Gleneagle Asset Management Limited
Gleneagle Investment Trust (Equity Fund)

April 2023 Review

Summary

A reasonably quiet month in terms of index moves after several weeks of sideways consolidation, with the ASX 200 finishing up 2.1%. April was earnings season for the US, and was largely better than expected, although most companies had set very low bars to beat. Deteriorating data and a looming crunch suggest limited upside for equities for the time being. The portfolio declined 0.41%.

The big picture

Covid was the catalyst for the global central banks to open the taps for printing trillions of dollars combined with governments injecting huge amount of fiscal stimulus into economies. With covid shutting down global supply chains, the world went from 'just in time' to 'just in case' in terms of inventory.   Excess money and supply chain issues created the perfect storm for inflation to finally take hold.   The central banks were slow to react, claiming the inflation spike was transitory, and have now been forced to play catchup. The Fed has now raised interest rates 10 times, the latest rate hike just last week.

Higher rates have started to produce stresses in the system with the collapse of US regional banks. Three out of the four biggest bank failures in US history have happened in the last month and corporate bankruptcies are happening at the fastest pace since 2009. Markets remain buoyant though since the US response was to backstop all deposits and inject loads of liquidity into the system, the Fed undoing 6 months of quantitative tightening in just 4 days!

Despite many signs that a recession is about to hit in the US, markets are currently very complacent. Part of the reason for this is the market is expecting the Fed and other central banks to pivot and cut rates. The bond market has priced in the Fed making three 25 bps rate cuts by the end of the year. At the latest FOMC meeting, Fed Chair Powell was asked about reaching the 2% inflation target and he was resolute. He even rejected the idea that if inflation fell to 3% the Fed would be ok with it.   It is important to remember that the Fed has already been embarrassed by their transitory call on inflation, so they are unlikely to risk another major policy mistake and cut rates prematurely.

Markets are currently discounting the Fed pivot before we have seen real pain, but the pivot will only happen because there is pain. If rates remain elevated throughout the year, and these assumed cuts priced by the market don't eventuate, it likely means equities will struggle as rate cuts are priced out.

Monetary policy works with long and variable lags, and despite some serious banking blow-ups, we are yet to see the full effects. We are seeing data suggesting a major construction slowdown, and construction is a very important metric for the broader economy, as it drives spending. You spend money building houses, which drives lots of employment in construction, then further spending when buying all the furnishing. So, when construction spending drops off, it is a leading indicator suggesting a contraction in spending is coming.

Despite the recent strong streak in employment data (non-Farm payrolls has now exceeded expectations for a record 13 straight months), we are starting to see signs of a slowdown. The NFIB small business confidence index has just fallen to a 10-year low which means it is now worse than during the depths of the Covid lockdowns, and small businesses are the engine of job creation. Again, fewer jobs mean less spending.

Less spending combined with a tightening in credit runs the risk of a serious credit crunch. Banks make money by borrowing short term and lending long term, and when yield curves invert (short term rates are more expensive than long term), banks see margins fall and so do less of it. The regional banking issue in the US is only making things worse, as these banks are being forced to increase short term rates to stop further deposit outflows, which is reducing their profitability and reducing loan creation even further. I should also point out that currently nothing has been done to prevent further regional bank implosions. Deposits continue to leave, especially when people can switch from making sub 1% interest in a regional bank to getting nearly 4.5% in a money market account. Apple just announced a 4.15% interest rate via their app which makes the switch easy. It is difficult to see how the problem will not continue to worsen.

With the Fed still raising rates and actively trying to get the unemployment rate to rise, we should expect credit defaults also to rise (think credit card interest payments, car loans, mortgages etc). During a recession unemployment tends to rise anyway, so it's not a stretch to assume we are going to see more credit defaults in the pipeline. This is a huge problem for these regional banks, who are currently losing money on their loans, losing deposits, and may have to start writing down some of their existing assets. This all points to more regional bank failures, and a greater tightening in credit. Tightening lending standards act like additional rate hikes. Credit has often been described as the oxygen for the markets, as when people find it harder to obtain money, they reduce their spending.

This all points to a slowing economy. This will impact company earnings and reduced earnings will likely weigh on pricing. I believe we will see at least a garden variety recession in the coming months. While equities may hold in as we work our way through it, they are currently trading at a forward PE of ~18.5, and, with interest rates at over 5%, it appears caution is still warranted. As Stanley Druckenmiller likes to say, "I'm waiting for a fat pitch".

I continue to believe we'll see further weakening of the US Dollar and continue to like the long gold trade.

Helios

A gas compressor unit has been installed on the latest well, and we expect a market announcement once flow rate testing has begun and how long it should take. The April visit of Helios to the Gleneagle Sydney office was postponed until the 3rd week of this month – so hopefully we won't have to wait much longer.

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

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