Chris Burrell's Market View Blog

Inflation and Interest Rates

Since the previous blog was published, inflation has been the central topic on almost every daily financial press report. Overnight, US inflation showed consumer prices fell in December for the first time in 2.5 years.

The **non-core inflation** has continued to fall. This comprises sectors such as energy, where the EU gas prices fell for the fourth consecutive week; fruit and vegetables which were particularly hard hit in the US by a shortage of water in Arizona from the main river system due to drought; and supply chain shortages, where the freight costs for moving containers having fallen from $US 20,000 at the peak almost back to the starting point of $US 5000. Central banks do not believe they have much influence over non-core inflation, nor should they. Their focus in raising interest rates is to jawbone the business sector into not passing on inflationary increases in prices and wages. Rather the central banks are seeking to portray this inflationary spike as temporary and able to be dealt with by increased interest rates. **Core inflation** in the US is comprised of 40% in rent and other home costs. The price of properties going up and down is not as such reflected in the official inflation numbers. However, due in no small part to the overly low interest rates and loose monetary policy post COVID, the central banks helped fuel a speculative spike in property prices. Where properties are going up and owners are able to realise gains at increasing prices, there is less incentive to rent the properties. This left a smaller pool of properties for rent e.g. in Australia there was a suggestion that there were 1M properties that were vacant and not currently being rented. The increase in interest rates and flattening/decline in property markets means that those investing in residential real estate are more likely to either rent the property or sell it. This should result in increased supply to alleviate the tight rental housing market over the next 18 months and put a cap on rent rises.

The overnight US inflation numbers have resulted in the view from several US Federal Reserve Governors that the days of 0.75% rises in the official US interest rate were over, to be replaced by probably two increases of 0.25% in February and subsequent months in the US. There is also some speculation that rates may actually plateau and decline more quickly than previously anticipated, although central banks have not supported those views.

Recession

There are several industry sectors affected by loose monetary policy and the resulting building boom including the building industry, where builders with fixed price contracts have suffered trading losses as home building materials rose, in some cases by 20-50%. Nor is this phenomena restricted to residential housing, with Clough being placed into voluntary administration (VA) due to its fixed price contract on Snowy Hydro.

16/01/2023

Another indicator of recession-like conditions in some industries will be inventories. In response to COVID, industry has moved in a number of instances from "just-in-time" to "just-in-case" or "not at any time". This has resulted in significant stock purchases, sometimes driven by what was available than rather necessarily what was optimal to purchase. Bunnings commented that they had run out of space in their stores for additional stock and were finding the costs of renting industrial property to store excess stock high. There was a report from New York retailers that they simply had no more space to store excess inventories. Industrial property trusts visiting Burrell offices in the last few months of 2022 were showing occupancies at over 99% and rental customers saying they saw the need to store additional stock as not a short-term phenomena, but rather a longer term requirement and needing further industrial space.

In contrast to these examples, the US economy remains strong and unemployment is low. Australia is similar, being a beneficiary in terms of commodities, both quantity and price, from the terrible events in the Russia/Ukraine war.

Thus, while there are a number of commentators advising that one should brace for recession in 2023 and further stock falls, particularly in the USA, there is an increasing commentary that says the US and Australian economies are strong, that unemployment is low and that Australia in particular is benefitting from strong commodities demand and high employment.

The central case remains for Europe (EU) to experience a mild recession, for the US to be touch and go as to whether growth turns negative and for Australia per the Australian Treasury to have a gross domestic product (GDP) growth of ~1.5% in 2023 and 2024.

Sectors

The previous blog noted that in a recession, defensives perform well, as do gold, health, telcos and utilities. On the other hand, banks and financials tend to react negatively to the threat of recession.

While these sector calls may be useful, Burrell are of the view that 2023 is back to fundamental analysis and looking at particular businesses to see how they are performing to current inflationary conditions.

The commodities theme remains intact with Fitch in a report on copper (Cu) forecasting 2023 copper prices of $US 8500 increasing by 2032 to a forecast of US $11,500 on supply shortages and electronic vehicle demand for copper. Goldman Sachs say $US 13000/t is required to bring greenfields copper mines online. Battery electric vehicles (BEVs) require 83kg of copper compared to 8-22kg for conventional cars. EV sales are forecast to increase 280% to 25M units p.a from 2021 to 2031.

