

Macro Folly – Commentary January 2023

Returns for the first month of 2023 were strong globally. The MSCI World Index returned +7.1%, while Emerging Markets were slightly stronger at +7.9%. Within Value and Growth, both “styles” rose but Value was relatively weaker at +4.7%

The US market was also slightly weaker relative to the MSCI World, while the Nasdaq strongly outperformed the S&P 500.

Finally South Africa was weaker relative to Emerging Markets, returning +6.3% in USD terms with +2.4% in USDZAR depreciation.

These various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for January 2023*

	Jan-23	YTD 2023
FTSE/JSE ALSI (ZAR)	8.9%	8.9%
FTSE/JSE ALSI (USD)	6.3%	6.3%
MSCI World	7.1%	7.1%
MSCI EM	7.9%	7.9%
MSCI Value	4.7%	4.7%
MSCI Growth	9.7%	9.7%
S&P 500	6.3%	6.3%
Nasdaq 100	10.7%	10.7%

*Total return indices, Source: Factset

Markets began 2023 in feisty mode giving the impression last year’s worries are all forgotten. Treasury yields declined - the 10-year US Treasury yield declined from 3.9% to 3.5% and this likely spurred equity markets higher. These in turn were driven by moderating inflation statistics and a declining pace in US Fed rate hikes, fuelling a fast +10% rise in the Nasdaq.

Added to this is a perceived decline in recession risk.

Markets this time last year started out in dramatic fashion. We note that over and above the negative returns experienced in the first two months of 2022, the market was quite worried about inflation. As a result commodity stocks, Oil included, performed well. Around April however, the market appeared to become concerned about a recession. So commodity stocks declined, along with wider market declines. This persisted for the rest of the year in a cycle of worries about inflation, Fed rate rises, and recession fears.

It now appears there may be no recession at all so the market is rising.

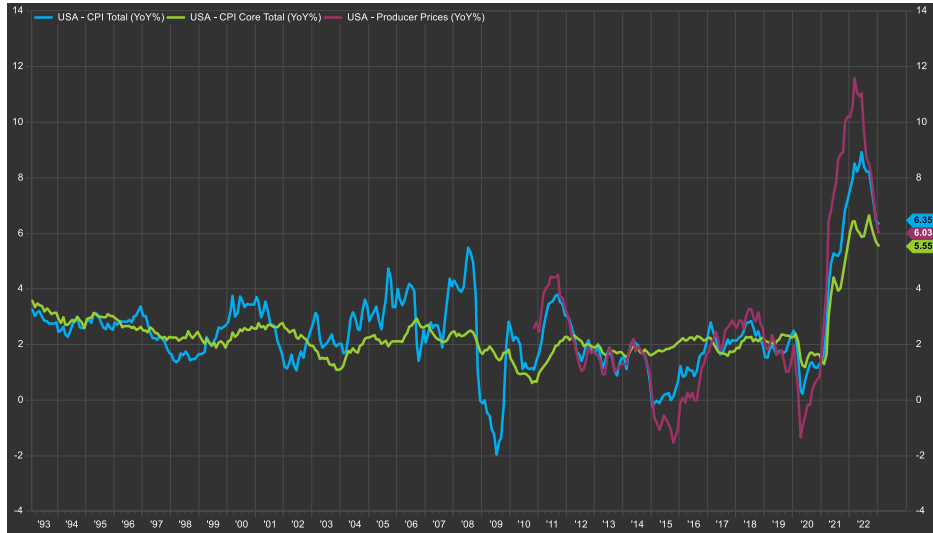
All this underlines the difficulty of macroeconomic forecasting and, importantly, managing funds based on macroeconomic forecasts. It is our view that outcomes are often too difficult to determine correctly on a consistent basis and before the fact – witness the ongoing doubts about a recession and the associated market yoyos. We prefer to focus on underlying assets which have performed well operationally and in stock price terms, historically and through cycles.

Having said the above, we review some recent macro developments and what they might suggest for the future.

Inflation

The recent declines in US CPI have been widely covered. The US CPI, Core CPI and PPI are set out in Chart 1 below. PPI exhibits the largest decline, and while CPI has also declined, Core CPI has at best stabilised to exhibiting modest decline.

