Aurimax Investment Club

Member Newsletter

Q3, 2023

Prolonged Challenges Ahead

In our Q4 2022 newsletter, we highlighted the high-stakes game being played between the market and the Federal Reserve. We cautioned that investors heavily reliant on a Fed pivot could face repercussions if things didn't unfold as expected. Unfortunately, this cautionary tale is now becoming a reality. As anticipated, the Fed maintained steady interest rates during its September meeting. However, their commitment to a "higher for longer" stance has significantly caused long-term yields to surge.

With the Federal Reserve's hawkish policy outlook unchanged until at least late 2024, we are closely monitoring several key factors that could substantially influence market trends.

Key Factors to Monitor

Inflation

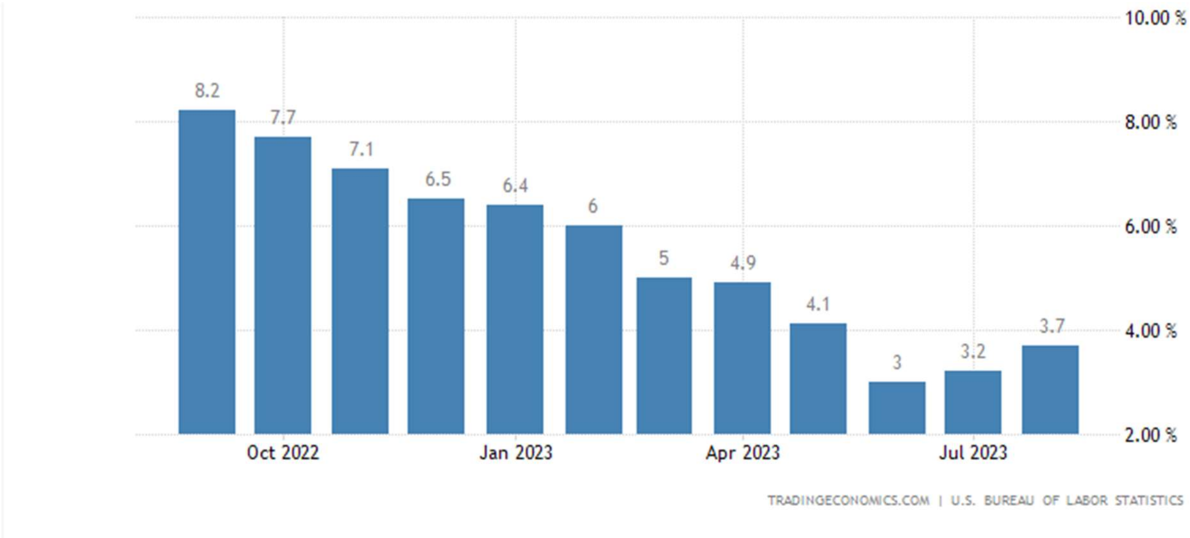
US inflation (CPI) has fallen sharply since its peak in June 2022, but the August number showed an uptick at 3.7% YoY, mostly due to a 10.6% surge in gas prices. Rising shelter costs also contributed to inflation[1].

The monthly annualized rates, or run rates, are a cause for concern. The Consumer Price Index (CPI) has increased by an annualized change rate of 3.09% and 3.98% in the past

[1] The recently released September CPI report showed a similar trend, with headline CPI and Core CPI both up from last year at 3.7% YoY and 4.1% YoY, respectively.

six and three months respectively. This indicates that the rate of inflation in recent months is increasing at a faster pace than in previous months.

