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What to expect from markets and the economy in 2024

BY DAVID BASSANESE

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INSIDE

Having enjoyed a better than feared consumer-led recovery from COVID lockdowns, Australia's economy in recent years has quickly been beset by a new problem: very high inflation, caused principally by stronger-than-expected demand running ahead of a slower-than-expected supply response.

Australia is not alone in facing this problem, with central banks around the world forced into aggressively raising interest rates from their COVID-low emergency levels to contain demand and pricing pressure – lest high inflation become embedded through an increase in inflation expectations and a self-reinforcing wage-price spiral.

The mantra of central banks has been to "not repeat the mistakes of the 1970s" where a series of oil price shocks led to a ratcheting up in inflation for over a decade. Interest rates in most countries, including Australia, have been lifted to above-average restrictive levels.

Yet while the hope was that inflation could be contained without the need for a global recession, history suggested otherwise. Getting inflation down from high levels has never been achieved in modern times without a recession. History also suggested that once economic growth slowed to a sufficient degree, a 'tipping point' can be reached whereby a hard landing is hard to avoid.

An economic 'soft landing': the runway is in sight

As we head into 2024, however, the news is so encouraging it's almost hard to believe.

Although Australian and global economic growth has slowed, it has proven more resilient than expected – unemployment rates globally are still low, and recession has been avoided.

Source: LSEG Datastream, Betashares.

At the same time, the resilience in economic activity has not come at the expense of inflation remaining stubbornly high. Inflation has been falling broadly in line with expectations. Inflation is still too high, but it's moving in the right direction. So much so that central banks have slowed the pace of interest rate increases and are starting to contemplate lowering interest rates at some stage this year.

In financial markets, bond yields have stopped rising and equity markets are staging a recovery. The corporate earnings outlook is encouraging. The advent of new consumer-friendly artificial intelligence technologies is adding to investor excitement.

Source: LSEG Datastream, Betashares.

It's almost too good to be true: can we truly achieve an economic 'soft landing'?

We can dare to hope. In dealing with today's high inflation, the history we feared may end up being a poor guide.

How does today compare with past inflationary environments?

Compared to the 1970s, the cyclically volatile manufacturing sector is today a smaller share of the economy, inflation expectations are better entrenched, and competitive pressures arguably stronger – thanks to widespread technology disruption and globalised markets.

The nature of the inflation shocks also differ. During the 1970s, the onset and return of high inflation was caused principally by two sharp oil price rises due to OPEC oil restrictions in both 1973 and 1979. These negative supply shocks not only pushed up inflation but also sharply reduced household income and corporate profits – making

Source: LSEG Datastream, Betashares.

it harder to avoid recession. The post-COVID inflation burst, by contrast, was largely due to a stronger increase in demand relative to supply. Inflation lifted, but demand remained strong.

The post-COVID inflation we've experienced now appears largely to have been a series of one-off price level adjustments to clear markets suffering from short-term excess demand. This was first evident in the goods market during lockdown, but spilled over into services and labour markets when economies reopened.

Higher interest rates and inflation have so far merely reduced this degree of excess demand, without unduly hurting actual economic activity. At the same time, supply capacity in both goods and labour markets has gradually recovered.

As would be expected, better-balanced markets are leading to a levelling off in pricing pressure. Importantly, with longer-term inflation expectations still contained, the much-feared entrenchment of high inflation through a self-defeating wage-spiral so far has not materialised.

Three risks that could make for a bumpy landing

While the economy appears to be improving, some risks remain. If the risks in one or more of these areas is realised, it could spell trouble for our 'soft landing' scenario.

Risk 1: Inflation and interest rates

Of course, risks remain. It's still possible that the lagged impact of past interest rate increases catches up with the economy, especially as more households and businesses are forced to refinance cheap COVID loans at higher rates.

A modest slowing in growth could also still reach a tipping point, triggering a deeper downturn. But if inflation keeps trending down, either of these outcomes may only mean central banks cut rates more quickly and deeply, limiting the economic downturn.

