DECEMBER INVESTMENT UPDATE

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WCO GROUP

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Executive Summary

- **US Reporting season is all wrapped up and results beat expectations.**
- **Revenue continued to grow rapidly whilst profit margins remained near record highs.**
- **The next 12-months may however come with slower share market growth and more risk.**
- **A key area to watch is China as Beijing attempts to slow house price growth.**
- **Inflation is hot with the bond market seeing higher US interest rates in 2022.**
- **Much of the good news is already priced into share markets with several risks overlooked.**

The strength of the recent US reporting season carried share markets higher through to early November. With few positive catalysts to follow, upward momentum faded and share markets mostly moved sideways.

Investors once again pulled out their list of worries. The list does not look much different to what it did 6-months ago. **Supply chains remain stretched**, most notably with the movement of goods. October **US inflation data came in at +6.2%**, the highest since November 1990. **US labour shortages are not easing**, with still more vacant jobs (10.4M) than unemployed workers (7.4M). **Rising COVID-19 cases in the Northern Hemisphere**.

However, it was the unexpected that rattled share markets most. News of a new COVID-19 variant, Omicron. The US S&P500 Index sold off rapidly recording its worst day in 8-months (-2.27%). **Clearly investors remain very nervous about COVID-19** and more especially vaccine efficacy against the new variant.

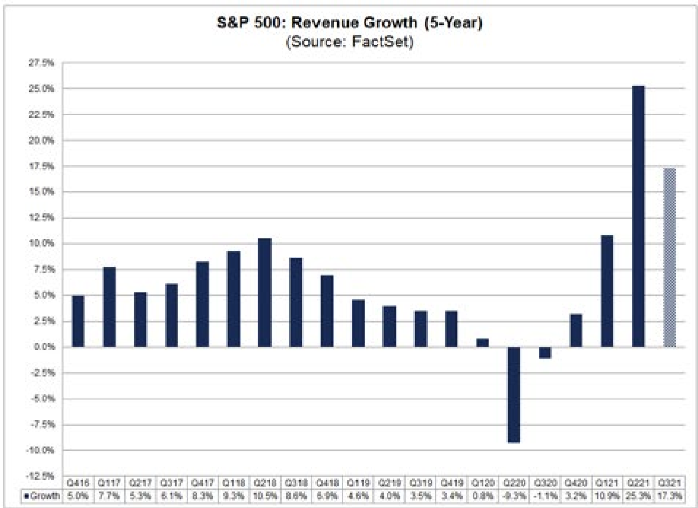
Renewed COVID-19 restrictions could only intensify the challenges already on the worry list. Supply chain pressures would worsen as labour becomes even more scarce. All of this whilst demand for goods, as proven before is likely to remain strong ultimately sending prices even higher.

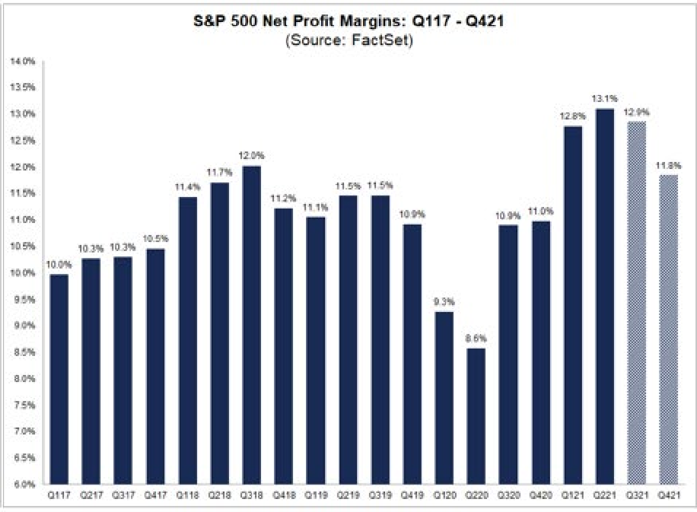
All eyes are on the US Federal Reserve Bank. Fed Chair Jerome Powell last week indicated they may need to speed up their plans to exit the $120B per month stimulus program. **Ending these support measures and tightening money supply by mid-2022 will have markets paying attention**. This is a difficult task and even more so with the Omicron uncertainty.

In this newsletter we highlight the **strength of the recent US reporting season**. Whilst this is positive, we would not expect this trend to continue as the business cycle matures. **Central Banks know they need to remove emergency policy settings and that is not going to be easy**.

A Cracking US Reporting Season!

- **Fears of Stagflation (high inflation, slowing growth) were put aside when the US reporting season started in early October**. The mood on Wall Street changed. Investors were once again buying the dip and pushing share markets to all-time highs.
- **The catalyst for the optimism was higher revenue growth** (left bottom chart). Revenue growth for the last 12-months came in at +17.3%.
- **Further fuelling the October boom was easing concerns about profit margins** (right bottom chart).





