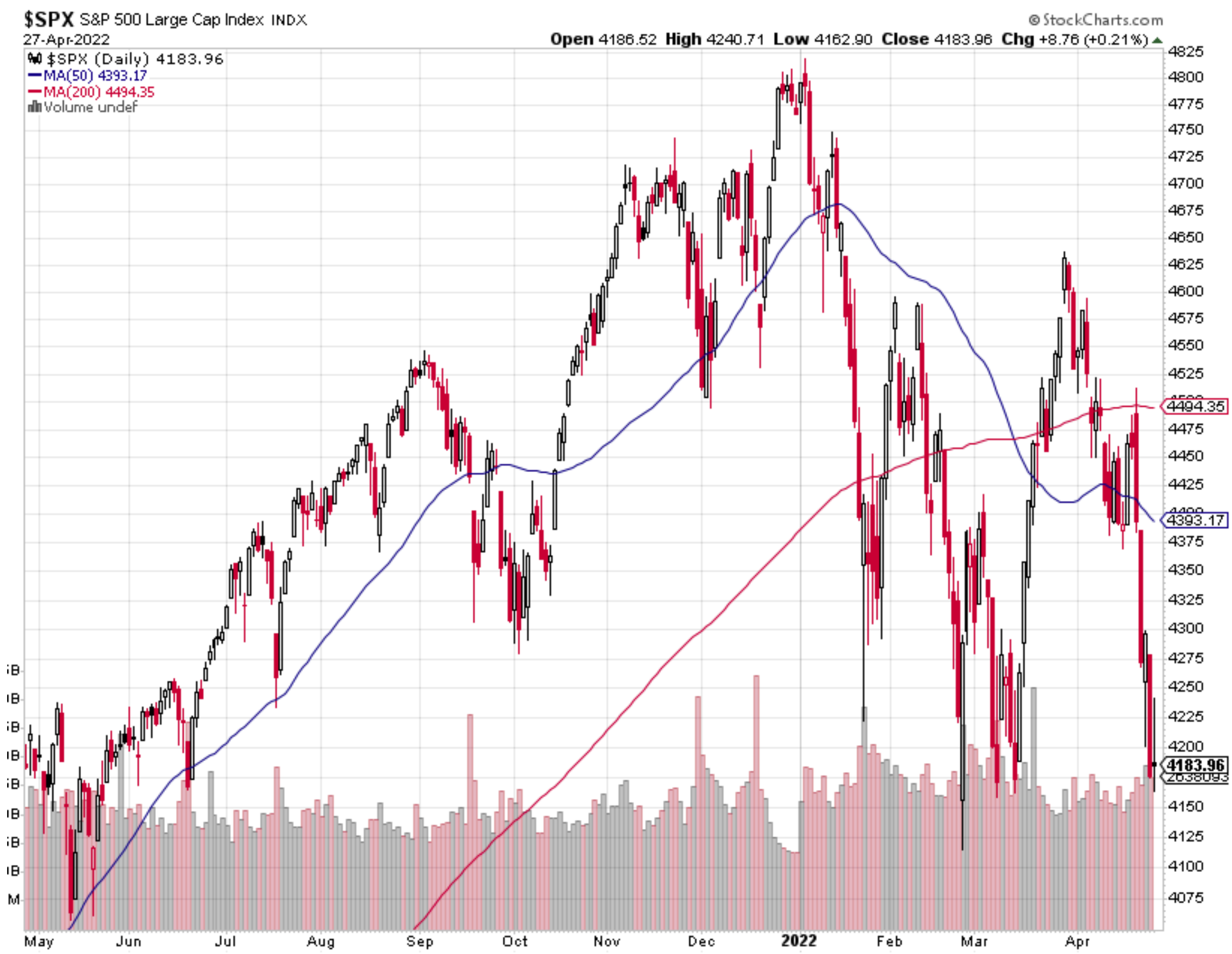
# Aviator Update – April 2022
## Lindsey Lawrance

