The Encyclical

December Quarter 2024

TO OUR PROFESSIONAL AND WHOLESALE INVESTORS

Market Review & Strategy

Stocks rallied through the quarter, posting their highs in the early days of December before conceding ground into period end. The December quarter will likely be remembered as the busiest quarter for professional investors since the period surrounding the Covid-19 lows of March 2020.

Two attendant drivers would dominate investor attention-the US presidential election and the deliberations of global central banks with respect to interest rates.

Early in the quarter, unexpected yet synchronised, shock and awe announcements from several Chinese monetary agencies appeared to mark the beginning of a Sino stimulus plan and this stirred confidence among languid China-watchers.

US equity investors began placing Trump victory bets in the final two weeks of October, confirmed by a spike in US breakeven inflation rates, as the market began to discount the likely inflation ramifications of Trump's 'America First' platform. The decisive Republican election win in both houses, as well as in all battleground states and a red-wave across virtually all voting genres, ushered in the strongest post-election-day stock market performance since records were kept, according to Bloomberg.

Investors sought out pro-cyclical sectors with banks/financials rallying and small cap (Russell 2000) and mid cap (S&P400) names staging sizable advances. US penitentiary stocks were the biggest movers and Google reported an exponential surge in 'Moving to Canada' searches!

Stock and bond volatility indices promptly moved lower on the result, whereas foreign currency volatility (as measured by the Deutsche Bank FX Vol Index) initially slumped but then turned and rallied through quarter end, suggesting concerns around the short-medium term direction for the US dollar.

The US Federal Reserve would cut rates 2 days post the election result to a receptive audience and again on December 18, only this move would be less warmly received. Equities had a rare, 10:1 down day (downside stocks versus upside stocks), reflecting investor angst around the close committee vote, a flagged reduction in the number of 2025 rate cuts (from 4 to 2) and a tacit message that the FOMC might be closer to R-star (r*), aka the neutral rate of interest, than previously assumed. US stocks swiftly retraced on these concerns.

In late November the local market saw the arrival of 'Asian pods', reputedly a brigade of hedge funds distended from profitable Indian and Japanese stock market sorties, leery of Chinese equities but primed for opportunities on the ASX. Perhaps these pods were emboldened by AFR headlines on November 18 decreeing The IPO Ice Age's Big Thaw Accelerates?

Four companies IPO'ed during the quarter, including the highly fancied Digico Infrastructure that raised an upscaled $2bn and became the biggest IPO raising of the past 6 years. None of the four debutantes were above issue price at the time of writing though. Interesting to read JP Morgan Aust Emerging Co Research, January 2025, confirming only fourteen companies IPO'd (> $10m raised) in 2024, in line with 2023 with this being 70% below the ten-year average IPO count.

Secondary raisings and major shareholder selldown activity was feverish during the quarter in review. Chinese investor CIC quit its $1.9bn position in GMG in controversial circumstances (turns out the stock didn't have the hallmarks of a Veblen good[1] after all *), Auckland Council sold its 9.7% stake in AIA (following on from the company's own $1.4bn equity raising a month earlier) and Promedicus founders sold ~ a $500m parcel of shares between them. Elsewhere, major holders reduced or exited positions in Wisetech, Ausbrokers, ZIP, Life360, TUAS, Netwealth, Judo and Perenti.

Merger and acquisition activity gathered pace through the three months to December. Among notable transactions, Amcor merged with NYSE-listed Berry Global, Elders bid $475m for unlisted Delta Ag, Northern Star bid for DeGrey Mining and PEP announced a scheme of arrangement with SG Fleet. Regal Partners and Platinum Asset Mgt ceased takeover discussions.

The annual general meeting season ran through October-November with positive earnings surprises, more or less, offsetting negative ones. 80% of companies maintained guidance with analyst earnings adjustments skewing negatively, a move endorsed by our team who on average recast FY25 EBIT and EPS by low single digit %'s across the EGG mid cap50/small ords universe.

Technical Summary

Stocks

A years' worth of historic highs for the S&P500 and the unsurprising higher-high, higher-low configuration says it all, with strong upward momentum giving way to index consolidation in early December. The equal-weight S&P500 has not been quite so breathtaking but regardless, it can also lay claim to a remarkable performance for the year.

For me it is the S&P100 (OEX) chart with its textbook trend channel, that provides the best account of 2024. It should be noted that the OEX is currently trading through channel resistance and this is often an early indicator of lower price action ahead.

