Mandatory Reminder

The sole disclaimer relevant to the Baillie Capital Monitor is that it is designed as a reliable source of data and provider of insights for Professional Investors as defined under the Corporations Act.

Orientation

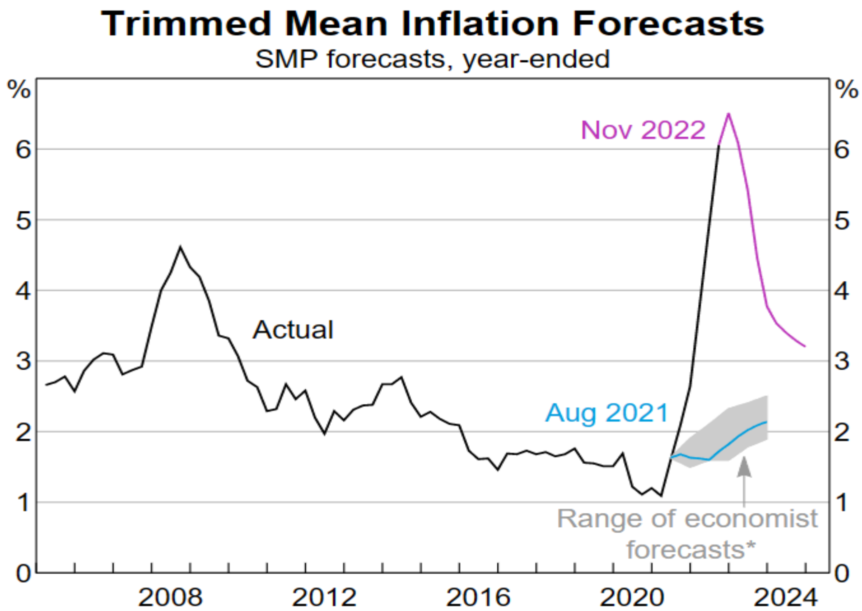
In the Queen's Birthday 2022 edition of this Irregular publication, Baillie nominated that the critical element to be considered in Capital Stable monitoring was not whether the US Fed Reserve and the RBA would "tame inflation" it was **"the time taken and the cost"** to do it.

Their policy execution, and the market reactions to these, would determine whether it was a "soft landing" or an unpalatable "hard landing": which would be expensive and lengthy.

The Fed, publicly expressed that the re-inflation that arose last year was triggered by fiscal reactions to the COVID pandemic, COVID related supply interruptions and the Russian invasion of Ukraine's impact on global energy prices, was only transitory. This lulled too many into a false sense of security.

Those that entertained the notions of the Fed, would have not entertained that the yield on the 10-year US government bonds would jump from 1.4% to 4% or the possibility that the Fed would raise its cash rate to 5% or more. This was a mortal mistake for the shareholders of Silicon Valley Bank.

The RBA in its November Statement of Monetary Policy (Box C) explains why it made its forecast errors in August of 2021: No economists in the Bank surveys nor market-based measures predicted the extent in the pickup in inflation as best illustrated in the graph.



* Based on the RBA Survey of Market Economists.

Sources: ABS; RBA

In the year to 31 December 2022, the re-inflation mess destroyed 11.5% of the "real" capital utility of your investment benchmark, the Future Fund of Australia.

Performance to 31 December 2022	6mths	1 year	3 years	5 years	10 years
AustralianSuper Balanced (default)	2.8	-4.8	4.9	6.5	8.8
Future Fund – Professional Investor Benchmark	0.9	-3.7	5.3	7.1	9.1
Headline CPI	3.7	7.8	4.0	2.8	2.2
Real Return for Future Fund	-2.8	-11.5	1.3	4.3	6.9

Interlude

Many years ago, this Irregular started by considering the RBA and APRA's recent activities on the basis that those regulators could be trusted. A key insight at that time was that Australia's regulatory system was the envy of the rest of the developed world. This certainly remains the case: the Silicon Valley Bank episode could not happen in Australia. Credit Suisse was akin to the mistakes of the State Bank of Victoria leading to that Bank being swallowed by the CBA in 1990.

