thenavigator

Spring 2022

You better think (think)
Think about what you're trying to do to me
Think (think, think)
Let your mind go, let yourself be free

People walking around everyday
Playing games, taking scores
Trying to make other people lose their minds
Ah, be careful you don't lose yours, oh

You need me (need me)
And I need you (don't you know)
Without each other there ain't nothing
people can do, oh

Aretha Franklin – Think

NO TIME TO DIE

I was watching the latest installment of the James Bond franchise as a form of escapism from current events. Upon reflection, maybe it was a bad choice and perhaps my 13 year-old daughter is eminently more sensible by watching constant reruns of Friends. At some point the following thought dawned upon me: Are we living in a real-life James Bond movie? We have the psychopathic mass murderer seemingly intent on world domination. We have a deadly virus circulating along with the possibility of even deadlier viruses being released from biolabs, either intentionally or unintentionally. We have a hero underdog facing overwhelming odds and, of course, we have the possibility of the end of the world via thermonuclear war.

It is almost unbelievable how real life can resemble the movies, but I would sound a note of caution in this regard.

There is only one Hollywood!

Almost like a horror movie, just when we seem to get through one fright on the financial markets, another one comes along. Just when we thought Covid was over, the Russia/Ukraine conflict emerges, and now we are worried about slowing economic growth as well. However, if you watch enough horror movies they gradually become less and less frightening. The same applies to financial markets, which whipsawed during the eurozone crisis but then eventually became deadened to the headlines.

Of course in the old days life was much simpler. I remember as a kid watching westerns with my dad on a Sunday afternoon – the bad guys always wore black hats so you knew who to shoot at. With the advent of the smartphone and social media, the world is more sophisticated now. Who would have thought that Mohammed bin Salman, Maduro and the Iranian mullahs were actually good guys? Their disguises were so good.

THE PRICE IS RIGHT

Looking back historically at previous conflicts (history doesn't always repeat itself, but it has every single time so far in this respect), you would find it hard to believe that even with the tragedy that was Pearl Harbor, if you were invested before this devastating event you would have recovered all your losses in under a year. If, of course, you had invested or added to your investments at the scariest time, your returns would have been turbocharged.

Geopolitical Events And Stock Market Reactions

Market Shock Events	Event Date	S&P 500 Index One-Day	S&P 500 Index Total Drawdown	Calendar Days To Bottom	Calendar Days To Recovery
Iranian General Killed In Airstrike	1/3/2020	-0.7%	?	?	?
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.2%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		**-1.2%**	**-5.0%**	**22**	**47**

Source: LPL Research, S&P Dow Jones Indices, CFRA, 1 June 2020

Wars and conflicts are emotional events and often cause investors to shoot from the hip without taking the time to analyse in a detached way which, by the way, is completely understandable from a psychological perspective. Looking at the current Russia/Ukraine conflict, which is now only in week three, investors have as usual drawn a straight line in terms of conclusions as to what is going to happen by fleeing European stocks en masse, predicting a big growth slowdown and perhaps recession in Europe and downgrading expectations for European profit expectations due to increased supply constraints.

What if it actually proves to be a short conflict and we are closer to the end than the beginning? Or it is another forever war that becomes less heated over time and we just get used to it, like others before? There are enough supplies to see us through for a while yet and in the constant tug of war of the markets it is not implausible to believe that the more powerful force for economies and supply chains is the move towards some kind of post-Covid world.

Human psychology is a strange beast, with one prime example being the increase in spending by German consumers, whose animal spirits were stirred by Covid after decades of saving.[1] While there is probably little doubt that in the very short term consumers may be cautious, the question to ask is whether, once we get through to the other side of this crisis, people are likely to be cautious or carefree in their spending habits.

At the end of the day, Ukraine and Russia share a border and are neighbours and therefore the current tensions will only be resolved through dialogue and compromise.