Chart 1. US CPI, Core CPI and PPI



Source: Factset

We suggest the PPI and CPI declines are primarily due to the Oil price declining (illustrated in Chart 2 below) and are easily reversible should the Oil price increase again. PPI reflects goods inflation and is the most sensitive to oil price changes, hence unsurprisingly it has also had the largest decrease. Yet some prominent commodity hedge fund managers are forecasting an Oil price of US\$140 on China's reopening. The argument is valid but begs the question, if it were so obvious why is the Oil price at US\$80? Fear of recession no doubt plays a role. We note the Oil price has been flat since December, apparently searching for direction from new data.

Chart 2. Oil price

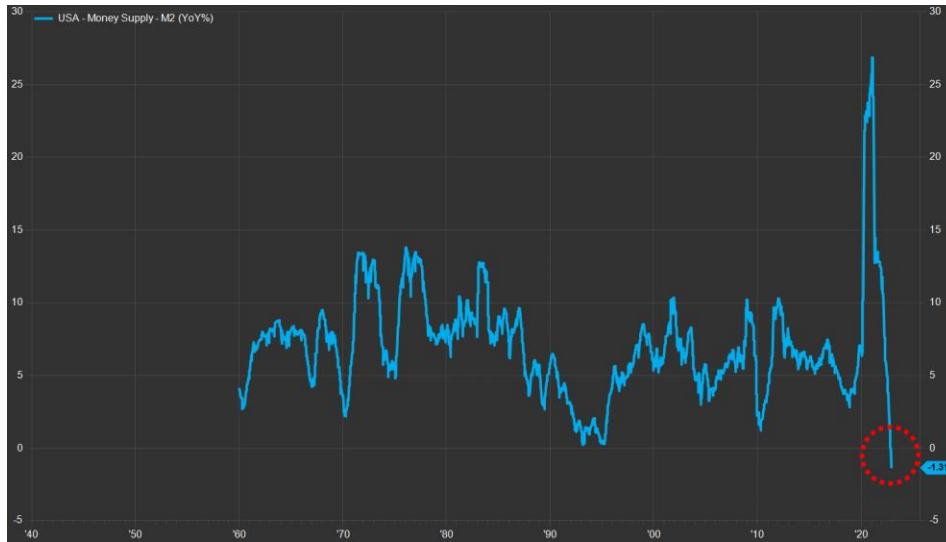


Source: Factset

What about money supply?

The growth rate of this classic indicator is set out in Chart 3 below. We note that after rising at the fastest rate in 60 years due to the US Government's Covid response, the growth rate has now reached extreme levels in the opposite direction. It has turned negative for the first time in over 60 years. We view money supply as the primary driver of inflation and suspect that the sharp decline in its growth rate will exert strong downward pressure on CPI.

Chart 3. US M2 Money supply growth rate

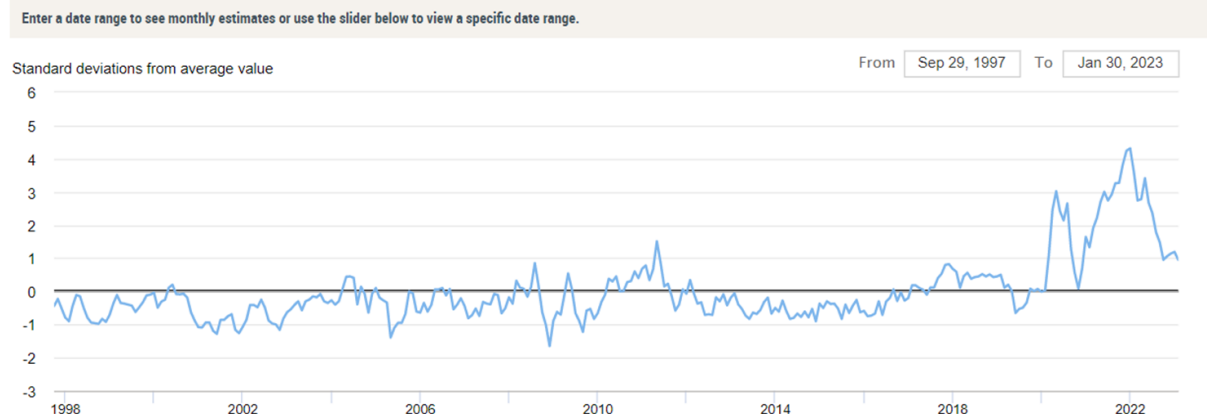


Source: Factset

A second driver has been supply chain disruption. An index of Global Supply Chain Pressures published by the New York Fed shows these pressures to be abating. This is set out in Chart 4 below.