The Consumer Price Index increased from 3.2% to 3.7% in August

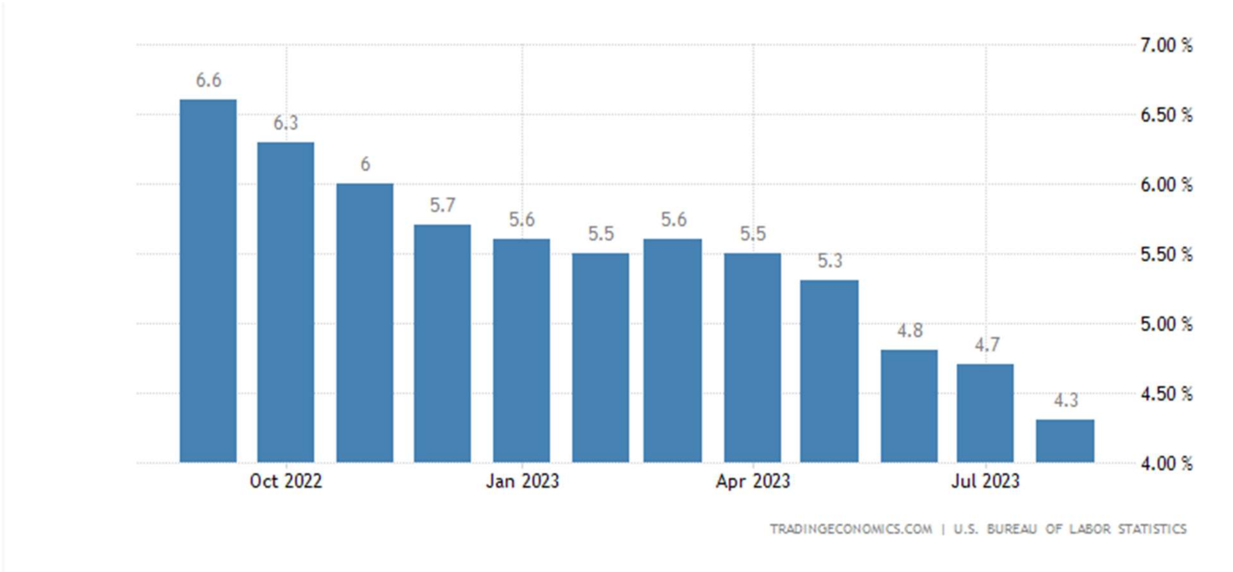


Source: Trading Economics

However, US core inflation, which excludes volatile food and energy prices, continued to slow in August, increasing 4.3% YoY, marking the fifth consecutive decline since March 2023. The monthly annualized change rates also showed the same trend (6-month-run-rate at 4.01% and 3-month-run-rate at 3.63%).

Our view is that while inflation rates are still far from the Fed's target rates, the overall trend is heading down. The future trend will largely depend on energy prices, which are uncertain due to the reduction in oil production and the recent war in the Middle East.