Asset allocation

Given the geopolitical risks as we enter 2023, the Burrell investment and research committee raised the suggested cash target to 10-20% from 5-10% so to have funds available for any periods of volatility over the coming 6 months. It is likely that various stocks will be seen as good buying at different times.

The focus is on value and growth-at-reasonable-prices (GARP) stocks rather than growth-at-any-price (GAAP) stocks including a number of technology and other speculative businesses. There will be various instances of strained businesses and business models in the GAAP sector over the next 12 months.

In the crypto space, the failure of crypto business FTX highlights the risks of these largely unregulated businesses.

Several commentators have also forecast some strained businesses in the venture capital or private equity areas. Rogoff commented on the risk of financial contagion with rising interest rates a huge threat to private equity (PE) firms that have borrowed heavily to buy property. Telstra Ventures commented that they saw PE as having been undisciplined and paying too much for businesses acquired over the past few years likening some of the behaviours to a bull in a candy shop.

Thus, the focus must be on value and GARP businesses and we should not be distracted by the noise from the momentum and sentiment players.

Possible X Factors

X factors are those Black Swan events that come from left field and change likely outcomes in a material way. Possible X factors for 2023 include:

- Central banks hold high interest rates for too long. This is likely one of the key risks for 2023. Given that central banks reduced rates too much and were a material contributor to the present inflation, there is an incentive on them to overregulate to be seen as the good guy in an attempt to expunge their previous behaviour.
- COVID continues to have a material adverse impact on business globally, though the effect in Australia is much less than in countries with poorer vaccination regimes e.g. China. The COVID risks in 2023 are firstly around the new variant XBB in New York and secondly the spread in China as a result of removing restrictions almost all at once. There is a risk that the Chinese will carry on a period of infection, similarly to the initial transmittal back in 2020, although again vaccination rates and herd immunity should reduce this risk.
- The risk of crypto contagion is raised by Rogoff. While crypto was not a central source of monetary supply and Burrell didn't engage in the purchase of crypto, nevertheless, it has captured the imagination of the average man in the street and the losses are likely to be higher at the individual level. There are also entities who have borrowed and lent based on crypto as the underlying asset and there is already some evidence of contagion amongst these entities. At present it does not appear to be sufficient to create a significant global event, but it is a risk. Moreover, while there are those calling for regulation, the fact that it is an instrument of the black market and crime may well make regulators reluctant to step into this murky space.

Other Matters

During the past month, there were a number of other announcements.

Innovation continues in the medical space with CSL achieving FDA approval for HEMGENIX, a breakthrough treatment for haemophilia. This is a one shot cure, a blockbuster. HEMGENIX allows patients to produce their own factor X, which allows blood clotting.

Woodside announced third quarter results with an exceptional 50mmboe (millions barrels of oil equivalent), $US 5.8B in revenue at an average price over $US 100 for oil and $US 32 for LNG. Oil prices have eased since, and Australia is a beneficiary of current commodity pricing.

NBN Co "writes off" $31B of build costs. They announced they were not actually writing anything off – only in the government sector! This is important because the Gillard government prescribed that the NBN should recover a return on all of their costs including $44B of losses, which were capitalised to the Initial Cost Recovery account. The net result of this change is that the returns the NBN will require on its asset base will reduce allowing for some price resets and this should allow for the resellers such as Telstra and TPG to finally earn a more reasonable return. It never made sense that the NBN's biggest asset wasn't the network but the losses and the resolution of this long standing sore is positive for Australian telecommunications.

Merger and Acquisition (M&A) continued. David Jones was a notable example being sold by the South African Woolworth to Anchorage Capital Partners (a private equity firm) for a rumoured $100M excluding the Melbourne real estate. This compares to a cost of $2.1B.

Carbon credits in Australia are known as ACCUs i.e. Australian Carbon Credit Units. Professor Chubb presented his report on the regulatory regime for ACCUs, which is seen as positive in the context of ensuring activities companies engage in are in fact green and the credits that result are bona fide and verifiable. Jamie Elgar (Burrell Associate Director & Senior Advisor) has been following an ETF on carbon credits which can be purchased as an ETF on the ASX.

Finally, in an interview with CEOs to commence the calendar year, they were asked what was the secret to business success, one commented "don't do stupid".

Happy Investing,

Chris Burrell