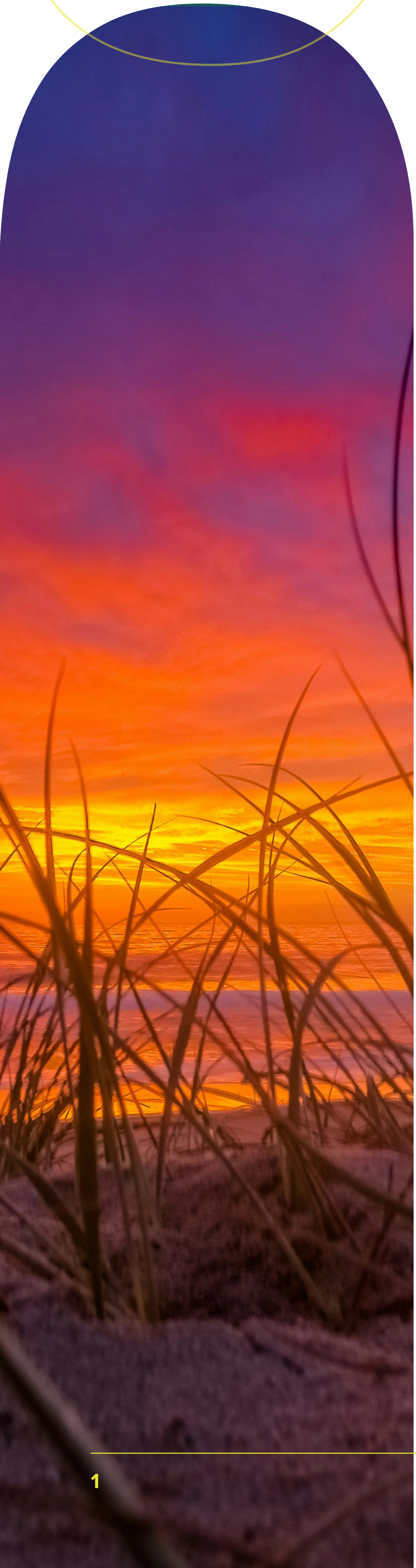

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Chris Burrell's
Market View Blog

Global Market Correction

Early August of 2024 saw a drawdown (correction) in global markets, fuelled by several factors.

There was a concurrence of:
a) the Bank of Japan, Japan's central bank, raising interest rates and reducing liquidity in that market;
b) implications for the carry trade;
c) poor Chinese economic data; and
d) Warren Buffett's Berkshire Hathaway announcing a sell-down of half of its Apple holdings, valued at US$116 billion.

These announcements occurred over the weekend. The information effect of Buffett's sales from previous quarters led to a view that this was a sell signal, given the amount of cash that Berkshire Hathaway is holding. The carry trade refers to borrowing at a low interest rate in Japan and then investing in a stronger currency, such as US tech shares. Global markets fell materially on the Monday after a dramatic decline in Japan. Following further consideration, the prevailing view was that this was a one-off event with some concurrent information sets but not a systemic issue. The global markets broadly held steady on Tuesday and recovered most of the losses during the remainder of the week.

The consensus is that this volatility may continue. The US markets, particularly those sectors with high growth and high valuation multiples, have been vulnerable to correction for some time. It seems likely that there may be further events causing those sectors or stocks that are overvalued to revert. The exception will be where earnings justify the valuations, as high valuations are very dependent on earnings forecasts.

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Themes to start 2024/2025

The following observations are made considering various news and company announcements from early July.

Retail

Retail continues to show weakness both in Australia and globally. In Australia, car dealers have softened following a buildup of stock as consumers become more cautious. This theme applies to retail generally, across almost all sectors, with the three factors of fuel, interest rates, and food inflation impacting consumer sentiment and spending behaviour. Your diarist always takes the first week of July to recover from the year before and to prepare for the year ahead. Since then, I have asked several shopkeepers about their trading, and the overwhelming response is that sales are down by 10-25% on average. The implication is that we should exercise caution with consumer stocks and perhaps consider taking some gains to preserve capital.

Banks

Jamie Dimon from JPMorgan, viewed by many as the leading banker globally, stated that share buybacks are a mistake for banks if they are trading at more than twice book value. Implied in this statement is the well-regarded benchmark that banks should generally trade between 1 and 2 times book value. There is somewhat of an enigma with the Commonwealth Bank presently in Australia trading at over 3 times book value, and NAB also looking expensive. It is noteworthy that ANZ has not actioned much of their approved on-market share buyback, given the run-up in the price prior to the early August volatility. ANZ may also face an issue with information provided to the Commonwealth Government regarding their bond purchasing history.

Telcos

Telstra followed Optus and TPG in mobile plan price increases above inflation in early July. This confirms a more positive view for the sector for 2024/25.