The Core inflation (ex-food and energy prices) continued down from 4.7% to 4.3%

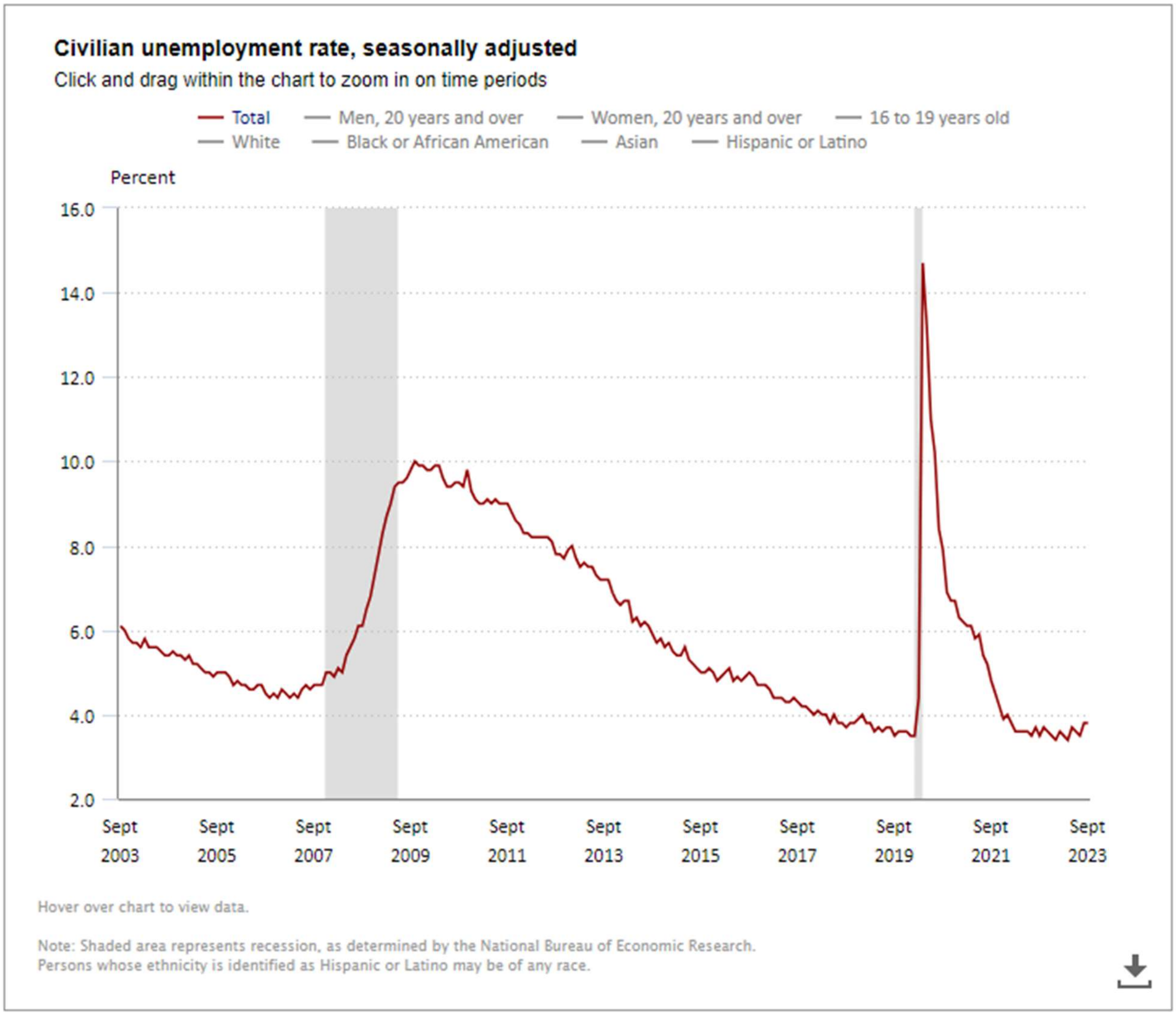


Source: Trading Economics

US GDP Growth and US Employment

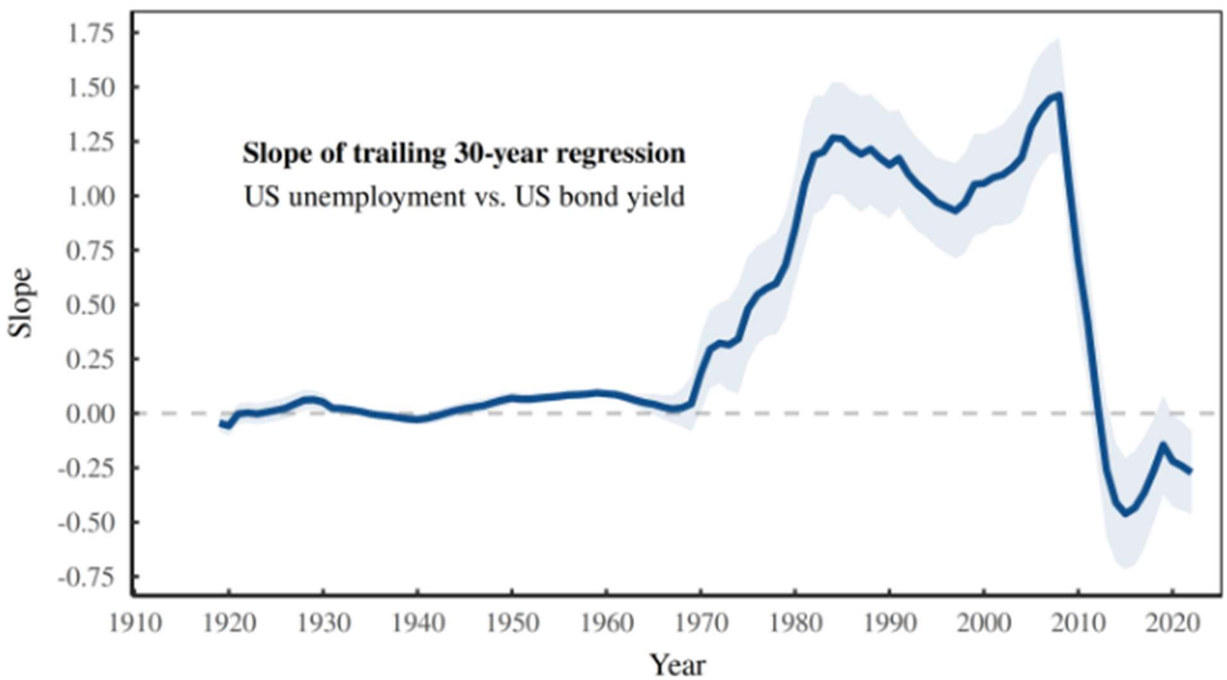
The US economy is still growing at a healthy pace, even though growth slowed slightly in the second quarter of 2023. The job market remains strong, with unemployment rates at record lows.

The Federal Reserve has been raising interest rates in an effort to combat inflation, which was at a 40-year high in June 2022. However, the unemployment rate has remained at a historical low despite the Fed imposing a series of 11 rate hikes at the fastest pace in decades.



Source: BLS

There are varying opinions among economists regarding the effect of monetary policy changes on the job market. Some argue that there is a delay in this impact while others believe that the correlation between interest rates and unemployment is not as strong as it was in the past. Additionally, Blair Fix, a political economist and blogger, suggests that the relationship between interest rates and unemployment may not be a universal truth and may have been a theoretical response to a temporary period in US history.



Source: economicsfromthetopdown.com

We hope that the Fed will be able to achieve a soft landing, meaning that it will be able to bring down inflation without triggering a recession and high unemployment. The Fed Chair has said that a soft landing is possible, but not guaranteed.

US Consumer

The biggest question about the US economy right now is whether consumers can continue to spend money at the same rate. Student loan payments will resume in October, and pandemic-era excess savings are expected to run out this quarter. The personal savings rate is now at 3.5%, near all-time lows.

Two main factors are keeping US consumers confident to spend: the strong job market and the house wealth effect. The house wealth effect is driven by the surge in home equity during the pandemic. Home equity as a percentage of disposable personal income is above the highs seen in the mid-2000s, even with the recent decline in home prices.

The million-dollar question is whether home prices will continue to decline and even collapse, given that mortgage rates are at their highest level since the 2000s and are expected to rise further.