Risk 2: Labour and unemployment

A more troublesome risk is if the declines in inflation start to slow, with wages and service sector inflation remaining too high given labour markets are still tight. Again, this risk should be averted provided overall economic growth keeps easing for a time, with a gradual lift in the unemployment rates in countries such as Australia and the US to around 4.5% – hopefully without triggering a deeper downturn.

If excess demand for labour slows or labour supply continues to recover, it's possible that wages and services sector inflation slows further without a significant rise in unemployment.

Risk 3: Geopolitics

A final risk is geo-political – an escalation in the tragic conflicts in the Middle East and Europe that pushes up inflation through disruption of critical global food and energy supplies. Chinese tensions with Taiwan also persist, and the potential re-election of Donald Trump as US President later this year would be a new wild card.

So far at least, geo-political tensions remain contained, and the consequences of an escalation could be so disruptive that major players such as the US, Europe and the Middle East will likely continue to try hard to avoid it.

Global growth and markets

Against this backdrop, the most likely outcome for 2024 appears to be a further modest slowing in growth – but not recession – which allows for further declines in inflation and central bank interest rate cuts by year end. Lower rates would then allow a stabilisation in growth and moderate recovery as we head into 2025.

Such an outcome could be favourable to both bond and equity markets this year. High but falling bond yields bode well for decent income and capital returns from fixed-income markets. Lower bond yields could also support equity valuations at least holding around current levels, while allowing dividends and growth in earnings to deliver positive returns for investors.

In currency markets, easing global recession risks and likely deeper interest rate cuts from the US Federal Reserve (which raised rates more aggressively than most) would favour a weaker US dollar and firmer Australian dollar. A weaker US dollar, lower bond yields and improving global growth prospects later this year could also be positive for commodity markets, especially gold.

Within equity markets, an easing risk environment could also see the dominant outperformance of US large-cap technology stocks eventually give way to more investor interest in cheaper and long-neglected areas such as emerging markets, small caps, Europe, Japan and even Australia.

BetaShares is a leading Australian fund manager specialising in exchange traded funds (ETFs) and other Funds traded on the Australian Securities Exchange (ASX). Since launching their first ETF more than a decade ago, BetaShares has grown to become one of Australia's largest managers of ETFs.

Lessons from the battery metals bust

BY JAMES GRUBER

Republished from firstlinks.com.au

A few years ago, I bumped into an acquaintance who told me that he'd quit his job as a lawyer because he'd made a killing in lithium stocks. He had most of his net worth in these stocks because he was sure that he'd make a lot more money - enough to retire on.

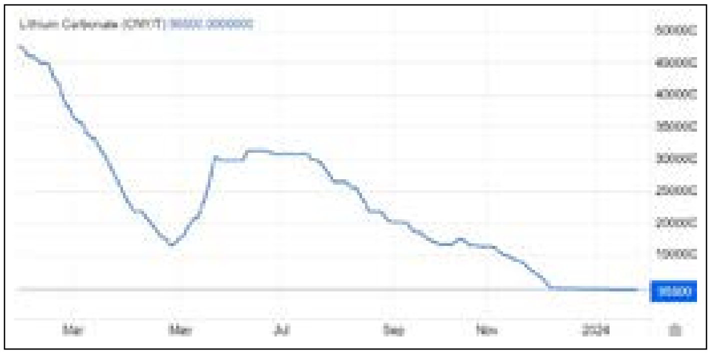
At the time, alarm bells rang in my mind because:

1. There's no sure thing in markets.
2. Putting most of your net worth in commodity stocks is rarely a sound strategy.
3. Having been a commodities analyst, I knew that the mining sector was extremely volatile and tricky to get right.