AVIATOR CAPITAL

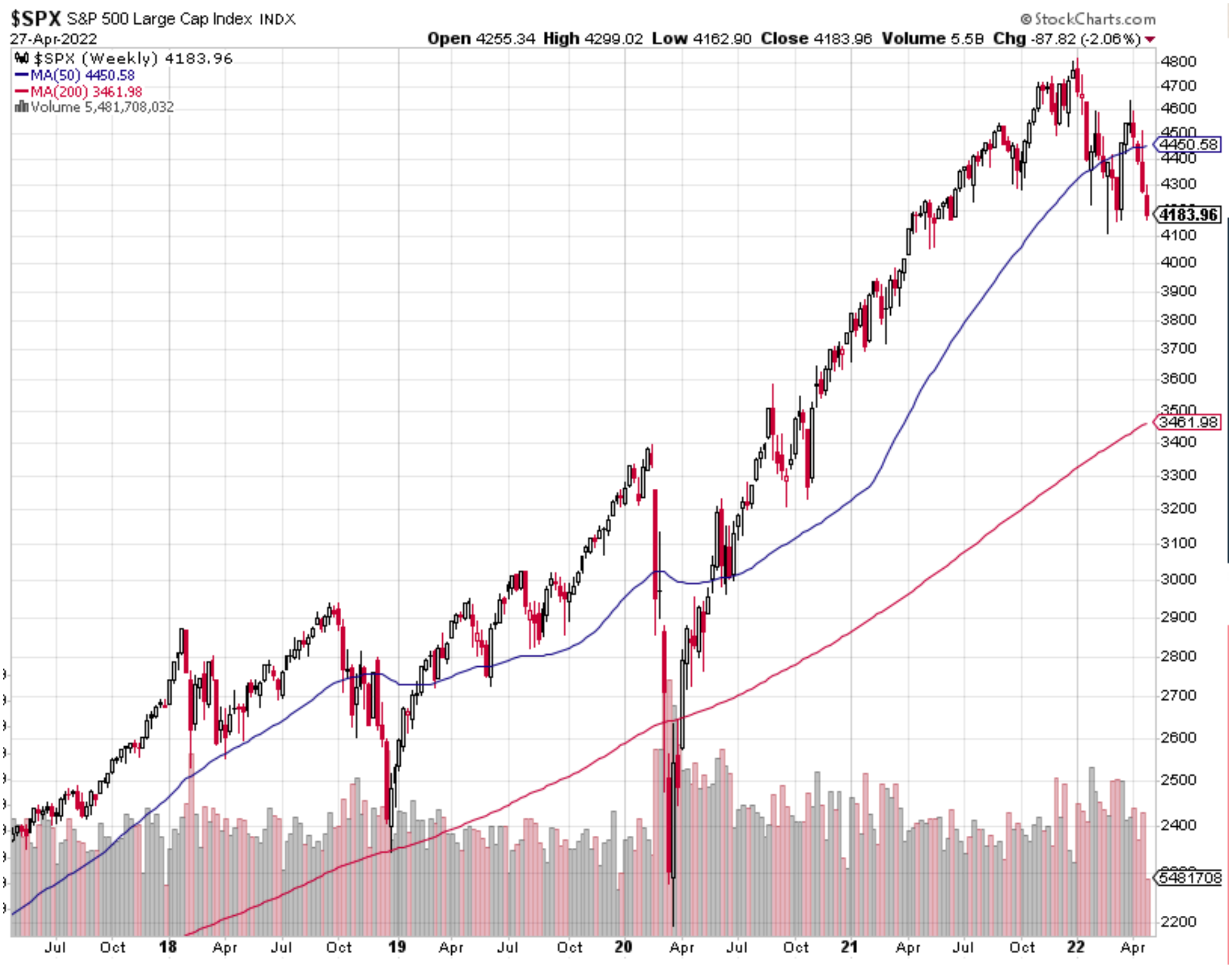
## And then what happens?

Another month of 2022 has passed us by. As expected, it was another rocky month for investors. In fact, the last month has been a volatile trip to nowhere for the world's most important equity market (the U.S.A.):




We are back close to the lows recorded during the initial selloff from January.

Moving out to a weekly view, things look like this:




The chart setup is so interesting that some "technical analysis" commentary is irresistible.