Chart 4. New York Fed Index of Global Supply Chain Pressures

Latest Update January 2023



Source: Factset

What About Recession Risks?

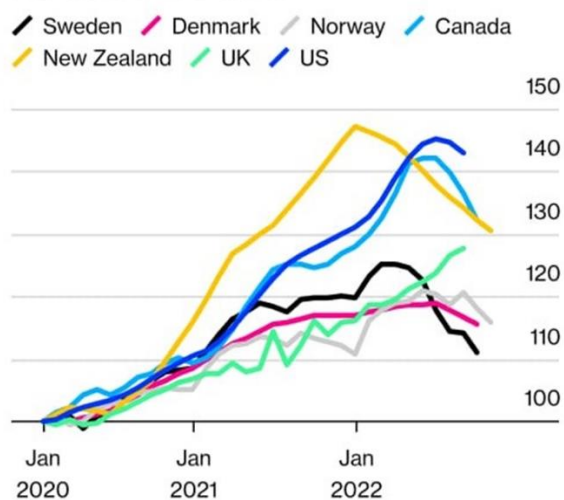
We do not engage in an extensive discussion on this subject here except to note that the driver of the last recession was a declining real estate market which pressurised overleveraged banks. Banks curtailed lending in response.

Housing markets tend to be less liquid versions of equity markets and respond to similar drivers, especially interest rates – with long duration and rental streams stretching into the future, they tend to respond to the same macro stimuli with a delay. So in 2021, commodity markets being the most liquid responded first to inflation, followed by equity and bond markets. Real estate markets appeared to respond last.

These now also seem to be responding with a delay to the interest rate increases of 2022. A recent Bloomberg chart illustrates the point.

Chart 5. Some recent developed real estate market movements

Swedish Housing Market Has Shed Most Pandemic-Era Gains



Source: Norges Bank, Bloomberg
Note: House price indexes. January 2020=100.

Bloomberg

Source: Bloomberg

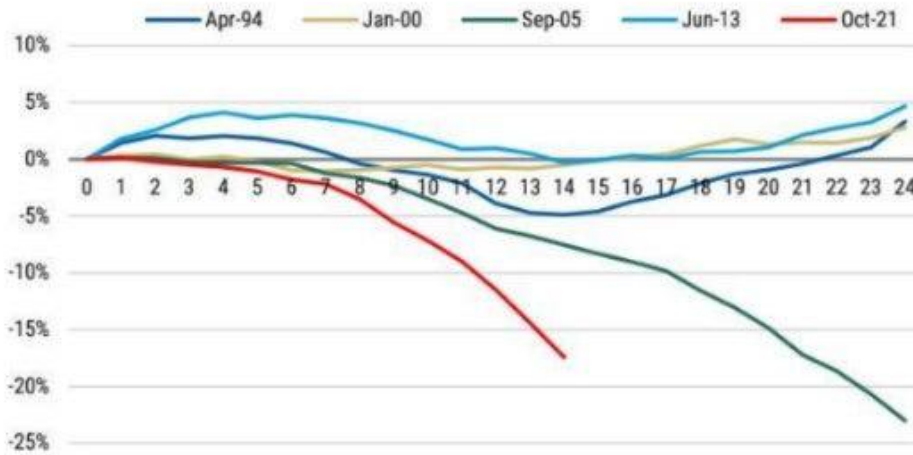
Whereas Covid overvaluations appear to largely have been worked out from equity markets it appears the same process has only just begun in real estate. Per Chart 5 we suspect declining real estate markets will be a strong lever driving recession forces.

Further support to the above argument is provided in Chart 6 below. Existing US home sales appear to be declining faster currently than prior to the financial crisis in 2008.

A final point is that academic research suggests recessions only begin 12 months after the central bank has stopped raising rates. This means in theory at least there is still some time to a recession, if one materialises.

Chart 6. Existing home sales declines

Existing home sales falling faster today than during the GFC



Source: Alfonso Peccatiello, LinkedIn

Summary

In summary we continue to expect inflation to decline, however a strong oil price poses a significant short term risk. At the same time we feel recession risks have not abated. It appears the market is over-enthusiastic at the start of 2023. As a matter of process however, we tend to focus on better-performing companies in constructing equity portfolios, and not at all on macroeconomic forecasts. As a consequence, should a recession materialise we expect the holdings of the M1 Capital Global Equity Prescient Fund to perform relatively better.