Mortgage Rates Continue Heading Higher

Source: Freddie Mac

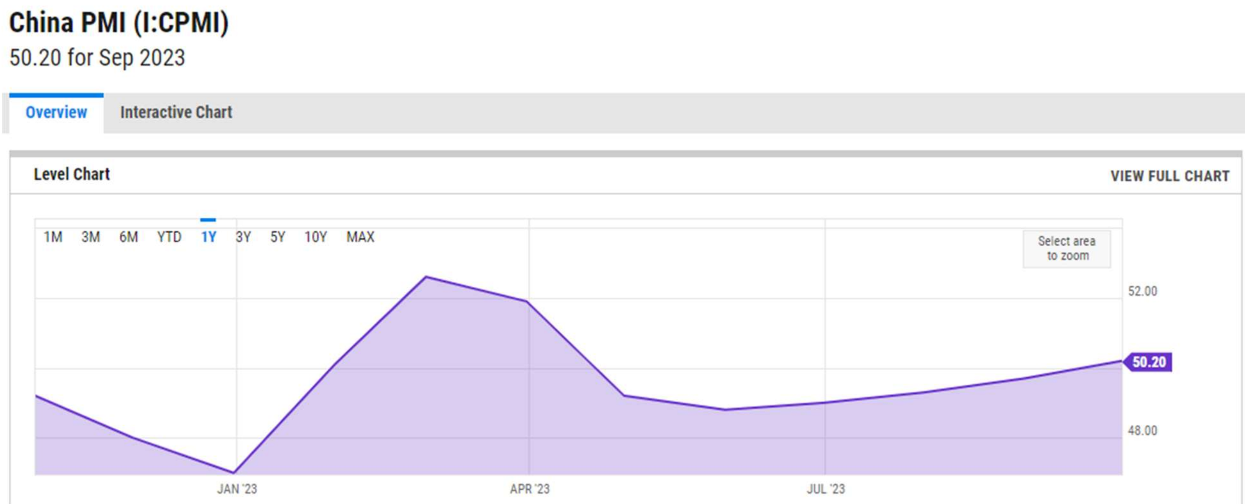
China Growth

The old saying is that "if the US sneezes, the world catches a cold." But with China's rise as an economic powerhouse, we can now say that "when China's economy feels the heat, the world sweats."

There are two very different stories about the Chinese economy today.

One story is that the domestic economy is struggling. The population is aging, youth unemployment is high, and the real estate industry is collapsing. This is a serious problem because real estate accounts for a large share of the Chinese economy and household wealth.

The other story is that China is making extraordinary technological progress. The country is developing its own semiconductor industry and Huawei is catching up to Apple in terms of technology. China's domestic jet maker Comac recently received its biggest order ever, and the country's EV export business is booming. The China PMI rose to 50.2 in August, indicating expansion for the first time since March. Activity in services and construction also accelerated last month. During the recent Golden Week holiday, domestic travel and spending both increased compared to 2019, before the pandemic.



Source: YCharts

In our opinion, China's recovery since most pandemic controls were relaxed in early December last year has been disappointing. However, we believe that the economy will gradually improve. The real estate crisis is a significant threat, but since Chinese society has a saving culture and the government has a firm grip on the banking sector, the crisis can be contained to prevent it from developing into a full-blown economic crisis like the one in 2008.

In Summary

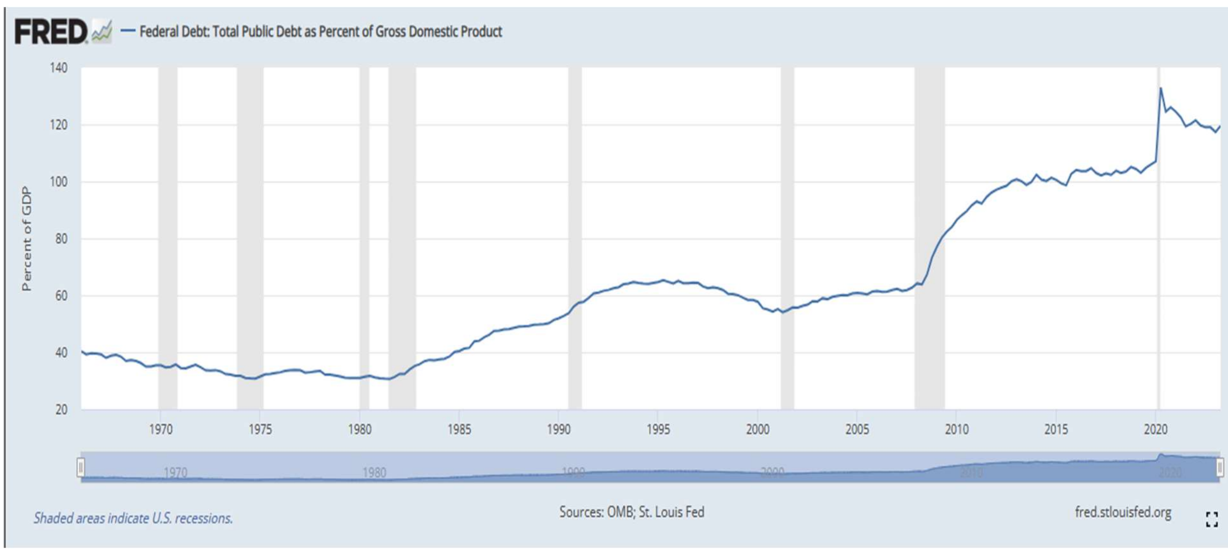
The world's largest economies are affected by macro factors that have both positive and negative sides. Despite the ongoing economic and technological tensions between the US and China, we believe that the global economy can still navigate through the current interest rate hiking cycle. It is hoped that the US economy will achieve a soft landing, also known as "The Golden Path." However, predicting the future is impossible, so we must remain vigilant and take action as early as possible.

