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Woodhall's Wrap

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Too much talk of recessions!

Does anyone have a strong track record in predicting recessions?
US and China ready to act
Australia likely to cut rate and give a fiscal boost

The Big Picture

Most of the market volatility in recent times has been due to fears of an impending recession – in the US, in Australia, in Europe. Let's put this nervousness in context.

Paul Samuelson, the 1970 winner of the Nobel Prize in Economics, once quipped that the stock market predicted 11 of the last five recessions!

Two and a half years ago – when Trump was about to start his first term as President – Bloomberg reported that "a pack of Nobel Laureates" gave Trump's economic policy the "thumbs down" and one even predicted a severe recession as a result. The US has had two and a half years of very strong growth and the unemployment rate has dipped to 50 years lows.

But, perhaps, the best comment on recessions was made by an anchor on CNBC last week. He likened recession calling to badger watching in England. To paraphrase, "Badgers are rarely seen in the English countryside (they are nocturnal and live in very long inter-twined underground burrows). But we know they exist because, from time to time, we see one on the side of the road after having collided with a car."

In short, recessions are almost impossible to predict by any economist but we know they exist and one will occasionally happen with almost no warning!

Some headline-seeking commentators are suggesting the fact that a short-term interest rate (say 90-day rate) is greater than a long rate (say the 10 year) is symptomatic of an impending recession.

In the past, central banks have sometimes forced the short-term rate higher (above the long rate) to slow down a booming economy and have gone too hard. This time the short rate has not been pumped up but the long rate has fallen on inflation expectations. There is no reasonable evidence that this phenomenon precedes recessions! Of course, we acknowledge the past possible impact of over-zealous central banks.

If Trump forces tariffs too high with China, he could cause a recession. But Trump cannot afford the US economy to stop booming before the November 2020 presidential elections. From past experience we know that China will not stand by and let its economy stumble. Both will do something – and it does not matter what – to prevent a recession or even a significant economic slow-down.

Before our Federal election, our Reserve Bank (RBA) looked reticent to cut rates and we were facing the prospect of higher capital gains tax; restrictions on negative gearing; and restrictions on franking credits. Whatever one's shade of politics, we now face none of these four factors. The RBA has stated (with almost certainty) that it will cut rates on June 4th (and probably again a few months later) and the three tax policies are not shared by those in government.

Markets had priced in those four factors and must now unwind those expectations. Our labour market and economic growth were fine (but not great) and, on top of that, there are now to be tax rebates of more than a thousand dollars in July/August for a whole swathe of tax payers. Even if our economy wobbles for a couple of months, it is set to bounce back in the second half of the year.

Analysing monthly data on our stock market since 1893, we note there has only been one (in around 1,500 months) when the market fell more than 15% in one month (the '87 crash) and the prior month in that case fell nearly 15% as a warning. Importantly, the market then had more than doubled in just more than one year before the crash! In less than 1% of cases did the market fall more than 10% in one month.

Our thesis is simple. If we sell too early, we could miss out on big gains. And if we had sold before the peak, what would then induce us to buy back in while the market continued to climb? We would have been waiting at least 30 years after the last recession in Australia (while the US had three) from 1990 to the next! We believe it is better not to try and predict the top but to wait for it to become self-evident. The small likely paper loss from a (then) previous high is likely to be small compared to the gains from the previous big lows or premature sale date!

Recessions and deceased badgers alike will, unfortunately, come and go. Investing needs strong, thorough analysis and a very calm demeanour.

Asset Classes

Australian Equities

While most major markets around the world finished May firmly in the red, the ASX 200 kept its head above water. The surge in Financials stocks on the day after the election results of +5.9% obviously helped but Materials, Health and Telcos also put in better returns than Financials over the month.

Since we have the ASX 200 only modestly overpriced with strong earnings growth prospects, we see further gains over the second half of the year.

Foreign Equities

The May sell-off on foreign stock exchanges comes after four very strong months of gains in most cases. We now have Wall Street rated as moderately under-priced with strong prospects for earnings growth and so we see further gains as soon as the tariff war subsides.

Bonds and Interest Rates

The CME Fedwatch tool for pricing possible rate changes by the US Fed this year continues to be volatile in its predictions. The latest data puts one cut this year as the most likely scenario followed by two cuts and then no cuts. Even three cuts have a 10% chance!

