Aviator Update – June 2022
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AVIATOR CAPITAL

Wait for the other shoe to drop

“How did you go bankrupt?” Bill asked.

“Two ways,” Mike said. “Gradually, then suddenly.”

This passage from Ernest Hemingway’s 1926 novel The Sun Also Rises is popular among financial commentators – myself included. In a humorous kind of way, it epitomises how financial entities fail. I’m a believer that the circumstances we find ourselves in rarely boil down to just one decision we’ve made. It’s the culmination of many decisions.

If you’ve followed our commentary for any length of time you should have a pretty good understanding of what we’re about. If I try and distil it into a succinct catchphrase, we’re about making sensible investment decisions based on a deep understanding of financial market operations and financial history.

We’re in search of that rather elusive “absolute return” – the goal of making money constantly in all market conditions. Do we achieve that? Of course not! Every investor has the occasional down year (at least!) – that’s assuming they have been around long enough to experience different market conditions… The “full cycle”…

As I’ve described in the past, this objective requires having a very special characteristic – a willingness to be wrong on your own. This may seem relatively innocent and straightforward. But understand that in investments-land, it is very profound.

You see, under-performing the market carries tremendous risks for most market participants. If you’re a portfolio manager, it’s a good way to get fired. If you’re the manager of that investment fund, it’s a good way to elicit redemptions from your fund.

Similarly, if you’re a financial adviser or stockbroker dealing directly with a book of clients, under-performing is a great way to lose clients to another adviser that hasn’t.

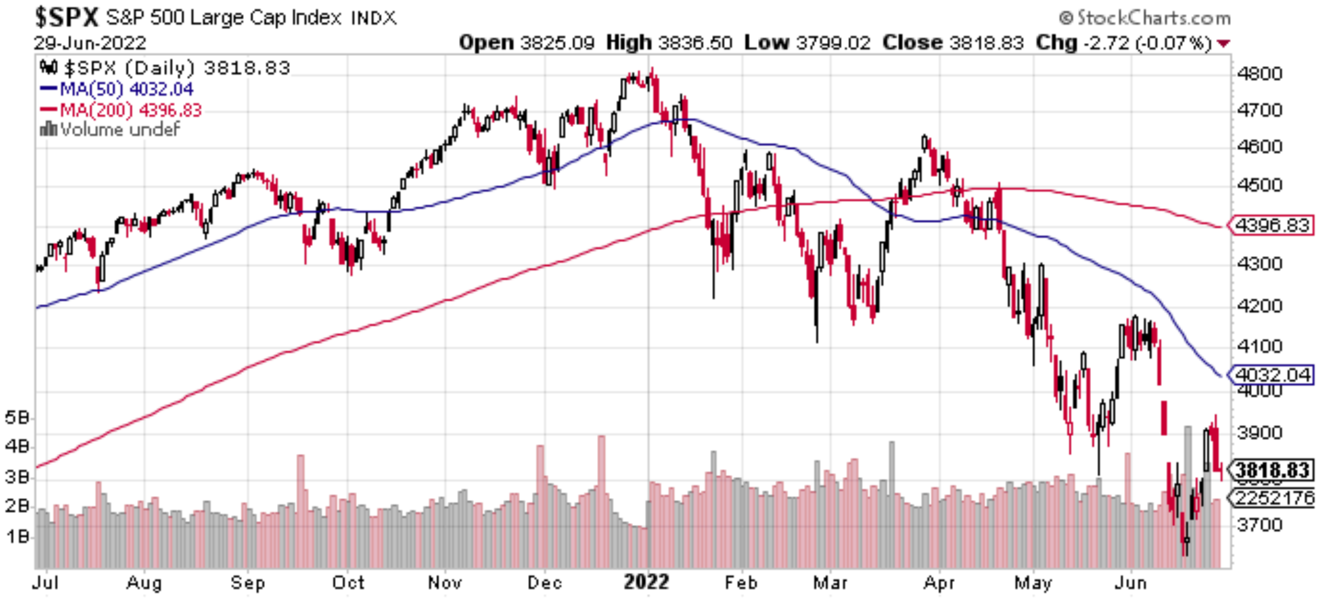
Out-performing the market (and your peers) requires you to take risks that could result in under-performance. There’s few “free lunches” – that is, there’s very few ways to add return that doesn’t carry additional risk.

What’s my point? Well, I’m hopeful that these monthly missives stimulate some thought. I’m not telling you what you should do – I’m not even allowed to do that. I’m sharing what we’re thinking and hopefully there's something in here that you find helpful as you navigate your way on your own financial journey.

Understanding how we think and approach the markets is an important part of this – it's probable you have different views and a different approach to us.

First Half Recap

In case you haven't' been paying attention, it's been a terrible year for the market so far. The U.S. flagship S&P500 is down around 1,000 points, or 20%. Larger falls have been experienced in "riskier" areas such as the NASDAQ and small-caps.

