Aviator Update – February 2022
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AVIATOR CAPITAL

Blocking out the noise

There's often periods of time in finance-land where things are boring for weeks or months on end. Markets slowly meandering on their natural upwards path, volatility low, economic data "meh", corporate earnings "fine", economic outlook "okay", valuations "reasonable"…

Then there's periods like today…

Markets are noisy. And accompanying this is the deafening noise from financial media and the commentator community.

Of course, there was one major "theme" – being inflation and interest rates. We now have lumped on that a second theme, being Russia invading Ukraine.

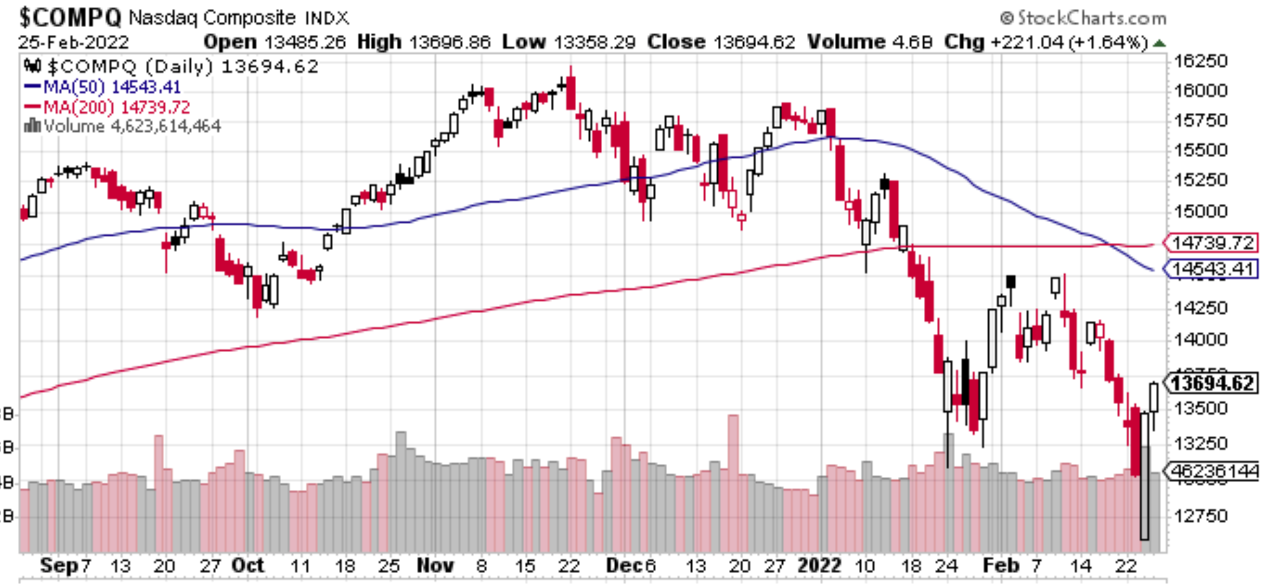
Skilled traders like environments like this (volatility = opportunity). Similarly, brokers like it because there's plenty of reasons to transact. Conversely, many financial planners/superannuation/investment advisers don't like it too much as, generally-speaking, they don't really know what to say when worried clients ask "what should we do?"

For most investors, during times like this it's usually valuable to put on the earmuffs and simply block out the noise. We don't put on a blindfold – we observe what's going on, but we want to do it through our broader lens of where we're at in the grand scheme of things. Finally, as described below, it's really not time for the "rose coloured glasses".