Uncertainty and Grey Rhinos

The US Debt

The US government has a lot of debt, and this could be a problem if interest rates go up a lot or if the government is unable to manage its finances effectively.

The US national debt is now over $33 trillion, and the ratio of debt to GDP is around 120%. This is a high level of debt, but it is not necessarily a problem as long as the economy is growing and the government can afford to make its debt payments.



Source: FRED

However, there are two factors that could make the US debt a problem in the future:

Rising interest rates: A surge in interest rates could lead to an increase in the cost of servicing the US debt. This, in turn, could put a strain on the government's budget and lead to higher taxes or lower spending.

Ineffective government governance: If the US government is unable to manage its finances effectively, it could default on its debt. This would be a very serious event that would have a devastating impact on the US economy and the global financial system.

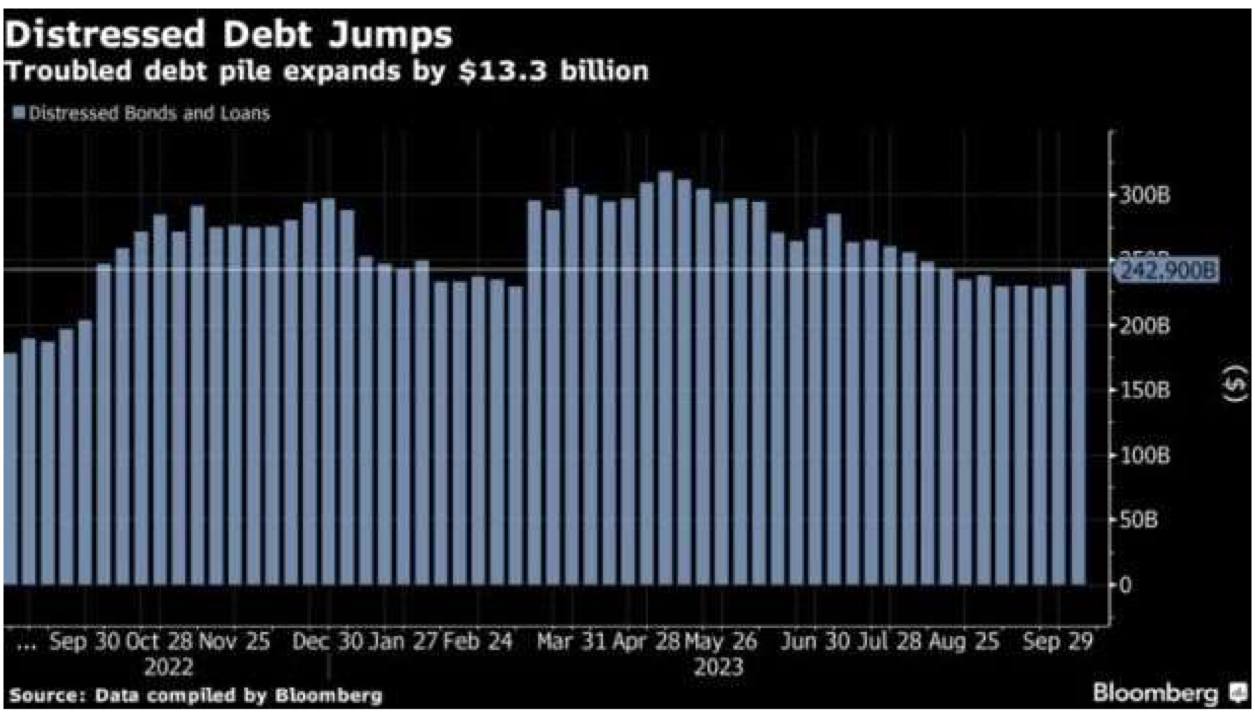
Currently, the US is facing both of these challenges. Interest rates are rising rapidly, and the US government is deeply divided. This makes it difficult for the government to make the tough decisions that are needed to manage the debt.

If the US government is unable to manage its debt effectively, it could have a significant impact on the equity and bond markets. For example, the government might be forced to raise taxes or print more money, both of which could lead to higher inflation and lower economic growth. This would hurt corporate profits and stock prices, and it would also make bonds less attractive to investors.

