the advisor

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Sunny & Warm

"No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future." Ian H. Wilson

"It is our attitude towards events, not events themselves, which we can control. Nothing is by its own nature calamitous." Epictetus

Weather forecasters have a thankless job: it is often difficult to get an accurate prognosis even two days hence, and then they get blamed for being wrong. Yet some climate alarmists, rightly or not, predict with certainty what global temperatures will be one hundred years from now. But there is an awful lot of uncertainty between now and then.

The trouble with the future is that it's unknowable. And investing is all about the future.

For the majority of people, thoughts of what the future holds are an extrapolation of the immediate past, a general feeling it will be more of the same. This probably means not much better and not much worse either.

The assumptions people form about the future are heavily influenced by the mainstream media's control of information. But the MSM's narrative is often shaped to distract rather than to inform. As a society, we seem to be poorly served by it.

Economic forecasters have little choice but to base their judgements on models. Whether complex or simple, models consist of economic assumptions which are based on individuals' relationships and responses. To employ a model's output, one must believe the model is reliable. However, as investing legend Howard Marks has argued, modelling something as complex as an economy is incredibly difficult.[1]

An economy depends on individuals whose "… behaviour is unpredictable. And if the participants' behaviour is unpredictable, how can the workings of an economy be modelled? What we're talking about here is the future, and there's simply no way to deal with the future that doesn't require the making of assumptions. Small errors in assumptions regarding the economic environment and small changes in participants' behaviour can make differences that are highly problematic."[2]

If Howard Marks finds economic forecasting difficult, what is the average investor to do?

Let's start with the current financial market conditions and then examine some keys that may help us navigate the future.

Right now, there is no shortage of exogenous shocks (energy, supply chains, inflation, borrowing costs, war, etc.) to complicate assumptions. The investment consequence of these shocks is like living in a Groundhog Day movie, with a slow market grind lower day after day after day. We don't know when it will end.

In recent weeks, central bankers have been following the US Federal Reserve's panicky monetary policy, desperately trying to raise rates as fast as they can to contain inflation. This is causing all sorts of havoc and destruction along the way. Thus far this year some $30 *trillion* invested in stocks and bonds has been eviscerated.

Once you apply stress to a complex system, the resulting pressure will seek a release valve - currencies being one of the obvious candidates. Rising interest rates have powered the American dollar, up 16% year to date relative to a basket of other currencies. The flow of capital towards America's fast-rising interest rates is proving increasingly difficult for other economies to handle. Falling currencies mean higher import prices, exacerbating inflation problems and forcing other central banks to undertake their own painful rate increases.

Emerging market countries with deficit and dollar-denominated debts are slipping into recession. Developed markets are not having a good day out either.

The result of tighter financial conditions and hawkish monetary policy has been an epic rise in global bond yields. Rising interest rates have given US bond investors the worst shellacking since 1949.

Equity investors have been similarly pummelled. Faced with low interest rates beginning over a decade ago, stock investors became convinced that they had no alternative but to

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speculate. As speculation drove valuations beyond their historical norms, investors embraced the idea that valuations no longer mattered. Until they do.

American stocks, down some 20% and more this year, are still not fairly valued. Based on Warren Buffett's preferred valuation model (the ratio of the US stock market to GDP - see chart this page), prices are 24% above trend. This model does not mean markets face imminent collapse. If markets return to trend though, forward returns will likely be lower compared to what we have experienced over the last decade. Remember the financial dictum, "The price you pay today for any investment determines the value you will receive tomorrow." Valuations are one key to the future.

This maxim does not mean that markets will produce low returns every year for the next decade. There may be some great years to invest during that time. Some of those years could also be spent making up for the losses from the (likely) coming recession and market correction.

If we get a recession, it will be because central bankers have misdiagnosed the nature of today's inflation. They are trying to throttle it by reducing demand in the economy. They are focusing on "demand pull" inflation, where consumers buy in anticipation of even higher inflation to come. But the inflation we are experiencing is "cost push" inflation, which comes from the supply side, not the demand side. It comes from global supply chain disruptions and the war in Ukraine.

