the advisor

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Is the Worst Over?

"Going into bubbles breaking, profit margins are always at a peak. Bubbles don't peak for no reason. They peak because economic conditions are nearly perfect. The first thing to go is the profit margin."
Jeremy Grantham
CNBC, 18 May 2022

What a first half it's been for capital markets! Global equity and debt capital markets have lost a cumulative $31 trillion. The main American index, the S&P500, is down 20% from its high, the Nasdaq, where tech darlings are listed, is down 30%, and bonds have experienced their worst episode since 1994. Many investors are wondering if the worst is over.

Markets deal with the allocation of capital. When the markets are functioning effectively, they allocate capital efficiently based on the associated risks at the right price. When they don't work – because of crises, shocks, or distortions – there are consequences.

Since the Global Financial Crisis of 2007-09, central bankers have set interest rates at artificially low levels, distorting markets and the relative price of all financial assets. Central bankers' then advanced their monetary experiment with quantitative easing, which hides liquidity gaps that only appear during a crisis; the same bankers then have to bail out the affected assets. When well-meaning politicians also start interfering with the workings of markets (as during a pandemic or a war), things are more likely than not to go pear-shaped. Now they have.

Inflationary forces not seen in forty years have been unleashed. Until last year this was mostly a supply chain issue. But politicians could not resist getting involved (energy restrictions, economic sanctions, etc.) too. With the lifting of covid restrictions, demand has increased but we still have supply constraints, so prices must adjust to reflect the imbalances. The only way to get prices back under control is through "demand destruction".

Thus the US Federal Reserve will likely continue increasing interest rates and decreasing its balance sheet (i.e. quantitative tightening) - until demand is reduced. With inflation reaching high single-digits, rates may need to exceed 10% - over three times current levels to make a difference. The US government has $32 trillion of debt and simply cannot afford those kind of rates. If rates just equalled the level of inflation, the interest payments alone would exceed 100% of tax receipts. This year's bear market has been largely warranted by the sharp rise in expected interest rates now embedded in real bond yields.

Raising rates has an indirect effect on the level of inflation. When commercial bank rates increase, people borrow less. Banks create fewer loans via the fractional reserve system. Less money is then deposited by the borrower to be re-loaned again. Higher rates typically cause the amount of borrowing from commercial banks to drop and that affects the money supply, not inflation directly. Higher rates curb demand.

A larger influence on inflation is the American government's borrowing to fund its annual deficits. A lot of the debt created is non-productive and does not enhance economic growth. The government cannot sell all that debt to the public or to foreign investors so they have to sell the unsubscribed debt to the Fed, which buys it by printing money. All that newly printed money affects the US dollar's purchasing power and its value relative to other currencies.

Our view of the medium term is that today's inflation will likely decline to 3% - 4% once the multitude of shortages driving up inflation stops getting worse. All that is required to drive down inflation is for prices to stop rising - even if they stabilise at elevated levels. Living standards will be negatively impacted due to the permanent increase in what people pay for commodities. However, the future rate of inflation could revert to 3% even if prices remain elevated.

What motivates investors are prospective returns in excess of inflation. Yield to redemption is a one measure of the expected return for a bond; the higher the yield, the greater the expected return. Similarly, the earnings yield (i.e. the inverse of a stock's price-to-earnings ratio) is a reasonable estimate of the expected return for a stock. These measures can be aggregated across the bond and stock markets. The gap between

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Is the Worst Over? (cont'd)

the two yields provides a forward-looking measure of the equity risk premium for long-term investors. The higher this premium, the keener investors should be to own stocks over bonds. The latest equity risk premium suggests equities are more reasonably priced and have incorporated higher future interest rates. In spite of the first half's carnage though, equities are not (yet) priced at levels associated with bargains. We are still missing fear.

