MULVIHILL

By the Way

Monthly commentary from Jack Way

"whack-a-mole"

The outlook for the U.S. economy, and by extension all global economies, remains at best murky. Cogent arguments can, and are, being made for a variety of potential outcomes: recession, deep recession, no recession, soft landing, and just about anything in between. While we can't be sure of the final destination, we can say things are definitely slowing down. First quarter U.S. GDP growth was announced at 5.1%, but when the effects of inflation are removed, "real" GDP growth was only 1.1%. That compares to a consensus estimate of 1.9% and a 2.6% reading in the 2022 fourth quarter. Estimates for the second quarter are in the range of 0.2%, continuing the trend lower, although still not negative. There is insufficient evidence to make any categorical statements at this time, but such slow growth combined with high inflation is the very definition of "stagflation" and not a good environment for equities. Purchasing Managers Indexes are across the board below 50 indicating more contraction in the economy is on the way. The consumer continues to save the day, adding 2.3% to 1st quarter GDP, but that was offset by a 2.5% decline in inventories. I suspect the consumer can't keep this up forever as the overall economy slows, and if I throw in FED tightening policies, declining growth of corporate earnings, tighter credit conditions, and financial instability due to the banking crisis, I am of the opinion a recession looms on the horizon.

It is impossible to predict how governments and central banks will react in a recessionary climate, but if recent history is any indicator, more liquidity and fiscal spending will be brought to bear on the problem. It's like they're playing "whack-a-mole"; whenever a problem pops up, throw money at it and it will go away. I'm far from the first to say it, but I agree with those who argue this isn't how capitalism is supposed to work. At some point the piper must be paid; "creative destruction" of poor investments is necessary for longer term growth. If, as, or when a policy reversal takes place, the risk of a renewed inflation spurt will increase dramatically.

In the meantime, the FED appears to remain steadfast in the fight to slow the economy with at least one more quarter point increase in regulated rates. (Although as suggested above when the Silicon Valley Bank bankruptcy occurred, the Board wasted no time in piling in additional liquidity.) While not as frightening as some of last year's CPI readings, March's number was still 5.0% year over year and well above the FED's target. Longer term inflation is dependent on psychology and so-called "sticky inflation" like wages and benefits which once increased are unlikely to be given back. The Bureau of Labor Statistics releases a quarterly report called the Employment Cost Index and in the first quarter the ECI rose 4.8% which is not a great number for lower inflation. Major corporations in their recent quarterly conference calls have revealed a different mindset that we may have to get used to, and it too will make inflation stickier. Procter and Gamble in particular espoused a "price over volume" approach which ignores the old Economics 101 theory that if price is lowered, volume will increase. In fact, quite the reverse, companies are prepared to give up volume as long as prices are higher. (Coke and Pepsi each said much the same thing.) P&G announced sales were up 7% in the quarter, which consisted of a 10% increase in price and a 3% decline in volume. Sounds "sticky" to me.

The S&P 500 remains in a trading range with very low volumes and little consensus on where the economy and inflation are headed. Even on a day-to-day basis, opinions can make a 1800 turn; Tuesday's decline had 7 stocks down for each one up; but Wednesday markets rallied and 4 stocks rose for each 1 down. Of concern is a weakening in many measures of breadth. At the end of January 80% of stocks were above their 200-day moving average; today that number is less than 50%. Even technology stocks are currently below 50% after touching 83%. Insider buying is a plus, but overall flow continues to migrate from equities to fixed income. A recent Bank of America survey reported equity exposure versus bonds is at its lowest level since 2009. A final note on market valuation; much is being written about what a proper price to earnings multiple should be in the current environment. Most of the proposals are somewhere between 15 and 20 times, but I was a portfolio manager in the last period of stagflation from 1974 to 1982 and only briefly did multiples ever reach as high as 10 times earnings.

The U.S. dollar was probably the most crowded trade a year ago, and it is again today, but in reverse as a long position then and a short now. At any rate the dollar has been weak for the last six months and as expected the price of gold has been strong. The twin U.S. deficits of trade and budgets, as well as the financial upheavals post the SVB debacle have foreigners less certain about the dollar as a place to hide. It seems to me, however, that there is more to the strength in gold than merely a play on the dollar. Globally, central bankers are seeing gold as a place to diversify their holdings. The purchases of gold made in 2022 by central banks set a record and so far in 2023 a new record is likely. China, the world's second largest economy, is a leading factor, having purchased 524 tons of gold worth around $33 billion last year. Given the antagonism between the U.S. and China, there is no reason to expect any change in that policy. Jason Trennert of Strategas Macro put it best: “China is a rival at best, an enemy at worst.” The U.S. sanctions on Russian currency reserves are a warning to China it does not want to find itself in a similar position. Since peaking in 2013 at $1.3 trillion Chinese reserve holdings of U.S. Treasury debt has dropped to around $860 billion today. Emerging markets are also attempting to diversify away from U.S. dollar assets as policy changes by the U.S. have an outsized impact on their local currency and economy. All of which is good for the price of gold.

Republicans stole a march on Democrats and won round one in the debt ceiling debate. Leader of the House of Representatives, Kevin McCarthy, managed to pass a Republican bill though the House by the slimmest of margins 217 to 215. It will never see the light of day in the Democratic controlled Senate, but it does force President Biden and his party to react and respond. I believe McCarthy's success surprised the opposition, and now Democrats are playing defence. As one analyst pointed out at least this moves the negotiations forward and it becomes a question of “how” not “whether”. Nevertheless, I feel the vitriol between the two parties will push any agreement to the very last minute, (possibly as early as late June) during which time market reaction will likely be negative. Counterintuitively though, as the risk of default draws closer, the “powers that be” will, in fear, add liquidity to the system, which could actually prove a positive for financial markets. After a settlement that liquidity will be withdrawn and could affect stocks adversely.

I remain fearful of all the possible economic and geopolitical risks facing us. The market seems not as concerned.

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.