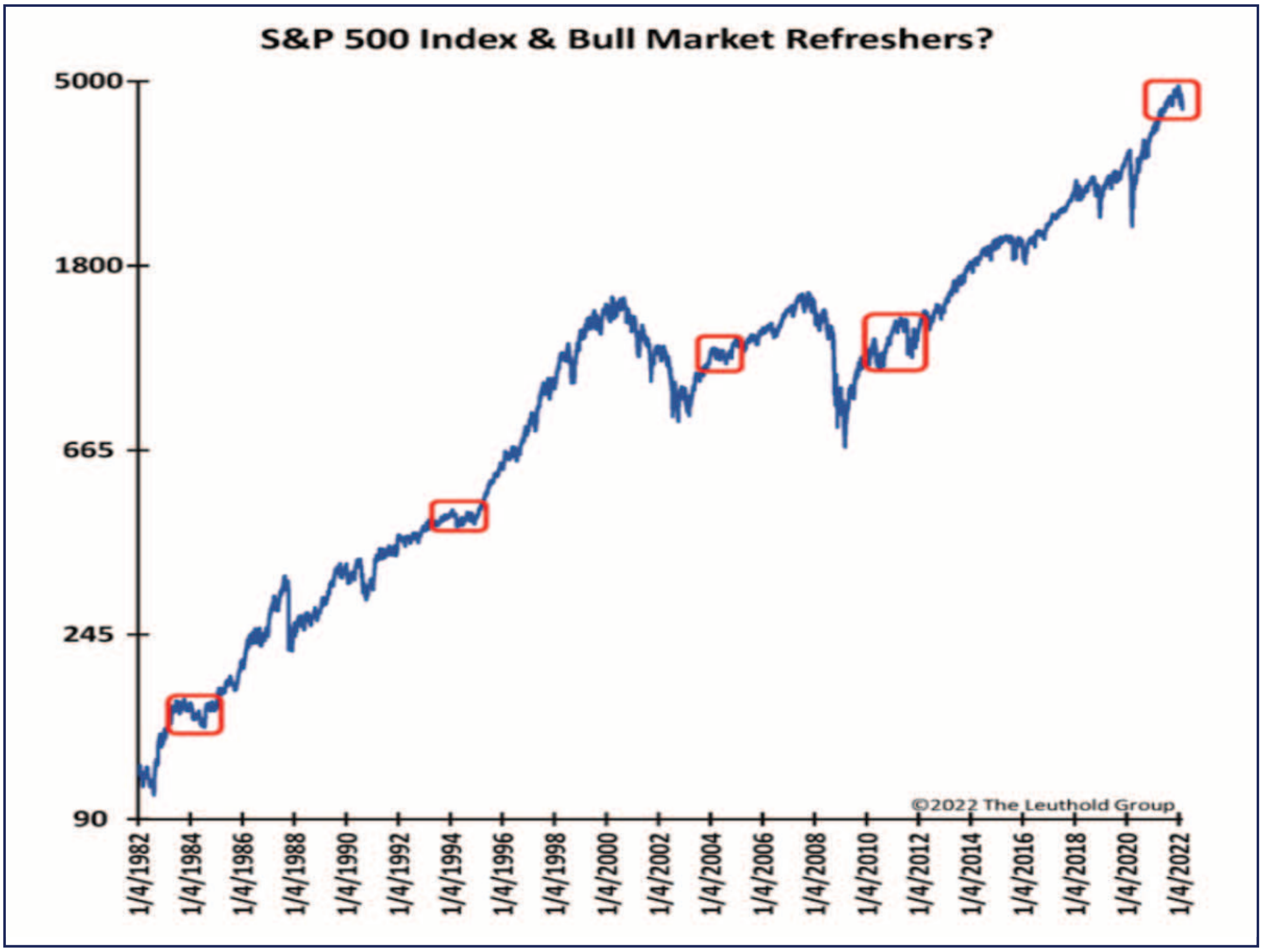
One of the questions we should always ask ourselves as investors is what is priced in to current market levels or stocks?

I am not sure I have seen such a negative confluence of events being discussed in over 35 years!