As a brief introduction, "technical analysis" is essentially the concept of predicting price movements based on chart patterns. It is incredibly widely used – both by professionals and, well, "not-so-professionals". If you've ever been lured into looking at one of those "learn to trade Forex in a day" or, these days its more often "learn to trade Crypto", it's inevitable that they are selling you lessons in technical analysis. Learn a few charting concepts and off you go – you're a trader!

For me, I believe I'm a fairly "typical" experienced investor. I've studied technical analysis extensively over the last 23 years and I do apply it to an extent in my decision-making but it isn't the cornerstone of decisions.

For me (and Aviator more generally) investment decisions are made based on a deep understanding of how the global financial markets and monetary system works together with a sound understanding of financial history.

If anything, technical analysis is important because of the fact that a lot of investors rely on it solely (often "less sophisticated" investors – although many with significant capital). If enough people act on a certain chart pattern, the result is, to a degree, "self-fulfilling".

“Technical analysis” encompasses a variety of techniques. Perhaps the simplest is the old adage “the trend is your friend” – if an asset price continues to trend higher then why wouldn’t you keep holding it for as long as the trend stays intact?

Then there’s analysis of “support” and “resistance” levels – lines that can be fitted to a chart where a price seems to not fall below or doesn’t want to go above. These may be horizontal lines or upward/downward sloping trendlines/channels.

Then there’s all these kinds of “patterns” such as the “head and shoulders”, the “double top”, the “cup and handle” and oh so many more…

Additionally, there’s all sorts of “indicators and oscillators” – “moving averages” being the simplest then more complex things like “MACD”, “RSI”, “Bollinger bands”. These are derived from price data using mathematical formulas – e.g. the 10-day moving average is the average of the last 10 days of price data (or it can be weekly, monthly… or for hardcore daytraders perhaps 1-minute or 5-minute intervals).

So basically, technical analysis can be simple or very complicated. However, when used in isolation, the important thing to note is that there is absolutely no consideration of anything “fundamental” – no consideration about valuations, earnings outlook, expected interest rate changes, geopolitical factors… it’s all simply interpretation of price charts.

**Is the trend turning?**

Let’s have a look at that weekly chart above. What do we see? Well, aside from several significant corrections the trend has been up for at least the last 5 years (the timeframe covered by this chart). The markets had a very strong 2019 and then in early 2020 there was a brutal selloff.

Then “bang” – an incredibly strong uptrend that took the market from around 2200 to 4800 with barely a pause along the way.

But things seem to have changed. The market has now basically gone nowhere in a year. What’s more, we’re starting to see what might be a new trend forming – the highs set on rallies are lower… the lows set on selloffs have been lower. “Lower highs, lower lows”… We seem to be seeing a downtrend form.

**Buy high, sell low**

A fair bit of technical trading involves giving things “the benefit of the doubt”. This generally means the prospect of selling lower or buying higher. Let’s look at the daily chart for some examples. You might for example hear a technical trader say the following:

*“I went long (bought) around 4450 on that big reversal day a few days ago – thought there’d be some follow-through.  Gees, wrong!  Still, the range is intact and unless those prior lows around 4110 are decisively broken I still think there’s a good chance of a big bounce higher again.  I’ve got my stop set at 4100.”*

What this trader is saying is they are down on their entry point (losing money), but they still think it’s going to go up and although they have a chance to get out and cut their loss at 4180, they’d rather wait and, if decisively wrong, sell at 4100.

That’s fair enough.  It just doesn’t really sit too well with me.  Its well-known that many successful technical traders only make money on around 40% of their trades.  They key to success is managing losses.

For me, when it comes to technical decision-making, I’ve always been more drawn towards selling an asset that’s been excessively strong (“over-bought”) or buying when the selling has been brutal (“over-sold”).  This means going against a strong trend and that’s not normally considered the right thing to do.  But again, I’m not a technical trader and the chart setup has only been a modest component of that decision.

**Where’s the support?**

With the above understanding of how traders generally think, let’s focus again on that weekly chart.  If the market moves a little lower it will probably unleash a good amount of selling. From there, where’s the likely support?

“Support levels” tend to be previous highs or areas of “congestion” (areas where the chart chopped around in a relatively narrow band for a while).

At the moment you’ll hear some talk about “measured moves”, “Fibonacci levels” and the like. But keeping it simple, the strength of the previous uptrend means there’s little on the chart till we get to the pre-covid highs/the covid recovery congestion – the 3300 to 3460 band.  That’s around 20% away!

