Aviator Update - August 2022
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Investors aren't considering…

August has been quite an eventful month in finance-land. The markets and economic data have offered up something for everyone – big up-days, big down-days… "positive" data, "not-so-positive" data…

We learned that U.S. inflation "cooled" to some degree – the CPI was flat month-to-month, bringing annual inflation down to 8.5%. That seems to have signalled "game on" for many participants – well, at least earlier on in the month.

We've also seen confirmation of declining U.S. GDP over the past two quarters. Raging inflation and stagnant economic growth – not a recipe for happiness and prosperity.

We've seen a continued decline in China's economic conditions – something that I feel isn't getting the attention it deserves, especially here in Australia. They are our biggest trading partner after all.

Many smart people believe that the Federal Reserve will hike rates until either inflation declines (declines a lot, that is) or until unemployment rises to uncomfortable levels. This makes perfect sense given these two factors – price stability and full employment – are their mandates.

Others think the Fed will quickly "pivot" on any signs of economic weakness – reducing rates and getting back into the "quantitative easing".

Here in Australia, we all know our Reserve Bank has been raising rates quite aggressively as well. The further rate hikes priced in to our money-market futures are quite surreal – suggesting 3%+ rates will arrive next year.

There's some spirited debate on all this. Many Aussie economic commentators – including some I respect – are highly critical about the increases so far. Sure, raising from 0.1% to 1.85% over the course of the last 4 months is steep. But a little longer-term perspective is warranted:

Official rates are still lower than at the depths of the global financial crisis. In the face of 6%+ inflation, and record low unemployment I'm not sure what people expect. The argument against the rises seems largely to be "the inflation is an external force for us…interest rate rises won't help…there's risk of damaging the economy so they shouldn't bother".

The view I've frequently expressed is that official rates really shouldn't go lower than about where they are now – ever! Lowering rates to excessively low levels doesn't stimulate "good" economic activity. Think about it this way;

Economic policy – both monetary and fiscal – should be focused on alleviating restraints in the economy that are holding the economy back from "performing better". By reducing interest rates, you're working on the logic that the economy is being "held back" by a high cost of capital – that by lowering rates, businesses will be able to access funds easier and cheaper and thus invest more.

But what projects become viable at 0.5% interest rates that aren't viable at 2% interest rates? Does a new manufacturing plant get the go-ahead? A new iron ore mine? A new Amazon distribution centre? A new shopping mall? Does a medium-sized financial services firm expand to new premises or upgrade their computer systems? Do a couple of young technology entrepreneurs pursue their business venture backed by the tailwind of lower rates?

No, not really… What excessively low rates do encourage is debt-fuelled speculation.

By increasing people's purchasing power, you encourage people to pay a higher price for a house. Rising prices begets rising prices and encourages speculators to bet the trend will continue for a while longer.

Rather than investing in "getting better", you encourage corporations to instead eliminate competition by buying their competitors – cheered on by their Wall Street bankers eager to extract handsome fees for advising on the transaction as well as fees for the debt capital raising. (In case you're not aware, part of the "service" provided by many an investment banker is to offer unsolicited suggestions to CEO's on which competitor/s to buy.)

As has unfolded in the U.S., by systematically robbing people of a risk-free return for so long, you push people further out on the risk spectrum and encourage a market bubble. A share market bubble that now hangs over global capital markets.

Central Bankers globally have made some poor decisions in the past 10 to 20 years. Whilst aggressively raising rates *may* have bad consequences, that's the situation they put themselves in – there's no good choices at this current juncture.

Animal Spirits

August saw a resurgence in some of the crazy speculative behaviour that existed up to the end of 2021. The "meme stock" craze again erupted.

Bed Bath and Beyond was one stock to capture the retail crowd's imagination this month. Despite there being a real chance that the company will end up bankrupt, this didn't stop the heard pushing it nearly 500% higher over the course of a few days:

Another amazing story came out of this. A 20-year-old university student had spent around $25M of family and friend's money building a stake in the company in the months leading up to the surge. He's a wannabe "activist investor" – after building circa 6% stake in the business, he wrote management a letter explaining what they are doing wrong and what they need to do to turn the business around. (Managers love unsolicited advice from minority shareholders on how to do their job – especially when the shareholder in question is barely out of his teens!)