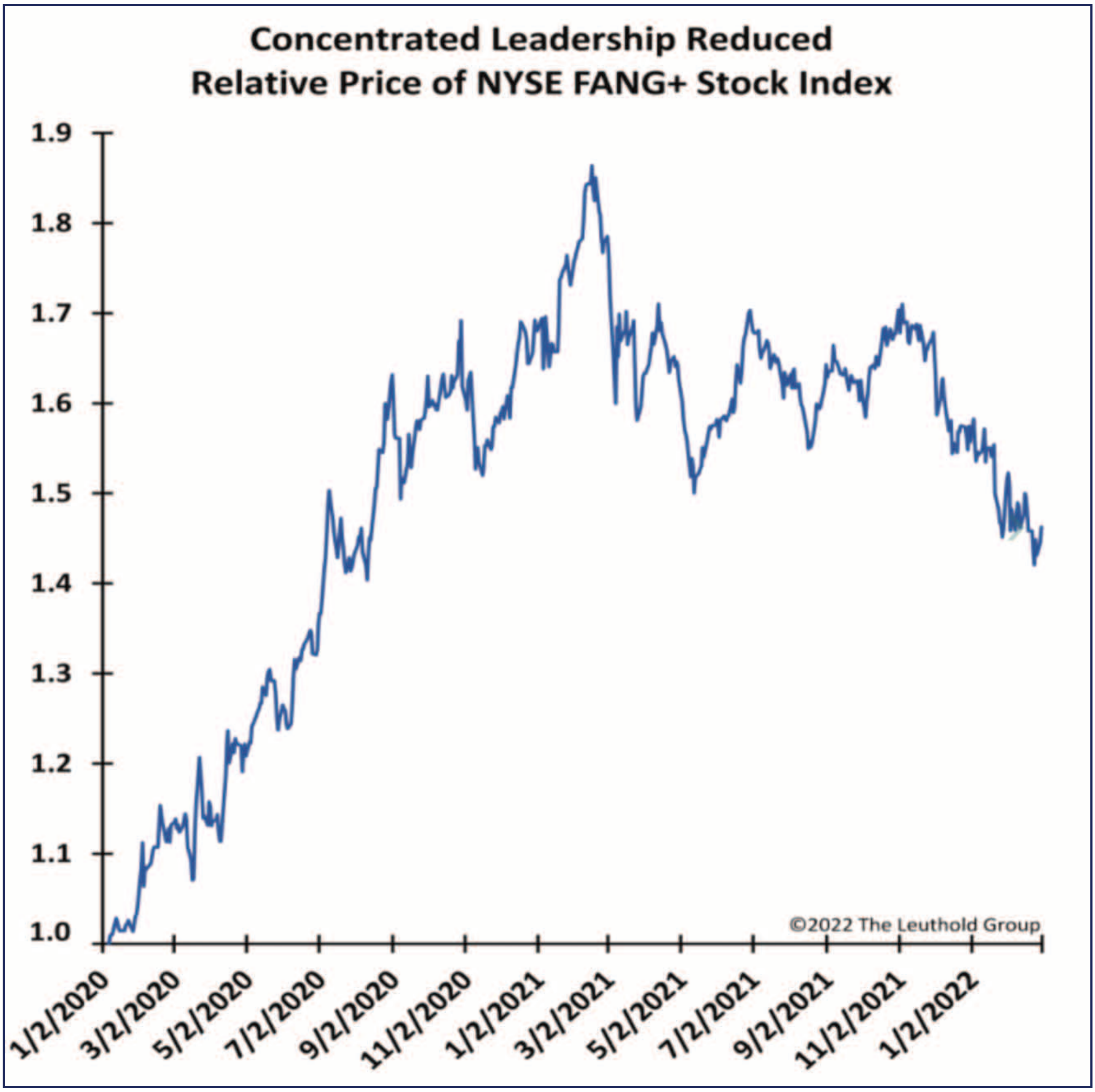
- Certain markets/stocks are very richly valued by historical standards.

