thenavigator

Summer 2022

THE ANSWER, MY FRIEND, IS BLOWIN' IN THE WIND
Bob Dylan

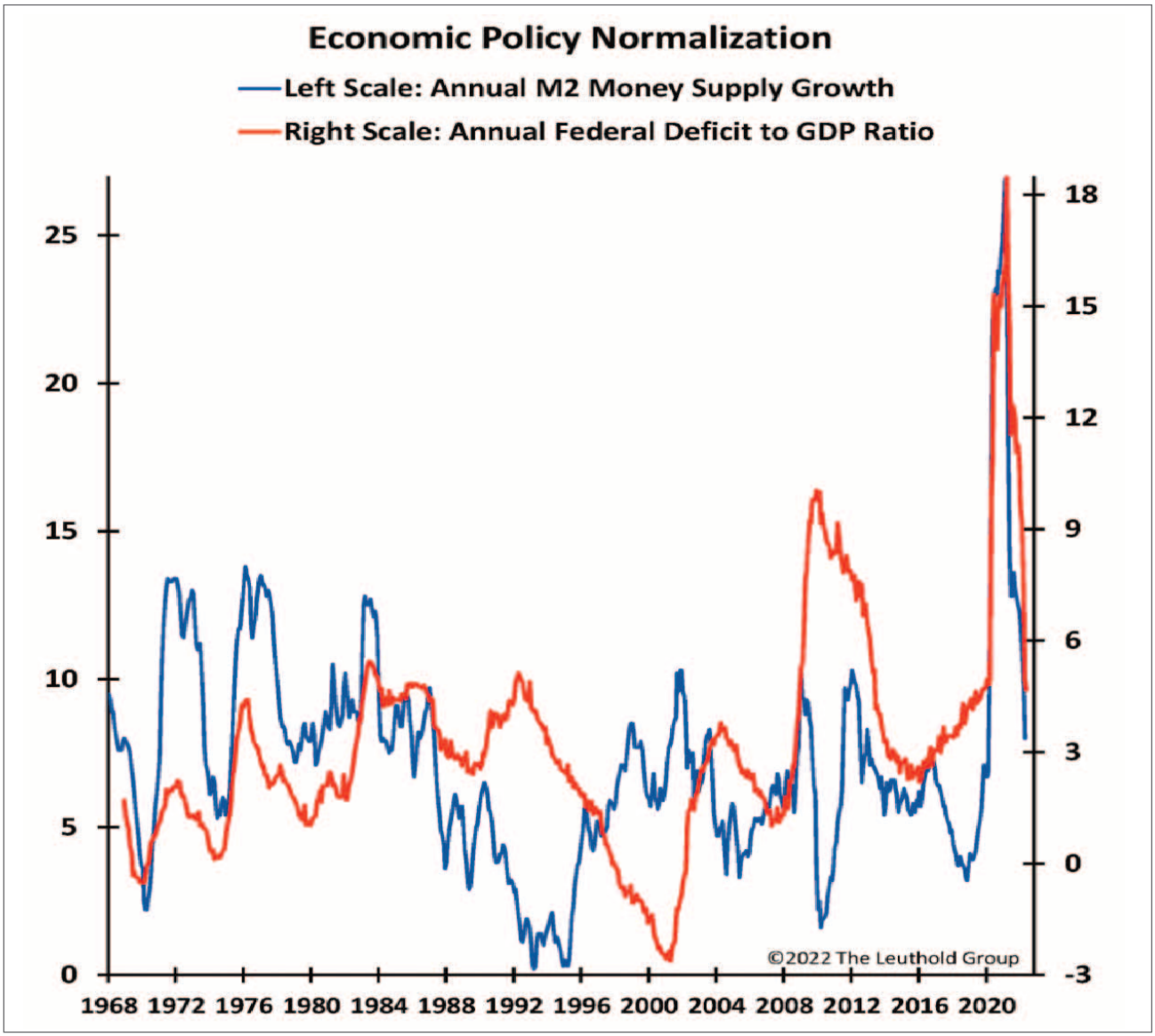
Although the widely expected excitement finally did arrive on the markets, it was not the kind most investors call fun. The end of the "everything up" period for markets had to come to an end eventually. Of course, not every crypto investor was going to become a billionaire or millionaire – although some did (at least briefly). The relentless grind higher in certain stocks regardless of valuation and the incessant rise in house prices was also unsustainable. Of course, it was also pretty obvious that bond yields could not decline forever after doing so for decades.
With so many cross-currents in the global economy at the moment, calling the outlook murky would be an understatement.
Meanwhile, like lovesick teenagers investors are still pledging their allegiance to – and making bets on – either inflation or recession.

