Financial Markets Perspective

July 2022

Struggling with Uncertainty

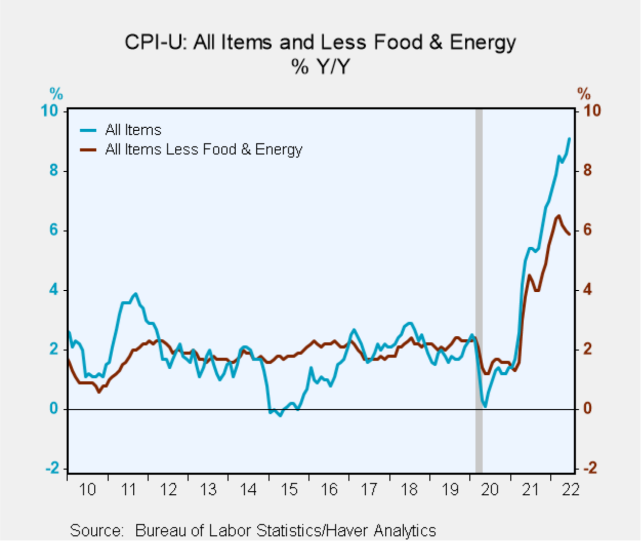
Introduction

As we concluded our Financial Markets Perspective at the end of the first quarter, we forecasted the following:

"If these new fiscal and monetary policies are implemented over the next few months, both financial markets and the economy could be under more pressure. If the invasion of the Ukraine continues through the summer, markets are likely to remain volatile…"

Unfortunately, federal government policies continue to be increasingly restrictive with interest rate increases and fiscal policies that appeared moribund in the face of major disagreements over government spending and taxing. In addition to an increasingly tight monetary policy announced by the Fed in mid-June, the federal government benefitted from a 97% increase in tax revenues for its most recent fiscal year. In addition, state government revenues have been exploding due to rising income tax collections as well as real estate and sales tax takings. Just look at California that was crying poor a couple of years ago and now has more than a $100 billion surplus! In other words, the government is taking billions of dollars out of the pockets of tax paying Americans resulting in the largest ever deficit decline (77%) in the first nine months of the fiscal year.

In addition to restrictive government policies, one probable cause of both bond and stock markets' deterioration was a surge in inflation that rose to a 40-year high during the month of June as you can see in the chart below. The main culprit for higher inflation has been energy as oil prices bounded above $120 per barrel and natural gas zoomed above $9 per British thermal unit. Additionally, many of the regular items purchased at grocery stores had double-digit price increases that strained consumers.


CPI-U: All Items and Less Food & Energy
% Y/Y

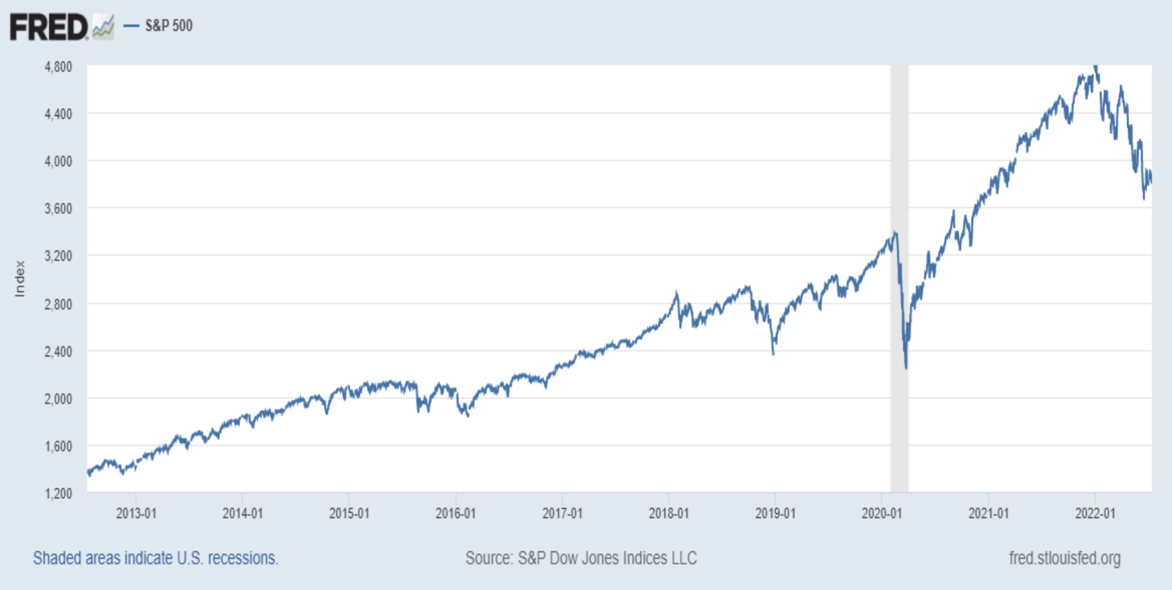
Source: Bureau of Labor Statistics/Haver Analytics