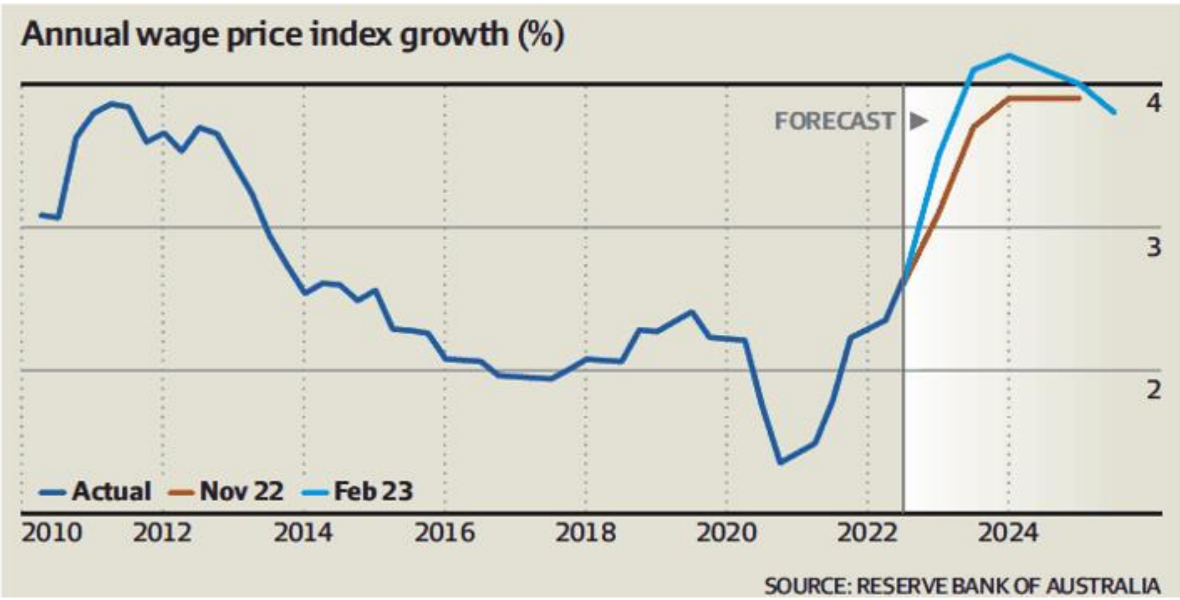
The stress test used by APRA is the combination of:

1. Residential property falling 30 % in value.
2. Commercial property falling 40% in value.
3. Unemployment hitting 13%.
4. The economy as measured by GDP falling 15%.

If the very deep recession conditions of this stress test occurred our Banks would have CETI 1 ratios of 6.5% nearly 1.4% above the level of compulsory conversion of Bank Hybrids to Equity.

The Problem

The graph below was the major determinant of our agnosticism last year as to whether we would experience a "soft" or a "hard landing".



The insight you should gain from this graph is that since mid-2013, the RBA knew it could not reach its lower band of its inflation target and it called upon all players, Government, Business and Wage earners to do their bit in concert with the RBA's own efforts.

There are four main players in our socio-economic environment when it comes to inflation:

1. Government fiscal policies can stimulate, hold steady or constrict economic conditions. Governments are by their very nature price-makers.
2. Consumers are the main drivers of the economy, yet in most respects they are price-takers, though the subset community of unions try to balance power with respect to the price of labour.
3. Business is a price-maker, purportedly the best educated, representing all Stakeholders. In practice, Businesses will always need to trade-off dynamic issues and be forced to make judgements on when it cannot afford to alter priorities between its various Stakeholders.
4. The RBA is the choreographer responsible to keep the music playing, the actors usefully engaged, and the dance floor available.

Despite the RBA's efforts, the Government valued their wish to produce an operating budget surplus higher than playing their part in solving the problem the above graph evidences.