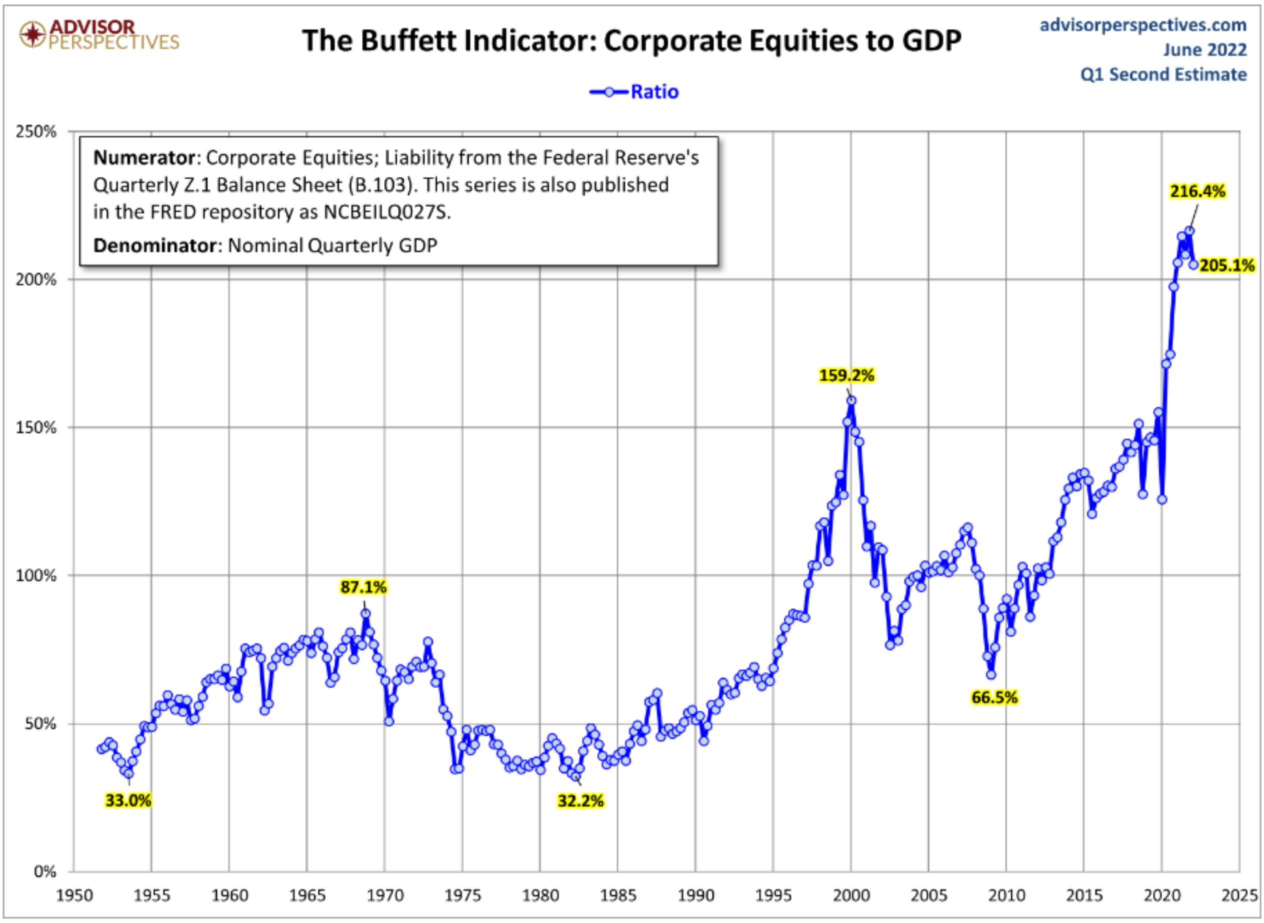


It's been a lot better for Aussie investors with our ASX200 down somewhere around 10%:

Buts just like every day, yesterday is in the past and today comes full of opportunity to make some new (hopefully good) decisions.

What to expect

Our thesis in terms of equity markets has been consistent for some time now. We witnessed an incredible surge in the markets – particularly the most important, being the U.S. markets – coupled with a surge in crazy behaviour. I've been quite comfortable in calling U.S. shares a bubble.



Bubbles deflate. History suggests that the market is a decent chance to gravitate towards some form of "trend" valuation.

It's rather uncomfortable to talk about what "reversion to trend" implies – it just seems crazy. Based on reliably long-term valuation models, the S&P500 needs to fall around 50% to tag some kind of long-term trend valuation. Note that's 50% from here, not from the record high. Can the S&P500 drop to around 2,000?

It's important to emphasise this isn't a prediction – merely an observation.