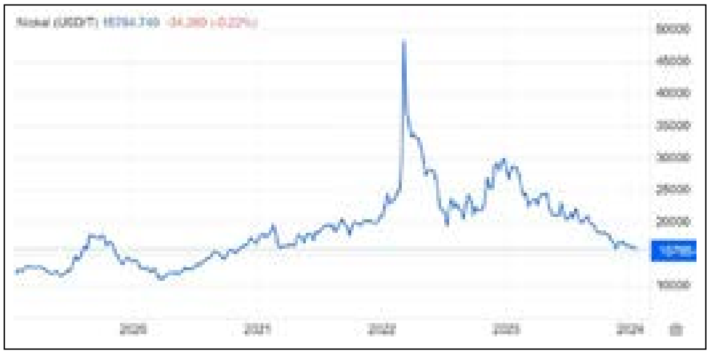
The recent crash in battery metal prices has caught many, including this acquaintance, by surprise. Billionaires such as Gina Rinehart, Andrew Forrest, and Chris Ellison are nursing losses. Some of the companies who'd previously boasted of never-ending industry riches are now struggling to survive. Investment bankers who'd pumped up these companies are having to explain what went wrong, while they've walked away with tens of millions in fees.

What's happened with lithium and nickel isn't unique. It's a classic story of boom and bust that's occurred many times, both in the commodities space and in other sectors.

It's worth examining what went wrong with battery metals and what lessons investors can take away from the episode.



Source: Trading Economics



Source: Trading Economics

The capital cycle

What's gone on is best explained via a framework developed by London-based hedge fund, Marathon Asset Management. Called the capital cycle approach, it's the basis for two books by well-known financial writer, Edward Chancellor (Capital Account and Capital Returns).

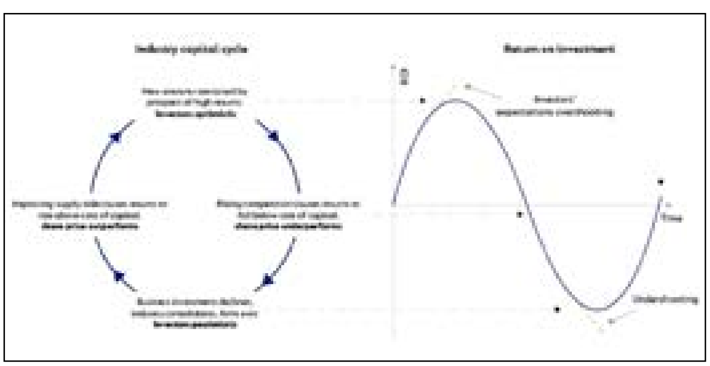
What Marathon does is apply Professor Michael Porter's famous 'five forces' competitive strategy to the stock market. Porter said that companies don't exist in a vacuum and that their fortunes are determined by the activities of other businesses. He outlined five forces which influence a firm's strategic position: the bargaining power of suppliers and buyers, the threat of substitution, the degree of rivalry among existing firms, and the threat of new entrants. Unless a business is protected from these forces, then competition will "drive down the rate of return on invested capital toward the competitive floor rate of return".

Marathon has taken Porter's theory into the world of investments. They suggest that in a free market, high returns on capital or the potential for growth will attract new investment. The stock market can accelerate this process because if a company's shares sell at a premium to the replacement costs of the firm's assets, then there is a strong incentive for management to increase their spending on new or existing projects.

High stock prices not only influence decision making in public markets, but private ones too. Private firms, observing similar businesses selling at high multiples of replacement cost, may also decide to increase business investment. Venture capitals and investment banks can spur this on by helping to finance this investment. They may also assist new firms to enter the fray. All of this drives up supply in the industry.

Marathon says that high returns on capital should act as a warning sign, but companies and their managements often extrapolate these returns far into the future. They assume that their prospects are bright, and the returns are assured. And they're often surprised when the competitive forces that bring on new supply in the industry act to lower returns.

Marathon suggests that professional investors, who often take their cues from company management, are also liable to be caught wrong-footed.