Part of the rise in oil prices was caused by federal and state government policies that have constrained domestic production. The current administration has weakened U.S. energy independence with proposals, policies and nominees that blame the fossil fuel industry for their missteps and out-of-touch aspirations, further harming an industry America needs now more than ever. When President Biden took office on January 20, 2021, the national average for a gallon of gas was $2.38. Today that price is $4.61 after reaching a high of $5.02 in mid-June of this year! The good news is that inflation has rattled the halls of Congress and policies to stimulate domestic production are having the effect of increasing oil and natural gas output.

Rising interest rates have a twofold effect: rising costs for borrowers and rising income for savers. The negative effect of rising borrowing costs can be seen in the rise of the 30-year fixed mortgage rate to 6.1% after bottoming last year at 2.7%. This increase has more than doubled the monthly payment on a mortgage loan that has pushed many borrowers out of the market and has punished retirees holding bonds. Fixed income securities across the spectrum are down double-digits so far this year with longer-dated paper suffering the most. Today, expectations are that a slowdown in the housing market is imminent, and history tells us that when such an abrupt change takes place, home prices are also likely to fall. However, home prices are not included in the calculation of the consumer price index. What is included is the change in rents and expectations are that rents will continue to increase and contribute to higher inflation. This rise will likely be offset by the decline in energy prices.

The Bear Market in Stocks

Investors who have a long-term perspective on investing in the stock market recognize that there are reasons for periodic declines in stock prices. Sometimes the business cycle is the culprit and other times there is an unforeseen event that causes a decline. The Y2K dot.com crash combined with the attacks on September 11th of 2001 resulted in a three-year bear market. The financial crises of 2008-2009 took more than 30% off the value of the stock market. Yet in these circumstances, investors fell back on the history of stock market returns that have always emerged from the darkest of times to move on to produce average rates of return of around 10%.



Shaded areas indicate U.S. recessions.

Source: S&P Dow Jones Indices LLC

An important factor in the current market decline that has contributed to a larger than expected retracement of the gains made since the beginning of the pandemic has been the unfortunate collision of record-low borrowing rates and a massive $7 trillion distribution from the government. As a result, the stock market soared to record highs with speculative stocks exploding on the upside. For example, the S&P 500 index gained 16.3% in 2020 while the more speculative NASDAQ Composite rose a remarkable 43.6%! Many companies that participated in this surge had no P/E ratios because they had no earnings! These stocks were bought on the hopes that a great idea today would be a great profit-maker tomorrow. Speculators could borrow at record-low interest rates and invest in a market of stocks that seemed to have only direction to go: up!

The bubble of 2020-2021 had to collapse because the economy would ultimately re-open after a forced shutdown and all those companies that benefitted from the work-from-home phenomenon would have to shift their business plans as employees started to go back to the office. Take, for example, the company Peloton that is an American exercise equipment and media company based in New York City. Peloton's main products are internet-connected stationary bicycles and treadmills that enable monthly subscribers to remotely participate in classes via streaming media. This classic work-from-home stock peaked at $167 on January 13, 2021. At this writing, the stock is trading at $8 and change. There are many other examples of companies that existed only because of the pandemic.

