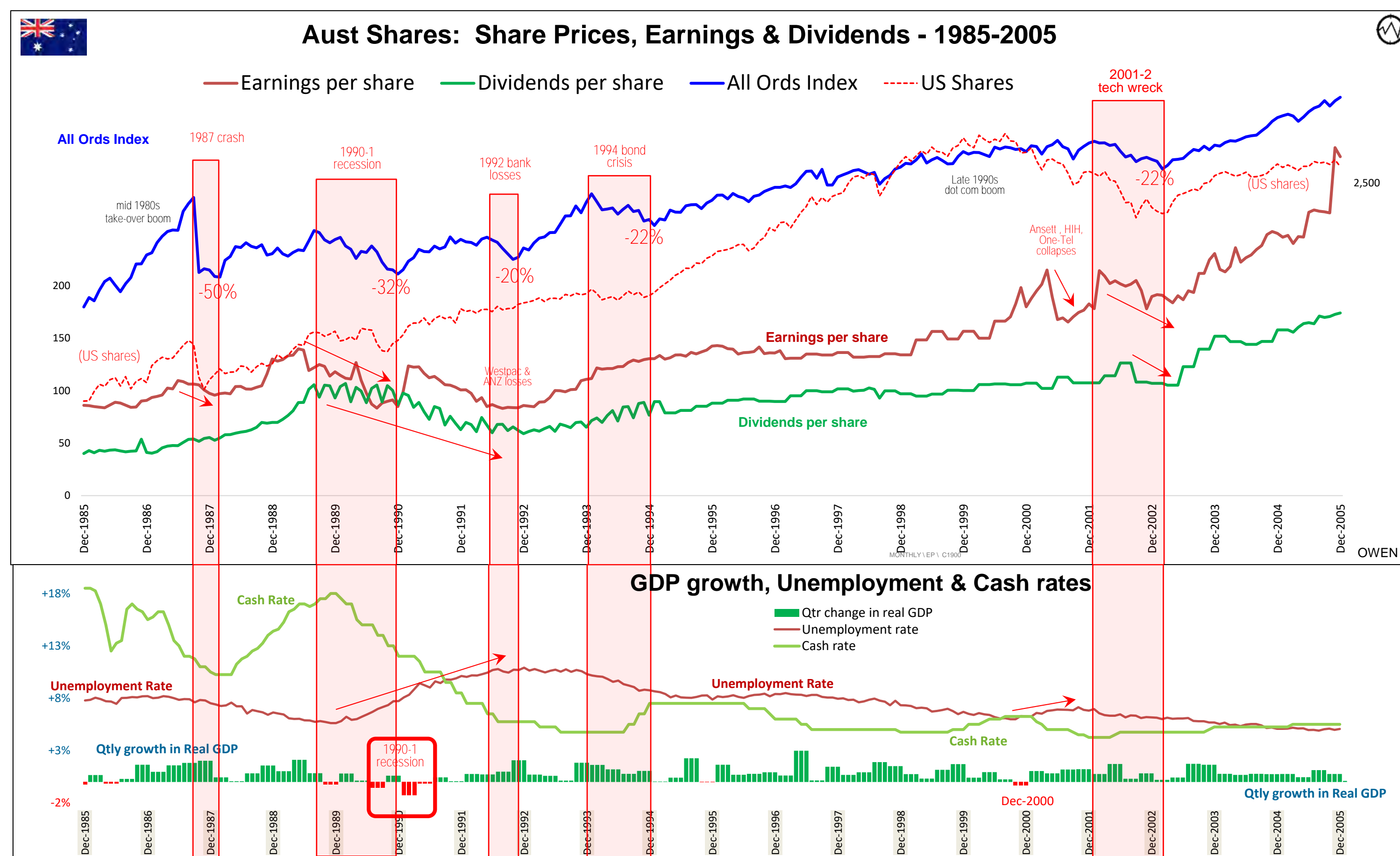
busting ‘recession we had to have’ in 1990-1. Australia’s early 1980s recession included six quarters of contraction spanning a period from the fourth quarter 1981 to June quarter 1983 inclusive.

As per the usual pattern, the share market started falling from early 1981, some nine months before the start of the recession. Share prices started rebounding strongly from the middle of 1982, which was right in the middle of the recession, while profits were being cut and unemployment was just starting to rise.

