Gleneagle Asset Management Limited
Gleneagle Investment Trust (Equity Fund)

November 2022 Review

Market Summary

Another flat month for the portfolio, and as we get to the end of 2022, I believe most market participants will be happy to see this year out, as it's been one of the most challenging investment environments since the GFC.

Since the start of the year

- the Nasdaq is down ~30%,
- SPX is down ~18%,
- We've had 375 bps increase in US rates, 300 bps in Australia
- US/Russia/China deterioration has accelerated
- We have seen 40-year highs in inflation
- Crypto (bubble) imploded with Bitcoin down ~75% from its all-time high and massive frauds exposed such as the fall of FTX, Luna and most likely more to come.
- Real-estate pricing continues to fall (now down over 7.7% in Australia) with the decline continuing.

Paradigm Shift

The period since the GFC has been dominated by central banks flooding the market with free money and keeping rates at historically low levels. Interest rates were falling, which provided businesses and governments with easy finance. This created an environment of strong growth and low volatility, and interest rate sensitive sectors like equities and real-estate boomed. All the while inflation remained low.

During this period, we saw the rise of a new economic theory called Modern Monetary Theory (MMT). With a fiat system, money can be printed from thin air, and thus central banks should print money which governments can then spend whenever the economy shows signs of weakness. It argues that a country cannot run out of money, so deficits don't matter, and this is especially true for the US which holds the reserve currency. The only constraint is inflation, which can be controlled by raising interest rates.

I forced myself to read 'The Deficit Myth' by MMT's leading expert Stephanie Kelton, as it was clear to me and many others that it all sounded too good to be true. MMT proponents argue that central banks can print money without triggering dangerous levels of inflation, and for many years this seemed to be the case. QE1, QE2, Operation Twist, QE3 and inflation was nowhere in sight. The problem came after covid, when central banks and governments went to town with stimuli and overcooked things, as inflation finally appeared.

The central flaw with MMT is that once inflation starts to show, central banks and governments would act sensibly and swiftly to rein in inflation with interest rate hikes and reduced spending. What we have seen is that instead of the central banks moving early to curb the rising inflation threat, they put their heads in the sand and used words like 'transitory'. Governments are not incentivised to act, as any policy that reduces spending is not popular and officials need to be re-elected. The famous quote by Alexander Tytler: "A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury…"

When you have structurally declining interest rate for decades, it builds up to a crescendo of scams and malinvestment which are now being exposed. The poster child of fraud, Crypto, has been the wild west with fortunes made and lost, but mostly stolen through a range of scams such as pump and dump schemes, pyramids, and just pure fraud. I believe Sam Bankman-Fried belongs in jail. Bitcoin and Ethereum might survive, but 10,000+ others will end up as zeros. Tether is the next big domino which could fall.

Market outlook

December is normally a strong month for markets, so we haven't written off the chance they hold in for the year.

However, economies are going to slow down next year, as they suffer from the 'long and variable lags' induced from the interest rate hike. We have witnessed the first phase of asset repricing due to the higher rates, but I believe next year we should see the second phase where the higher rates and higher inflation lead to a reduction in earnings. If earnings per share normalise to pre-covid levels, and profits fall in line with these earnings, we could see further falls in asset prices.

We are likely to continue to see the effects of an eroding 'wealth effect', as the growth outlook continues to deteriorate. While it appears inflation is coming off, I believe we are likely to remain in an environment of elevated inflation ie 2-5% range.

We just saw Swedish Retail sales numbers which have deteriorated to the point where they are facing the worst recession in 30 years, and Swedish data tends to lead the broader Eurozone by several months. Europe might be looking at a tough winter.

One sector I am starting to get bullish on is the precious metal space. Gold and precious metals have performed poorly over the last year in the face of sharp interest rate rises and strengthening US Dollar, despite the rapid rise in inflation. However, interest rates are getting close to topping out, and with ongoing economic deterioration, I think gold and precious metals are starting to look relatively attractive. If markets do deteriorate next year, central banks will face a choice between market collapse and more stimulus. It's clear that the path of least resistance will be stimulus and, if this happens, precious metals will fly.

Australia

At this end of November, we had the RBA governor Phillip Lowe come out and apologised for their terrible interest rate guidance. The RBA had said rates would not rise until 2024 and we have just had the 8th rate hikes in a row. "I'm sorry if people listened to what we'd said" might ring hollow to anyone who took out a record mortgage. I believe it is incredibly disingenuous of him to pretend his words don't carry weight with the average man on the street. Should we be surprised? In 2019 Lowe also said the next move in rates was likely to be up not down, and anyone postponing buying real estate because of this missed out on a ~40% rally.

We just had another 25 bps raise this month, but I believe that this might actually be the last one for a while. GDP is already slowing with the latest print for the September quarter of just 0.6%. The momentum in economic growth is now clearly slowing, and the indicators for the December quarter are weaker, with negative retail sales, building approvals falling, and falling consumer sentiment. Household savings ratio has dropped from 8.3% to 6.9% so many mortgage holders will be breathing a sigh of relief if there is a pause.

Australian markets have performed fairly well, largely due to China re-opening and removing their covid restrictions. This has certainly provided a boost to industrial commodities and we've seen the Australia dollar continue to strengthen on the back of this.

If you have any questions or comments, please drop me a line at tim.muirhead@gleneagle.com.au

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