June 2022

By the Way

Monthly commentary from Jack Way

"Hey, there's nothing typical about this market."

While the overall market trend remains bearish; as is typically the case, there have been intermittent short, sharp countertrend rallies. The trick is to divine whether those rallies indicate a change in the major trend, or merely a respite before the decline continues. We look to measures of internal market strength to help in our analysis. It's a two-edged sword; on one hand has the weakness been severe enough that there are signs of investor panic and capitulation, such that there are few sellers left. Indicators might include high volume on the downside, high buying of puts for protection or a high level for the VIX (the CBOE Volatility Index). So far this year these and other measures have from time to time reached levels severe enough to demonstrate an oversold market and shareholder anxiety, but not enough to suggest fear has gotten to a place where it seems the worst is over. On the other hand, have the rallies been strong enough to convince us that they are more than just countertrend in character. We have had three such upturns so far this year, and the first two (March and late May) lacked conviction as volumes were light, the put/call ratio wasn't strong enough, and defensive stocks outperformed. As such it was relatively easy to discount their strength as likely short lived. The third, just last week, has shown somewhat more potential, but not sufficient yet to convince me it is more than another in a series of rally attempts. Longer term issues continue to be headwinds; the economy while not declining is softening; corporate earnings too; monetary and fiscal policy are no longer supportive; nor is TINA (There Is No Alternative, the idea that equities were the only place to profit when interest rates were so low.) I'll quote another Goldman trader; "Hey, there's nothing typical about this market."

The U.S. reported another inflation rate in excess of 8% last month disappointing the "peak inflation" advocates. I was part of that crowd and am still looking for some easing this month, but with no particular reason to back that up. Obviously, a peace settlement in Ukraine would help immensely, but there is no expectation for that outcome either. The Fed concentrates on longer term inflation expectations that may become embedded in consumers minds and make future inflation almost self-fulfilling. Therefore they appropriately focus on "core" inflation numbers as opposed to "headline", which is the more commonly reported rate. The core statistic excludes food and energy which are the most volatile and thus least useful for longer term evaluation. However, food and energy are top-of-mind to the average consumer and most likely to influence their buying habits. There is a theory going around (with which I have sympathy) that consumers, both household and corporate, have already changed their behaviour due to higher prices and supply shortages. Overbuying and overordering have pulled demand forward and could lead to easing in inflation as supply ramps up and demand drops. Amazon, Walmart and Target have all expressed a need to unload inventory providing evidence that there may be some truth to the theory. In addition company surveys are showing that order backlogs and delivery times are rolling over, another sign of price pressures possibly being alleviated. Anything that brings supply and demand more into balance is to be devotedly wished. It is encouraging that the recent University of Michigan survey of 5–10-year inflation expectations declined from 3.3% to 3.1%. That doesn't sound like much, but it is the kind of thing the Fed takes to heart in deciding how draconian its policies need to be.

Speaking of the Fed it is only 12 months since the June 2021 Fed meeting when it first mentioned a concern about inflation, but only as an aside since supporting economic growth was still by far the most important mandate. Bond market levels at that time were indicating that the first increase in Fed rates wouldn't happen until May of 2023 and would only rise to a high of 2%. Today, we've already had a .75% increase with consensus expecting more of the same and the predicted high is closing in on 4%. It is well to remember that policy acts with a delay, and it concerns me that Fed members often say that they will react to reported numbers. We risk being in the middle of a recession before the Board sees such numbers and takes it's foot off the brakes too late. Jason Trennert of Strategas reminded me of an old saying; "There are two kinds of economists - ones who don't know and ones who don't know they don't know." I don't know which describes Chairman Powell and his team (neither I hope), but either way they're driving the bus right now.

Global Purchasing Manager's Indexs continue to describe most global economies as growing more slowly but not contracting (locked down China is an exception). In the face of war, sanctions, and supply problems that's as much as we should expect. U.S. Industrial Production remains relatively strong, and optimists are counting on a continuing robust labour market and reserves of both household and corporate cash to avoid a policy induced recession. Wall Street strategists continue to avoid predicting a recession as the most likely outcome, and despite higher input and interest costs and declining productivity, have yet to meaningfully reduce S&P 500 earnings per share estimates. I believe they should.

I called this letter "By the Way" not just because it was a cute play on my last name but also because it allowed me to drift off onto tangents not directly involved with markets and economics. Today the deep division in politics and so-called "culture wars" in the U.S. seem to me to be pervasive and serious enough that they do in fact cause risk to both the economy and by inference markets. For context, I am a lifelong conservative and always voted Republican (I'm a dual citizen and please forgive me that Nixon vote). However, I never imagined what that party stands for today, but it's not me. I've tried to understand the recent Supreme Court decisions in the context of guns are a right according to the Constitution, but abortion isn't. That may well be an argument worth having, but when Clarence Thomas encourages review of precedents on contraception and gay rights, I have to believe he has an agenda beyond constitutional law. Congress remains deadlocked and the simple rule seems to be if that guy votes for something I'm voting against. I don't understand the intricacies of how Congress works, but I continue to be perplexed that despite Democratic control of the House, the Senate and the Presidency, no major piece of progressive legislation has been passed into law.

Here are some other issues to consider:

1. Traditional investment managers (and Matt Damon) finally bought Bitcoin and put in a top
2. Gold is outperforming Bitcoin (mostly because BTC is awful)
3. Energy is top of mind – policies to lower the price of gasoline would support demand and thus prices – U.S. consumers have not stopped driving despite the price – refiners are making $50-70 per barrel today versus $10-20 normally since many have been shuttered due to the pandemic
4. What is worse for Biden, inflation or a recession? Both?
5. ESG used to be green investing – Environmental, Social, Governance – now the war has given it new meaning – Energy, Security, Governments.

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.