Markets in pictures

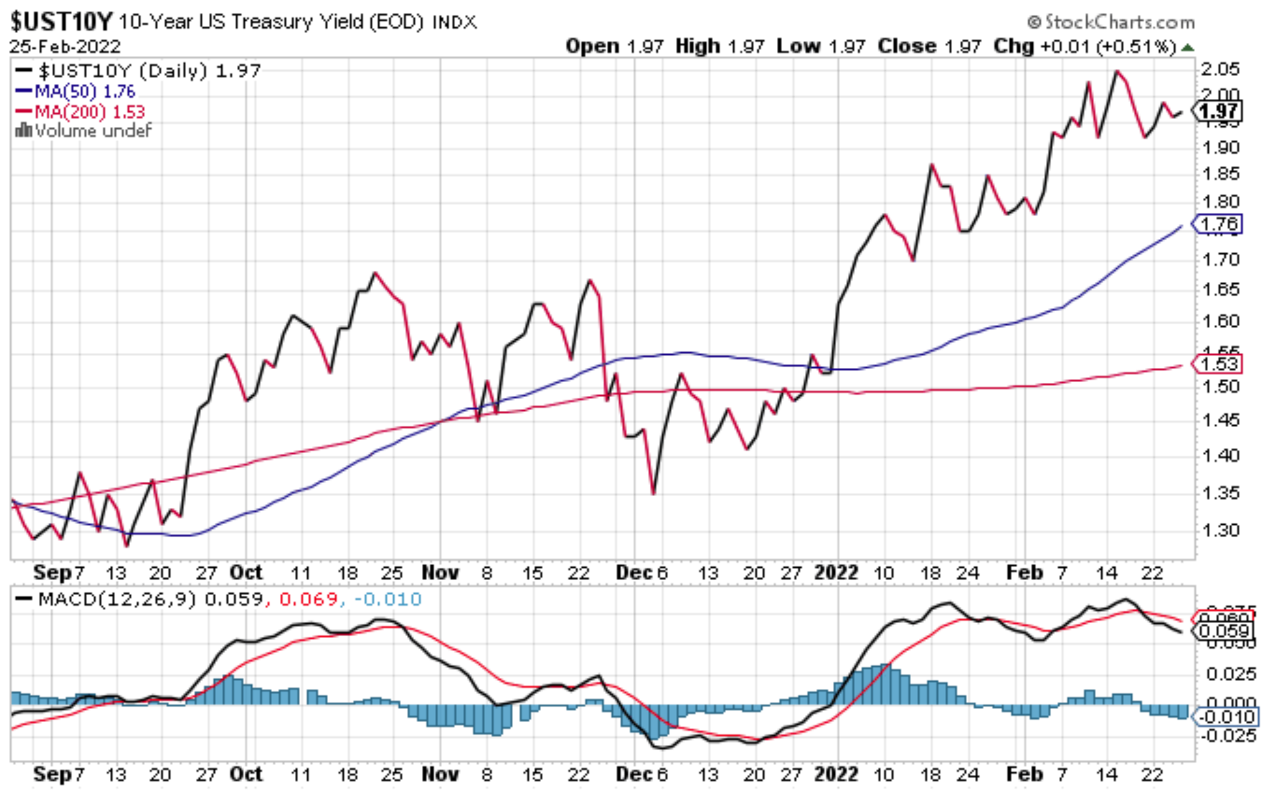
It's been a pretty rough 6 months for share markets. Here's the world's most important market; the US S&P 500 index:

The growth and tech-heavy NASDAQ is a similar picture, although with greater volatility and lagging a bit further from the highs:

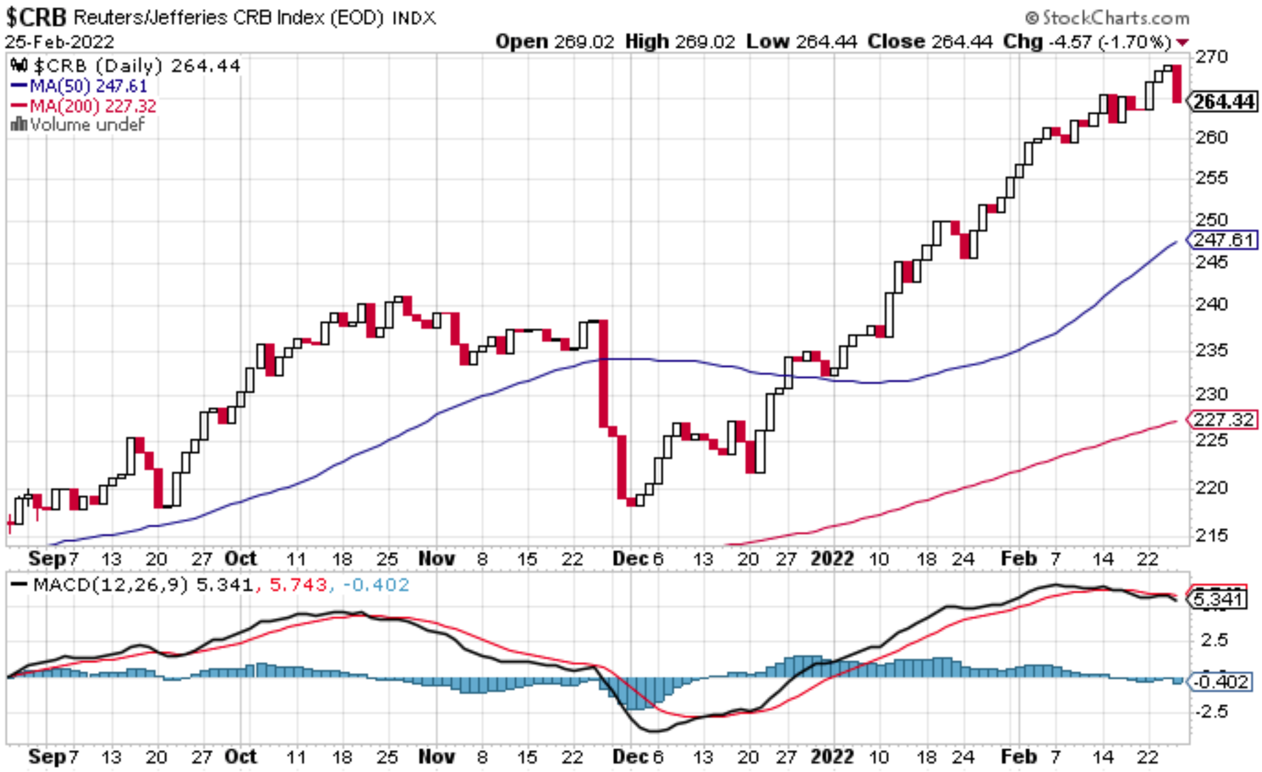


Tough time for Aussie investors too:

There has been winners however. Interest rates have climbed over the past 6 months. Here's the benchmark US 10-year:

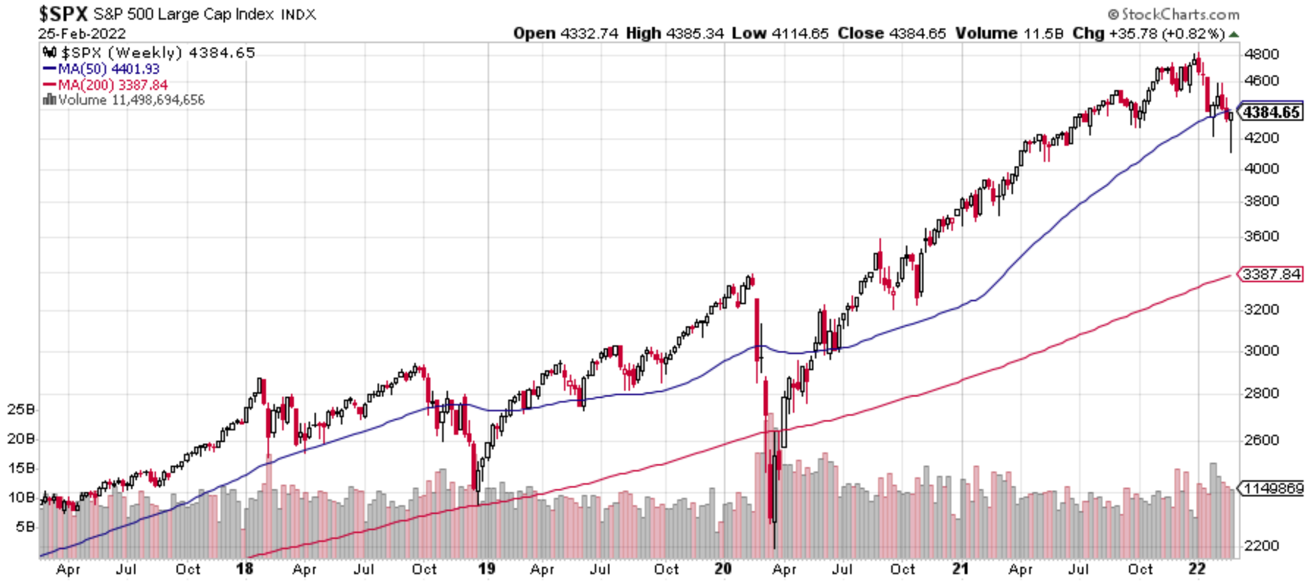


Commodities – wow:



US Dollar has been strong. Seems it hasn't got the "money-printing… dollar-debasement… hyperinflationary collapse imminent…" memo that quite a few were talking about:

Taking a longer-term view, the weekly chart of the S&P 500 is spectacular. It highlights the incredible run over the past 12 to 18 months and also shows how close the market remains to new all-time-highs.



Sadly, for Aussie investors, the last 5 years has been far more subdued.

Ukraine

We'll begin with the easy one.

First and foremost, when bad things like this happen, I'm conscious to take a moment to be grateful about choosing my parents wisely and being born into a part of our tiny planet that's safe and secure. It's really sad that despite humans continuing to become more amazing with respect to technology and innovation, some bad aspects of human society never seem to change.

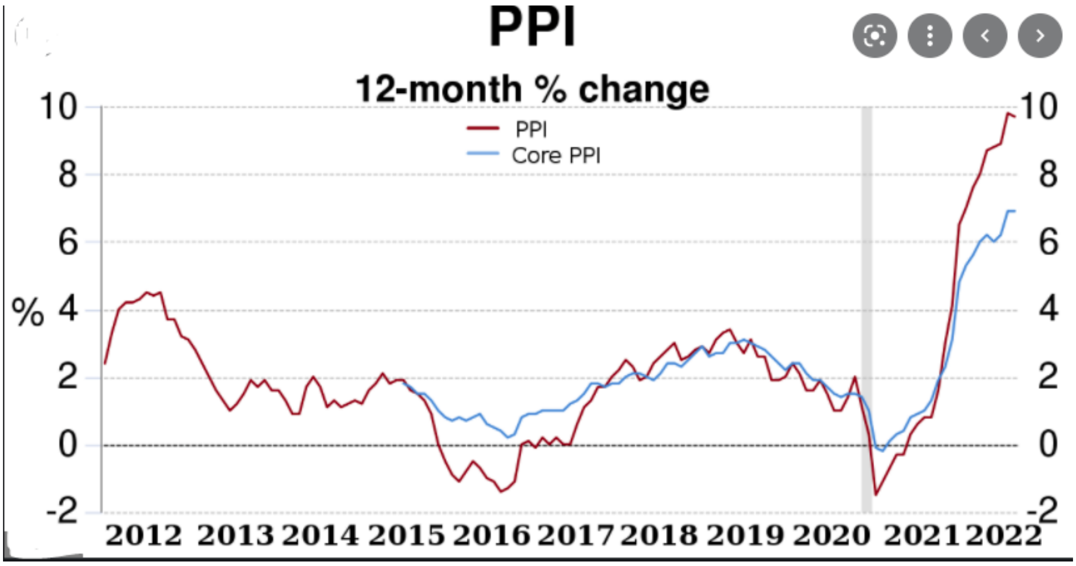
Okay let's face it – the ugly truth is that in Finance-Land we really only care about Ukraine to the extent it impacts our investment portfolios. So how might this impact markets?