Tougher Corporate Earning Environment

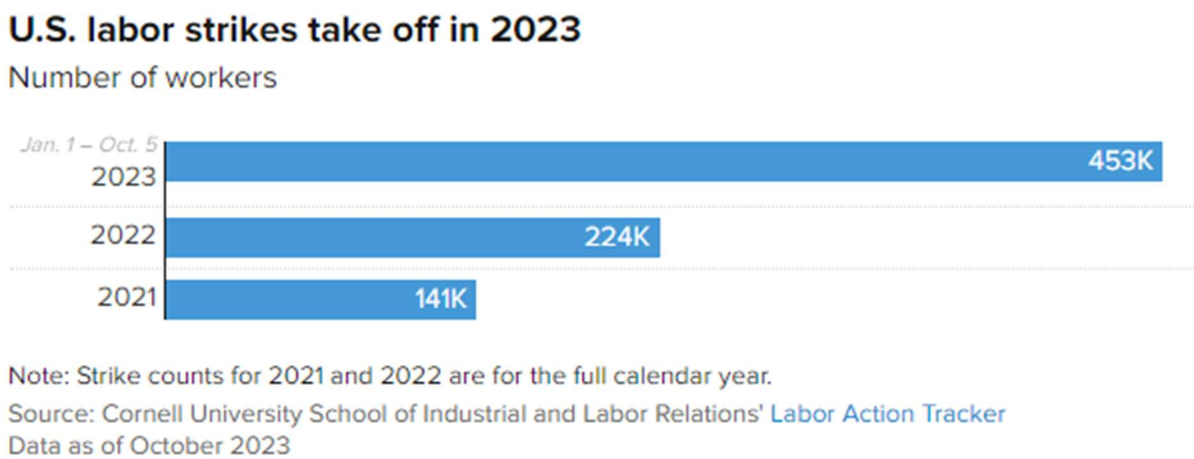
The Federal Reserve's plan to keep interest rates “higher for longer” has caused bond yields to rise, especially for longer-term bonds. This means that many corporations will have to pay higher interest rates when they refinance their debt next year.

In fact, the surge in US interest rates over the past year has already caused some industries to struggle. Bankruptcies are rising at the fastest rate since the pandemic, but companies are still taking on more debt. Restructuring experts and debt investors warn that there is more pain to come.



Source: Bloomberg

In addition, the resurgence of workers' strikes led by unions could put pressure on corporate profits. These strikes span a wide range of industries, from Hollywood writers to Detroit auto workers to Kaiser healthcare workers. Altogether, roughly 453,000 workers have gone on strike so far in 2023, as employees across industries fight for better wages and working conditions. With each successful strike, others are more likely to follow.



