ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

The market can remain irrational longer than you can remain solvent.
John Maynard Keynes

Friday, 17 February 2023

In this week's Investment Insight

Shifting sands
Both equity and debt investors have enjoyed an early rally this year as some of last year's oversold positions begin to revert. However, part of the support for the rally was borne of a view that interest rate increases, particularly in the US, would come to a halt and possibly even start falling. This might have been prematurely optimistic based on recent pronouncements from the Fed and the ECB. One way or the other, inflation and interest rates are highly likely to dominate the investment environment for the next several years. In *The Inside Track* we share some thoughts on the topic from Oaktree Capital Management's Howard Marks, who believes that the investment environment is currently going through a major transition, only its third in the last half-century.

The only way is up
During the dot.com bubble, about a decade after Yazz and the Plastic Population reprised Otis Clay's hit, many investors convinced themselves that 'the only way is up', as if to hedge investment bets was pure folly. In 2008, just as the Global Financial Crisis was about to unleash itself on the world's financial markets, barbers and taxi drivers had become investment analysts. During the Covid bubble, day traders, a sector of the market substantially dormant since the dot.com era, drove meme stocks to fanciful values and caused cryptocurrencies to soar. Each time, a different cause, a different duration, a different size but many similarities in investor behaviour and, of course, ultimately a similar outcome. Having just come through another apparent bubble, in *Pic of the Week* we pause for examination.

Newswire
Some interesting nuggets from this week's newswires.

Market view
A visual snapshot of recent market performance.

The Inside Track: Shifting sands

While mostly still cautious, after a strong start to 2023 investors have started wondering if the worst is over following the 'perfect storm' of 2022. While not predicting a repeat of 2022, Oaktree Capital Management's respected Chairman, Howard Marks, is cautious. He makes the folloiwng points:

- The underlying causes of today's inflation will probably abate as relief-swollen savings are spent and as supply catches up with demand.

- While some recent inflation readings have been encouraging in this regard, the labor market is still very tight, wages are rising, and the economy is growing strongly.

- Globalization is slowing or reversing. If this trend continues, we will lose its significant deflationary influence. (Importantly, consumer durables prices declined by 40% over the years 1995-2020, no doubt thanks to less-expensive imports. I estimate that this took 0.6% per year off the rate of inflation.)

- Before declaring victory on inflation, the Fed will need to be convinced not only that inflation has settled near the 2% target, but also that inflationary psychology has been extinguished. To accomplish this, the Fed will likely want to see a positive real fed funds rate – at present it's minus 2.2%.

- Thus, while the Fed appears likely to slow the pace of its interest rate increases, it's unlikely to return to stimulative policies any time soon.

- The Fed has to maintain credibility (or regain it after having claimed for too long that inflation was "transitory"). It can't appear to be inconstant by becoming stimulative too soon after having turned restrictive.

- The Fed faces the question of what to do about its balance sheet, which grew from $4 trillion to almost $9 trillion due to its purchases of bonds. Allowing its holdings of bonds to mature and roll off (or, somewhat less likely, making sales) would withdraw significant liquidity from the economy, restricting growth.

- Rather than be in a stimulative posture on a perpetual basis, one might imagine the Fed would prefer to normally maintain a "neutral interest rate," which is defined as neither stimulative nor restrictive. (I know I would.) Most recently – last summer – that rate was estimated at 2.5%.

- Similarly, although most of us believe the free market is the best allocator of economic resources, we haven't had a free market in money for well over a decade. The Fed might prefer to reduce its role in capital allocation by being less active in controlling rates and holding mortgage bonds.