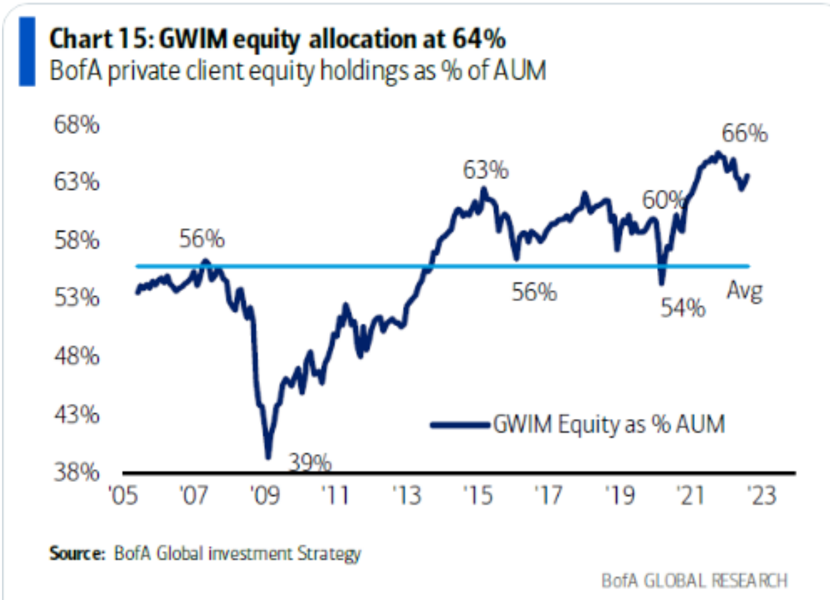
Anyhow, lightning crazily struck and the kid's stake increased fivefold. Wise beyond his years, he sold – netting a profit of over US$100M!

Of course, this story will be the inspiration for another bunch of speculators to take a big risk in the hope of instant riches.

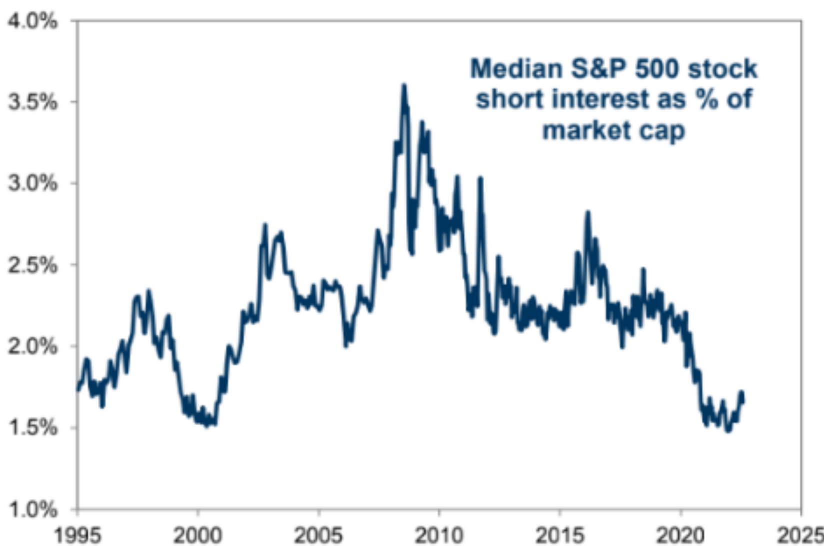
As I've already mentioned in recent times, a characteristic usually seen towards the lows of a bear market is complete loathing – "invest in shares? You crazy!"

Sentiment sure isn't anywhere like that.

Here's another anecdote – Bank of America's huge number of private clients aren't especially bearish… or if they are, they aren't selling their shares! Equity holdings as a percentage of total assets still hovers near the highs:



Similarly, if investors are bearish, they aren't expressing it via short positions, which remain well under recent historical levels:

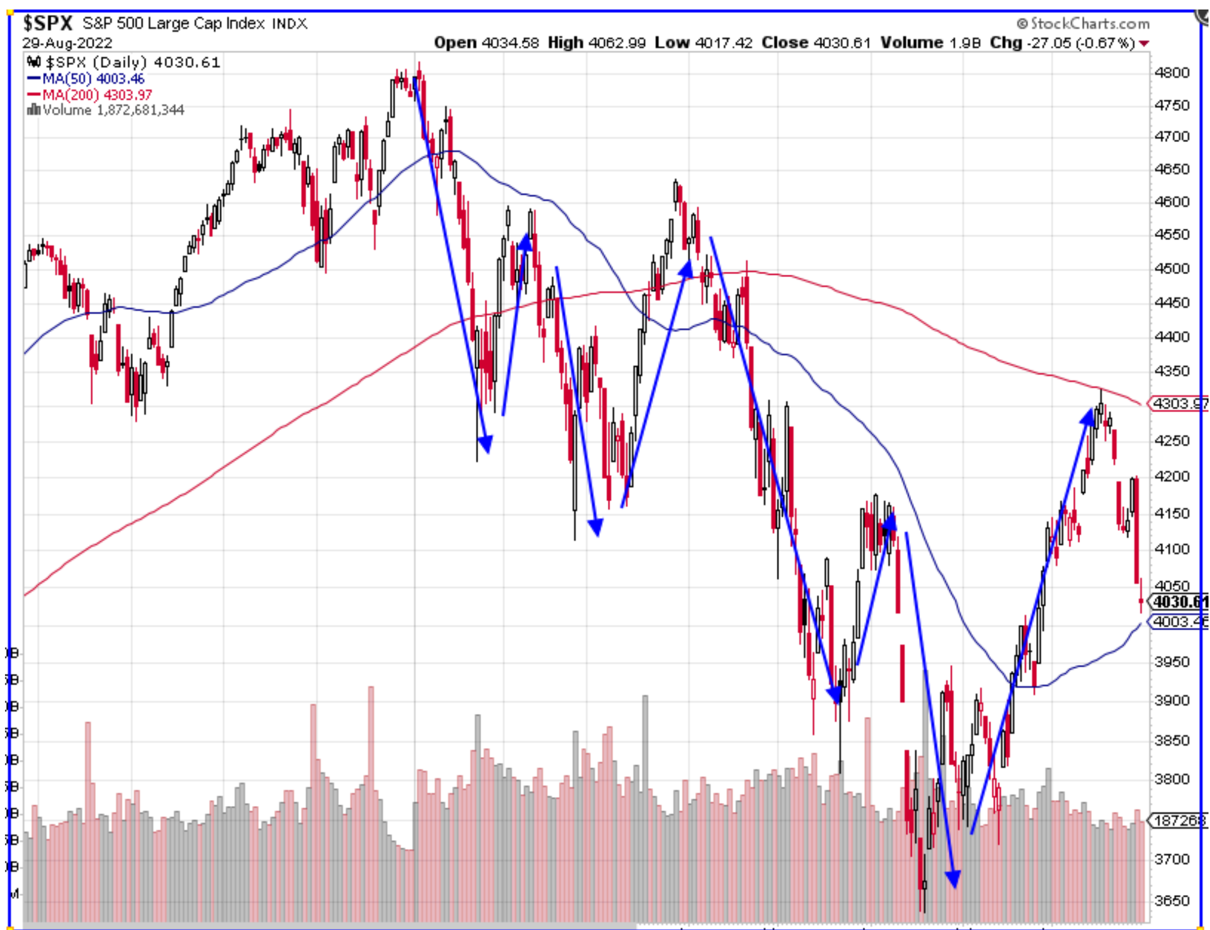


Trying to get comfortable

During the rally of the last month, many commentators (including myself), have presented compelling analysis suggesting it's far too early to declare "all-clear" for the markets. The commentary often comes with a statement to the effect of "investors aren't considering…" or "investors don't seem to realise…" or "investors seem content ignoring…"

During times like this, I really don't think that's a particularly accurate way of describing things. I'd argue investors aren't "overlooking" anything.

Let's recap the past 12 months' worth of the daily price action for the US S&P 500:



It's been a rather wild ride. Notice what happens:

The market has experienced some severe selloffs.

It works itself into an "oversold" condition, then…

There's a powerful "clearing rally" which clears the oversold condition and restores positioning to some kind of "equilibrium".

Of course, what we've witnessed so far is the market has set new lows on each successive down-leg. That will end at some point – there will be an ultimate "low".

The way I like to think of this is investors trying to "get comfortable".

The fundamental backdrop is terrible. But to be a little politer, let's just say its "uncertain". This uncertainty makes investors uncomfortable.

Further, the noise created by the commentator community is deafening. Conflicting opinions, all delivered with bravado and conviction. Who's an investor to believe? What's an investor to do?