**In summary:**

Technical analysis is very widely used.

The charts are looking ugly.

Further falls will induce selling – the charts will "break down", stops will be triggered and a lot of people will become bearish on the outlook as the uptrend will have broken and a downtrend formed.

Those of us with more of a fundamental bias have been bearish for a while. That's because reliable valuation measures show markets as over-valued as they have ever been. I've been quite comfortable calling U.S. equities "a bubble" for a little while now and a 15% correction to current levels doesn't change this.

Pulling these things together, this helps explain why history shows that over-valued markets tend to fall quite abruptly. Remember that all-important concept of "equilibrium" – for someone to sell, someone needs to be induced to buy from them. If markets are over-valued, the "fundamental" guys (and girls) won't be too interested in buying. If the charts look terrible, the technical guys aren't buying (they are the ones doing much of the selling!)

The current setup is not good – a very negative fundamental setup meets a possible technical turning point.

There's scope here for a rather significant, abrupt, price adjustment lower.

As usual, this is not a prediction, just an objective observation…

**Inflation and Interest Rates**

The debate continues to rage about how high U.S. interest rates will rise and what will happen with inflation.

As we've discussed in recent months, the Federal Reserve is in a very difficult position. The Fed's policy mistake has already occurred. By choosing to hold rates too low for too long (whilst also engaging in their ridiculous Quantitative Easing" strategy), they can take a lot of credit for the bubble in share markets. Then throw on top of that massive fiscal stimulus in terms of government Covid responses, it's little wonder inflation is a bit of a problem.

For the Fed, their intentions have been good. They don't want to be remembered as the guy who stood by and did nothing whilst America suffered – that's ultimately what drove Ben Bernanke to start this quantitative easing experiment. You can apply that logic to their current predicament – do you think they want to risk being remembered as the guy who did nothing whilst inflation ran rampant?

Over the past month, various Fed officials have spoken about the situation. They have been preparing everyone for the likelihood of significant rate rises – multiple 0.5% rate hikes are now expected this year.

Markets are also starting to price in interest rate increases in Europe.

The ECB deposit rate currently sits at -0.5% (!) and an increase would be the first since 2012! The latest Euro-zone inflation number came out at a record 7.5% - smashing expectations (not sure why!). Australia's CPI for the March quarter was released just the other day. It confirmed what most of us already knew – inflation is here also. The yearly rate of 5.1% is the highest in 20 years.

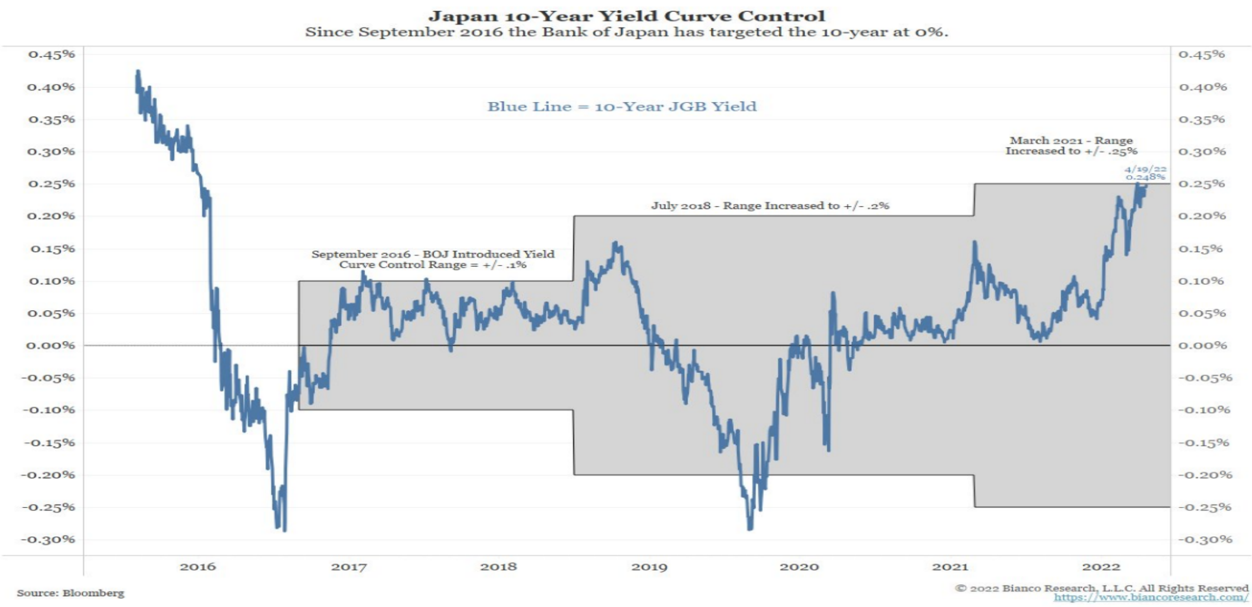
Before we return to the interest rate outlook, let's take a detour to examine one of the winners from the last month or so.