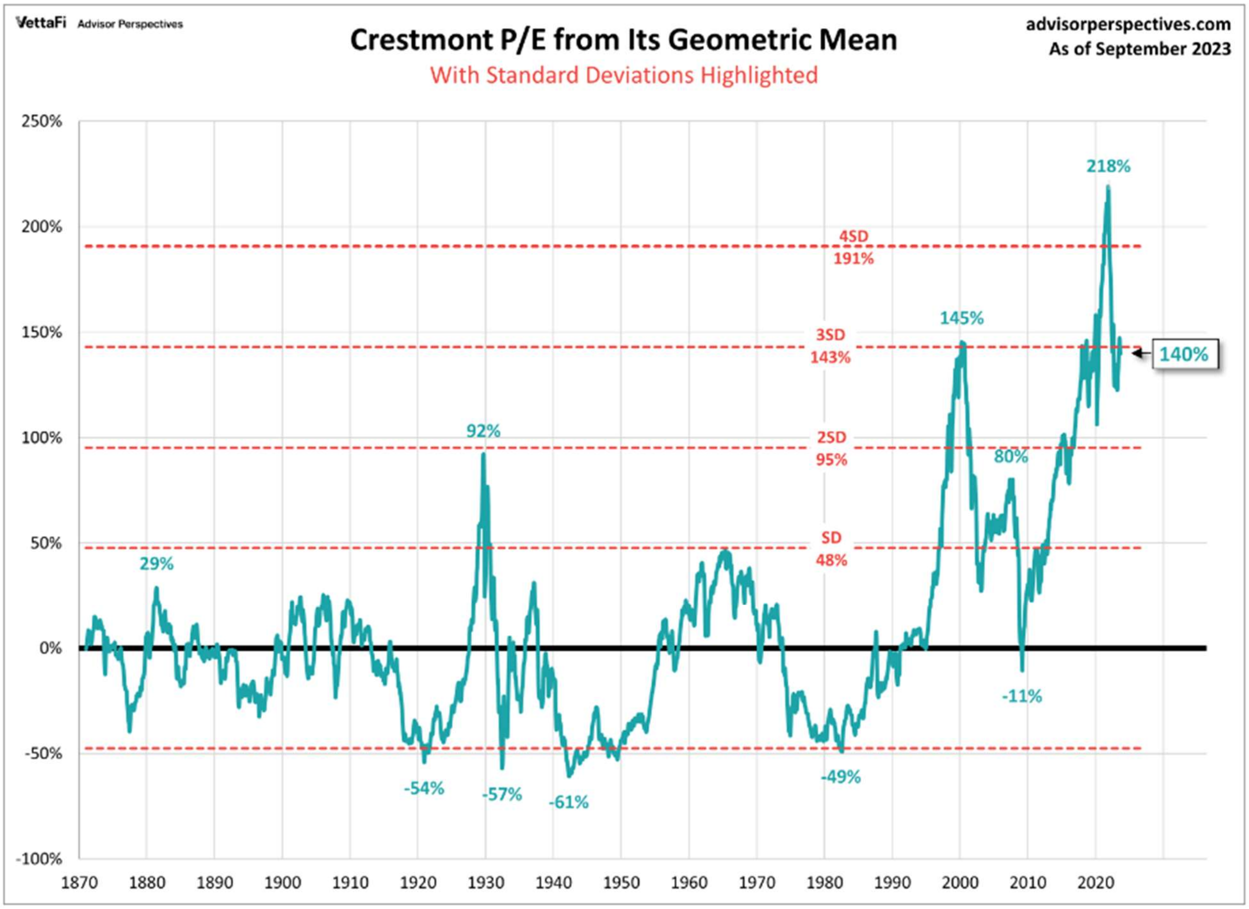
Source: CNN

Workers are demanding higher wages to keep up with inflation, which is reasonable. However, higher wages could also lead to higher inflation, creating a vicious cycle.

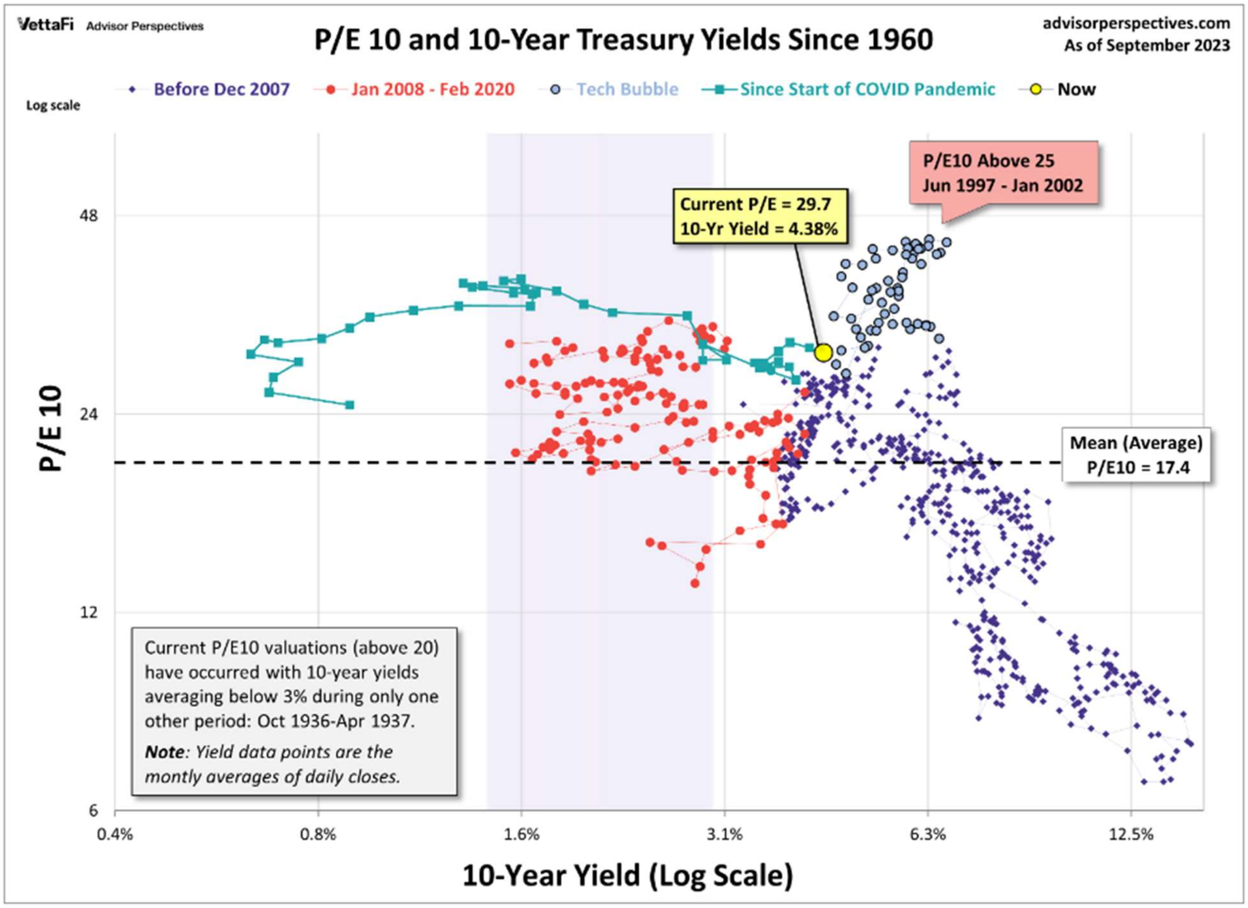
Equity Valuation Remains Elevated

The charts below show that US stock prices are currently the second highest they have ever been, relative to their average, after the 1999-2000 tech bubble. The same is true when inflation and the 10-year Treasury yield are taken into account.