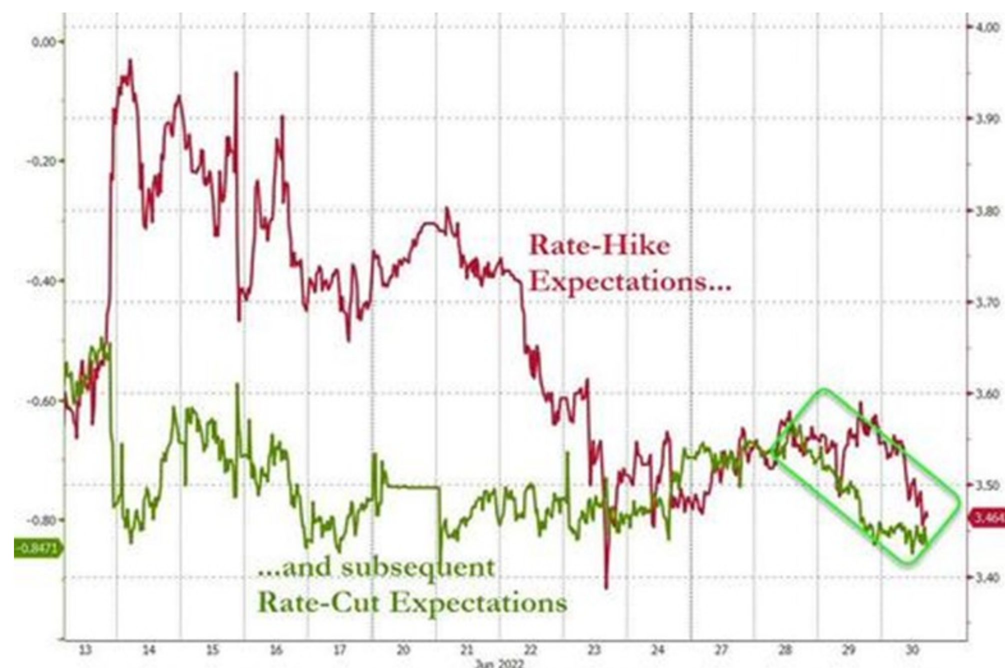
In a recent interview, economist Stephanie Pomboy explained that a measure that she relies on as a proxy for corporate profit margins has plunged to lows not seen since the mid-1970s. Pomboy said that this proxy gauges the difference over time between consumer price inflation and business input cost inflation [the Consumer Price Index (CPI) versus the Producer Price Index (PPI)]. It basically measures the input costs to business versus their ability to pass them on to consumers.[1]

If the proxy dips into negative territory, it means that consumer price inflation is higher than producer price inflation, a situation in which businesses are absorbing part of the inflationary surge and impacting their bottom lines. "In the last year, we've seen a gap between the two of those that implies the most acute profit margin squeeze … in 50 years," Pomboy said.[2]

Pomboy described the implications as a looming "profit recession" for U.S. businesses, arguing that Wall Street earnings forecasts will likely face sharply downward revisions, putting pressure on already-battered stock markets. Her grave forecast comes as a number of major American corporations have said they are stuck with extra inventory that they will have to mark down to sell, impacting their net profits.

Perhaps investors have not fully priced in the threat of a recession, meaning stocks could be poised for more downside. As investors shift from inflation anxiety to recession worries, rate-hike expectations have been tumbling. Subsequent rate-cut expectations are actually rising (see chart this page). But for now it appears investors are more worried about the Fed forcing the economy into recession than a post-recession rate reprieve. All of which suggests the Fed is now hiking rates going into a potential recession.

The stock market does not necessarily have to be pricing in a recession. It could simply be pricing in an era of higher inflation with higher interest rates and of an adjustment in valuations. At least equity prices now have a more realistic expectation of future interest rates.



For now recession is only a forecast. Maybe the capital markets suspect we are already in a recession. Or perhaps the markets are pricing in a recession that never comes. Or maybe we do get a recession but by the time it is recognised the markets have already bottomed and moved on.

The stock prices on offer do not yet suggest a bottom. Enduring bottoms usually begin in fear, spread in panic and end in capitulation.

Capitulation is reached when panic spreads not just from one stock to another, but across indices and asset classes. Capitulation typically manifests itself in downside waves. The greater the starting valuations, the more waves one typically observes. Set against these conditions, this bear market has yet to reach its nadir.

Capitulation is often a good buying opportunity, though it is rarely easy to take advantage of it at the time because of fear. However, if you are a long term investor, lower prices really are in your favour. Concentrate on building positions over time, accumulating whole positions in small stakes.

Because the future is unknown, taking a long-term investment horizon is essential. Decisions should be made from the perspective not of six months from now but of six years from now.

The worst is over. Or it is not. Use the situation to your advantage.

Sources:

1. Tom Ozimek, "A Profit Recession is Brewing That'll be the Worst in 50 Years", The Epoch Times, 24 June 2022
2. Ibid
3. Chart, "Ten Year Yields Tumbles Back Below 3.00%" Zerohedge, 30 June 2022

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