1983 turned out to be the best ever year for the Australian share market – with the broad price index surging an astounding 60%, while unemployment soared above 10%, and while profits and dividends were being cut.

# Share Markets and Recessions – 1985 to 2005

During this period, there were several significant share market falls, but only one economic 'recession', plus two very minor, temporary contractions:




## 1990-1 recession

Treasurer Paul Keating's famous 'recession we had to have' in 1990-1 was the only economic recession during this period. This was Australia's equivalent of Paul Volcker's deep inflation-busting early 1980s recession in the US a decade earlier. The Australian economy started to contract in the September quarter 1990, but the share market started falling a year earlier in October 1989. The share market started to rebound from the start of 1991, which was in the middle of the recession, while unemployment was rising rapidly and while profits and dividends were being cut, and the daily news was full of stories about corporate collapses and bankruptcies.

## 1987 crash

This was Australia's sharpest and deepest share market fall, but it occurred at a time of strong economic growth, falling interest rates and rising dividends. We cover this in detail in other chapters.

The share market fall in 1992 (big losses by Westpac and ANZ as a result of bankruptcies from the late 1980s lending binge) occurred while economic growth was strong coming out of the 1990-1 recession, and interest rates were still being cut.

The 1994 share market fall (bond crisis) was also at a time of strong economic growth. Indeed, growth was so strong that investors sold off bonds and shares, fearing a return of 1970s and 1980s style inflation, which was still fresh in their collective memories at the time. Fortunately, thanks to the inflation-busting 1990-1 recession, high inflation did not return, and bond and share markets soon recovered.

## 2001-2 'tech wreck'

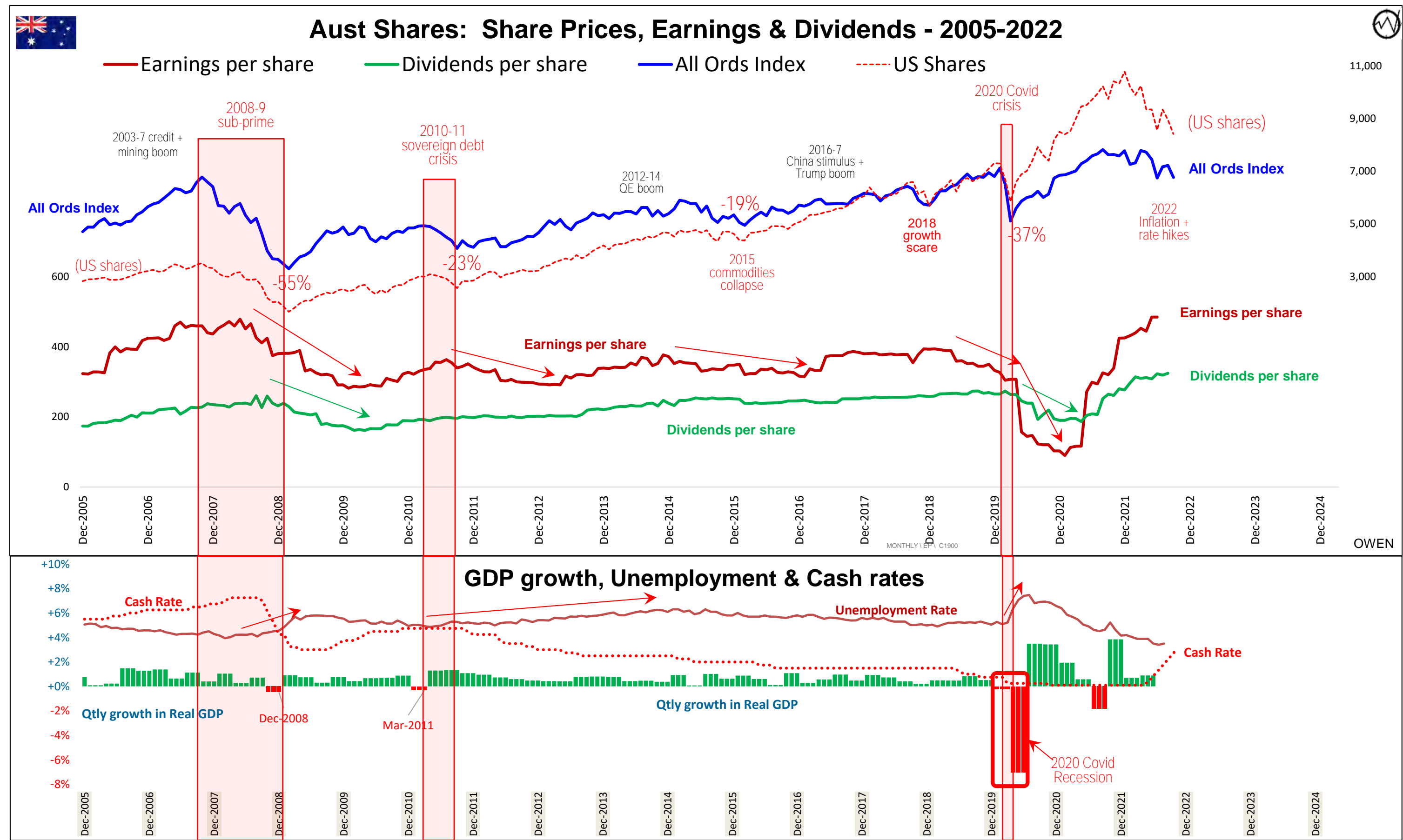
Australia's late 1990s 'dot com' boom was not nearly as strong as it was in the US , and so our 2001-2 'tech wreck' was also not nearly as severe as the US. Our share market started to fall a year into the US tech wreck, while economic growth remained strong throughout.

