MULVIHILL

By the Way

Monthly commentary from Jack Way

May 2022

"abandon ship"

As a trader at Goldman Sachs put it, the last two months had the sensation of "abandon ship". He's not wrong. The first 100 days of this year ranks in the 5 worst in history, including years like 1932 and 1939 during the Great Depression. The good news is that the previous 4 all ended the year in the plus column. The severity of the decline is not all that surprising given the onslaught of negative news including inflation, Fed tightening policies, war in Ukraine, and supply disruptions particularly in food and fuel. While individually each was not sufficiently adverse to cause such an unfavourable market reaction, it did finally make investors sit up and take notice of the overvaluation and overexuberance present in markets. The old saying about throwing the baby out with the bathwater came to mind, as although the high-flyers suffered the most, all stocks were for sale. The result was a rapid and painful decline based in large part on a change in perception and psychology and letting air out of the valuation balloon. Then came the sudden recovery of last week, which raises the question, was that a bear market rally or the beginning of putting in at least a medium-term bottom? Historically, bear markets have featured lengthy declines interrupted by short violent upside moves much like we saw last week. On the other hand, the S&P 500 did hold the support level around 4100 that we mentioned in the last letter, and it's a long standing tradition that mid-term election years feature weak equity markets in the first half followed by a strong second half. I would not be surprised to see lower lows in the short term, but I support the idea we will see better prices going into the election, all else remaining equal (which never happens).

In that vein we can establish several things we know to be true today and then react to change as it comes at us. We can all agree central banks are removing liquidity; economies are slowing but not declining; ETF and mutual fund flows show demand for equities is waning; the U.S. economy and corporate earnings remain supportive despite the slowing rate of increase. The negatives are widely understood and are definitive headwinds to higher markets, but at least being well known they can't surprise us.

Inflation and the Federal Reserve's response to inflation remain the major issues impacting financial markets, in my opinion. Headline inflation has eased very slightly and easier comparisons with the higher releases of a year ago will make things at least appear better (May, 2021 - 5%; June, 2021 - 5.4%). At this point there is nothing to suggest the Fed will be dissuaded from its mission to fight inflation; however, I would be surprised if there is not some easing in policy or even a pause as the election nears. The Board is definitely supposed to be apolitical, but continuing to stand on the brakes and possibly crushing economic growth would be very political and destroy the Democratic Party's chances for re-election. We could see the Fed speed up the tightening process in order to have room to ease back in the fall. The Fed has increased money in circulation by 40% since the financial crisis of 2008, which explains a lot about our current inflation problem. It was fun while it lasted but reeling that money back in will be difficult, and in all likelihood unpleasant. Too much money chasing too few goods is a classic definition of inflation and it's where we find ourselves.

Beneath the headline numbers there's a lot to be analyzed. For one thing there is an interesting rotation going on as hard goods like lumber and used cars prices have turned flat to down, but service sectors such as hotels and other travel are seeing strong increases. More important is discerning which part of the whole is subject to variability and which part is "sticky" and difficult to reverse once embedded. Wages are considered the posterchild for "sticky" inflation. While there is lots of concern about the difficulty in filling job openings and the wage increases needed to attract new workers, we haven't reached a crisis level as yet. RBC cited a LinkedIn study that of workers who quit their job to take another position, 6.5% did not last a year in that new job. It's a record high. Grass is not always greener? Hopefully Goldman Sachs is correct that "labor stress is easing". Whatever the future holds, it is not possible for the rate of inflation to remain two to three times the level of Fed regulated interest rates; one has to come down or the other has to go up.

We continue to follow various Global Purchasing Manager's Indexes (PMI) in an attempt to anticipate economic growth. The U.S. flash composite for May was reported at 53.8 – down from 56.0 the month before; below expectations but still an indication of 2% GDP growth for the year. Despite the war and commodity price increases the Eurozone April report was 54.9 – down from 55.3 but still impressive. The U.K. on the other hand saw service PMI numbers drop from 58.9 to 51.8. (How's that Brexit going?) Finally, China, given the lockdowns, came in at 47.4 for April, below the 50 level thus indicating economic contraction. The U.S. number is reassuring, but no reason to relax with the Fed intent on slowing things down. Consumer confidence is depressed but consumer spending remains firm; still with government checks stopped, households may need to dip into savings and make more use of credit cards. An interesting if meaningless aside; U.S. federal tax revenues are rising so fast due to the rapid increase in incomes post-pandemic, and the end of fiscal stimulus, it could actually lead to a balanced budget.

While inflation is front and center, perhaps the potential for the most disparate outcomes lies in the geopolitical arena. The Russian attack on the Ukraine after the China/Russian alliance had proclaimed their friendship with "no limits" raises fear of what the two countries will attempt in order to bring about what they are calling a "new world order". While that doesn't necessarily imply anything immediately dangerous, it is certainly disturbing. Both China and the U.S. are travelling around the world courting relationships with countries large and small. Globalization has seemingly died, and regional alliances are the new answer. Recent questions about the U.S. commitment to international security isn't helping in this quest.

Internally the U.S. continues to struggle. The recent shootings in Texas and Buffalo, New York prove Congress is unable to compromise on anything. The ex-Speaker of the House, Paul Ryan, said there are too many "entertainers" in Congress, and I would add too few Statesmen. I admit to a bias, but if even one Republican Senator can't see a way clear to vote for something as simple as background checks, what more is there? Further on legislation, key votes may be upcoming in Congress on important bills; one to pass a "build better smaller" spending proposal, and another to regulate the high-tech industry. I was startled to read that southern border apprehensions which Democrats had promised to reduce are in fact up by 73% in the first four months versus last year. That could be another problem for that party come November. Be safe!

Disclosures

Mulvihill Capital Management Inc. is registered as (a) an adviser in the category of portfolio manager under the securities legislation of each of the Provinces of Canada, (b) a dealer in the category of exempt market dealer and an investment fund manager in the Provinces of Ontario, Québec and Newfoundland and Labrador and (c) a dealer in the category of mutual fund dealer in the Provinces of Alberta, British Columbia, Manitoba, Newfoundland and Labrador, Ontario, Prince Edward Island and Saskatchewan. Mulvihill's directors, officers and portfolio managers are registered with the various commissions.

The information contained herein is for general information purposes and should not be construed as an offer to purchase fund units or advice on the suitability of the fund for your specific investment needs. Important information regarding the Fund including it risks, costs/fees and tax treatment are set out in the fund's offering memorandum or simplified prospectus which should be reviewed with your financial advisor before investment.

Historical returns and their performance relative to the benchmark returns shown herein, may not be indicative of actual future fund returns. There can also be no assurance that actual performance will be in line with targeted performance set out herein. Any third party information provided here has been obtained from sources believed to be accurate, but cannot be guaranteed. Any opinions expressed in this document are based on current analysis of market events and circumstances as at the date of publication and are subject to change. Mulvihill Capital Management Inc. does not undertake to advise the reader of any such changes.