Perhaps a better use of time is to focus on certainties and productive courses of action given how bad the industry (including central banks) is at forecasting.

Every bear market is followed by a bull market – without exception. No one knows the duration of each bear market, but we can make an educated guess. In my opinion, this one is unlikely to be as short as the Covid-induced downturn because governments and central banks cannot shower economies with free money like last time given that this intervention is the major reason for the inflation we are seeing at the moment. It is, however, a central bank-induced recession/slowdown. This means that when the monetary guardians judge the timing to be right they can back off – don't get me wrong, I'm not talking about rate cuts, as this would perhaps confirm they are no better at steering economies than drunken sailors (no offence intended to drunks or sailors). They could, however, pause their tightening cycle earlier than many predict given that money supply growth has slowed dramatically, there is evidence of economies already slowing and inflation seems to be peaking (at least in the short term), as indicated by commodity prices, house prices, asset prices, second-hand car prices and second-hand watch prices. I find it hard to believe that any central bank would knowingly cause a deep recession.
The important takeaway is that because the Fed especially was too late in raising rates, it had to amplify its rhetoric as US interest rates were too far behind the yield curves in the US bond market. As the Fed funds rate catches up with these levels, I expect the Fed to become more relaxed and data-dependent. The only instance in which I believe the Fed would act earlier would be if there were a sharp rise in the jobless rate or if inflation dropped quickly to or below the central bank's 2% target level – neither of which I expect to occur.

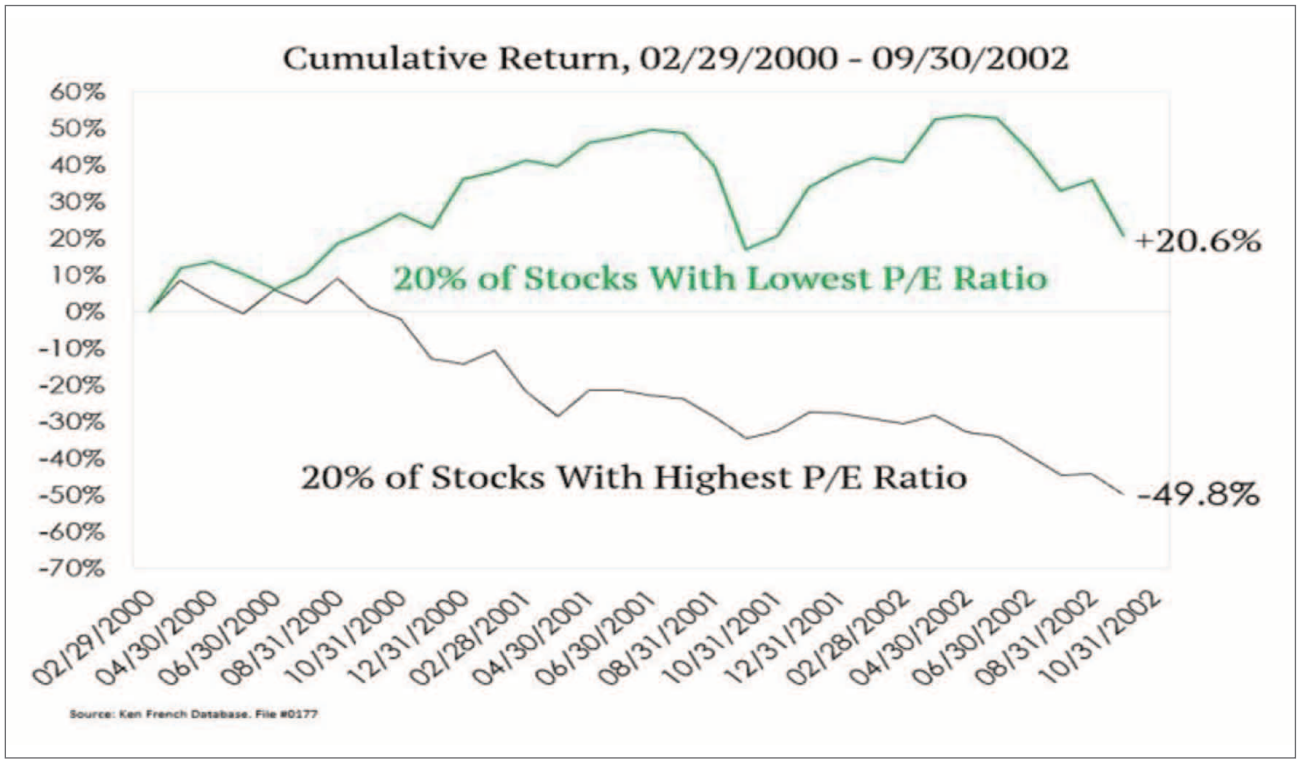
We should not expect central banks to bail out investors when markets drop – their mission objectives have changed.