The Third player as the graph illustrates was too easily distracted to postpone making all the hay for tomorrow from its profits, rather than using them for today via increased wages. The general community, player 2, were lulled into a false sense of security, enjoying the benefit of negative interest rates for Borrowers without understanding what that really meant.

Background

Over the past two years, you have witnessed that the primary role of OECD Central Banks is Financial Stability. You are now experiencing a rare occurrence where there are conflicting sources of Financial Instability – inflation and Bank solvency.

Baillie closely monitors two economies to set its Financial Repository Risk Mitigation Meter, the United States and Australia.

There are differences not just in the relative performance, size and structure of these economies but they have different measures of note that deserve detailing.

	United States	Australia
Inflation target	Fixed rate of 2%	Target range 2-3%
Current overnight cash rate	Target range 4.75% - 5.00%	3.6%

The preferred measure of inflation that the Fed uses for core inflation is the Private Consumption Expenditure Deflator, whereas the RBA uses the Trimmed Mean measure derived from the CPI.

Both of these measures are core inflation measures, not the "headline CPI numbers" released by the respective Government agencies tasked with that reporting responsibility.

The possible conditions for an individual's economic environment are the economies are:

I. reflating with higher-than-normal volatility,
II. stable and non-volatile, or
III. disinflationary with lower-than-normal volatility.

If re-inflation pushes inflation beyond the level that Central Banks consider to be a threat to Financial Stability, they will act by increasing nominal interest rates. The rate and levels of these rises require high levels of judgement as the market reaction occurs well after the event.

You will experience the power of the "regression to the mean" characteristic of Monetary Policy this year more starkly than probably any other year of your life.

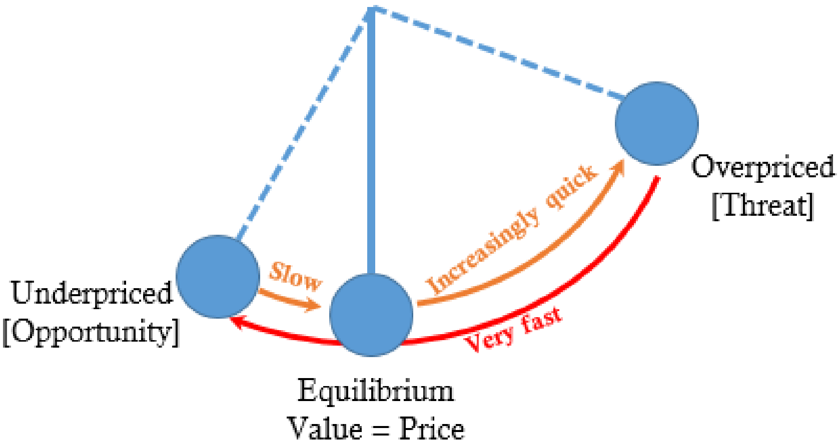
With the benefit of hindsight, the Fed moved later than it should in "taming inflation", misinterpreted the constituent elements of that inflation that led to the necessity to do same, and tried to tame it too quickly without due regard to the problems that this would cause to bank solvency in particular and asset values in general.

Our fixation on inflation is driven not only by inflations outsize power over nominal interest rates, but our wish of accuracy of measurement in both "real" earnings and "real" total ownership returns for the Contented Capital Tribe.

We are not constrained by being solely in the Fixed Interest Investment silo and nor are we in the business of trading or betting on interest rates.

In these times of reinflation, triggered by extraordinary events, with no existing remedial experience available, we are "flat-footed." The liquid risk-free return for our audience will be negative pre-tax and patently worse post-tax.

We suggest you surrender the business cycle model and adopt a pendulum model were there will be overshoot and undershoot and the timing and size of both is random because of the different context and proportionality dimensions that apply in a short period of time.



The spread of fear in the US Banking Crisis proves our tenet that fear spreads quicker than greed expands.