If it's your job to "play" every day, you need to do just that – you need to try and navigate the swings as best as you can. When the market is going against you, every day brings more of that dreaded "relative under-performance". When the pain gets too great, you're forced to join in.

This goes a long way to explain the wild swings. As the market pushes higher, it sucks people in. Not necessarily people that believe it's the start of a new bull market – people that are either un-invested or – worse still – "short". They are forced to buy into the strength. On the flipside, at least some investors are forced to dump as prices fall.

Of course, another feature of modern markets is "algorithms" – computerised trading programs. Most of these are programmed around chart patterns. If the market moves higher, it triggers a "buy" signal. Similarly, a move lower triggers a "sell" signal.

There's a lot of selling to be done at lower levels.

Investors are overlooking…

Repeating what I think I've said nearly every month this year, nothing has changed in the past month that changes our core investment thesis and outlook.

Years of a (slowly) growing economy combined with low inflation and excessively low-interest, "activist" monetary policy helped fuel a huge bull market in many asset markets.

This culminated in the Covid experience where governments injected trillions in poorly-targeted stimulus whilst central banks pushed accommodative monetary policy to new extremes, inadvertently recruiting waves of new retail investors into a market already exhibiting most reliable indicators of a bubble.

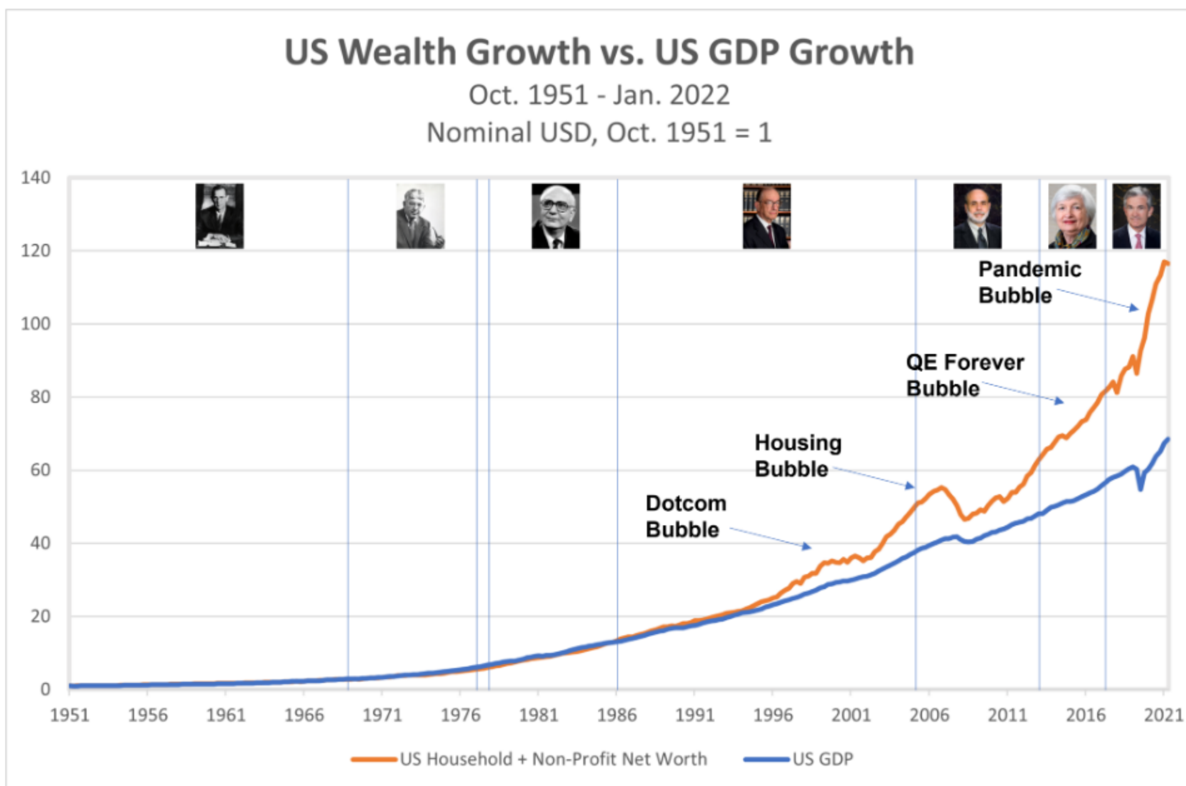
U.S. equity valuations remain as high as they have ever been prior to 2020/2021.

