thenavigator

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SO FAR SO GOOD!

This could be the one-liner summary of market performance so far for 2023, but there is also the joke that this is what the optimist said as he fell from the top of the Empire state building, passing each floor on the way down.

As we mentioned in our last publication, we felt that investors had become way too negative in the short term. Perhaps this could explain the very powerful rebound we have seen in financial markets this year. However, with many hedge funds buying certain stocks just because they have gone up (momentum strategies), we have to ask the question as to whether things have gone too far?

Inflation - Interest rates

Faites vos Jeux. Rien Ne Va Plus

This is the expression used before they spin the roulette wheel at casinos. Investors are still obsessed with gambling on interest rates and inflation, yet for anyone who has ever visited a casino more than once you will realise that the deck is heavily stacked against you and no hot winning streak lasts forever.

The continued speculation surrounding these two narratives is very likely to result in significantly increased market volatility,with investors moving from bouts of euphoria to depression many times over.

WHAT IF?

Sometimes in life it is fun and useful to question the consensus and just ask: “What if?”

What if the only people who care about interest rates and inflation are the participants in financial markets and not consumers in the real economy?

While we all know that there has been a marked increase in food prices, for example, it is fair to ask whether, at the consumer level, even if the price of a loaf of bread has gone up 10% this will stop you having toast each morning. From the perspective of an external observer of consumer behaviour globally, it is very hard to see any significant evidence of a slowdown. If you have a growing family and your house is too small, would an extra 1% on rates deter you from moving? If your car is on its last legs do higher rates deter you from buying a new car on lease(or perhaps you just extend the lease duration)? The point I am trying to make here is that many economic needs are somewhat interest rate-insensitive.

What if the last decade or so of low interest rates and inflation was the anomaly in the longer-term view of economic cycles and we are now returning to a more normal period of sustained higher inflation and higher interest rates?

Looking at Japan as an example of a country that has gone through decades of low interest rates, one might conclude that this has been a completely failed experiment that has been unable to produce decent economic growth. Would permanently higher interest rates be such a bad thing? It would mean, for example, that companies wanting to engage in M&A would really need to be sure that any potential acquisition would be worthwhile.

It might also mean that savers, who have had a particularly lean time over the last 13 years or so, would finally get some positive return on their deposits and may even have a shot at making a positive real return should inflation moderate. Those about to retire would also have the benefit of having a larger annuity.

While it is always scary to move from a comfort zone of what we know (negative or very low interest rates), perhaps this new era may actually be beneficial and not as scary as at first blush. Acceptance and adaptation to this new environment are likely to lead to some wild swings in financial markets as investors adapt.

What if the last three decades of deflation have run their course and there has been a seismic change in global economies where the previous powerful deflationary forces are no longer present?

An argument could perhaps be made for this outcome due to the inflationary forces of higher wages, the greenification of economies, onshoring, geopolitical tensions which lead to more expensive supply chains and the maturation of the Chinese economy, which in the past was exporting deflation globally.

What if we are moving towards an era where the average worker has more pricing power due to labour shortages and will have more financial firepower at the end of each month?

While this will dent the profit margins of some companies, it could also lead to a more virtuous circle of economic growth given that the average worker is more likely to spend more of their income than the average billionaire, for example.

What if recessions are avoided and economic growth picks up?

We cannot rule out interest rates staying at higher levels for significantly longer than many anticipate; but does this even matter if economic growth is strong? We have witnessed environments like this in the past and they didn't always end in disaster.

What if we have reached the peak in passive investing and economies do well but markets (especially the US because of its unique make-up) don`t do a lot except exhibit volatility? Investors are most likely going to have to go back to the classroom and learn how to analyse company balance sheets and fundamental data and work a lot harder to generate returns.

What if the last 15 years or so of US stock market outperformance and dominance has finally come to an end? While this may sound unbelievable to many investors given the recent history in financial markets, one of the most important lessons that could be learned is that nothing is forever.

What if central bankers, after years of fighting deflation and getting more than they bargained for, finally realise that their arbitrary 2% inflation targets are no longer appropriate and instead adopt a more tolerant approach to a permanently higher level of inflation, realising that it is not such a bad thing?

What if the real stock market gurus are not those on financial TV but rather the fashion industry, which brought back the Y2K fashion trend a while ago?

What if the central bank put that has been in place for decades is no longer there and central bankers won`t cut interest rates even if markets fall? Wouldn`t this perhaps actually be a healthy development and force investors to make carefully judged risk/reward calculations before investing, maybe even leading to less market volatility?

The strong start to the year for financial markets has caught most investors by surprise but can perhaps be explained by the fact that investors were just too pessimistic at the end of last year.

My intuition (and it can be no more than that) tells me that we have seen a seismic shift in the global economy and markets that has not been witnessed for over 30 years.

While returning to normal would be considered boring, the repercussions for financial markets are likely to be anything but. Significant change can be scary, but as Charles Darwin said: “It is not the strongest or most intelligent of the species that survives but the one that is most adaptable to change.”

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