- Tightening financial conditions, both in terms of balance sheet reduction by central banks and also via higher interest rates
- Concerns over slowing economic growth and subsequently slower corporate profit growth
- Stubbornly high inflation, especially in the commodity complex
- Worries over wage price inflation spiralling
- Worries over stagflation in some kind of rerun of the 1970s
- Broken supply chains
- Fears over the re-emergence of a new Covid variant
- A long drawn-out Russia/Ukraine conflict spilling out into a wider area
- World War 3

Reading this list might make you feel rather depressed, and I'm sorry about this. But from my perspective it makes me feel rather upbeat. Most investors and markets are already aware of these risks and many of them will already be priced into certain stocks and areas. It seems highly unlikely that all of these negative catalysts are actually going to occur, and if they don't there will have to be significant upward repricing. While US markets are not at very cheap levels, a good amount of froth has been worked off since the beginning of the year and the overall market makeup is looking somewhat better (although there is still likely to be more multiple compression ahead in richly valued stocks).



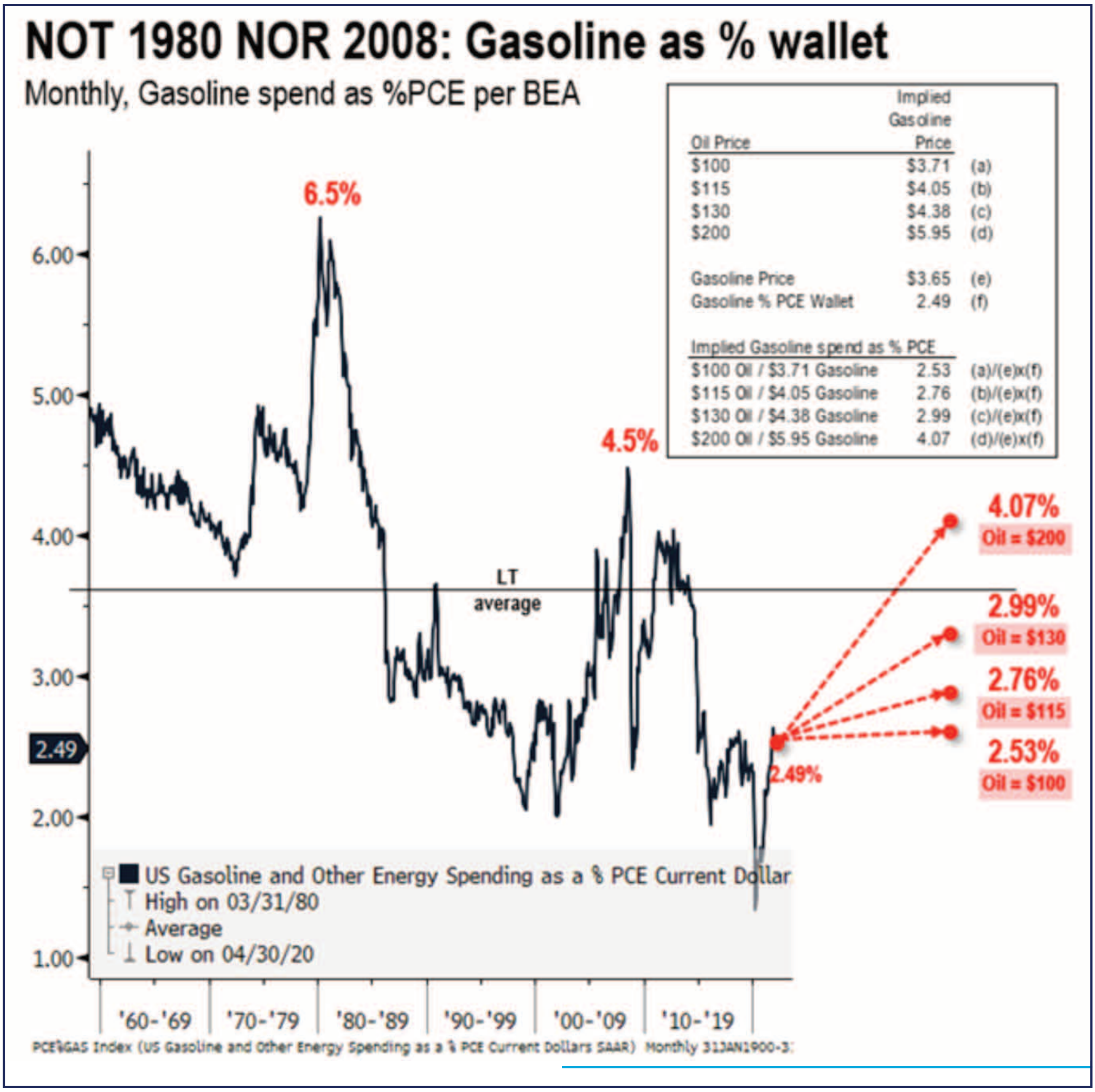
Source: The Leuthold Group Research 2022; drawdowns in S&P 500 bull markets that refreshed the market and resulted in it going higher afterwards