Nickel

BHP has suspended Nickel West mining until 2027. This decision is due to the large ramp-up in Indonesian nickel production, funded by the Chinese, in response to an export ban by Indonesia on unprocessed nickel ore several years ago. Will Nickel be repeated in iron ore? There is concern that the Chinese-funded new iron ore mines in Simandou, Guinea, West Africa, may reduce the iron ore price over the next few years from the current US$100 benchmark. It may be that BHP's takeover offer for the global South African miner, Anglo American plc, was partly an attempt to increase copper and gold production at BHP. Following the rebuff of this offer, BHP has made a further copper play in South America.

Lithium

Lithium is another battery metal that has been the subject of considerable volatility. The price of lithium has fallen from US$91,000 to US$11,000. Many, including your diarist, believe that because this price is less than the cost of production of around US$20,000, supply and demand should result in some recovery in prices over time. In addition, the announcement that solid-state batteries will enter commercial production is significant. The current lithium batteries in motor vehicles are quite rudimentary and might be compared to the large black batteries that originally came out with mobile phones. The next generation of lithium batteries, known as solid-state batteries, use twice as much lithium, charge twice as quickly, and discharge twice as slowly, resulting in more than doubling the distance a car can travel. Samsung announced in the past fortnight that their solid-state lithium batteries have been with car manufacturers for testing for around six months, and they are looking to commence commercial production in 2025.

The lithium story shows again that the rhetoric around green energy is often well in advance of commercial technology. For every two steps forward, there seems to be one step backward, and sometimes two. In recent weeks, General Electric wind turbines have failed, and parts were washed up on the nearby eastern US coast at Nantucket. From an investment viewpoint, there remains much research and development to be completed. Green investments have not performed well over the past two years, so a key question with this new technology is what is investable at this time and what is still in research and development. It is likely that green energy subsidies will be a feature for many years, and these subsidies should be subject to explicit tendering rather than being buried in government entities or bundled into electricity prices.

Gas

Gas remains the transitional fuel in electricity modeling by most authorities. Speaking recently at CEDA forum, the Powerlink CEO showed the buildup in solar (known as PV) and other green energy, assumed that coal was phased out and that the difference was taken up by gas. On the other side of the continent, Woodside announced a major contract with Taiwan. Woodside signed up Taiwan as a long term customer through to 2043 as Taiwan decommissions its remaining nuclear power plants.

COVID-19 Recovery

Covid19 recovery continues as a theme for 2024/25, with many businesses still showing impacts from COVID-19, some leading and some lagging. The shift from “just in time” to “just in case” or even “not at any time” is due to the closure of China during COVID-19, meaning that businesses are now carrying more stock in Australia. The stock build up is stored in industrial stocks. Vacancy rates in industrial property for some of the listed companies are under 1%, and industrial property rents are rising at the expiry of leases by 20-50%. However, building costs have also risen dramatically, with some estimates suggesting an increase of 60%. It is believed that industrial property rents will need to rise further to justify the risk of constructing new industrial sheds and providing an adequate return on capital. For 2024/25, the NSW government’s order to return to the workplace continues to drive a return to pre-COVID patterns of behaviour. There is also a recent news report indicating that corporations are again finding the need to meet face-to-face, with corporate travel likely to increase by 20% in the 2024/25 year.

Property Trusts

Property trusts showed a decline in the face of increasing interest rates and thus capitalisation rates during the 2022/23 financial year. In 2024, there has been some recovery, but the listed market still seems to overcorrect for the remainder of the increases in capitalisation rates, i.e. reduction in net assets, with this process now well advanced.

Debt Costs

Debt costs will continue to be relevant. On the global stage, there was a report that the interest on the debt of the US government is now higher than all of the money spent by the US on defence. This seemed a staggering statistic. While markets continue to be sanguine about country debt levels, they will not be sanguine about corporate debt levels. In this regard, if a company is expanding with high debt levels, such as Mineral Resources with its $4.4 billion of debt in a difficult iron ore market, there is increased risk. This is a time to ensure companies are profitable and have strong balance sheets. Our fixed interest desk and the Burrell team generally hold the view that interest rates in Australia will be higher for longer because inflation will be higher for longer and unemployment is not at recession levels. The Reserve Bank of Australia has now announced that there will be no cut in interest rates in 2024, and some commentators believe there will be no cuts in 2025 either, although this is probably a minority view at this time. A useful strategy is to add some duration to fixed interest holdings and not to have all of one's eggs in short-term baskets, including term deposits. The US economy is achieving inflation reductions, so the US is more likely to see a rate out in 2024 and again in 2025. This should help the $A/US exchange rate.

International

International – 2023/24 showed the value of including international stocks in portfolio returns. The rationale is firstly, diversification, i.e. not having all one's eggs in Australian stocks. A second driver is the muted Australian outlook for retail, iron ore, and Australian banks as noted above. There are some wonderful buys internationally. International exposure is available via direct international stocks, exchange-traded funds (ETFs) and selected managed funds.

Happy Investing!

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