MULVIHILL

# By the Way

Monthly commentary from Jack Way

"Paradigm shift"

Commentators are referencing a "new tone" in financial markets, and a Goldman Sachs piece even suggested there is a "paradigm shift" taking place in investors' perceptions. It's as if we are just becoming aware of the negative impact high interest rates and a collapsing bond markets can have on the economy and equity prices. I wrote last month about the AGG (an ETF tracking U.S. investment grade bonds) not having seen a new high in 37 months; (it's now 38). I was surprised, but now much more dramatic numbers are being brought into the light of day that give new evidence of just how badly bond investors have suffered. The destruction isn't new, but it has all of a sudden become much more widely reported and referenced in forecasts. Last year the bond market lost 15.7%; according to Bloomberg that's the worst year since 1871. 2023 could do one better as an annualized rate, given the year thus far, would come in at negative 17.3%. Not to be outdone, the Bank of America Global Research department claims to have gone back to the 1700's and the founding of the United States and have proclaimed "This is the greatest bond bear market of all time". (Evidently there is no history prior to the Revolutionary War, 😉.)

As of last week, despite the 10-year U.S. Treasury Bond yielding 4.88% and the FED rate at 5¼%, no major Wall Street economist is predicting the 10-year bond will be trading at a yield of 5% or more at the end of 2023 or 2024. Surprising to say the least, especially given the many reasons to believe these high interest rates are not about to disappear. Here are some reasons: the FED's policy of "higher for longer"; the FED shifting from quantitative easing to tightening; a huge supply of Treasury debt to be issued to finance the budget deficit; labor gaining leverage for wage increases; corporations borrowing for capex and to pay back old debt; consumers spending more as opposed to saving; and less demand for the bonds from governments, both foreign and domestic. To that final point it will be incumbent on U.S. individuals to pick up the slack whenever the Treasury Department comes to market. The Congressional Budget Office (notoriously conservative in its estimates) reported Treasury "debt held by the public" was $5 trillion in 2007, or 35% of the total. The CBO expects in 10 years that amount will be $47 trillion and 119% of the total. That will put a lot of strain on the economy. Nevertheless, the resilience of the U.S. economy continues to be impressive with no strong reason to expect anything different. As we have said many times, payroll growth and consumer spending are supportive of ongoing strength despite the high rates. U.S. Purchasing Managers Indexes are rebounding after a period of some weakness. The September release of the Manufacturing Index was 49, up from the month earlier 47.6 and an expected 47.8; and New Orders were 49.2, up from 46.8. Neither as yet indicate expansion, which would need 50+, but both are headed in a positive direction. Notwithstanding these positives, and in the interest of transparency, I remain of the opinion a recession is the likely outcome over the next 12 months. Recessions don't generally happen gradually but more quickly, induced by an economic or geopolitical shock.

The risk of a geopolitical shock seems as high as we have experienced in recent memory; Ukraine, Taiwan and now Israel. I find the Middle East a more dangerous situation. The potential for NATO to become involved with Russia on the battlefield has kept support for Ukraine to the level of munitions and money. There seems to be no such obstacle to expanding the hot war in Gaza to other players in the region (other than common sense). The U.S. is already moving naval and air assets into the area, and is supposedly being encouraged by Israel to strike at Iran for its supposed involvement in the missile attacks. As to other possible negatives arising from the conflict: higher energy prices will cause inflation to increase and growth expectations to decrease; the recent deal between the U.S. and Iran to release hostages in exchange for easing of some sanctions is not a good look for President Biden and his reelection hopes should Iran be proven to be involved; an improvement in relations between Israel, Saudi Arabia, Iran and the U.S. which all were under negotiations would now appear to be dead in the water. It could however prompt the FED to ease its tightening policies which usually helps stock markets. Perhaps most disturbing to me which sets this conflict apart is it could become a war of cultures, not just a land dispute. Samuel Huntington was a renowned political scientist and Harvard professor; he wrote, “The West won the world not by the superiority of its ideas or values or religion…. but rather by its superiority in applying organized violence. Westerners often forget this fact; non-Westerners never do.”

We can never ignore the risk to economic growth evident in the inability of the U.S. Congress to govern. The recent ouster of the Leader of the House of Representatives by a few ultra conservative members is further proof of the problem. Under the guise of containing budget spending (which is a good idea) the group brought legislation to a standstill. Even more unbelievably, one man, Tommy Tuberville, Senator from Alabama, has been able to block approval of military nominations despite the wars in Israel and Ukraine. The country seems incapable of getting out of its own way. As Mike Lawler, Republican Representative from New York said: “If you keep running lunatics” (for office) “this is the result”. Also Larry Fink, head of investment manager BlackRock Inc. opined: “In no other country does the government routinely incapacitate itself for the sake of political stunts.” Interestingly at a recent Strategas forum attendees had Republican Glenn Youngkin (Governor of Virginia) and Democrat Gavin Newsome (Governor of California) as most likely nominees for President in 2024. Neither Biden or Trump made the cut, but those surveyed said that Trump would win such a race should that occur.

Although 1987 and 1929 make us think of October as a scary month, it has actually delivered average S&P 500 returns since 1950. The recent rally has not provided a commensurate amount of internal breadth by most measures. Simply put, the top 7 to 10 stocks continue to provide most of the strength in the Index, while an equally weighted Index actually dipped into negative territory for the year last week. In 14 of the last 15 years the NASDAQ 100 has provided a positive return. The area of 4200 on the S&P 500 has become a consensus area of support, and it proved effective last week; keep an eye on that level. One thing concerning me is the lack of strength in the banking sector, a very important part of the overall economy and markets. Chis Verrone of Strategas points out that while the S&P is up around 15% since last year's October lows, the banks are down 20%.

I write assuming “all other things being equal”. They never are.

## 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.