The Fed pretends to be standing firm but the market does not agree.

With a drop in 10-year bond yields, the short interest rates are above those at the longer end. While this behaviour has concerned some recession watchers, we do not agree with their analysis.

With the Fed rate range at 2.25% to 2.5%, we cannot agree that there is currently tight monetary policy – the phenomenon which arguably caused some previous recessions.

The RBA has stated that it is all but certain to cuts its benchmark rate on June 4th. Another is then likely in the second half of the year. That means our benchmark rate may well end the year at only 1% (and possibly below that next year).

The RBNZ cuts its rate from 1.75% to 1.5% in May.

With bond rates so low, equities is about the only asset class to offer a reasonable yield. And with franking credit refunds back on the table, many will consider investing in that asset class even into retirement.

Other Assets

Iron ore prices shot through the roof after the Brazilian mine crisis. Oil prices have been a little volatile over the Iran sanctions but the prices of both major commodities remain firm.

Regional Analysis

Australia

The federal election gave a surprise, comfortable majority to the incumbent coalition party. Many speculate on the reasons for the upset but, for investors, the result means no increased capital gains tax, loss of franking credit refunds or removal of negative gearing. Indeed, the government is poised to hand out over $1,000 in tax rebates to a large group of middle-income earners.

While the government will not also have a majority in the senate, it will likely have fewer cross benchers to woo to get its policies through. We look forward to a stable government for three years.

The labour force data were not strong. The unemployment rate rose to 5.2%, up from 5.1% the month before and from 4.9% the month before that. With imminent rate cuts from the RBA and a lowering of borrowing requirements for home loans from the regulator, any dip in economic fortunes should be quite short lived.

Wages grew by 2.3% over the year and the minimum wage rate was just increased by 3% to $740 per week. Price inflation is below 2%.

Just prior to the election we lost one of our truly great leaders in Bob Hawke, aged 89. Along with Paul Keating, he internationalised our economy to make it the great one we all enjoy today. Vale Mr Hawke.

China

Unusually all of the main China data released in May missed expectations. However, we fully expect its government to be working at stimulus programmes that will avert any meaningful slowdown.

Owing to the nature of a one-party government. Its policies can afford to be long term with less interest in shorter-term wobbles.

President Xi has dug in his heels over certain aspects of its alleged violations of IP law. He will meet Trump at the end of June in the Tokyo G-20 summit but we are no longer hopeful of a quick resolution. On the other hand, Trump cannot afford a global or US slowdown so some sort of deal must be cobbled together this year.

US

The US increased tariffs on many imported goods from 10% to 25% as they had foreshadowed. However, Trump made a last-minute decision to hold off on the auto tariffs' increases for six months as they would really have hurt Japan and Europe.

The unemployment rate came in at the lowest since December 1969. At just 3.6%, anyone predicting a recession anytime soon must have a very different crystal ball! US wages were up 3.2% which is well above its price inflation rate. There is fat in the economy to shed long before any real problems can emerge.

Trump needs a strong economy going into the November 2020 elections. Four years of strong growth – against popular opinion in 2016 – will promote his chances of a second term in office. Since a sitting president cannot be tried in the federal courts, Trump has an extra incentive to win next year!

Trump made a quick visit to Tokyo to shore up support on the North Korea and China fronts.

Europe

At last prime minister Theresa May has fallen on her sword. She was gifted the unenviable task of negotiating Brexit. With Nigel Farage getting the biggest slice of the cake in the recent EU elections, his call to arms for a Brexit has been rekindled. It was Farage who started the Brexit movement.

Indeed, in the rest of the European elections there was a significant move towards parties leaning towards breaking up the union. A so-called hard-Brexit (meaning the UK leaving without a deal on October 31st) is on the cards.

UK economic growth was the best since 2017 at 0.5% for the quarter. After Trump visits in the first week of June to meet with May and the Queen, May will leave office on June 7th.

Rest of the World

The Ukrainian comedian who swept into office a few weeks ago has already called a snap election to get out quick and return to his TV career.

India posted an impressive rate of inflation at 2.9% while its prime minister, Narenda Modi, was re-elected in a landslide.