At the risk of being too flippant, why would this Russia-Ukraine thing have any appreciable impact on the Australian economy or corporate earnings? It impacts the supply of resources to some extent – that could obviously place upward pressure on commodities prices and therefore inflation. That's not great when inflation is an issue already, but good for old economies that dig stuff out of the ground.

The other potential ramifications come from sanctions the West places on Russia. There's moves to lock it out of the global financial system. This might have significant and unpredictable ramifications – if I were a major European bank, I sure wouldn't want a lot of exposure to any Russian banks or businesses right now.

Inflation

Not much changed here in the last month. CPI inflation in the US is 7-point-something from 12 months prior. What's more, producer prices are up 10%!



US-based small-cap managers that share some of their laborious bottom-up research report that inflation is a worry to companies in all sorts of industries. It was a common theme through earnings calls during the month of February.

It seems pretty clear that the US has at least a few more quarters of high inflation to deal with. This makes sense on the basis that the year-over-year numbers only really jumped in the last quarter of 2021. Therefore, some softening can be expected by the final quarter of this year as the year-over-year comparison gets tougher.

What's a central bank to do?

Amazingly, the US Federal Reserve continues with highly-accommodative monetary policy. They expect to begin to change course in March – better late than never, I guess. They are expected to raise rates to 0.25%... or maybe even 0.5%.

The markets are pricing in a probability that rates are progressively hiked through this year – perhaps 7 times.

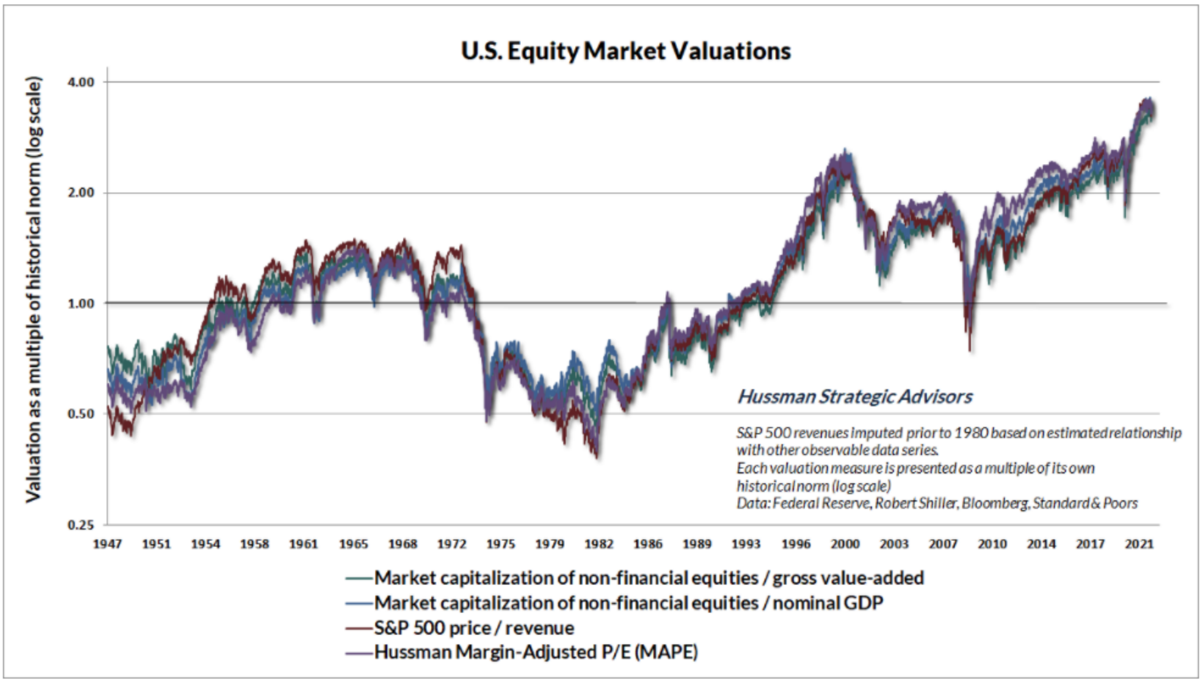
The financial media is awash with commentators hypothesising whether the Ukraine situation changes this.