Valuation measures are not reliable predictors of short-term stock prices. However, there is always a possibility of a sudden and steep decline in stock prices, particularly when the Federal Reserve has decided to maintain high-interest rates for an extended period of time and corporate profits are facing challenges.



Source: Jennifer Nash of VettafI



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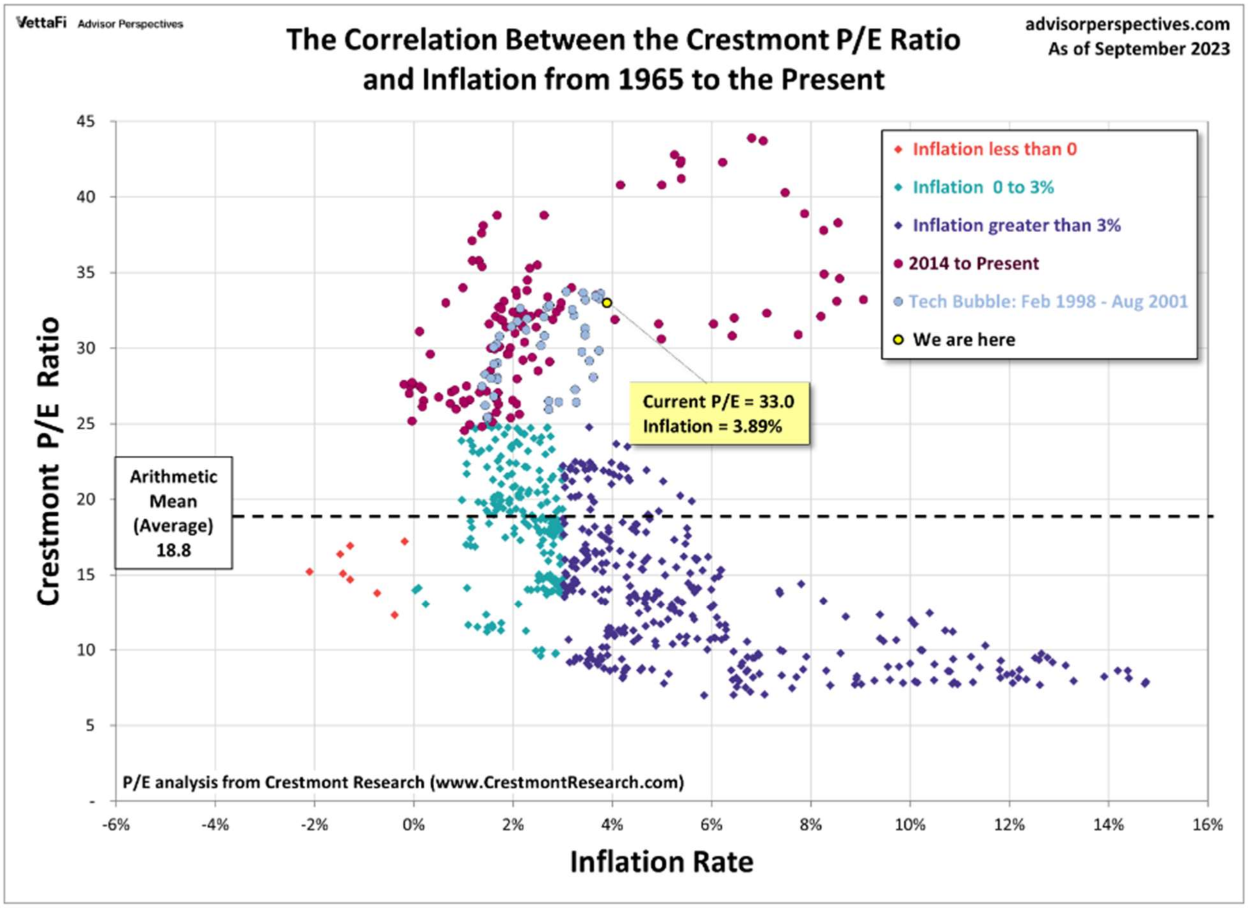

Source: Jennifer Nash of VettafI

Aurimax Investment Club Q4 2023 Investment Strategy

We anticipate that major economies will be able to manage this cycle of increasing interest rates. Both the equity and bond markets are likely to survive. 2024 is a presidential election year. It's worth noting that historically, 83% of election years since 1928 have resulted in positive performance, with an average return of 11.28%. Given this, it may be advantageous to consider deploying capital in Q4 of 2023.

Many economic factors that we observe have uncertain outcomes. Given the challenging earnings environment, high equity valuation, and recent escalation of geopolitical tensions, it is wise to adopt a cautious approach. It is important to acknowledge that there is a possibility of a significant correction or even a brief bear market.