Source: Bloomberg

The one clear area of concern that has developed since the final days of November relates to the health of the US stock market *internals*. Specifically, advance-decline lines for the S&P500 as well as for mid and small cap benchmark's have begun to break down, suggestive of market exhaustion. Simply put, fewer stocks are leading the advance and more are declining or holding steady. This builds on the concerns I have expressed previously with poorly performing correlation indices finishing below where they began the year. Essentially, the same dominant 7-10 stocks maintain upside momentum whilst the balance trade with heightened volatility.

[1] Veblen good-a good where demand increases as the price increases, frequently associated with luxury goods and counter to the normal laws of demand.

The prognosis is a breadth problem among US stocks and *The Encyclical* had expected this to have at least started to correct itself by now. The other issue to consider is that in the midst of record fund and ETF inflows there simply aren't any US market bears left from those of the October 2023 lows. Not one it seems.

European equities have been hidebound since February 2024, with the STOXX600 facing resistance at 526.00 and enjoying support at 495.00. Time will tell whether this consolidation presages a move higher, or is in fact symptomatic of investor fatigue and confirms a looming downthrust.

Locally, the market has taken its cue from the US stockmarket rather than investor angst around delayed interest rate cuts. Record highs for the S&P/ASX All Ordinaries, ASX 100, 50 and 20 Indexes around year end. No joy for small and micro-cap indices though with their time coming with the unfolding market advance. It is pleasing to see the customized index SPAMSBAT (70% Mid cap/30% small cap), around which the EGG Mid Cap Fund is benchmarked, achieving all-time highs in early December.

Commodities/Currencies/Bonds

The US Dollar Index (DXY) popped nicely from a long-term support line originating in 2011, moving decisively from 100.0 to ~ 108.00 where it is trading at the time of writing. It was remiss of the author in my last report to not heed the time-honoured convention that sees the US dollar rally immediately after the first cut in rates irrespective of recessionary of non-recessionary backdrops. The upper bound of the bullish trend channel currently sits at 121.00 with 114.80 an important hurdle to overcome.

Gold put in a key reversal day on October 31 and when bound-up with a galloping US dollar it is easy to see why bullion has not had the easiest time of it. The last Encyclical captured affairs concisely:

'*New highs were almost a daily occurrence through the quarter but at the time of writing upside momentum appeared to be abating and US$2685/oz safe from fresh challenge. Gold equities appear fatigued and in need of consolidation'.*

The price of gold has slipped 5% whilst gold equities have corrected ~ 25%. Futures positioning is not what the bulls are looking for with open positions lengthening from 5.3:1 (long to short) at September end to 8.1:1 at end of December.

A ten month long rising wedge suggests investor torpor might reasonably result in lower prices for gold stocks.

Speculative positioning in silver has come in appreciably (from 4.3:1 to 2.3:1) and bears out trader frustration that the metal has not been able to kick clear of US$35.40/oz-US$37.40/oz, a price area set down in 2012 and problematic resistance as it now turns out. The silver price remains one of the most tantalizing in The Encyclical's compendium of charts. Positioning is constructive, fundamentals positive but price action remains equivocal. The metal remains one for the true-believers, medium term anyway.

Brent crude turned in a desultory performance in 2024, breaking down through a valid support emanating from the 2020 lows. Price has spent 4 months range trading between US$70.60/bbl and US$76.00/bbl, allowing a tussle to play out between stale longs and impatient shorts. The first days of January saw the unthinkable occur. A break of the upper bound occurred with a tentative move higher in price. A measured move here would equate to US$81/$82/bbl which neatly places the commodity back to October 2024 pricing from where last years correction commenced. Such a move would also constitute a break of a resistance line from the US$139.00/bbl highs. Crude is beginning to look constructive precisely at a time when market participants had given up all hope of a revival. It must be stressed it is early days here.

US 10 Year Notes continue to sell-off at pace, with traders either recasting the appropriate term premium or adjusting pricing in line with evolving inflationary expectations. Either way, the Encyclical has been anxious around price action for a while. Note the June quarter 2024 sentiments:

The notes feel 'sticky-downward' (in terms of yield) with the likely path of least resistance upward. The long-term chart is indisputably bearish for bond prices moving forward.

The long-term chart is chilling as are the natural levels of resistance as prescribed by Fibonacci theory. First key yield level (based on the 1981-2020 major trend move) is at 6.25%.

