Monthly Newsletter – December 2023

As we start a new year, it is customary to look ahead and try to see what we can expect in the coming year. This does of course always require the quotation ... ***"Prediction is very difficult, especially if it's about the future!"***

Inflation
The last few years have seen a rise in inflation in the western economies and the central banks have increased interest rates in an effort to reduce it. Having risen to about 9% inflation is now around 3% to 5% and therefore the policy seems to have worked. However, some argue that the rise in prices was due to shortages as a result of policy actions during the Covid19 crisis and this has now dissipated. It was not true inflation they argue, which is always due to expanded monetary policy, but was simply a supply problem due to lock downs. This happened in the late 1940s when after world war two the global economy was suffering severe supply shortages and that lead to inflation reaching 20% in the USA in 1947. Three years later it was down to just a few percentage points and that is what we are now experiencing.

If that is the case then the rate of inflation should continue to fall in the coming year. There is always the risk of oil supply shocks particularly if the war in the Middle East expands but I have never understood why higher oil prices, due to supply shocks, should make central banks raise interest rates. That policy does not improve the flow of oil.

Interest Rates
When Covid19 arrived the central banks, in an effort to support the economies, cut interest rates to near zero. That policy has been reversed with significant rises in rates by central banks in the USA and Europe. The low rates encouraged lending and the property markets in particular took off. Also bonds were bid higher and higher in the search for yield and central banks themselves bought long term bonds in a effort to reduce long term rates. Higher interest rates brought down both these markets significantly. The domestic property markets are now facing mortgage rates double what they were one year ago and banks, that have significant commercial real estate holdings, are facing similar stress. Should central banks hold rates at current levels this year the main economies are likely to slip into recession.

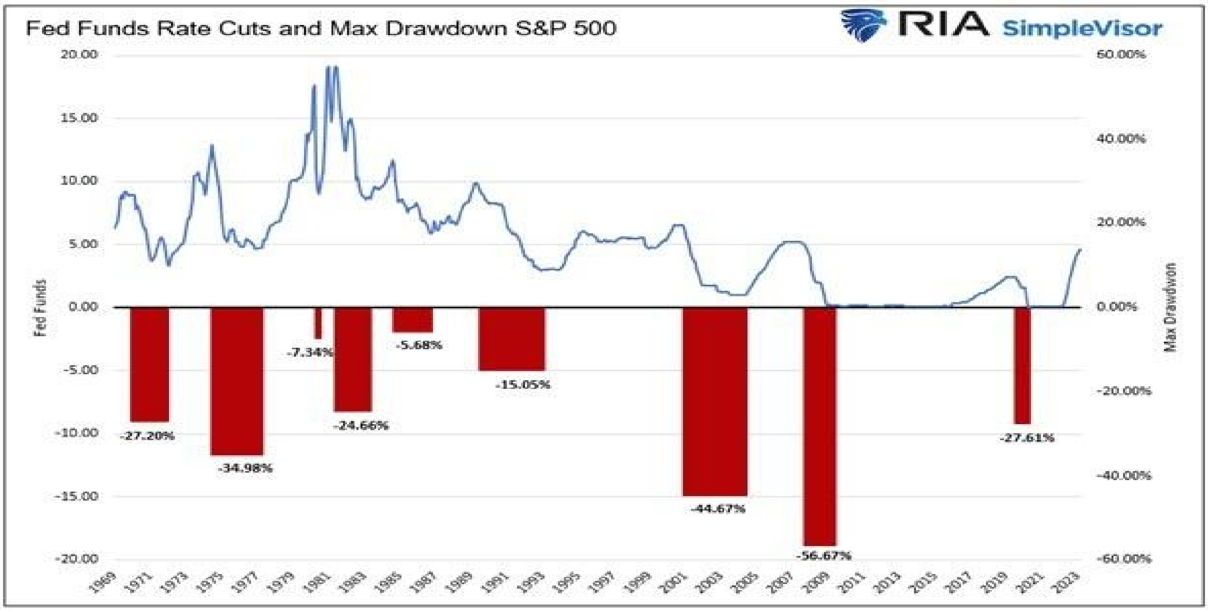
Recession risk
Central banks set the overnight interest rates but the bond markets set the rates for the longer term as investors, pension funds, insurance companies etc bid for long term bonds. If the interest rates on these long term bonds eg. 10 years, falls below the overnight rate or even the two year rate, it is called a rate inversion and usually foretells a recession. This inversion has been the situation for over one year now so the recession risk is real.

The problem with recessions is that economic activity falls away, profits fall and unemployment rises as workers are laid off. This is what central banks and politicians want to avoid and so they cut interest rates when this happens. But they have yet to do so. In the USA the central bank has started talking about rates cuts, but in Europe the ECB seems determined to resist even though both Germany and France are in recession. I suspect central banks will act too late.

Stock markets

The last month of 2023 saw the US stock market push higher on talk of interest rate cuts. As was the case for all of last year the move was dominated by a handful of companies. Amazon was one which now trades on a price earning ratio of 80. At $155 a share today it is about where it was at the start of 2022 but by the end of that year it had dropped to $90. These huge swings in share prices for what is now a very large company has also happened to the other leaders of the SP500 such as Facebook and Netflix. This is the sort of price action expected of a new start up company and not a leading corporation. And like the start ups they do not pay dividends.

If the economies do start to drop into a recession and these highly valued companies come under pressure, lower interest rates by the central banks are expected to support them and their share price. But that is not what has happened in the past.



The chart above shows that when the US central bank starts to cut interest rates it is in response to weakness in the economy and subsequent falls in the US stock market can be severe. The Federal reserve then follows the stock market down rather than help them avoid large drawdowns.

Maybe it will be different in 2024.

On the other hand a positive case can be made for the UK stock market as the attached FT article from 23 Dec 2023 explains and while aiming for capital growth it also pays a decent dividend.

Best wishes

Tim 12 January 2024

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