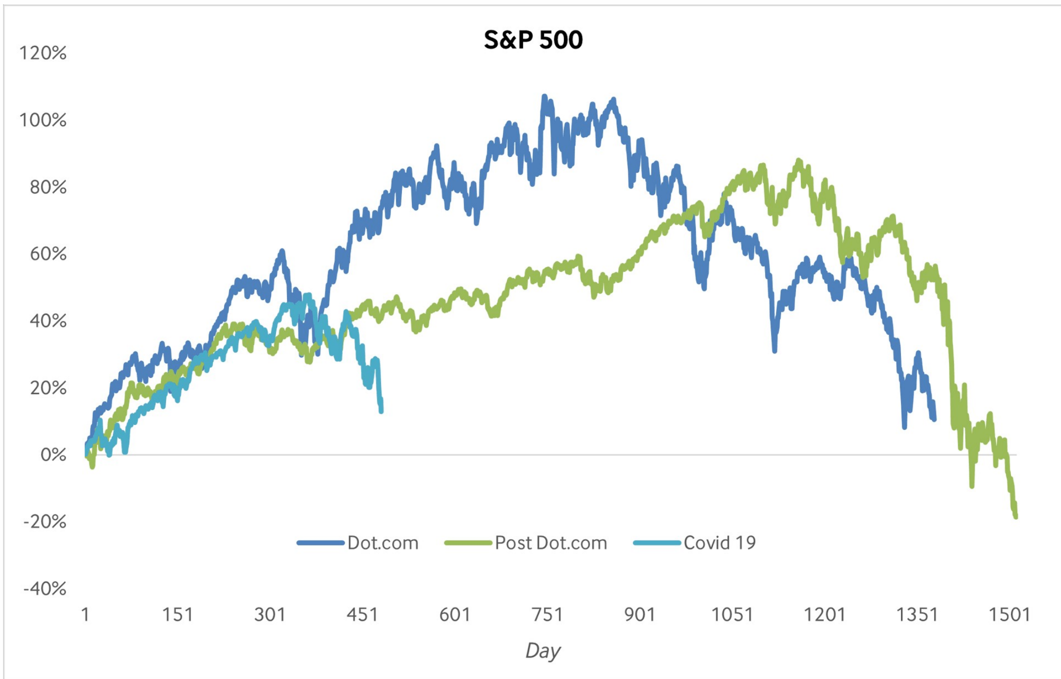
- There must be risks associated with the Fed keeping interest rates stimulative on a long-term basis. Arguably, we've seen most recently that doing so can bring on inflation, though the inflation of the last two years can be attributed largely to one-off events related to the pandemic.

- The Fed would probably like to see normal interest rates high enough to provide it with room to cut if it needs to stimulate the economy in the future.

- People who came into the business world after 2008 – or veteran investors with short memories – might think of today's interest rates as elevated. But they're not in the longer sweep of history, meaning there's no obvious reason why they should be lower.

Pic of the Week: The only way is up

Even with hindsight, it is seldom easy to point to the pin that burst a stock market bubble. It is not all that difficult to recognise the build-up of bubble-like conditions in the market. However, foretelling the length of, or trigger for the end of, a bubble is fraught with risk. As the chart shows, bubbles (often only thus-recognised after their deflation) vary substantially in duration and extent. The great bull markets typically turn down when the market conditions are very favourable, just subtly less favorable than they were previously, and that is why their end is almost always missed or called way too early.



Newswire

...on Monday
Wall Street claws back the losses from the previous week with the S&P500 rising 1.2%.

...on Tuesday
Japan names academic Kazuo Ueda as its pick to become next central bank governor.

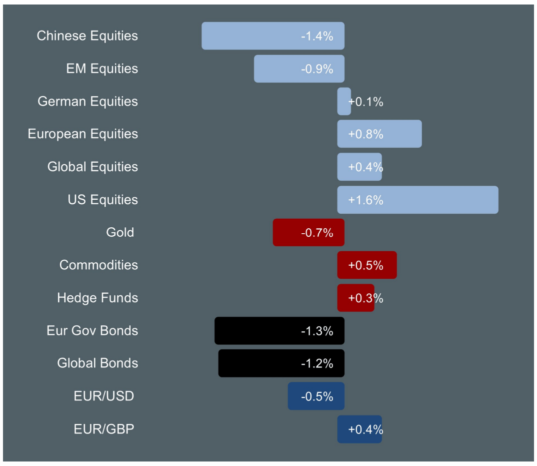
...on Wednesday
ECB study finds one third of Eurozone employees favour remote working.

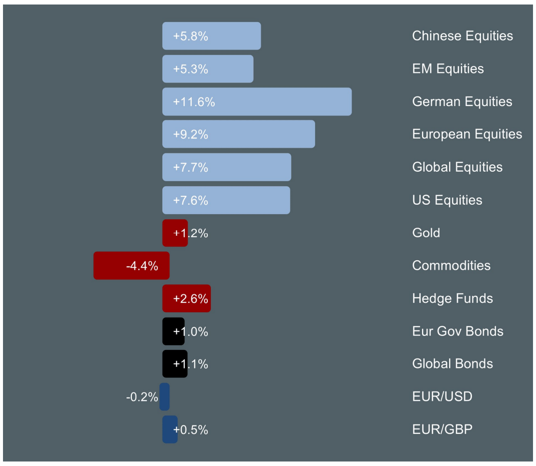
...on Thursday
China sanctions Lockheed Martin over Taiwan arms sales.

Market View

Last 7 days (€)

Year to date (€)





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