The Log

Charlie Munger's $2 Trillion Coca-Cola Target

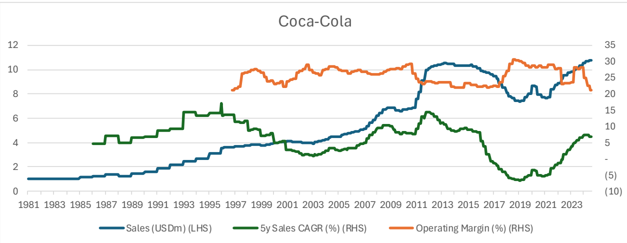
Back in the 90s, Charlie Munger was riding what would have been his best investment at the time, in the Coca-Cola Company (Coca-Cola). He had invested 10% of his net worth in the stock and it had grown to 50% of his net worth.

Charlie's 1996 speech titled "Practical Thought about Practical Thought", which examines what can be learned from Coca-Cola's journey, is a great example of what he described as inverting or approaching a problem from its opposite perspective. In that speech he pretended he was pitching the idea of Coca-Cola as a business in 1884. He used the exercise, with the benefit of hindsight, to highlight the power of combining elementary ideas across disciplines.

His speech also implied Coca-Cola would hit $2 trillion in market cap by 2034, which would have required an 8% increase in market cap per year from its 1996 market cap of USD 125 billion. Today, its market cap is USD 269 billion, having grown by only 2.7% annualised since then.

With less than 10 years left to play until 2034, it's safe to say that Munger's market cap target will fall short[2]. To understand why, we need to examine the forecasts behind the target.

Item	Forecast for 2034	Actual in 2025
Market cap	USD 2 trillion (PE of 17x)	USD 269 billion (PE of 23x)
Market cap growth (annualised)	8%	2.7%
Net profit per 8 ounce serving	USD 0.04	USD 0.0145*
Change in net profit due to inflation from 1884	40x rise (2.7% p.a.)	13x (1.9% p.a.). 36.8x for US CPI (2.6% p.a.)
Sales volume in 8-ounce servings	2.92 trillion	0.8 trillion**
Sales growth (annualised)	6%	3.1%
Net profit	USD 117 billion in earnings	USD 11.66 billion
# of beverage drinkers (equal to global population)	8 billion	8.2 billion
Daily water consumption per person	64 ounces (8x8 ounce serves)	Aligns with current averages
Beverage market share of ingested water worldwide	25%	20% to 25%
Market share of the beverage market	50%	>40% of CSD market. 13.8% of NARTD market.*



*Divide profit (USD 11.66 billion) by implied sales volume (0.8 trillion). **Divide 6.39 trillion ounces (188.9 litres) by 8 ounces to get an implied sales volume. See Coca-Cola's 2023 portfolio update. ***See beverage-digest.com/articles/topic/162 & gitnux.org/coca-cola-sales-statistics.

Source: Eley Griffiths Group, FactSet, "Damn Right" by Janet Lowe

Munger's net profit per serve of USD 0.04 was nearly triple today's USD 0.0145. Despite concerns over the bargaining power of bottler franchises, Coca-Cola's steady operating margins of 20% to 30% suggest that lower net profit was due to lower growth in sales price, not lower margins. Additionally, Munger's sales volume growth of 6% per year was nearly double the actual sales volume growth of 3.1% per year to present.

The overestimation of both sales price and sales volume means his 2034 earnings estimate of USD 117 billion was 10 times larger than actual 2024 earnings. Even with today's higher PE multiple of 23x compared to his implied 17x, Coca-Cola's market cap is well below Munger's target. To hit the target, market cap would need to grow by 22% per year for the next decade.

[2] It's comforting to know that even the greatest investors can get it wrong, and in fairness to Munger, the payout ratio has increased from 35% to 68%. If we add these extra dividends and all buybacks since 1996 to market cap, the adjusted market cap is USD 379 billion or USD 456 billion with annual reinvestment.

So why did Munger's sales price and sales volume forecasts diverge from what ultimately unfolded? First, beverage inflation was lower than Munger anticipated. Although US CPI since 1884 has gone up 38x (2.6% annualised) in line with Munger's estimate of 40x (2.7%), the price of a bottle of Coke has only increased 13x (1.9%)[3]. A staggering difference attributable to more health-conscious consumers and the rise of substitute beverage products.