Inflation Angst

Inflation remains a key theme for the markets as well as the global economy. It's causing a lot of angst both for the general population as well as governments and central banks.

If you think we've got a problem, spare a thought for nations like Turkey:

Nearly 80% inflation. That's a recipe for social unrest and political instability.

The Eurozone is back as an area to keep a close eye on. As we all know, they had an existential crisis soon after the global financial crisis. The problem of having a single currency across a range of different countries and economies without a formal "fiscal union" was never fixed, but thanks to low inflation for the last decade, their central bank has been able to use stimulatory monetary policies to keep things under control. That's a lot harder in an inflationary environment.

In the U.S., a lot of people have an opinion on what the Fed should do. The typical view seems to be along the lines of "they need to focus on the economy and markets". This is often sprouted by investors and what they really mean is "I don't care if inflation is 8% - I'm extremely rich and its meaningless… but I'm at risk of losing hundreds of millions in capital – hurry up and do everything you can to juice the markets back to all-time-highs!"

In this respect, it's important to remember that the Fed – all central banks for that matter – have just one or two mandates. Price stability and employment. They are not supposed to care about the share markets at all and the economy only to the extent that it impacts employment.

Respected analysts (i.e. those that try their best to produce accurate and prescient analysis rather than merely being part of the Wall Street cheerleader squad) are quite bleak on the outlook for U.S. inflation and the economy. They largely fall into two camps – either they feel the Fed will ultimately be too aggressive and spark a significant recession or they won't do enough and inflation will be bad for some time to come. There's *very* few who believe they can navigate through to the "soft landing".

Most analysts are also encouraging the Fed to err on the recession side. A recession is preferable to persistent high inflation – it seems that Chairman Powell, as well as many of the other Fed governors, agree this is the case.

The divergence in interest rates throughout the world is placing some significant strains on markets. In particular, China and Japan continue the pursuit of "easy money" policies. The Japanese government bond market is quite broken as their central bank continues to fight rising yields. It's the second-biggest bond market in the world – it's a big deal…

If "recession" is coming, what can we expect?

Its relatively easy to predict the types of things to expect during different period of the economic/markets cycle – a lot of it is common sense.

For example, the market surge of the past couple of years has seen many "passive" investment strategies outperforming "active" strategies employed by most investment funds. Many commentators have (rather gleefully) reported about the relative under-performance experienced by many a respected hedge fund.

This is typical of late-cycle bull markets. It's common for investment managers to become defensive before the market tops out. Out-performance often re-asserts itself on the other side. Any fund that's generated zero return so far this year is sitting on some very impressive out-performance compared with passive strategies. Oddly enough, commentators aren't quite as keen to report on this.

As the economy weakens, fairly logical things transpire:

Corporate profits come under pressure

Share markets often experience weakness

With this, investors become more cautious and selective. New listings dry up. Raising capital via share issuance gets harder

Ratings agencies downgrade credit rating for companies that are suffering a decline in earnings

Bond market investors become more cautious

A significant increase in interest rates is also straining

Suddenly, a company that was able to borrow money in the bond markets at 1.5% finds investors demanding 6%, further pressuring their cash flow

Defaults rise, exacerbating investor wariness

Banks tighten up on lending standards

Unprofitable companies have difficulty raising new capital in any form

Leveraged buyouts become much rarer

Again, much of this is just common sense…

We should all recall reading stories during the last few years of ridiculously low interest rates about the big “equity to debt swap”. Companies realised they could borrow billions in the bond markets at very low rates. Many did so, using the proceeds to fund share buybacks. The corporate sector goes into this period of economic weakness more levered than ever before.

“Gradually, then suddenly”… If an economic slowdown gathers pace, these sorts of economic strains will be felt. There’s probably going to be plenty more shoes to drop – maybe some major corporate failures… failures that induce investors to think “who’s next?”… failures that induce investors to think “which bank/s is exposed to these losses?”

This is simply the economic cycle.

Within this, it’s important to remember that *things will look their worst at the bottom*. Just like, in hindsight, things looked pretty much the best at the top.

It’s far too early to conclude that recent falls present a buying opportunity. Things don’t look too bad - there’s some ‘other’ shoes to drop before a durable low is established.

But never fear – it’s not all doom and gloom. Even during a period of economic weakness the world keeps turning. Advances in technology and medicine will continue. Standards of living (for the majority) will continue to improve.

Hopefully during this period, we move away from the prior period of silly, unproductive capital allocation. Instead of allocating billions to an unprofitable company that delivers food via a man on a bicycle with a backpack, maybe capital will be allocated more prudently to companies capable of really delivering something meaningful to the world.

But perhaps I’m being a little too optimistic…

In summary, I'm feeling quite confident and optimistic at this time. Confident we have the know-how to navigate our way through this market environment and optimistic of delivering positive returns regardless of what the market throws our way.