We did have a few large corporate collapses during the period – including HIH (a major general insurer, where the indirect negative impacts on business customers were far more severe than the impact of the collapse of HIH shares on the share market), Ansett, and One.Tel. The collapses of HIH and Ansett were unrelated to the tech boom, and One.Tel was a tiny phone company dressed up as a tech play.

The Australian economy only suffered one negative quarter (December quarter 2000) but that was due to a brief slump after the Olympic Games building boom, not due to the tech wreck.

# Share Markets and Recessions – 2005 to 2022

In the most recent couple of decades, there were also several big share market falls, but only one economic 'recession', plus two very minor, temporary contractions:




## 2008-9 GFC

The Global Financial Crisis started with the collapse of the US housing boom and its impact on the US banking and insurance sectors turned it into a global financial crisis. The US economy contracted by -4% over six quarters, making it the deepest and longest contraction in the US since the 1930s Great Depressions. In contrast, Australia's economy contracted by just -0.5%, hardly a blip, and lasted for just one quarter (December quarter 2008, the 'Lehman Brothers' quarter).

Australia did not suffer a housing bubble or bust, nor any bank collapses, but the local Australian share market fell by even more than the US market. The reason is that, while Australia also had a wild credit boom like the US and other countries, we also had a tremendous China-led commodities boom, which spawned a massive speculative mining share boom. As a result, Australia's 2003-7 share market boom was bigger than the US, and so its 2008-9 GFC crash was also bigger, even though the economic contraction in Australia was very mild compared to the US.

In terms of the timing of the cycle, it followed the traditional pattern. Share prices started falling in November 2007 while economic growth was strong and interest rates were rising. After falling heavily during 2008 and early 2009, the share market started rebounding strongly from early March 2009 through to the end of 2009 while corporate profits and dividends were being cut severely, and unemployment was rising.

## 2020 Covid lockdown recession

This also followed the usual pattern, albeit with the timing compressed by sudden and unexpected government actions, firstly in imposing economy-wide lockdowns on households and businesses, and then with their massive fiscal and monetary stimulus announcements. The heavy-handed government interventions in 2020 exceeded even the 1930s experience.

Share prices started falling from late February, before the worst of the lockdowns were imposed. The share rebound started from late March, in the middle of recession, while the economy was still contracting severely. The share market rebound continued through 2020 to late 2021, while profits and dividends were being cut savagely.

General comments on timing

It should be noted again here that, for more than a century, the Australian share market has followed the US market through each cycle, with very few isolated exceptions, even if local conditions were very different here. Both the Australian and US share markets have mostly followed the same pattern through recessions – with share prices falling before economic recessions, and then rebounding out of the middle of recessions, while economic activity is still contracting, and while profits and dividends are being cut, and unemployment is rising.

The two markets follow the same pattern at more or less the same times because the underlying drivers of activity that affect both markets are largely global in nature – inflation, interest rates, commodities prices, trade, capital flows, investor sentiment, as well as fiscal and monetary policy thinking and practice.

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Stanford Brown

2022

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