MULVIHILL

By the Way

Monthly commentary from Jack Way

July 2022

"Fed policies are always a mystery wrapped in an enigma"

Here we are in the midst of the lull in the investment business not so affectionately known as the "summer doldrums". Stock exchange volumes are extremely low, and there's a lot more action in the Hamptons than on Wall St. For the most part what trading we are seeing is following in the footsteps of the year's first half, an overriding trend lower interrupted by sharp moves higher. Each countertrend rally appears to be stronger than the previous one, but not sufficiently so that the bearish direction has been negated. If history is our guide, we would want to see a high-volume, broadly-based surge in prices to break the back of the negative trend. Two examples might be that 90% of stocks trade above their 50-day moving average, or perhaps we experience a day where 60% of issues make a two standard deviation move higher. (Credit to Chris Verrone of Strategas for those insights.) As mentioned last month the decline in the S&P 500 this year has come almost exclusively at the expenses of the price to earnings multiple. From levels above 20x we are today around 16x, which is not an exorbitant valuation. However, we have yet to see a significant reassessment in the outlook for corporate earnings, particularly given the widespread anticipation of slower economic growth. Brokerage analysts are well known as a group to avoid going out on a limb with their estimates, but as corporate executives provide more guidance, I believe we will see forecasts being lowered for the rest of this year and next. Certainly, we are hearing a lot of companies moaning about cost inflation and its impact on expected profits. Although, to misquote Shakespeare, methinks they do protest too much (likely to justify higher selling prices). Nevertheless, lower earnings projections will weigh on markets.

Fortunately for those who can't afford the Hamptons, or simply enjoy working, there is ample room for argument and controversy about the outlook for inflation and economic growth. Differences of opinion on these matters are only heightened when expectations for Federal Reserve policies and actions are added into the discussion. Can the Fed engineer a soft landing for the economy while raising interest rates and tightening money supply. History would suggest it is unlikely, but there are a couple of hopeful signs this time around; the U.S. labor market remains strong and should better withstand the changes in policy; and despite the almost grotesque level of the CPI, there is evidence that at least in certain areas price pressure is easing, (not that it will happen suddenly, but markets anticipate and will be pleased with a change in direction).

Fed policies are always a mystery wrapped in an enigma. I'm sure they purposely march out different board members to say different things, if not just to confuse us, to at least gauge market reaction. We can ill afford another policy blunder like last year when the Fed continued to promote growth despite obvious signs inflation was getting out of control. This year's policy error could see the Board either tighten far too long to the detriment of the economy or pivot too soon and risk losing control of inflation. Raising rates aggressively is a policy I endorse (not that anyone cares), but the market interpreted Chairman Powell's recent press conference as somewhat more dovish despite the 75 basis point increase in the Fed funds rate. We haven't seen or heard the last of this debate, and a lot more water will pass under the bridge before we will know what other policies emerge and what the end result of those policies might be. Economic theory suggests that to defeat inflation the Fed funds rate should exceed the CPI; with the upper boundary on the regulated rate at 1.8% and CPI at 9.1% the prospect of such an event is daunting.

I find it difficult to make any definitive statements about the U.S. economy since so far it has been a glass half-full or half-empty situation. As mentioned, the labor market remains strong and purchasing managers surveys are hanging in. On the other hand, tighter monetary policies, lack of government stimulus cheques and inflationary cost increases for consumers are all putting pressure on growth. Small items of concern do catch my eye from time to time, such as credit card debt expanding and ATT announcing payments are arriving two days later than last year. It is also likely that weakness in other areas of the globe, such as China and Europe, will eventually impact U.S. growth. So, a slowdown is certainly baked in, and since the first two quarters of U.S. GDP were negative, we are at least in a technical recession. Nonetheless we aren't yet close to the kind of severe downturn that would crater stock markets.

With the latest CPI report coming in at 9.1% it's not hard to appreciate that inflation is here and is a problem. However, there are signs that at least the worst is over. Of the three most important consumer expenses food prices show no sign of weakening. The global impact of food costs are diverse and have a disparate affect on consumers' quality of life. A U.S. Department of Agriculture study highlighted that fact, providing the percentage different populations spend on food; U.S. - 7%; Japan – 16%; Russia – 28%; and Nigeria – 59%. Keep in mind that averages can hide serious issues; a poor family in the U.S. would actually be closer to the Russian than the U.S. average. In North America the other two expenses, energy and housing, are both showing declines in price as demand has weakened recently. The supply chain problems that were so prevalent only months ago are also showing signs of easing. Empirical, but not conclusive evidence, is being seen in many areas: Walmart and Target continue to lower prices to reduce inventory; Apple, Amazon and Google are cutting back on staff and facilities; Micron announced computer chips are in oversupply in certain sectors (not autos); and many companies are wondering how strong order backlogs really are, since lower demand and previous over-ordering are causing cancellations. We are nowhere near out-of-the-woods, but at least we can see some hopeful clues.

Joe Biden's approval ratings continue to drop as we near the mid-term elections. Districts where the voting is competitive are leaning toward the Republicans, although even with the party doing well, many of the candidates are so unlikeable the Democrats are still a viable alternative. (from survey data, not just my personal opinion). It's not good news for Biden and his party that a Democratic pollster found 84% of voters think the U.S. is "headed in the wrong direction"; 69% of the President's own party agreed. It seems the last chance for Democrats to live up to some of their climate change and health care promises is embedded in the so-called "Inflation Reduction Act" now in Congress. Once again, a member of their own party, this time Senator Kirsten Sinema of Arizona, stands in the way of passage. More shooting yourself in the foot.

In other news it is interesting, and I suppose somewhat discouraging, that as the economy has become more of a concern to people around the world support for climate change and the Ukrainian war has fallen dramatically. Biden and Xi are expected to meet face to face and hopefully ease tensions despite Nancy Pelosi's trip to Taiwan. Also adding to the geopolitical uncertainty, in Europe the "throw the bums out" mentality continues as the leaders of the U.K. and Italy step down. There is much to process; we must be prepared to adapt.

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.