Poor medium to long-term returns are a given from this point – there is basically no doubt that the market will be "unchanged" from today at some point well into the future.

However, whilst valuations are a reliable indicator of longer-term returns, they are not a reliable indicator of short-term returns.

That's what makes this point in time so difficult.

I've typically accompanied these sorts of comments with any number of historically-informative valuation models showing valuations "off the charts". For something different, I want to share this chart from a recent article by Ben Hunt at Epsilon Theory:



The chart plots U.S. "net worth" against GDP. As Ben describes, these two really should track each other very closely. Overlaid on the top of the chart are the respective Federal Reserve Chairpersons during this period.

As Ben describes, Alan Greenspan began the trend of unconventional monetary policy during the low-inflation '90's. He realised that he could potentially use monetary policy to influence the economy – even to generate some extra "wealth" via asset price inflation without impacting wage/price inflation. This, combined with his lobbying for deregulation in the financial services industry was the beginning of the "decoupling".

Bernanke followed on from this and introduced us to the concept of "Quantitative Easing" (QE).

Ben Hunt considers the Janet Yellen Fed to be “peak Fed” – not in the sense of peak QE, but the pinnacle of “faith” – a true belief that Federal Reserve monetary policy could control the economy. They did a good job at convincing the wider world of this, but equally as bad, they convinced themselves. As Janet was quoted as saying, financial crises were a thing of the past. There was even a sense that the business cycle was no longer a thing – it was perpetual growth from then on driven by the new-found powers of the Federal Reserve.

Circling back to our investment thesis, I believe there’s going to be at least a certain degree of “unwinding”. Or, as I’ve previously described it, a “wringing out of the excesses” …

Why now? Well, a lot of the positive economic tailwinds that helped fuel the boom are beginning to reverse;

The global economy is coming off the “high” delivered from mountain of Covid stimulus

Inflation is no longer “not an issue”

Interest rates are rising - rapidly

The positive effects of “globalisation” are beginning to reverse

These factors have the potential to significantly impact economic activity and corporate earnings.

More simply, the previous trend of asset price inflation outstripping economic growth cannot go on forever. What cannot go on forever won’t go on forever.

Also, based on the things he’s been saying (most recently at the Jackson Hole conference), I do think that Fed Chairman Powell understands all this. I believe he realises that monetary policy has lost its way… that the faith held in monetary policy’s ability to control the universe was somewhat misplaced.

I believe that Powell will only open the “unconventional monetary policy” toolbox if the economy is in crisis. I do believe that investors are overlooking that…

The positive case

As investors, it’s important that we always keep an open mind and seek out the opposing view. I’ll admit that’s a little hard at the moment mostly because much of the bullish thesis seems to be rather far-fetched.

The main bullish case is essentially that interest rate rises will soon cease… that the Fed will panic at the first sign of any real economic weakness and will go back to their old tricks – cutting interest rates back to zero and get back into the Quantitative Easing.

The thesis also seems to assume that within this chain of events, nothing "bad" will really have happened in the economy – corporate profits will not fall and the markets will be positioned for a glorious new bull market.

Unsurprisingly, this thesis draws a bit of criticism – some of it quite amusing:

I'll end with a quote from a recent article by Eric Cinnamond – a small-cap value manager based in Florida. I thought this really captures the true "sentiment" existing today:

"*Investors, in our opinion, don't really believe recessions are good for stocks. Instead, they believe a recession will clear a path to another round of Quantitative Easing (QE). A QE that doesn't cause consumer inflation, only asset inflation. A QE that creates booms without busts. A QE that funds endless fiscal deficits and stimulus checks. A QE that solves climate change and erases social injustices. A QE that doesn't misallocate capital to money-losing SPACs and NFTs of rocks. A QE that enables millions to retire early without shrinking the labor pool. A QE that doesn't squash price discovery and free markets. A QE that puts central bankers on the front cover of magazines. A QE that monetizes trillions of debt without encouraging fiscal irresponsibility. A QE that doesn't create asset bubbles, wealth inequality, and a housing affordability crisis. A QE that resuscitates the longest bull market in history and the earnings boom of 2021. A QE that makes investing easy again. Yeah, that's the ticket!*"

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