Source: Edward Chancellor, Capital Returns: Investing through the Capital Cycle: A Money Manager's Reports 2002-2015

The classic bust

What's happened in the lithium and nickel markets mirrors the capital cycle described above.

In lithium, prices soared almost 13-fold in 2021-2022 as demand for electric vehicles (EVs) took off and supply couldn't keep up. Understandably, prices of lithium stocks exploded higher as investors bought into the 'multi-decade growth story' of EVs.

With stocks prices way above replacement costs, management at lithium companies decided to expand supply, either by boosting existing mines or bringing on new mines. Private firms, seeing the higher spot prices and share prices of competitors, also decided to increase supply to meet the greater demand for lithium.

Investment bankers raised new capital for public lithium firms to help build out new capacity. They also IPO'ed lithium companies, which brought more capital and supply into the industry.

At their peak, spot lithium prices were more than double the cost of production for companies at the most expensive end of the cost curve and about 3 times those at the lower end.

The result? The supply of lithium increased by almost 40% last year, as:

- Africa brought on supply at such a pace that it surprised everyone.
- Hard rock production rose in Western Australia.
- New salt lake sources were unearthed in China.

At the same time, demand for EVs softened in China, as the economy there struggled to rebound after Covid lockdowns.

Consequently, lithium prices and stocks cratered. Companies that were aggressively expanding supply are now pausing production and closing mines. Some are struggling to refinance loans. And others are pleading for government help for the industry (got love it when billionaires ask for handouts). There's also increasing talk of takeovers and industry consolidation.

Investment bankers that once forecast industry supply deficits are now predicting surpluses, perhaps for the next five years. IPOs in the sector have dried up as some firms struggle to make ends meet.

Lessons for investors

What's happened in battery metals isn't unique. Previously, the Buy Now Pay Later industry went through a similar boom and bust cycle.

Here are some of the lessons from the lithium and nickel rout:

- Everyone focuses on demand in an industry when supply is often more important.
- Be sceptical of any sector that's described as a structural

growth story, especially in the commodities space.

- Beware of a spate of IPOs in one sector. It can signal that more money will enter the industry, driving up supply, and potentially driving down returns.
- If investment bankers are pumping up a sector, run the other way.
- Don't blindly follow billionaires into investments. These people are often betting just a fraction of their net worth and won't get hurt if it doesn't turn out.
- With commodities, when spot prices are well above the costs of company production, it will almost inevitably lead to increased supply.
- When company management constantly talks up their share price, or bags short sellers, it's a red flag.
- There is never a sure thing in markets - spread your bets accordingly.

Where to from here?

The lithium and nickel markets are now working their way through previous excesses. As the capital cycle diagram above suggests, the end of a cycle is normally characterized by business investment declining, firms existing, industry consolidation, and investors being pessimistic. That describes exactly what's currently happening in these markets.

The industry is starting to get the attention of more fund managers. At a luncheon this week, Tribeca's Jun Bei Liu described lithium stocks as 'interesting' given recent developments of production cutbacks and consolidation. Other funds such as Pella Asset Management have recently invested in the sector. Pella believes that lithium demand will exceed supply by 2025 as EV sales grow and there's a shift to larger EVs, while lithium supply may struggle to ramp back up.

Investment bankers that once forecast industry supply deficits are now predicting surpluses, perhaps for the next five years. IPOs in the sector have dried up as some firms struggle to make ends meet.

Time will tell, though we're undoubtedly getting closer to the end of this cycle.

Firstlinks is a publishing service providing content written by financial market professionals with experience in wealth management, superannuation, banking, academia and financial advice.

Falling inflation – what does it mean for investors?

KEY POINTS

- Inflation is in retreat thanks to improved supply and cooling demand. A further fall is likely this year.
- Australian inflation remains relatively high - but this mainly reflects lags rather than a more inflation prone economy.
- Profit gouging or wages were not the cause of high inflation.
- The main risks relate to the conflict in the Middle East escalating and adding to supply costs; a surprise rebound in economic activity & sticky services inflation; and floods, the port dispute and poor productivity in Australia.
- Lower inflation should be positive for investors via lower interest rates, although this benefit may come with a lag.
- The world is now a bit more inflation prone so don't expect a return to near zero interest rates anytime soon.