**Winner of the month…**

There's been a few star performers for the month – many being in the commodities space. However, to many finance nerds, the most fascinating winning trade has been short Japanese Yen. We're all well aware that the Japanese have been the global leader in "unconventional monetary policy"

Their economy – or at very least asset markets – have never really recovered from the spectacular bubbles blown in the '80's. Whilst, "healthy" in some respects (i.e. low unemployment and low growth), deflation has been the key theme for many years and their central bank has been willing to try all kinds of things to stoke some inflation and growth.

Just one of their strategies began in September 2016 when they committed to a maximum interest rate ceiling of 0.25% for their 10-year Japanese Government bond. Remember that yield moves inversely to price – i.e. falling bond prices means rising yields. So in essence what the Japanese central bank pledged to do is if bond prices started to fall to an extent that yields pushed up to the 0.25% mark, they would step in and buy as many bonds as needed to keep yields below 0.25%. Here's what that period has looked like for the 10-year yield (courtesy of Bianco Research):



Notice that the yield has been pushing up on their stated ceiling.  And the central bank has been defending it by buying bonds.

But this defence seems to have come at a rather unexpected price:


The Yen has collapsed (the chart above being USD/JPY or the number of Yen required to buy a US$).

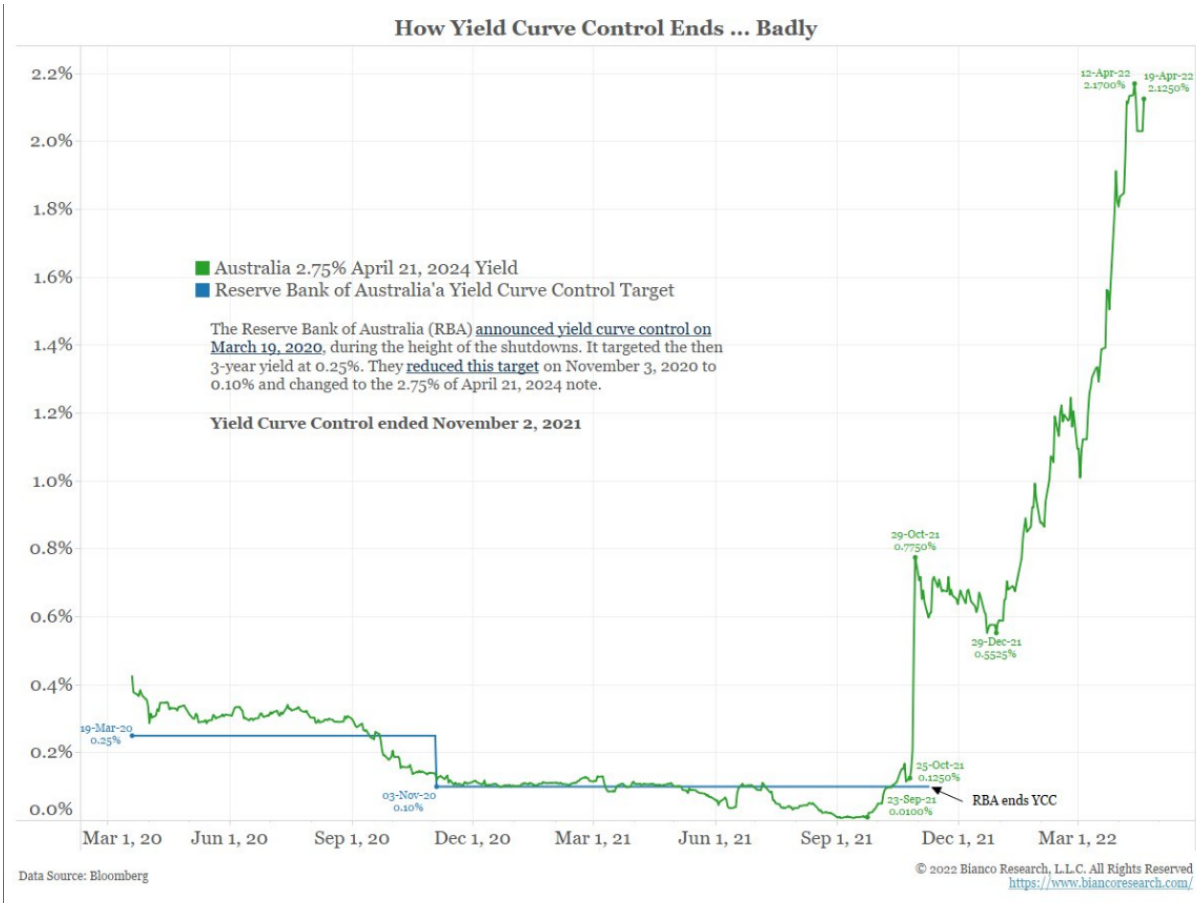
It seems that the Japanese Central Bank might be facing the need to make a choice:

