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By the Way

Monthly commentary from Jack Way

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"it's darkest before the dawn"

Contrary thinking, and its corollary for our purpose, contrarian investing, can be very profitable as seen in the movie "The Big Short". However, it's not that easy to pull off. First one must be sure what exactly is the current consensus, and more importantly know when it has reached a peak and is ready to turn in the opposite direction. It's a fact that consensus is actually correct the majority of the time, and only at major turning points are opportunities for large gains available to the contrarian thinker. Michael Burry (played by Christian Bale in the movie), suffered through two years of being wrong and losing clients before the massive profits rolled in. I point this out because almost all of this letter focuses on the negatives in the current investment environment. That leaves us with two reasons to be bullish: the market is already discounting the unfavourable news since it is well known or: it's time to be a contrarian. It's only my opinion, but while I don't think we are there yet, my optimistic nature says we are getting close. Whoever said "it's darkest before the dawn" had better be right because it sure is awfully dark out there.

The Federal Reserve and its Chairman Jerome Powell are driving much of the market narrative these days; directly through policies to slow the U.S. economy in the fight against inflation, and indirectly as those policies also impact other market sectors like the U.S. dollar. After Powell's speech at Jackson Hole, I offered the opinion that he hoped to use words to change people's outlook on inflation. Over the course of the last month, I have been dissuaded from that view as he and other Board members have been adamant in their resolve to continue to increase rates and employ "quantitative tightening" until inflation is beaten. This, of course, raises the risk of a recession as the brakes are applied to the economy. The Fed has a so-called "dual mandate" to achieve stable prices and maximum sustainable employment, but it seems to me they can only deal with one at a time. During the last decade the Fed used unprecedented amounts of monetary stimulation to support the economy, but with little mention of the potential impact on prices. (Of course, inflation was averaging 1.7%, so the concern was that it should be higher.) Now in 2022, stable prices are the focus. Why should we have faith in a group that was in denial and waited much too long to fight inflation, that they will now have the ability to slow the economy without losing control on the downside. In fact, there are already signs of demand weakness, e.g. housing (the Case-Shiller Index had its fastest decline ever in July). The Fed is at risk of being overly aggressive given the large rate increases and the fact quantitative tightening is only just beginning. History tells us such policies take 6-9 months to impact the economy, which could well be very unfortunate timing if growth is already in decline.

The high rates are also having an impact globally attracting investment into the U.S., pushing the dollar higher and damaging other economics. In particular any country with U.S. dollar denominated debt will be affected adversely (Canada included); also energy is priced in U.S. dollars to the detriment of Europe and emerging economies. Perhaps most frightening as pointed out by Michael Wilson, the Morgan Stanley strategist; "Such U.S. dollar strength has historically led to some kind of financial/economic crisis. If there was ever a time to be on the lookout for something to break, this would be it." (The U.K.?) The folks at Strategas are pondering the notion that foreign exchange markets will indicate trouble this time, much as credit markets did in 2008.

The S&P 500 has done a nice round trip from the June lows (3636) to the August highs and back. It would be beneficial for us all (to say the least) for this level to hold, as old areas of support have historically become resistant once broken. Many internal market readings such as the put/call ratio, the VIX (considered a gauge of investor concern), and various sentiment measures suggest increased anxiety amongst investors. Several of these indicators have in fact reached levels that are oversold which raises hope for at least a relief rally in the near term. For those desperate for anything positive, the S&P 500 has been strong from October to year-end in mid-term election years. As we have forecast in previous letters, S&P 500 earnings estimates are falling and will provide a headwind to better stock prices. (The strong dollar isn't helping companies with offshore revenues.) Most investors have never experienced a long-drawn-out period of market malaise, but it can happen. I took my first job in 1969 and with the exception of a few false starts, didn't see new Dow Jones highs until 1983.

Global geopolitical news is uniformly negative; threats of nuclear weapons; energy and food crises, and tensions between superpowers. You see it all wherever you get your news. You don't need me to rehash it.

As November's U.S. mid-term elections get closer, the vitriol between the two parties and individual candidates is ramping up. It's actually great entertainment, except it's so darn important and disturbing. Democrats, after President Biden took the lead in his speech of September 1st, are attacking the "extremist threat" they see from Republicans and have taken the gloves off in going after Trump and his followers. The irony is that many surveys have Florida Governor DeSantis as the likely Republican candidate in 2024. My more liberal friends in Florida are of the opinion DeSantis is more dangerous to democracy than Trump. On the Democratic side, Governor Newsom of California, a moderate, is the current favourite for a 2024 Presidential run if Biden is not a factor. Bottom line, a Democratic sweep will likely see a new round of spending initiatives while a Republican sweep would suggest the opposite. A divided government is probably the safest answer for all concerned, but it means the session of Congress between the election and new session in 2023 will be rife with infighting to get some things done.

Some final thoughts:

1. Is the cure for inflation worse than the disease?
2. Yield curve inversion continues to worsen.
3. U.S. 30-year fixed rate mortgages have doubled to 6% from 3%.
4. The Producer Price Index was down slightly in August.
5. My litre of chocolate milk is up from $1.19 to $2.19.
6. Deflation is as easy to embed in the minds of consumers as inflation.
7. A stock down 40% doesn't automatically mean it is cheap.
8. Capital has won over labour for years – now what?
9. Given we have experienced unprecedented monetary, fiscal and political policies, why should we expect a normal outcome?

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