Second, Munger was correct that the beverage market would account for around 25% of ingested water, but he did not anticipate the growth of other beverage products like juices, sports and energy drinks, and ready-to-drink teas and coffees. Indeed, Coca-Cola maintained half the share of the carbonated soft drink (CSD) market, but its share of the Non-alcoholic ready to drink (NARTD) market is estimated to be 13.8%.

Last, most of Coca-Cola's sales come from the US and Latin America. So, although the global population will exceed Munger's expected 8 billion beverage drinkers by 2034, the most populous countries like China and India continue to have strong local preferences for other drinks such as tea rather than Coke, meaning less sales volume growth.

What can we learn from Munger's exercise with the advantage of another 30 years of hindsight? One key takeaway is that we should be careful about inflation forecasts when it comes to a specific product category. It is critical that the price of a company's product or service keep pace with, or preferably exceed, broader consumer price inflation. Another insight is that while many investors focus heavily on the bargaining power of customers and their impact on margins, the threat of substitutes, and their impact on sales price, can be even more important. Finally, we can also conclude that country-specific factors like affordability and cultural preferences are extremely important when it comes to how successful a global rollout will be.

Outlook

Professional investors enter 2025 with more than the usual number of variables to brood over, not the least being the solid performance of US stocks in 2024, extended valuations and the acutely low cash weights among US asset managers.

Further, 2024 saw record ETF inflows of ~ US$1tn (~ 70% to equities) with 750 new ETF's being minted and brought to market, suggesting not many have missed this winning trade![4]

It is clear the *hot-hand fallacy* is very much alive and well in markets right now. It's become a 'given' that stocks will reclaim the December highs and that the pending Trump 2.0 agenda will extend the life of the so-called *US exceptionalism* and be an elixir for stocks.

Within the first 5 trading days of January, I received two missives from admired market commentators (H Marks, J Hussman) urging caution around the building market bubble in US stocks, joining similar sentiments offered up by seasoned strategist, David Rosenberg. These ran contrary to *Barron's* December 15/16 2024 (coincident with the S&P500 historic high) front page article 'Why Equities Could Have Another Big Year', imploring investors to embrace the expanding bubble.

[3] USD 0.05 per 12 ounces in 1887 (see foodtimeline.org) versus USD ~0.64 in 2025 (see amazon.com).
[4] FactSet, Monthly Insight, January 6 2025


BARRON'S

December 16, 2024

MARKETS | COVER

Stocks Could Gain Another 20% in 2025. Embrace the Bubble.

Wall Street's market forecasts are too tepid. The S&P 500 could rally next year on a combination of AI growth and deregulation. But investors should prepare for a wilder ride.

MAGAZINE

The Rally Shows No Sign of Stopping

Stocks could keep rising long after Santa is gone, powered by AI and deregulation. How to invest.

Source: www.hussmanfunds.com/comment/mc250107/

Either way, the fact that bubbles have entered the market vernacular talks to the likely late stage of the equity cycle. History does however suggest that when public commentators are onto them, then markets normally have more time to play out.

Market consensus S&P500 earnings growth for CY25e is 14.8% (versus a 10 year average of 8%) with revenues forecast to grow 5.8% (versus a 5.1% 10 year average) and operating margins of 13% (versus a 10.8% long term average)[5]. Healthy numbers and constructive for stocks if they can be delivered. Benign credit spreads should assist here, chiming in nicely with the traditional post-election year rally for subscribers to the US presidential cycle red-book!

Goldman Sachs expect a 25% uplift in US M&A in 2025, the energy space a prime target. Lower credit spreads, cost of debt, equity market buoyancy and significant private equity fund raisings over the past 3 years set the backdrop nicely. In recent weeks Japanese investment group, Softbank, announced plans to invest US$100bn over the next 4 years in the US.

Locally, the outlook for M&A remains positive, continuing the momentum of 2024. Stocks remain sticky-downward with earnings largely in-tact, interest rates set for a shallow and measured adjustment lower and the slowly unfurling Chinese stimulus programme to reinvigorate demand and investment, a clear positive for the Australian economy.

The primary trend for most developed stock markets, including Australia, is unambiguously a bullish one but investors will need to keep a weather-eye on the significant rise in the US real 10 year bond which is continuing to pressure the all-important equity risk premium, currently on the thin side at ~ 2.6% and at two-decade lows.

Ben Griffiths

Executive Chairman

[5] FactSet, Monthly Insight, December 2024