If central bankers have misjudged the problem, then they are applying the wrong solution. Higher interest rates will not fix a supply shock; higher prices will continue regardless. But elevated interest rates will hurt consumers through higher mortgage rates, negatively affecting housing prices. Higher rates will reduce consumption. This will have a knock-on impact for businesses and employment.

If history is any guide, the Fed will overshoot and there won't be a 'soft landing'. The damage inflicted may help the Fed get to its inflation target but at the cost of increased unemployment, deflated markets and growing misery.

Such is the nature of investing. There could be fantastic bull market runs in the future, but for you to experience the exuberant ups, you will have to endure the painful downs. It is part of the progress that makes up every economic cycle. Economic cycles are inevitable. While central bank interventions can delay and even extend the cycles, the reversion to trend will eventually come.

Every financial plan has to survive challenging times in the market. It's important to remember to focus on the right things during those market conditions. The shorter the investment horizon, the more influence psychological factors have on changes in valuations and market returns. For successful investing results, it's probably better zooming out and focusing on the long run. Perspective and time can help you navigate market dislocations.

If you've already accumulated financial assets, this drawdown is the other side of a decade-plus of gains in the stock market. For the first time in a long time, retirees can lock in higher yields on the fixed income part of their diversified portfolios. While equities have been the key driver of returns over the past decade, bond and GIC income can finally pick up some of the slack going forward. Diversification is another key.

If you're an accumulator of financial assets, this volatility should be viewed as an opportunity to incrementally buy quality assets at lower prices, in anticipation of better times ahead.

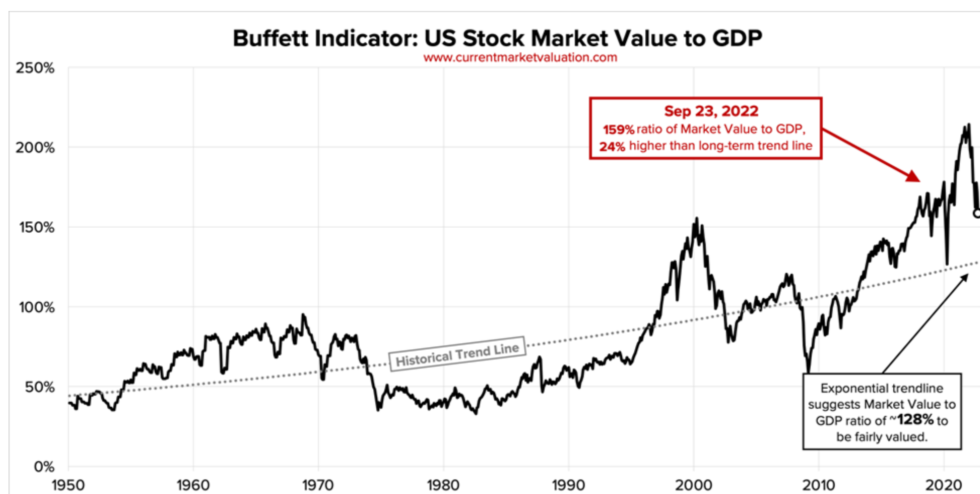
Either way, it's important to remember that volatility - up and down - is a feature of markets. There is nothing you can do to control that volatility. But you can control how you react to it.

The Stoic philosophers offer guidance for conditions outside our control. Seneca recommends: "He robs present ills of their power who has perceived their coming beforehand."

Being prepared for what may unfold - not prophesying - is key.

As for the weather, it'll be sunny and warm. On some days.

Just as in the markets.



Sources:

1. Howard Marks, "The Illusion of Knowledge", Oaktree Capital, 8 Sept. 2022
2. Ibid
3. Chart page two, Current Market Valuation, currentmarketvaluation.com, 23 Sept. 2022

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