Do they abandon their pledge to keep yields under 0.25% in order to protect the value of their currency?

Or do they continue to fight on?

And what will happen either way?

As Bianco Research reminds us, there's at least one interesting precedent in terms of what happens when you need to abandon yield curve control.  It comes from our own backyard…




As described on the chart above our Reserve Bank announced during the depths of Covid that they would cap 3-year yields at a certain level. That worked okay… until it didn't.

I've mentioned in recent months that evolving interest rate differentials might create some real issues in parts of the world. Notably, China needs to provide support to its weakening economy whilst many developed economies are set to raise interest rates significantly. I'd suggest this current Japanese situation is an emergence of the same forces.

**Fun with calculators**

With inflation finally arriving here in Australia, there's a growing expectation that our Reserve Bank will need to act.

The National Australia Bank expects rates to go up to 2.25% by the end of next year. Some are predicting them to go above 3%.

This would have a really profound effect – in various ways.

Here is Australia, our home mortgage market works predominantly on "floating rate" loans. The interest rate applicable varies over time based on official interest rates.

Currently, the average Aussie mortgage for an existing home sits at around $600,000.

The standard variable rate is currently somewhere around 2.5%

If we plug these numbers into a mortgage repayment calculator, we find that monthly repayments on a 30-year mortgage are around $2,300.

If official interest rates go up by 2.5%, we can expect the standard variable rate to follow this – to roughly double to around 5%

Plugging these numbers into the calculator we find that repayments would be around $3,200 per month.

Close to $1,000 per month increase.

If that happened, the household budget gets tighter for many – discretionary spending is reduced. For some, an increase in repayments of that magnitude would be disastrous.

Any appreciable rise in interest rates will likely have a significant impact on the economy.

That’s the pickle our Reserve Bank finds themselves in. A similar situation to the U.S. Fed. By cutting rates to nearly zero, people have adjusted to the current environment of low rates and are basing decisions on that continuing.

It’s worth remembering that the whole point of raising interest rates is to, essentially, “damage” the economy. Money is supposed to get more expensive and harder to come by thus having a dampening effect on the economy. If it isn’t, policy actions aren’t working and the central bank needs to work harder to tighten conditions.

This is the unpleasant dilemma for nearly every developed-market central bank at the moment – economies are hardly overheating yet they need to tap the economic brakes to address inflation without swerving off the road.

A shift in interest rates from, say, 0% to 1% might not seem like a lot. But we know that many things are finely balanced. It’s probable that there will be more unexpected/unintended consequences resulting from upsetting the delicate equilibrium.

We wish central bankers the best of luck in their pursuit of a “soft landing”.