BY SHANE OLIVER

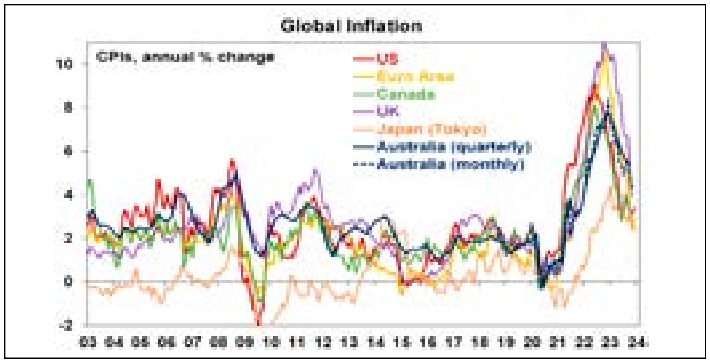
Republished from amp.com.au

Introduction

The surge in inflation coming out of the pandemic and its subsequent fall has been the dominant driver of investment markets over the last two years - first depressing shares and bonds in 2022 and then enabling them to rebound. But what's driving the fall, what are the risks and what does it mean for interest rates and investors. This note looks at the key issues.

Inflation is in retreat

Inflation appears to be falling almost as quickly as it went up. In major developed countries it peaked around 8 to 11% in 2022 and has since fallen to around 3 to 4%. It's also fallen in emerging countries.



Source: Bloomberg, AMP

What's driving the fall in inflation?

The rise in inflation got underway in 2021 and reflected a combination of massive monetary and fiscal stimulus that was pumped into economies to protect them through the pandemic lockdowns that was unleashed as spending (first on goods then services) at a time when supply chains were still disrupted. So it was a classic case of too much money (or demand) chasing too few goods and services. Its reversal since 2022 reflects the reversal of policy stimulus as pandemic support measures ended, pent up or excess savings has been run down by key spending groups, monetary policy has gone from easy to tight and supply chain pressures have eased. In particular, global money supply growth which surged in the pandemic has now collapsed.

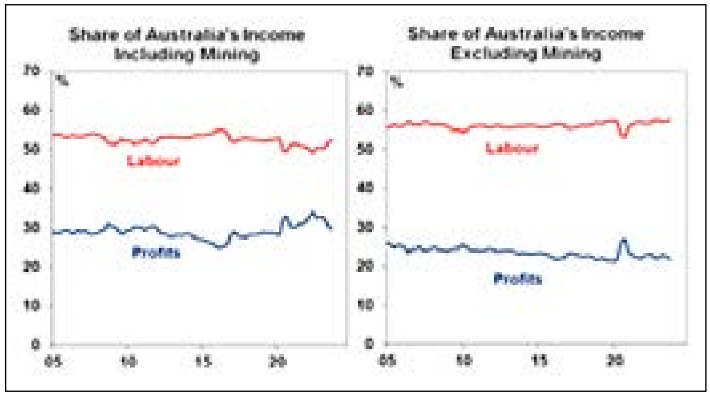
Why is Australian inflation higher than other countries?

While there has been some angst about Australian inflation (at 4.3%yoy in November) being higher than that in the US (3.4%), Canada (3.1%), UK (3.9%) and Europe (2.9%) this mainly reflects the fact that it lagged on the way up and lagged by around 3 to 6 months at the top. The lag partly reflects the slower reopening from the pandemic in Australia and the slower pass through of higher electricity prices. So we saw inflation peak in December 2022, whereas the US, for instance, peaked in June 2022. But just as it lagged on the way up it's still following other countries down with roughly the same lag. In fact, with a very high 1.5% mom implied rise in the Monthly CPI Indicator to drop out from December last year, monthly CPI inflation is likely to have dropped to around 3.3 to 3.7%yoy in December last year, which is more in line with other countries.

