By the Way

Monthly commentary from Jack Way

"Democracy is the worst form of government except for all the other forms."

It often pays to step back and try to see the big picture. I believe the present time offers an opportunity for such introspection. We have come to accept as gospel things that may well no longer be relevant or useful. I made a list (which is incomplete) of factors that were accepted as true only last year, but seem not to be anymore. As we fixate on analysis of GDP, CPI, P/E's etc., we can miss larger issues and global changes that should be impacting our decision making. If we are using wrong or outdated assumptions, we will more than likely come up with incorrect answers, or in fact ask the wrong questions. Here is a portion of my list which encompasses our attitudes as citizens and consumers, as well as investors:

1. The Fed is a friend to markets.
2. Deflation is baked in to the economy, due to factors such as demographics, technology and productivity, and as a result, any inflation will be transitory.
3. Large-cap tech stocks, particularly "FAANG" will continue to support higher stock markets.
4. Interest rates will remain low, and as such "TINA" (there is no alternative) will provide demand for stocks.
5. If you need to reach for better returns, high yield bonds are safe, private equity never goes down, nor do house prices. On the other hand, energy stocks never go up.
6. Corporate capital expenditures are dead as companies use debt issuance to increase dividends and stock buybacks.
7. New York City will become a ghost town as no one goes to the office and everyone moves to Florida.

Those are some of the items on my list, but there are also much larger, more sweeping changes at work globally that potentially will prove even more impactful:

1. Churchill famously said, "Democracy is the worst form of government except for all the other forms." He probably remains correct but modern democracies, in particular the Unites States, seem intent on proving him wrong.
2. We can no longer assume that countries and parties will exchange views, compromise, and agree to move forward.
3. The cold war is not over.
4. Climate change is still an extremely important issue, but supply shocks mostly from pandemic lockdowns and the war in Ukraine are forcing governments to revisit forms of energy production other than the obvious "green" providers.
5. We dodged a bullet when Macron won the French election, a Le Pen victory would have been very disruptive to Europe and in particular NATO. Nevertheless, populist candidates, such as her, present real concerns as they gain strength and support.

Things can change, but at this point it seems a given that by this time next year the Congressional agenda will be provided by Republicans, not Democrats. It's difficult to say what exactly that may mean as neither Republicans nor Democrats can agree on intraparty proposals let alone bi-partisan programs. Old-line conservatives and Trump adherents can't agree; and middle-of-the-road liberals are at odds with the more populist Bernie Sanders wing. With so many members of Congress losing the narrative, if not totally losing their minds, it is almost impossible to predict what legislation might become law. Given President Biden's poor approval rating, we can at least expect Republicans to be at the wheel in 2023. Even before the

November mid-term election, the primaries will give us a strong sense of how powerful Trump remains by seeing if his candidates can prevail. Looking at expectations for the 2024 presidential election is a useless exercise at this point in time, but one well known betting website has Trump with a 30% chance to win; Biden 23%; but most shocking to me Florida Governor DeSantis was also at 23%. (Spoiler alert; I'm not a fan.)

There is no doubt the Federal Reserve is all-in on fighting inflation both by raising interest rates and quantitative tightening (QT). QT involves reducing the Fed's balance sheet by selling the bonds acquired during the period of quantitative easing. The money the Fed accumulates from the sales will reduce the liquidity in the economy and hopefully put a brake on inflation. There are still two questions to be answered; how fast will the Fed move to implement these tightening policies, and will it be able to stem inflation without something breaking and causing a recession. This Board has done little to fill me with optimism. For those concerned about "stagflation ", one month doesn't make a trend but it's here. First quarter GDP declined by 1.4% while CPI came in at 8.5%. As I have mentioned before, wages are the "stickiest" part of inflation and hence can become the most entrenched. Current reports reveal payrolls and average hourly earnings are increasing, but not so much that we see it as endemic (yet). Supply and demand on the other hand can hopefully come back into balance and mitigate the current situation where supply is not able to keep up with demand and inflation is rampant. Supply shows signs of some improvement, but the war in Ukraine and the lockdown in China are not helping. Tamping down demand without putting the global economy into contraction is a much dicier proposition, although the war and lockdown are impacting demand as well.

The U.S. has proven to be the most resilient of the major global economies despite the recent report of a decline in first quarter GDP. As a consequence, the Fed is raising rates ahead of most other central banks, which as a consequence has attracted inflows into the U.S. and caused the U.S. dollar to strengthen against almost all other currencies. I'm not sure why but high levels of currency volatility such as we are currently experiencing is always disconcerting to me. Perhaps because it indicates a divergence in outlook for the different countries. At any rate the Euro and the Pound are much lower; the Japanese Yen is in total free fall due to government interest rate policy; and the Chinese Yuan has joined the decline. How it will sort out I don't know, but as a rule a lower currency will add to inflation and a higher currency will hurt a country's trade balance.

S&P 500 market action over the last 9 months has traced out a pattern between 4100 and 4700. It has been aggravating to those of us who use internal strength measures and sentiment indicators to gauge likely market movement. As quickly as signals indicated an oversold condition a rebound would occur and the market would quickly become overbought; only to be followed by another trip to being oversold. For those of us who profess at least a passing belief in the use of charts to anticipate future markets, a move outside of those levels would suggest a continuation of the direction in which the breakout occurs. Bottom line is; if we trade below 4100 a further 15% decline from there is likely, and above 4700 would call for a 10% improvement. As an aside, if you like to buy oversold markets with strong contrarian signals, the bond market has been crushed and is where you should be looking, even more so than the equity market.

My best guess is we will see stronger markets before an eventual resolution to the downside as Fed policies continue to negatively impact the economy. One of the cardinal rules of writing investment letters is you can forecast price or time, but never both. So I won't.

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