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By the Way

Monthly commentary from Jack Way

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""Better to remain silent and thought a fool than to speak and remove all doubt."

I wrote last month that the vagaries of war on the ground don't directly affect financial markets. That point was driven home for me last week. As I watched news reports of the destruction of the Ukrainian city of Mariupol, and in particular the bombing of a movie theater where hundreds of civilians were hiding, I received my regular morning market note from a major Canadian brokerage firm. The letter advised me that markets were "drifting on light volumes as the news flow remains minimal and uneventful overnight". Not my definition of uneventful, but as a different commentator bluntly wrote "war news is old news". This is not to suggest the Russian invasion isn't having a major impact on the global economic, inflation and geopolitical outlook, which in turn, definitely affects financial markets.

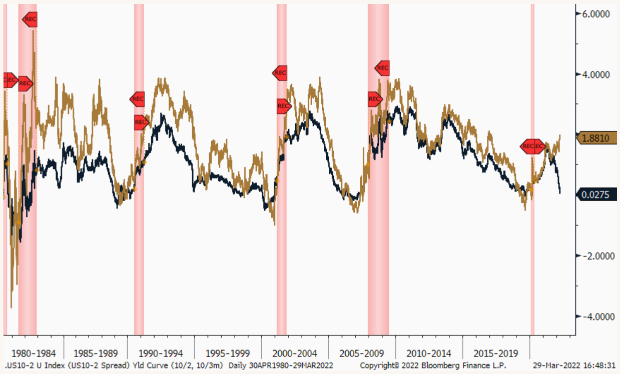
The length and severity of the conflict will go a long way to defining how harsh the effects will be, but even at this point we are getting a sense of where we could be headed. So far the area most immediately affected has been energy, as Russia is a major supplier of oil and in this case even more so of natural gas. As we all know and are experiencing, the price of both products has risen sharply, driving up the rate of inflation. Europe is dependent on imports from Russia to heat their homes, and as a result, energy is the one area that cannot, at this point, be the target of sanctions. European Council President, Charles Michel, said succinctly; "The goal is to be painful against Russia. The goal is not to be painful for ourselves". The result is energy exports continue to be a major source of funds with which Russia can finance its war efforts. As an aside, those saying we will need to broaden sanctions to include China; be careful, such a policy will definitely cause blowback on our own economies.

The second significant sector impacting global inflation and economic stability is agriculture. You'll get different numbers on exactly how much wheat and corn is grown/traded by the combination of Ukraine and Russia, but the amount is certainly meaningful. North Americans aren't going to be without their morning toast, but those on a subsistence diet, as in sub-Saharan Africa, could very well suffer from supply shortages and the price increases. In addition, the Ukraine and Russia are suppliers of nutrients for fertilizer production. A shortage of ingredients such as potash, nitrogen and phosphate are already driving fertilizer prices much higher, which raises food costs and also potentially decreases the yield from farmers' fields. Russia is also a key supplier of products like nickel and palladium amongst other metals and gases required in modern technology. The full extent of the economic damage remains to be seen, but we are already seeing estimates for GDP growth declining and for inflation rising. As for geopolitical risks they are obviously frightening and dependent on one's political bent.

The amount of discourse being disbursed on where inflation, and by inference Fed policy is headed, belies the fact that experts and the Fed itself are notoriously awful at such predictions. It may be hard to believe in the current environment that it was less than two years ago in August 2020 that Chairman Powell announced a new Fed policy to promote (not fight) inflation. After over a decade of easy monetary policy had been unsuccessful in getting inflation up to the Board's target of 2%, he stated that the fed funds rate would remain low for an extended period even as the economy ran "hot". This would allow inflation to exceed the target in an effort to reach an "average" 2% over time. Obviously the Board didn't foresee the 7.9% CPI we have today. Even more recently in its December 15th press release the Fed "reaffirmed the 0 - 1/4% target rate until labor market conditions reach levels consistent with maximum employment". Only four months later the labor market is definitely taking a back seat compared to fighting inflation. My point is that things can change quickly and none of us has a crystal ball, so those running around with their hair on fire predicting the Fed will sharply raise rates and throw us into a recession might want to relax just a bit.

Speaking of recession, a lot is being written about the so-called "inverted yield curve", which has historically been a precursor to many recessions. During normal markets short term interest rates are lower than longer term, which is to be expected as the longer one loans out money, the more risk one is taking. As a result, a line connecting the various rates of interest available over time will trace a curve starting in the lower left of a graph and rising to the right. However at times when short rates are rising (probably in expectation of the Fed raising rates to fight inflation or an overheating economy) they can exceed longer rates as investors become concerned about an economic decline. As a result they will buy bonds to ride it out and that demand increase will push rates down in the sector of the market. You'll note that the inverted yield curve reflects investor expectations, and is not necessarily a driver of economic results. It is an example of correlation not causation, but at the same time given the number of times a recession has indeed followed inversion it would be a mistake to ignore it. A major confusion in using the inverted yield curve as a predictive tool is that different people use different time periods to measure when an inversion has taken place. Academics tend to compare 3 month Treasuries to the 10 year rate; market pundits look more at the 2 year rate versus the 10 year; and the Federal Reserve prefers to study the current 3 month rate against the expected 3 month rate 18 months into the future. (The Fed measure is currently the farthest away from inverting.)

Figure 1:
US Yield Curve
10-2yr (blue line) curve is close to inverting while the 10-3mo (gold line) is steepening. Historically, an inversion of <u>both</u> has preceded a recession



Source: Bloomberg, Mulvihill Capital

The S&P 500 has displayed remarkable resilience, in my opinion, given the myriad pressures we are experiencing. Number one for me is the high and persistent rate of inflation, with the war in Ukraine only adding to that risk. Rising interest rates are also a major cause for concern, but at least to this point Chairman Powell has done an admirable job of preparing markets in advance. However, losses are being experienced in the bond market from the increase in interest rates and that has proven to be a win for stocks as investors make a switch to equities. Last month I suggested a break down in the S&P 500 would lead to a further 10 – 15% decline, but I added that many internal market and contrarian indicators gave hope for better things.

Both are no longer applicable. The index did indeed break below the indicated level, but then held and rallied strongly higher again. That rally pretty much reversed the contrarian indicators like the put/call ratio and bearish surveys which have now turned more negative. Volumes have become very low recently, perhaps responsible in part for some wild moves in markets. Here are three examples: between March 9th and 22nd, the S&P rose 9%; in a brief 5 day period the NASDAQ went from only 18% of its members above their 10 day moving averages to 90%; the S&P 500 was up at least 1% for four consecutive days which had only happened five other times in its history. (Every time it has occurred the market was up over 20% in the following 12 months.) All of which cautions us that short term predictions are a fools errand in the current environment. As for myself, I will fall back on the old quote often attributed to Abraham Lincoln; "Better to remain silent and thought a fool than to speak and remove all doubt."

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