Source: Bloomberg, AMP

What about profit gouging?

There has been some concern that the surge in prices is due to "price gouging" with "billion-dollar profits" cited as evidence. In fact, the Australian Government has set up an inquiry into supermarket pricing. There are several points to note in relation to this. First, it's perfectly normal for any business to respond to an increase in demand relative to supply by raising prices. Even workers do this (eg, asking for a pay rise and leaving if they don't get one when they are getting lots of calls from headhunters). It's the way the price mechanism works in allocating scarce resources. Second, national



Source: ABS, RBA, AMP

accounts data don't show any underlying surge in the profit share of national income, outside of the mining sector. Finally, blaming either business or labour (with wages growth picking up) risks focussing on the symptoms of high inflation not the fundamental cause which was the pandemic driven policy stimulus & supply disruption. This is not to say that corporate competition can't be improved.

What is the outlook for inflation?

Our US and Australian Pipeline Inflation Indicators continue to point to a further fall in inflation ahead.

Source: Bloomberg, AMP

This is consistent with easing supply pressures, lower commodity prices and slowing demand. We are not assuming recession, but it is a high risk and if that occurred it would likely result in inflation falling below central bank targets. Out of interest, the six-month annualised rate of core private final consumption inflation in the US, which is what the Fed targets, has fallen below its 2% inflation target. In Australia, we expect quarterly CPI inflation to have fallen to around 3%yoy by year end. The return to the top of the 2-3% target is expected to come around one year ahead of the RBA's latest forecasts.

What are the risks?

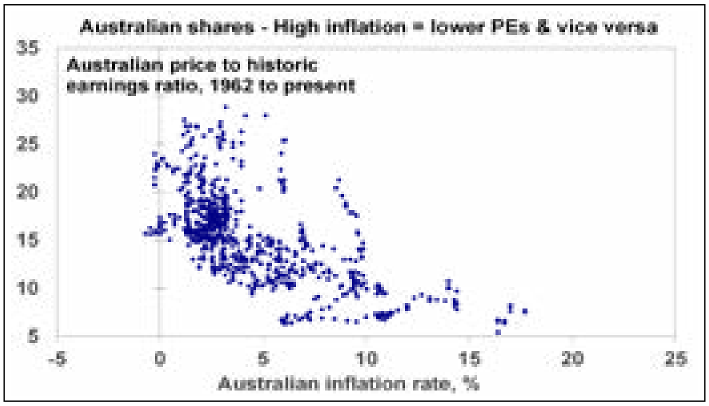
Of course, the decline in inflation is likely to be bumpy and some say that the "last mile" of returning it to target might be the hardest. There are five key risks to keep an eye in terms of inflation:

• First, the escalating conflict in the Middle East has the potential to result in inflationary pressures. Disruption to Red Sea/Suez Canal shipping is already adding to container shipping rates due to extra time in travelling around Africa. So far this has seen only a partial reversal of the improvement in shipping costs seen since 2022 and commodity prices and the oil price remain down. The US and its allies are likely to secure the route relatively quickly such that any inflation boost is short lived. The real risk though is if Iran is drawn directly into the conflict threatening global oil supplies.

- Economic activity could surprise on the upside again keeping labour markets tight fuelling prices & wages & hence sticky services inflation.
- Central banks could ease before inflation has well and truly come under control in a re-run of the stop/go monetary policy of the 1970s.
- In Australia, recent flooding could boost food prices and delays associated with industrial disputes at ports could add to goods prices. At present though the floods are not on the scale of those seen in 2022 and we expect any impact from both to be modest (at say 0.2%).
- Finally, and also in Australia if productivity remains depressed, 4% wages growth won't be consistent with the 2-3% inflation target.

What lower inflation means for investors?