Before we get to that, let's do what we set out to do and cut through all this noise.

Valuations

Referring back to the charts above, the markets are little changed in the last month. The S&P 500 remains less than 10% away from all-time-highs.

Valuations therefore are unchanged. Below is a composite of several historically-reliable measures courtesy of Hussman Funds:



These highlight that US equities are the most over-valued they have been in the past 75 years and stand around 3.5 times "historical norms".

Now, as we need to emphasise, valuations are hugely informative about long-term returns, however, provide little guide to short-term returns. Indeed, the only reason markets have managed to reach the breathtaking over-valuation seen today is because they shrugged off previous extreme valuations.

Could they go even higher and get even more over-valued? Of course! The question is whether you see that as a likely event – something you're willing to put money on.

I expect that there will be a time well into the future where major US indices are unchanged from today. I don't mean 6 or 12 months. I mean 4 years… maybe even 6 or 8 years into the future.

But as I'm prone to saying, don't worry – it won't be a boring "2% return…-3%...4%...-1%..." History shows what we can expect – at some point its probable that there will be a fairly swift retreat in valuations.

Overlapping the stories

So, what do we think? Will the Ukraine situation allow central banks to become less concerned about inflation?

Does it matter? What if they don't raise rates very much this year? Do you think that means "game-on" for equities? A continuation of the "there is no alternative", "let's all get rich speculating on ever-rising prices" mentality?

Remember that quantitative easing/super-accommodative monetary policy doesn't "make markets go up" – there's no direct mechanism there. What makes markets go up is eager speculators – people willing to bid the price higher because they are sure others will follow. It's therefore all about risk appetites.

So maybe a promise *not* to raise rates does embolden speculators… for a little longer…

It's a very difficult time for investors. Our benchmark risk-free rate is basically zero and really isn't set to rise very much from there in the coming 12 months. Yet, largely as a consequence of global central banks holding risk-free rates near zero for some time, risk assets are very expensive. Somebody needs to hold every asset at every point in time – every share, every bond, every dollar of currency. It's just a sad situation…

What about Commodities?

Some comments on commodities are probably warranted. As noted in the charts above, commodities have been tearing higher since December. Surely that's good for Australia given we're a large commodities producer.

It is, but there several problems with commodities.

Firstly, the commodities space has become highly “financialised”. As an example, when news of Russia invading Ukraine was breaking, wheat futures spiked 5% in a matter of an hour. Do you think that was the result of flour and breakfast cereal producers frantically seeking to lock in/hedge some of their required raw ingredients? Of course not – its due to speculators.

For resources companies, higher prices are surely good news – its logical that resources companies find some buying support, which is good for our market being rich in resources.

The trouble is, we need to remember what gives a share of a business “value”.

The “value” comes from the very long-term stream of cash flows that are delivered to the holder of those shares. Not just one or two years’ earnings – as long as you can reasonably predict into the future.

The final problem with commodities is that they are notoriously volatile. I met someone once who had a great long-term track record of predicting the oil price... Only joking – nobody has a great track record of predicting the oil price!

Given the above, if you think resources companies are a good place to hide right now, you need to be thinking one of two things (or possibly both):

“I believe that commodity price increases are durable and will not fall for many years to come”

Or;

“I fancy myself as a skilled speculator and am confident I can ride this higher and exit before they give back their gains.”

Until next time, keep the earmuffs on and your eyes peeled – things are starting to get interesting…