Source: The Leuthold Group Research 2022

US interest rates in particular are likely to go up higher than I originally anticipated, perhaps eventually reaching a normalised level of 3%, but this is for the positive reasons of consumer demand far exceeding supply, which will eventually increase as we move to a post-pandemic world.

While commodity prices have been grabbing the headlines, oil has now fallen back from its Ukraine invasion price levels, and reading too much into oil price movements is unlikely to tell you much. Just remember that during the Asian crisis oil dropped to USD 9 and strategists told us at the time it would never get back to double digits. The very same strategists told us when oil got to USD 120 it was going to USD 200 and then higher as the world had reached peak oil. Perhaps the only key take-away is that when the oil price is low global economic growth is weak, and exactly the inverse when the oil price is high. The overall oil price for consumers is much less of a concern now than it was in the past.



Source: Fundstrat, Bloomberg Finance L.P. 2022

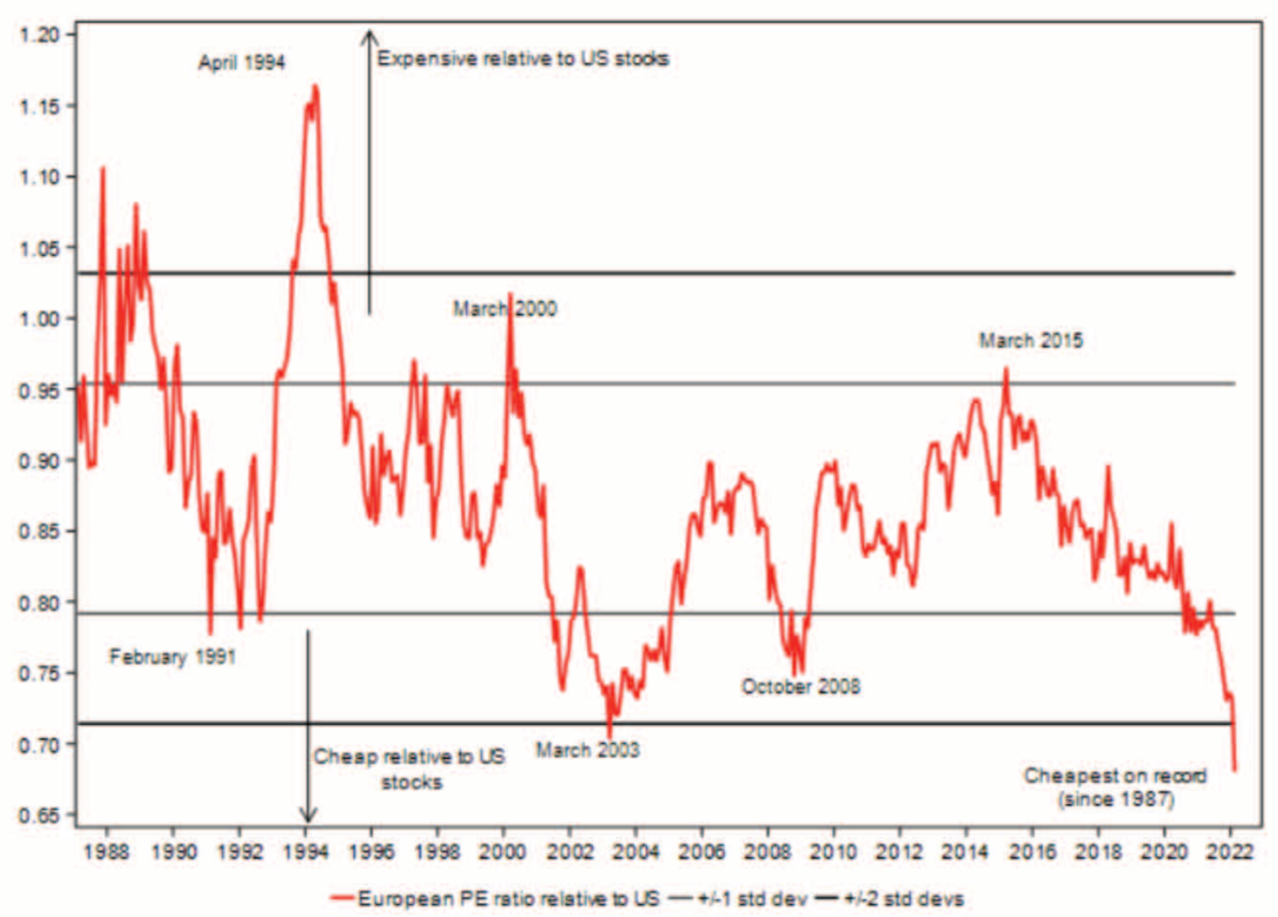
Of course there is inflation in other commodity complexes such as wheat, which is particularly affected by the Russia/Ukraine conflict, but a lot of these price increases may be temporary due to speculation given that the Russian army has not destroyed the Ukrainian agricultural belt. The same case could also be made for nickel and palladium, for which Russia is a major global supplier and is still supplying as normal given these two particular areas are not subject to sanctions.

Perhaps the major influencers of inflation will be time and mathematics. While we have seen a surge in prices right across the board, including wages, I find it very hard to believe that these high-velocity increases will be maintained at the same pace going forward, especially as we reach a more normal supply chain situation as the global economy gets back to some kind of normality. Don't get me wrong: we are not going back to central bank inflation targets of 2% any time soon and are more likely to see inflation settle around the 4–5% level, but conversely, we are unlikely to go back to the tepid economic growth rates of the last decade.