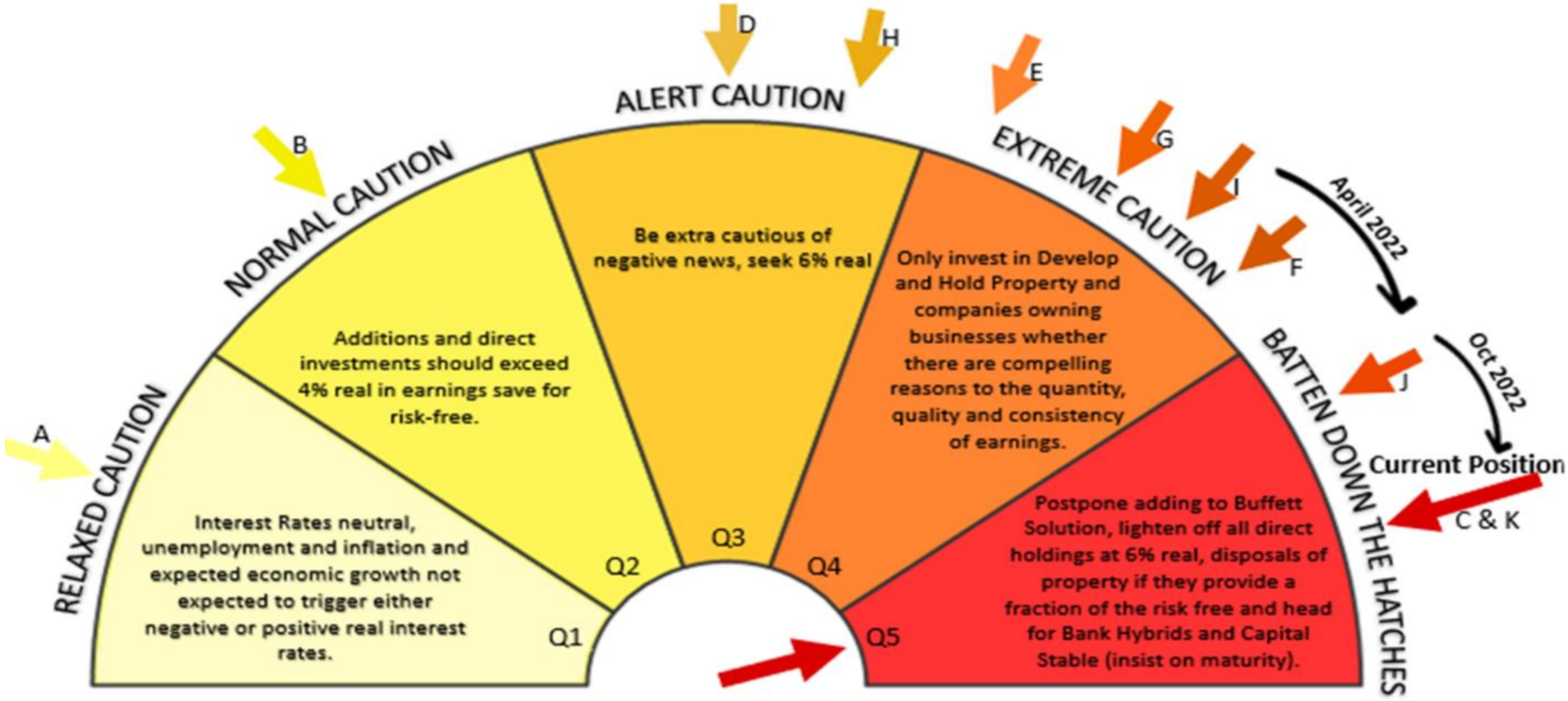
Current Context

Our major concern is that Australia's November Westpac Consumer Confidence Index fell to a reading of 78.0 which is the third lowest in the 46 years that the Melbourne Institute has provided this research. This reading is lower than the plunge following the Global Financial Crisis, which led to carnage on Wall Street where there was a 57% fall in the level of the US stock market in the period mid-2007 to mid-2009.

Bill Evans, who has interpreted more Westpac Consumer Confidence indicators than anyone else, explained that below 80 readings are very rare but recurrent readings of January 2023 and February 2023 of 78.5 are especially portent.