Source: Bloomberg Opinion, Subdial



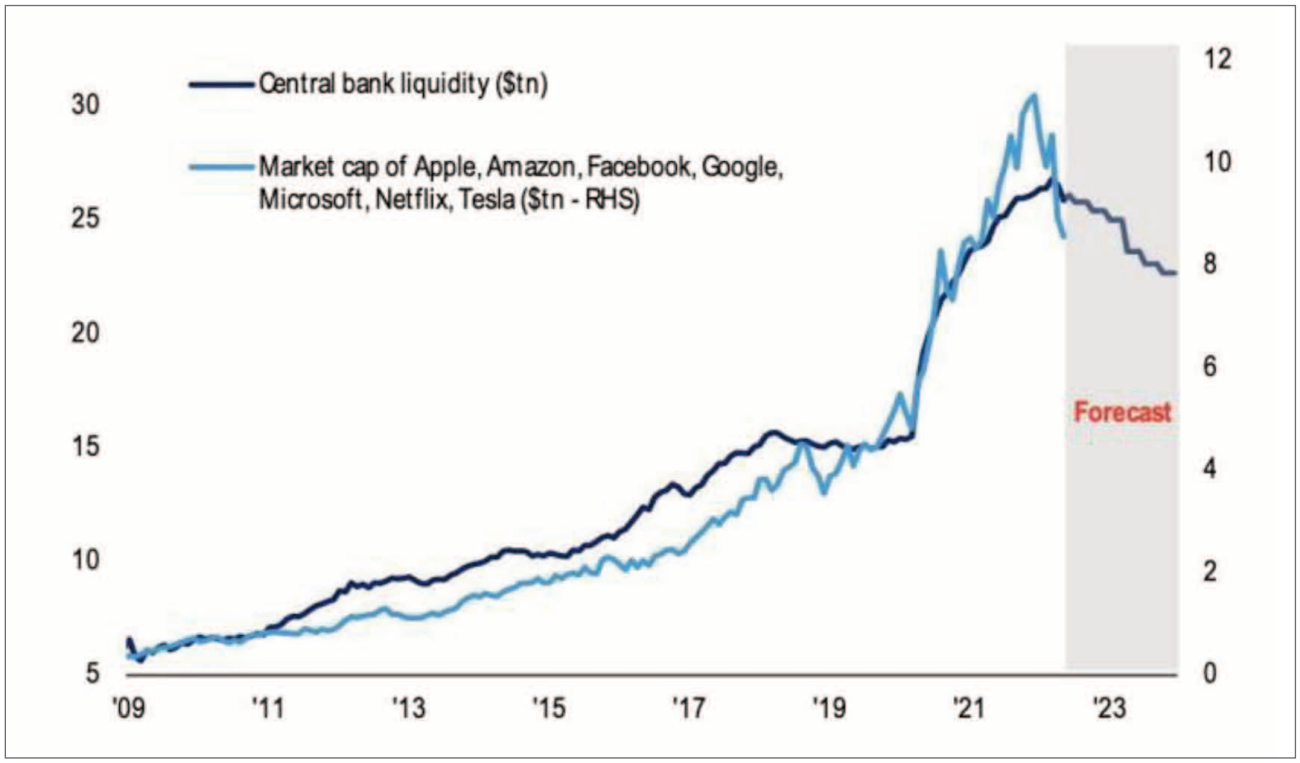
Source: The Leuthold Group 2022

Every new bull market has – without exception – always had new sector leadership throughout history, from the Nifty Fifty in the 1960s to the Nasdaq darlings of the 1990s. Avoid the most popular stocks of the last decade as the odds are heavily stacked against you making money.
It never is different this time!



Source: Ken French database, file #0177

Of course, it is human nature and a consistently recurring theme that investors fall in love with stocks and sectors that have made them money in the past, but my guess is that these are countertrend rallies and bear market traps. Although I expect inflation to moderate (but still stay high relative to recent history), interest rates are unlikely to come down as well. But perhaps more importantly for some of the most loved sectors, even after interest rates have peaked I expect central banks to continue with quantitative tightening.



Source: BOA, Bloomberg, central bank liquidity and market cap of tech 2009-2023.

Every recession is, categorically, always followed by a recovery. The quicker we have the recession everyone is worried about, the quicker we can get on with the recovery. My guess is that given the negative first-quarter US GDP print, forthcoming data will show that the US economy entered a technical recession in the second quarter of this year. I expect this recession to be shallow and short-lived, meaning that later on in the year we can focus on the positives of an economic recovery. Perversely, markets overall will probably see this as good news given that it entails the removal of at least one uncertainty.

WHAT TO DO?

A bear market is actually an opportunity for a well-prepared investor, as they don`t come along too often (historically, markets have been in bull cycles more than in bear ones).

While no-one can consistently predict the duration or magnitude of bear markets, by drilling down to the company level a good investment manager should be able to pick up some pretty good bargains for the not too distant future. No, I am not saying they should pick up high-flying stocks because they have fallen in price, as this just means they are less expensive. Rather, what I am talking about is paying attention to fundamental financial metrics and understanding the business you are investing in down to the nitty-gritty.