My guess – and it can only be a guess – is that the easy money has been made from passive investing in indices (beta) over the last 12 years and investors will have to gird themselves for higher volatility (from 1926–1945 volatility averaged 37% a year, while returns averaged only around 7% per year).[2]

Alpha-selecting individual stocks irrespective of the value or growth investment style is likely to be the key driver of portfolio performance going forward for the years ahead. This will require lots of hard work, research, understanding the businesses you invest in and pushing against the consensus, but the rewards could be significant.

Fig 9i: European (STOXX 600) PE ratio relative to US (S&P 500)



Source: Longview Economics, Macrobond

This is our daily bread and butter and explains why we do not believe you will be disappointed with your investment performance this year.
Within portfolios we have taken advantage of the volatility and found compelling new investments. We also reduced the gold position by approximately one-third at around the USD 2,000 level as the profit made was just too compelling to ignore.
We will continue to invest in a rational and unemotional manner and, as always, invest in businesses that we believe we understand and have high conviction in.

I would like to leave you with two thoughts:
• The pen is mightier than the sword.
• We learn more from listening than shouting.

The Navigator
has been written by:
Peter Ahluwalia
Chief Investment Officer

[1] https://www.reuters.com/world/europe/german-consumer-morale-brightens-heading-into-october-gfk-2021-09-28/
[2] https://smeadcap.com/missives/tombstone-of-high-returns-is-high-volatility/

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