- Costs are rising.
  - **Private sector wages are +4.1% higher** over 12-months to September 2021.
  - **Producer prices are +8.6% higher** over 12-months to October 2021.
  - **Consumer prices are +6.2% higher** over 12-months to October 2021.
- **Corporates are talking about this**. According to Factset 285 corporates made mention of inflation on earnings calls between mid-September and mid-November. That is well above the 5-year average of 137.
- Profit margins for the Jul-Sep21 period was +12.9%**. Analysts are now expecting margins to be +11.8% for the Oct-Dec21 period.** Still well above pre-COVID levels.
- Whilst we see high levels of inflation persisting, most corporates are successfully managing this at this stage.

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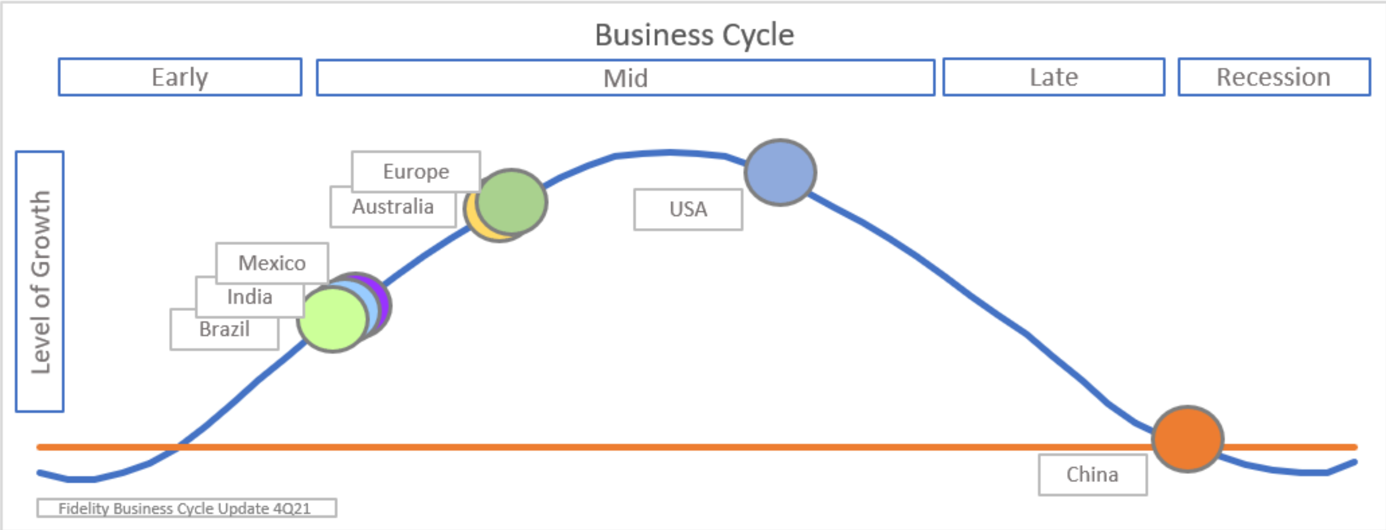
Get ready, it is Mid-Cycle…

- The last 18-months have been extraordinarily rewarding for investors willing to look through the short-term uncertainties. **Can share markets move higher from here?**
- This is an incredibly difficult question to answer. The reason is that share markets are priced on future earnings expectations which are uncertain. But let's try to establish where we find ourselves today.
- **The last 18 months was first about a recovering and then expanding global economy**. The outcome today is record high corporate earnings. That largely explains for record high share markets.
- Unlike last year **most economies are no longer in the early stage of the business cycle**. Leading the recovery was China and the US. Both these economies have now moved past the point of peak growth.



- The US economy is now firmly in the mid-cycle phase. Research by Fidelity does show **most corrections (10-20% fall) happen in the mid cycle**. On average they last 4-months with market declines averaging -14%.

- In our view this is not enough to tip the economy into a recession and share markets into a full-blown bear market. **These ingredients coupled with a policy mistake is however enough**.
- **That is a path the Chinese economy is potentially travelling on.** At the heart of the growth slowdown in China is the property sector. Beijing imposing stricter regulations to slow house price growth (affordability).
- Will the pickup in growth from emerging economies such as Mexico, Brazil and India be enough to **offset the growth slowdown in China**? Can Europe and Australia accelerate their growth paths in the coming months?
- The challenge is these **other economies are only a fraction of the Chinese economy**. GDP in China $15.6T, Mexico $1.2T, Brazil $1.6T, India $2.8T, Eurozone $15.1T, Australia $1.6T.
- This is one of the many reasons why **investors are watching closely what is happening in China**. An economic policy misstep in China is possible. This is likely to drag the global economy down with it.
- **Can share markets move higher? Yes, but at a slower rate** (than the last few years) as global economic growth slows. The 2022 investment journey is likely to also come with greater risk of market corrections.