A bear market eventually brings all stocks down, even unpopular and cheap ones. By looking at the individual businesses it is possible to judge whether investors' perception of the company has just changed in the very short term, whether much has really changed at the business level and if you are getting a bargain compared to the company's past prices and those of its competitors. Investors' perceptions and whims change at warp speed.

It is highly unlikely you will get the bottom price for most stocks, and you have to be prepared to take some short-term pain. But the rewards the other side will be significant when sentiment changes. Sometimes (quite often, actually) the only reason stocks fall is because people are selling, which convinces others to sell. Essentially, you need to invest like a psychopath. No, I am not talking about being morally depraved, but rather acting unemotionally and callously in the sense of having a disregard for what others (the herd) may think.

"To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward."
Sir John Templeton

MY BEST GUESS

Most of the declines (or at least 75%) in equity indices have already occurred. Moderating inflation, less hawkish central banks and consumers who are still in relatively good shape (albeit scared) will result in losses at the index levels being narrowed as economic growth stays resilient and actually picks up.
Housing on a global basis is likely to continue to face challenges especially outside of the USA, where prices have not adjusted yet. The combination of higher rates and overvaluation will probably lead to a 20% or so correction, but not a 2008 scenario as homeowners are less leveraged and have more positive equity.

2023 will be the year we enter a new bull market (that is to say we will make up all the losses and make some positive gains as well). Investors are likely to be sceptical and wary, so it might take some time for things to heat up as stock markets are the only markets where consumers like to pay higher prices.

2023 is also an odd-numbered year – haven't you noticed the recent trend? 2017: great; 2018: challenging; 2019: great; 2020: challenging; 2021: great; 2022 – well, you already know.

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