In October 2022, we moved our Financial Repository Risk Mitigation Meter further into the "Batten Down the Hatches" quintile. Of the four contributing factors to the shift, the four raisings of 0.75% in the US overnight cash rate was the most dominant. The US Bank panic does not merit a change to the Risk Mitigation Meter.

Current Financial Repository Risk Mitigation Meter



Alert State	Private Debt	Business Property	Ownership of Business - Equities
Q1	1.25 times risk-free rate	1.25 times risk-free rate	1.25 times risk-free rate
Q2	1.5 times risk-free rate for Private Debt	1.3 times risk-free rate for property	1.5 times risk-free rate of LEM for Equities
Q3	1.75 times risk-free rate for Private Debt	1.4 times risk-free rate for property	1.75 times risk-free rate of LEM for Equities
Q4	2 times risk-free rate for Private Debt	1.4 times risk-free rate for property	2 times risk-free rate of LEM for Equities
Q5	2.5 times risk-free rate for Private Debt except for Rare Beasts	No addition to property activities	3 times risk-free rate of LEM for Equities

The October change led us to consider that the United States had actually “tamed their inflation” if you used the last 6 months measures and doubled them to have a refreshed measure. We were hopeful that the positive news from the United States who had higher levels of inflation than what has been recorded in Australia would provide the certainty or the conditions to restore consumer confidence and prevent any chance of a self-fulfilling prophecy of a consumer led recession.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2013	0.2	0.1	0.1	0.0	0.1	0.2	0.2	0.2	0.2	0.1	0.2	0.2
2014	0.1	0.1	0.2	0.2	0.2	0.1	0.2	0.1	0.2	0.2	0.1	0.1
2015	0.1	0.2	0.2	0.2	0.1	0.2	0.2	0.1	0.2	0.2	0.2	0.1
2016	0.2	0.2	0.2	0.3	0.2	0.2	0.1	0.2	0.2	0.1	0.1	0.2
2017	0.2	0.2	0.0	0.1	0.1	0.1	0.1	0.2	0.1	0.3	0.1	0.2
2018	0.3	0.2	0.2	0.1	0.2	0.1	0.1	0.1	0.2	0.2	0.2	0.2
2019	0.2	0.1	0.2	0.2	0.1	0.2	0.2	0.3	0.2	0.2	0.2	0.2
2020	0.3	0.2	-0.1	-0.5	-0.1	0.1	0.5	0.4	0.2	0.1	0.2	0.1
2021	0.0	0.1	0.3	0.8	0.7	0.7	0.3	0.2	0.3	0.7	0.6	0.7
2022	0.6	0.5	0.3	0.5	0.6	0.6	0.3	0.6	0.6	0.3	0.3	0.4
2023	0.4	0.5										

US Inflation Source: Bureau of Labor Statistics Data (bls.gov)

From the data above, the US Inflation monthly data suggests US inflation peaked in June 2022 but the last few months have shown inflation remains persistently above the Fed’s target range.

Conclusion

The last few years we have moved from not having much inflation, to having possible deflation (in the pandemic), transitory inflation, to persistent inflation which has led to significant changes in nominal interest rates. This in turn has led to significant unrest and some failures in the US banking system and the continuation of a significant drop in Consumer Confidence in Australia.

We believe having logically designed Risk Mitigation Frameworks is the optimal way to make sure you’re not closing the gate after the horse has bolted. We do believe that the short-term US Monetary Policy will allow the zealous behaviour of 2022 to prove its success in “taming inflation” in the next two months.

Using the data coloured in yellow in the table above to reach an annualised rate of inflation results in a 5% annualised PCED result (last 6 months doubled), the lagged effect of Monetary Policy allows us to conclude that the US has tamed its inflation now. Interest rates are no longer negative.

We believe the largest financial threat is a “hard landing” consequence to poor fiscal policy compounded by a self-fulfilling prophesy of a consumer behaviour caused recession.

We will continue to monitor inflation and Monetary Policy settings closely to pro-actively anticipate when it becomes appropriate to adjust our Financial Repository Risk Mitigation Meter and tactical asset positioning.