COOPER WEALTH MANAGEMENT
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THOUGHTS FROM HOME

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The Opposite Reaction

"For every force applied, there is always an equal and opposite reaction."

- Isaac Newton, Newton's Third Law of Motion

Isaac Newton's Laws of Motion describe the science of objects moving in nature. His Third Law holds just as true in the investment landscape as it does in the real world, starting with the basic premise that for every sale to be completed, there has to be a buyer. When the U.S. Federal Reserve decides to use its considerable force to raise interest rates, markets around the world react. This month, we will focus on Fed Chairman Powell's recent comments about fighting inflation and try to determine the potential effects on the market.

Powell's comments actually centre around two potential actions: quantitative tightening and raising interest rates. Quantitative tightening is the process where the Fed begins to sell back to the market the bonds it has been buying over the last few years. This is intended to drive down bond prices and therefore send yields higher.

The very threat of this was enough to get bond dealers to sell off their inventories and caused the yield on the 10 year U.S. Treasury bond to spike from 1.51% to 1.92%. However, an unexpected reaction is leading to a new problem: the 2 year U.S. Treasury has jumped from 0.73% to 1.31% and has further flattened the yield curve between 2-10 years. A flat yield curve is generally bad for the economy as it discourages banks from making longer term loans. This tends to hit small businesses hardest. The Fed has an interesting problem on its hands. Currently, 69.3% or $3.96 trillion of their holdings are in bonds that mature in more than 10 years. As they are selling these bonds, it will put upward pressure on the 10 year yield, but will this increase by more than the 0.25% increase for the 5 projected rate increases without further flattening the yield curve? We view this as highly problematic as the Fed only has $3.96 trillion to sell. It sounds like a lot but is a relatively small number compared to available global liquidity.

Rising interest rates will have little impact on corporate America as all S&P 500 companies have locked in low interest, long term financing. The people truly impacted by rising interest rates are the general public. Statscan says that the average Canadian owes approximately $400,000. If we assume Canada matches the US in rate hikes and rates go up 1.25%, it would mean an increase of $350 per month or about 18% higher monthly mortgage cost on a 25 year amortization. You can't fight inflation by raising housing costs that much and crushing the average family. You certainly can't do it and get re-elected.

One of the major components of inflation is energy prices. With oil over $90 per barrel, the cost of everything from fuel through to consumer goods has risen sharply. Fortunately, the U.S. is expected to add about 900,000 barrels per day of production this year and Canadian producers are pumping all they can but we see oil prices remaining stubbornly high for at least the next year, particularly as global travel picks up post Covid. In order to get prices down faster, it will likely need prices to spike over $100/barrel to spur the U.S. government into action with approvals for pipelines and further releases from their strategic reserve.

Covid has also been inflationary, as the strong demand for consumer goods has raised prices and jammed up the global supply chain. Now that Omicron is now basically at 100% and daily case counts beginning to drop dramatically after the most recent wave, there is cause for some very cautious optimism. Delivery times are coming down and supply chain issues have begun to ease, taking some pressure from prices. Demand driven inflation is usually the first to recede but expect some upward pressure on travel related costs (hotels, air fares, rental cars) as demand picks up again later this year or in early 2023.

The cost of labour will remain an inflationary factor until companies can adjust their operations or find more help. Given the low 3.9% U.S. unemployment rate, either the participation rate will have to increase or immigration will have to increase. The definite short term problem is the mismatch between the jobs available and the work force, as employers are looking for higher skilled workers to grow our increasingly complex economy. Retraining and automation take time so this problem will likely take much longer to resolve. Energy and labour will remain at least 2-3 year problems for now so there will be some persistent inflationary pressure, despite the Fed's best efforts. The U.S. government needs to look at their energy policy and job retraining programs rather than interest rates to combat inflation.

When the Fed starts stomping its feet, the market reacts with equal force. During January, technology stocks were sent lower because the market uses interest rates to help calculate the current value of future growth. Basically, the higher the risk free interest rate, the less the market is willing to pay for future growth. This seems an absurd view to us as companies such as Apple, Microsoft and Advanced Micro Devices continue to grow at double digit rates, well above any rate increases the Fed could impose, and have no need to borrow. We are maintaining our technology exposure and expect these companies to rally significantly as the perceived need for rate increases lessens. The last week of January also saw significant resilience as the market rallied 3 times from over 700 point sell offs. Bond dealers sold off inventory and yields rose, sending the bond market to a record 3% loss and billions of dollars into cash. At the first sign of the Fed faltering, they will return with a vengeance to lock in higher yields.

The Canadian markets by contrast had a good month as energy, commodity and financial stocks all rose. We plan to add more Canadian energy exposure this month to add some further inflationary protection to the portfolio.

If inflationary pressure does not slow sufficiently this year, Chairman Powell might get the unexpected opposite reaction of a rising bond and stock market if his interest rate moves and quantitative easing do not produce the results he is expecting. With the hope that Covid may be waning, strong corporate profits and consumer demand and the very real threat that other governments may be reluctant to move as quickly, this possibility seems just as likely given the other factors we have explored. We will continue to watch this economic experiment closely and make any necessary changes. Until next month, stay safe and healthy.

As always, feedback, questions, comments and concerns are always welcome.

Yours truly,
Trevor, Walter and the Cooper Wealth Management team