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By the Way

Monthly commentary from Jack Way

"Life comes at you fast"

"Life comes at you fast" is a popular expression these days and given the inconsistencies in expectations and thus in investor psychology this year, very appropriate for financial markets. The parsing of Federal Reserve speeches and conflicting economic releases amongst many other things, have led to sudden U-turns in market direction. Standing back and looking at the bigger picture, it is easier to recognize the more permanent differences that have occurred in just the last 12 months. Tony Pasquariello of Goldman Sachs writes an excellent letter and this week quoted himself from last November: "2021 has brought record inflows to global equity funds….record activity from the US retail investor….record U.S. IPO volumes….record U.S. M&A announcements…record highs in the stock market, the housing markets and crypto….long may it run". As we all know it didn't run much longer. The high water mark was the first trading day of January and most of those 2021 positives have become 2022 negatives. I suppose in hindsight we should have recognized that it was all too good to be true. A notable anomaly this year was the equally poor performance of the bond market. Goldman Sachs tells us that for only the second time in the past 60 plus years bonds did not offer a hiding place from an equity bear market. It is curious though that equity inflows have remained robust particularly in the high-tech sector despite the market decline. The QQQ ETF (tracks the NASDAQ 100) and Cathie Wood's Ark Invest (heavily weighted to tech stocks) both have continued to attract new money in 2022. Lately, corporate stock buy-backs have increased in size and are also providing demand for equities. While tracking inflows, valuations, and fundamentals are all useful in forecasting markets, at least for the foreseeable future the policy stance of the Federal Reserve Board is the elephant in the room.

The most recent Fed meeting supplied a prime example of how the market's interpretation of the Board's intent can cause rapid changes in investor behaviour. The merest suggestion that the Fed intended to ease the rate of increase in interest rates sent the market higher. Perhaps more meaningful, was how quickly Chairman Powell quashed such an outlook and drove stocks lower, proving he remains adamant about using tightening policies to control inflation even at the risk to markets and the economy. Nevertheless, the recent tone of Fed speakers implies the worst levels of monetary tightening are behind us, but there is a lot more to come. The Board continues to stress that its mission has not been accomplished, but I continue to worry that given the lag for policy to have an effect it may be too late when the Fed feels the goal has been met to save us from a deep recession.

The effects of tighter monetary policies and higher interest rates are already being felt. There are signs of weakening economic growth in the U.S.; initial jobless claims rose slightly last week; the Conference Board's Leading Economic Index is negative; housing is in decline; and consumer confidence is weak as energy and food costs are having an impact. On the other hand, there is some positive good news that the worst of inflation appears behind us as demand destruction and supply chain improvements (delivery times are down, as are vendor lead times and expected order backlogs) are bringing things more into balance. The Fed is correct that the inflation fight is far from over, but there are reasons to be more optimistic.

The recent U.S. mid-term elections did not provide a clear-cut win for either party and leave us with a split Congress, a Republican House of Representatives and a Democratic Senate. Given President Biden's low approval rating, high inflation, and the fact Republicans took the popular vote by 4%, it is somewhat of a surprise that more elections did not go the Republican way. There is an argument that the party was held back by unlikeable and too far right candidates promoted by Donald Trump. Even some of his former allies seem to be easing away from him, and now Florida Governor DeSantis looks the favourite to be the party's 2024 Presidential candidate. (Still a lot of water to go under the bridge before then.) At any rate a divided Congress almost certainly will lead to alot of name-calling and cat-fighting in 2023. Hard to believe it could get worse, but my guess is that it *will. The higher interest rates will impact the ability to pass legislation next year with the interest on government debt increasing and driving up budget deficits and the need for a higher debt ceiling. The Democrats will have trouble finding room to increase spending, and the Republicans to lower it.*

Despite my lack of expertise about crypto markets, the front-page news about FTX and others involved in that market force me to say something. Keep in mind I'm the guy who told my waiter to sell his Bitcoin 10 years ago. I haven't seen him since so hopefully he didn't listen and is living large in some tropical paradise. I remain skeptical of the area although I've been offside for most of the past decade. In addition to a seeming need for continuing new investors and investment dollars to support the value of the coins (which in my mind is by definition a Ponzi scheme) recent revelations are questioning the ethics of the principals involved and the transparency of their holdings. The calls for more regulation in the space leave me bewildered since the original premise was participants would avoid regulation and government interference. I'm still giving it a pass.

Howard Marks of Oaktree Capital recently wrote what he describes as a memo (it ran to 13 pages) downplaying the ability of humans to predict the future, and thus the futility of making investment decisions based on expectations for near-term events. He points out that while Warren Buffet may buy a stock to be a part owner of a company that will grow in value, most investors buy a stock merely to sell at a higher price. It seems to me such trading is not far removed from the speculation in the crypto market. Mr. Marks also reminded me of an old and useful adage; sometimes it is more important to concentrate on return of capital – not return on capital.

Given the difficulty in anticipating international geopolitical events and the risks of negative outlier outcomes in places such as the Ukraine, the Middle East and particularly China, a more conservative investment strategy appears warranted. Here is one more surprising statistic from Mr. Pasquariello's letter; since 1992 Chinese GDP is up 44x versus the U.S. 4x, but the S&P 500 has increased 16x versus Chinese A shares only 6x.

Wishing you happy holidays and a more profitable 2023.

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