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By the Way

Monthly commentary from Jack Way

"we might well be missing the point."

For the fourth time this year the S&P 500 is in the midst of a strong rally against the prevailing bear market trend. Each rally has exhibited better internal strength than the previous with broader and stronger participation by a range of stocks. Nevertheless, the path to a new bull market is far from clear, and in fact the more likely outcome is for lower prices that will at least test the levels seen earlier in October. One thing that is becoming more and more obvious is a major change in sector and stock leadership. For a decade the strength in the S&P 500 came from the large-cap, heavily weighted stocks that for the most part make up the technology sector; the so-called FAANGS and their relatives. That has reversed in 2022 as a broad index of equally weighted stocks is outperforming those previous media darlings by a considerable margin. Recent poor reports from Amazon and Alphabet (Google) give fundamental credence to the weakness. This is somewhat predictable, since history tells us it is very rare for the stocks that outperformed in one market cycle would do so again in the following cycle. I learned that hard lesson in the 1980's, when after several years of relative success that came from owning a large number of Canadian oil and gas stocks and surviving the Volker induced recession, I bought back many of those same energy stocks when the market improved. As a consequence, while no money was lost, other stocks and other managers passed me by. Ironically the new S&P market leaders are to be found in that same energy area. ExxonMobil just achieved an all-time high price, and the sector weighting which was 2.3% in 2020 is now 5.5%. Another long-ignored company, Warren Buffet's Berkshire Hathaway, has returned to number 6 in total market value, merely by not going down this year while stocks like Tesla dropped 35% and Meta and Nvidia each lost over 50%.

Like most things in the world today, markets are experiencing the effects of a need for instant gratification and a lack of patience. While not necessarily a bad thing, it does mean less thought is put into decision making. Short term market volatility is increased without helping, in fact confusing, attempts to forecast the longer term. In 1960 the average holding period for a stock was 8 years, in 1969 (my start date) it had dropped to 5 years, and today it is less than 1 year. The old systems involving boring investment committee meetings, compiling lists of stocks to buy and sell, and making the required paper transactions with other humans was slow and wasteful, but at least left time for reflection. Markets are much more efficient now, there's no doubt about that but that does come with some negatives. We are seeing big increases in the use of ETF's, options, and futures, which adds to the speed with which a change in portfolio strategy can be implemented, but also promotes impulse trading. Even the bond market, long considered more sober and sedate than stocks, has become more volatile. In one week recently, the U.S. 10-year Treasury Bond moved 40 basis points; in 2017 the total range for the entire year was 59 basis points. Our ability to make an informed forecast is being hampered by what I would define as the "noise" in these short-term swings.

Inflation and Federal Reserve policy efforts to control it remain top of mind. The September index of Personal Consumption Expenditures (the PCE is the preferred measure of inflation for the Fed, not CPI) reported an increase of 5.1% year-over-year; not the best but less intimidating than many other recent statistics. For those who still use the simple definition of inflation as "too much money chasing too few goods", the level of Fed induced money supply increases in the last few years is informative and remarkable. In 2020 M2 (liquid and near liquid assets) reached a growth rate of 26.9%, which was about twice the previous record high; today it is at 2.6%. This is a prime example of the difference between the Fed easing and the Fed tightening, and should help in the fight against inflation. The speed with which supply and demand, and thus prices, can change is striking. Mortgage rates rose and home sales are plummeting; some shelves at Walmart were empty but now there is too much inventory and it is holding sales; only a month ago much was written about German people *freezing in the dark this winter, but a month of warm weather and a slowing economy have led to an oversupply of natural gas. Central bankers are already seeing the effectiveness of their tightening policies as Purchasing Managers Indices and Leading Economic Indicators are showing there is a slowing and even some contraction in global growth. None of this means inflation is going away tomorrow, food prices and wages continue to be problems, but it does indicate how quickly the narrative can change. As an aside on the outlook for wages, the days of cheap Asian labor holding down salary increases at home are largely over. In addition, jobs are being brought back to the U.S. for security of supply reasons (it's being called "reshoring") which suggests more power will swing to workers (and also unions) in coming wage negotiations. The Fed continues to talk a hard line and I have no doubt they mean it. I remain less concerned about long term inflation and more worried about the possible inability to control the weakness in the economy brought on by the tightening policies. I do take some comfort that while a Fed pivot on policy may not be near, it is at least nearer than yesterday.*

Geopolitical risks remain elevated: Russia shows no sign of backing down in the Ukraine; Xi Jinping has consolidated his power in China which makes him more unpredictable, particularly with reference to Taiwan; Europe seems on the verge of recession; and the debacle that is the U.K., both politically and economically, raises the possibility of a serious credit crisis. It is pure speculation to suggest any of the above will actually take place, but it does mean we live in a world where tail risks are larger than normal. Tail risks are those outcomes outside of the fat part of a normal bell curve, which means they are very unlikely to occur but would be extremely impactful should they take place. To be more specific, if global hostilities worsen or a negative credit or currency event takes place, markets could go considerably lower. On the other hand, a near term unexpected drop in inflation or a surprise Fed pivot would send markets higher in a hurry.

On a final sobering note, Strategas strategist Jason Trennert, reprinted the following quote from Harvard professor Samuel Huntington: "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." When we use western logic to try to understand what Putin or Xi might do next, we might well be missing the point.

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