Is the US Fed Trapped? Maybe.

- **Worryingly high inflation data has been grabbing headlines over the last month**. We now know that each dollar buys us much less today than it did a year ago.
- Compounding this problem is that times of **high inflation are often accompanied with an expectation for soon to be higher interest rates**. Not good for asset prices. This explains why Central Banks are walking back any expectation of imminent interest rate hikes.
- Central Bankers today have two choices.
    - Keep interest rates low and potentially **deliver elevated inflation for much longer**, or
    - Raise interest rates to curb inflation but **risk tipping the econony into a recession**.
- Raising interest rates seems like the right thing to do. Much more difficult is knowing when to do it and by how much. **Accidentally stalling the economy by raising interest rates too soon or too high is not good**.
- The last month has seen short term interest rate expectations move higher. The market is today expecting **the US Fed to raise interest rates a number of times in 2022**.
- The challenge for the US Fed is they are still printing $120B of new money each month. They cannot raise interest rates to curb inflation whilst printing money which stokes inflation.
- The US Fed last month announced that **starting late November they will reduce the amount of money they print** by $15B per month and fully exit by June 2022. Last week US Fed Chairman Jerome Powell said they may need to accellerate this plan.
- **So by June 2022 (or earlier) they can start raising interest rates**. The market currently places a 70% probability that interest rates will be higher after the 15 June US Fed meeting.
- More fascinating is that **the bond market is not too convinced about the long-term outlook**. Long-term interest rates are still moving sideways. The US Fed could make a mistake and stall growth.
- The US Fed watched asset prices fly higher. They waited for inflation. They waited for wage growth. They stuck by the transitory narrative. **Now they need to slow one of the biggest asset price parties in history**.

ASSET CLASS PERFORMANCE

	November Return	12-Month Return
Australian Equities	-0.54%	+15.48%
International Equities	-0.50%	+23.88%
Australian Property	+4.52%	+20.78%
International Property	-1.38%	+28.27%
International Infrastructure	-3.44%	+10.46%
Australian Fixed Interest	+2.08%	-3.23%
Commodities	-10.82%	+38.24%
AUD / USD	-5.24%	-3.02%

Sources
Australian Equities: S&P/ASX 200 Accumulation Index. International Equities: MSCI World Index(USD). Australian Property: S&P/ASX 200 A-REIT Index. International Property: S&P Global REIT (USD). International Infrastructure: S&P Global Infrastructure Index (USD). Australian Fixed Interest: Bloomberg AusBond Composite 0+Yr Index. Commodities: S&P GSCI Index(USD).

- **Australian Equities**
  - The S&P/ASX200 Index posted a -0.54% return for the month of November and +15.48% over the last 12-months.
  - Top-performing sector for the month was the Materials sector which gained +6.16% as the iron ore price bounced from oversold levels. BHP Billiton gained +7.6%, Rio Tinto +3.6% and Fortescue Metals +22.1%.
  - The weaker part of the Australian market was the Energy sector (-8.4%) impacted by a -18.3% decline in the oil price. The Financials sector was also under pressure (-8.0%) as reports from the banks had investors concerned about profit margins.
- **International Equities**
  - The MSCI All World Index gave back a marginal -0.50% over the month. International equities remain one of the top performing asset classes in what is now a post vaccine announcement 12-Month period.
  - Regional relative strength over the last month was in the US with the US S&P500 Index giving back a modest -0.69%. News of a new COVID-19 variant saw investors once again favour US listed stay-at-home stocks.
  - The S&P Europe350 Index was hardest hit giving back -4.75% over the month. Rising COVID-19 cases in northern hemisphere saw investors optimism wane by mid-month. This accelerated on news of a new COVID-19 variant which also saw the S&P Japan500 Index decline -3.24% over the month.
  - The S&P Dow Jones Emerging Market Index gave back -3.60% and remains out of favour relative to Developed Markets.
- **Property and Infrastructure**
  - Australian Property Index bucked the trend gaining +4.52% over the month. The strength was driven by index heavyweight Goodman Group which gained +12.7% over the month.
  - Global Listed Property (Hedged) and Global Listed Infrastructure (Hedged) both followed global equity markets lower ending the month -1.38% and -3.44% weaker.
- **Fixed Income**
  - The Bloomberg Australian Bond Index gained +2.08% over the month as investors once again favoured defensive assets.
  - The 10-year Australian government bond yield moved noticeably lower by month end. Now paying investors +1.75% pa compared to +1.95% pa a month earlier.

If you have questions regarding investments, please don't hesitate to contact us to speak to one of our experts.

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