High inflation tends to be bad for investment markets because it means: higher interest rates; higher economic uncertainty; and for shares, a reduced quality of earnings. All of which means that shares tend to trade on lower price to earnings multiples when inflation is high, and growth assets trade on higher income yields. We saw this in 2022 with bond



Source: Bloomberg, AMP

yields surging, share markets falling and other growth assets pressured.

So, with inflation falling much of this goes in reverse as we started to see in the last few months. In particular:

- Interest rates will start to come down. We expect the Fed to start cutting in May & the ECB to start cutting around April both with 5 cuts this year. There is some chance that both could start cutting in March. We expect the RBA to start cutting around June with 3 cuts this year.
- Shares can potentially trade on higher PEs than otherwise.
- Lower interest rates with a lag are likely to provide some support for real assets like property.

Of course, the main risk is if economies slide into recession, which will mean another leg down in share markets before they start to benefit from lower interest rates. This is not our base case but it's a high risk.

Concluding comment

Finally, while inflation is on the mend cyclically, it's worth remembering that from a longer-term perspective we have likely now entered a more inflation-prone world than the one prior to the pandemic reflecting: bigger government; the reversal of globalisation; increasing defence spending; decarbonisation; less workers and more consumers as populations age. So short of a very deep recession, don't expect interest rates to go back to anywhere near zero anytime soon.

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Q&A: Ask a Question

Question 1

I'm thinking of replacing my agreed value income protection policy for something that is cheaper. What are the benefits that will be lost when replacing an agreed value income protection policy?

Replacing your income protection policy with an agreed value pose several potential losses for you. Agreed value policies offer a guaranteed income level based on your pre-determined earnings at the time of application. If replaced with another type, like indemnity, your benefit amount will be capped based on your income over the 12 months to the time to claim, which may result in a lower benefit if your income has decreased since you initially purchased the policy, or you have a fluctuating income. More importantly, insurers no longer offer agreed value to new customers. That means that once you replace your agreed value policy, you will never be able to get it back ever again. Therefore, it is crucial that you see your financial adviser before making any decision to ensure it aligns with your needs and objectives.

Question 2

A friend of mine said that he is undergoing the "recontribution strategy" for his super to be tax effective. I was wondering what is the recontribution strategy and how does it work?

The re-contribution strategy is a two-step process that involves you making a lump-sum withdrawal from your superannuation account, (encompassing both taxable and tax-free components), followed by contributing (or 're-contributing') those funds back into your superannuation fund, often in the form of non-concessional contributions. The primary goal is to maximise the tax-free component within your superannuation fund, to reduce the potential death benefit tax liabilities for your beneficiaries (such as your adult children) inheriting these funds. However, the strategy's efficacy depends on individual circumstances and evolving tax regulations, which requires careful consideration and guidance from your financial adviser.

Question 3

I keep seeing on the news that the fastest way to get rich is by gearing. What is gearing and what are the benefits and potential risks of gearing?

Gearing is a financial strategy that involves using borrowed money to invest with the aim to amplify your potential returns. This practice allows you to control a larger investment value with a smaller amount of your own capital. The benefits of gearing include the potential for higher returns on your invested capital, as gains are calculated on the total investment rather than just the investor's initial contribution. Additionally, gearing can offer you access to investment opportunities that may otherwise be beyond your financial reach.

However, gearing comes with potential risks and considerations. One major risk is the cost of borrowing, as interest payments can erode your potential profits, particularly if the returns on the investment are not sufficient to cover these costs. Additionally, the strategy magnifies losses, meaning that if the value of the investment decreases, the percentage loss on the total investment can be higher than if you didn't engage with gearing. Gearing also introduces credit risk, as you are obligated to meet interest payments, and market fluctuations can impact the performance of the investment. The effectiveness of gearing depends on factors such as the performance of the invested asset, interest rates, and your individual risk tolerance. Before engaging in gearing strategies, you should seek your financial adviser to help you make an informed decision based on your individual circumstances.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to **centraladvice@wtfglimited.com.**