August 29, 2022

Fall 2022 Update

Our long-term outlook continues to be cautiously positive. It does feel that we are in the minority with our thinking these days, but there are more signs showing up that make us feel more comfortable with our view. We started this year focused on four themes poised to upset the rosy outlook felt by economic participants in the second part of 2021. These themes are still playing out, so let's check on where we stand with each one of them.

The Fed and the Economy

Most of the recent volatility in the asset and currency prices is due to the current policies of the central banks. We are getting into the period where our fear of growing inflation is replaced with our worry about lower earnings. Regardless of the political back-and-forth, we still believe that this significant inflation spike is part transitory and part permanent. Both parts are global and significant. The ratio of the two is different for different regions around the world. The transitory part for the US economy is easing and we now see some signals of inflation coming down from its early summer peak. This does not mean that the Fed will stop its tightening policy (If you remember in the 70's when the fed stopped tightening too early only to cause inflation to return with vengeance). If anything, strong labor numbers and continued consumer strength are allowing the Fed to increase rates and reduce the balance sheet further while still trying to avoid a deep recession. In a way, any good news on the economy could spell out more bad news on the rates.

The permanent part of inflation comes from the wage and spending (government) increases, as well as from growth of commodity prices resulting from both deglobalization pressure and the cost of transition to sustainable energy/materials. Only continued globalization and technological development could bring this inflation down. I am afraid that globalization has already shifted to strategic regionalization and that a significant technological development (i.e. internet) is not here yet. AI and Robotics are good candidates, but we must wait and see.

Increasing interest rates have already brought the housing market to a halt. Autos and consumer goods are next with revolving credit rates climbing fast. We are closely watching earnings numbers of US companies because if they soften at the same time as interest rates are moving up, valuations of stocks will likely be adjusted down further.

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In our view, we are already in a recession. The US GDP was negative for two consecutive quarters. Even though a recession gets proclaimed by economists based on multiple factors, negative growth is the primary factor for this determination. If we can imagine a "soft landing", so wished for by the Fed, it would be a period of lower growth, drop in prices, but stable employment and decent spending at the same time. However, something usually must give, so we are facing two possible scenarios with the first one being stagflation (a period of higher inflation and lower growth), and the second one being a recession started with drop in growth followed by a decrease in spending, rise in unemployment, and credit defaults. The Fed moves over this historic three-year period were resolute (even if a little behind at times) and we should not doubt their intentions going forward. Increasing interest rates until a "neutral" rate and reducing liquidity is their job at this moment, though they could become more dovish as the jobs market gets softer.

As expected, the rate increase affected the growth stocks the most (discounting long-term future earnings by higher rate is the reason for this). Opportunities are opening now for long-term investors to find positions in quality themes and stocks that can grow their earnings with a recovery.

Geo-politics

Energy (all commodities) inflation and energy as a factor in the global super-cycle… Post globalization, strategic regionalization and alliances, supply chain rationalization, security and defense, strategic technology trade control, space race, debt and foreign investment diplomacy, trade/defense alliance systems vs. colonial style systems and the trade between them, refocusing of the West and decline of populism, climate change and its effects… All this floats in my head as I think of the world today.

The 2008 Financial Crises started major changes in geo-politics. The Corona Crisis provided an opening to speed-up the process. Major state aggressive wars, hard to imagine since the end of the Cold War, are now our reality. We will not know the reason for Putin's decision to go for the whole Ukraine any time soon. However, we do know that the move went over the line that could be tolerated by the western democracies. Positives are in the ability of NATO to reconnect and respond, success in diplomacy of strengthening alliances and expanding the official commitments, and in a major policy turn in energy dependance on rival power. The negatives are the human and material costs, prolonged war with hard frontlines, faster turn away from globalization, and realization that economic sanctions are not enough (on their own) of deterrent of aggression.

Yes, sanctions on Russia are failing their expectations. Partially this is because Russia is becoming a gas station for Chinese and Indian ambitions, willing to accept any price offered by it's ego-inflated customers, and partially because deals are made and blind eyes turned in instances where some of the Russian oil, lightly refined, can be moved from tanker to tanker at sea, delivered to Saudi Arabia where it is mixed with other oil to change its recognizable contents and then still distributed to gas starved Europe. With the frequency of assassinations in Russia growing, its possible that the power becomes even more centralized before it eventually brakes in the future. The heroism of Ukrainian people clearly shows that people that had to fight for their democracy are willing to give the most to protect it. Let's hope that in the future, people of Eastern Europe, Middle East, Asia, and Africa look up to them as an inspiration.

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Effects of trade limitations due to technology protection we already feel in the market. Chips and other technology valuations are changing based on limitations on markets available to the producers. These effects must be taken into account in any future foreign investing, especially with China where everything seems to be in order with President Xi's coronation as the leader-for-life, later this year. His legacy moves will be fully revealed only after this event, but we can be pretty sure that those will bring further risk to the world balance and economic prosperity.

Valuations are pointing to opportunities in foreign markets that should be utilized. However, we believe that investors should be cautious both because of the above listed developments and due to actions of the central banks, which bring an added layer of currency risk.

Corona Crisis Recovery

As I am writing this update, FDC is announcing the approval of an updated vaccine that provides protection from multiple variances of the Corona virus, Goldman Sachs is doing away with Corona protocols, and our most concentrated urban area, NYC, is 90% vaccinated. After the initial mismanaged response, both previous and current administrations were able to rise to the task and allow for the states and private sector to find the balance and get us through this major crisis. The US consumer that cut the spending on goods, increased spending on services. We are out and about looking for the experiences we missed for two years.

Many other countries did not do as well. Chinese "zero covid" policy implemented over the last two years is still costing a large percentage of the country's and the world's GDP. Continued rise of populism successfully politicized the crisis and vaccination effort, but it does seam that we have turned a corner on that issue, at least in the West.

We feel that we no longer need to list Corona at the top of our risk themes. As the time is passing, we might see some waves of increased infection and, sadly, continued loss of life, but hopefully none of this will significantly hold back the economic activity.

Speculative Risks

As asset prices dropped through the course of this year, valuations of equities, bonds, alternatives, and crypto have substantially corrected. Only energy and commodities have moved in the positive direction. As we were expecting, the speculative, non-institutional investors got punished. The trade volume in speculative meme and Corona stocks decreased, and the purpose and validity of crypto is having a much-needed check-up.

Sitting here in the office, I have two apps open for hourly check-ups, the weather report for Labor Day weekend and the graphs of the S&P500, awaiting the technical support of 3900 level, or a further drop to our June lows. At those levels being retested, we feel that speculative risks have deflated without causing any major damage to the financial system.

With two of our risk themes still heavily affecting the economy and the markets, and the other two receding, we suggest a balanced and diversified approach to any portfolios.

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As always, please reach out with any questions or comments. It truly feels good seeing many of you in person and I am looking forward to our future meetings.

Yours,

Emir Culov

Partner, Senior PIM Portfolio Manager

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