A similar phenomenon occurred during the late Nineties when everyone was preparing for the Year 2000, also known as the millennium bug, and abbreviated as Y2K, which referred to potential computer problems which might have resulted when dates used in computer systems moved from the year 1999 to the year 2000. According to Wikipedia, companies predicted the global damage caused by the bug would require anything between $400 million and $600 billion to rectify. In anticipation of this computer-induced apocalypse, many companies were created to resolve these fears. Yet as we entered the year 2000 without a single glitch, all those companies related to preventing the catastrophe went away.

More recently, the speculative nature of bitcoin and its brethren are undermining the investment in legitimate securities. Why digital securities are called currencies is strange as they have no characteristics of a currency that are 1) A medium of exchange, 2) A store of value, and 3) A unit of account. Calling a hyper-volatile bitcoin a cyber-currency is like the sleight of hand of the insurance companies that call death insurance a life insurance policy. Over the past few weeks, we have seen the dark side of these so-called investments as some have become worthless and others have been subject to multi-billion-dollar thefts. Add in the non-fungible tokens that are cryptographic assets on a blockchain with unique identification codes and metadata that distinguish them from each other, and you have a tulip bulb-like situation.

At the TechCrunch conference, Bill Gates of Microsoft fame said that digital asset trends are "100% based on greater fool theory," referencing the notion that investors can make money on worthless or overvalued assets as long as people are willing to bid them higher. All these factors have added to the broad decline in financial markets so far this year. The silver lining is that even with these enormous declines in stocks that benefited from the pandemic, the stock market is still much higher than it was in early 2020 before the pandemic brought about an end to the longest bull market in history.

The Russian Ukraine War

During the financial market adjustment and the surprise jump in inflation with the Fed's commitment to raising interest rates to slow the economy, Russia initiated a World War II like invasion of Ukraine that contributed to further financial market declines. The impact on oil and grain exports from both countries began to drive inflation higher around the world. America committed to sending both oil and gas supplies to Europe since Russia reduced exports of those commodities to Europe. As a result, exports from the U.S. of these commodities has contributed to rising energy prices at home. The further commitment by the Administration to provide arms and supplies to Ukraine in the multi-billion-dollar range will continue to pressure domestic energy prices as long as the war continues.

The war has triggered an important change in the attitudes of European nations to the invasion. Higher defense expenditures, supplies to Ukraine and invitations to join NATO to both Finland and Sweden hardens the defensive capabilities of Europe. Even Bulgaria, a previous ally of Russia, ordered most of the Russian diplomats out of the country. At last count, the war continued to rage on the Eastern front of Ukraine and the outcome of the war remains uncertain.

Conclusions

The equity market decline of the first half is reasonable given the size of the market advance since the market low of March 6, 2009. Seasoned investors understand that corrections occur periodically to limit speculative activity. Many equity investments remain above their previous market records of early 2020 and statistics measuring the value of the market have returned to reasonable levels. Lastly, we are only months away from the mid-term elections that could have an important impact on economic policy and financial markets.

As the third quarter begins, the economic excesses that characterized post-pandemic market volatility have almost returned to normal. However, restrictive government policies that have driven mortgage rates up will slow economic activity. Given this outlook for an economic slowdown, not recession, equity markets could stabilize after the 20% decline in the first six months of this year. Returns of individual stocks will be reliant on the success or failure of earnings reports as we proceed through the next few weeks. Depending on the speed with which the economy slows, interest rates may be at or close to their highs for this cycle and the Fed may adopt a less aggressive interest rate policy in the face of lower future inflation.

The Russia/Ukraine war remains a wild card in the global economic outlook. However, the U.S. could experience a rise in demand for certain exports. This expectation is reflected in the strength of the dollar over the past six months. If there is a bona-fide peace negotiation, financial markets should experience a sharp rally.

Covid is still lurking in the background as variants of the disease continue to impact individuals and businesses. A less urgent attitude about the disease and the absence of masks in many public places suggest that further gains against the virus will be difficult to attain.