THOUGHTS FROM HOME

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Independent Thoughts on Groupthink

"If everybody is thinking alike, then somebody isn't thinking"

- General George S. Patton

Groupthink is the practice of making decisions as a group, resulting typically in unchallenged, poor quality decision-making. September has seen a remarkable example of groupthink in the market as traders abandoned their inflation hedging positions and are now solely focused on fear of a global recession. Basically, Wall St. believes the U.S. Federal

Reserve (Fed) will go too far in raising interest rates and force the world economy into recession. This month, we will be mindful of Patton's wisdom and review current market conditions, particularly inflation, with an independent eye so that we can best chart a course for the conditions going forward.

September was another tough month for markets with the U.S. markets down 10% and the TSX down 3.5% as the Fed's firm resolve to fight inflation via interest rate increases took hold. Traders gave up on the inflation trade, selling their commodity stocks and other inflation hedges, and moved en masse towards companies that might better weather a recession. Surprisingly, the Canadian market fared better despite being resource heavy. Oil and bank stocks held their own and the TSX has a much lighter weighting in technology. The market is now firmly betting that inflation is trending downward and the Fed will go too far with rate increases. We feel there are a number of factors which will play out in the coming months which could change this viewpoint from both the Fed's and the market's perspective so let's break them down.

First, a critical review of the inflation outlook. The prices of many goods are indeed coming down. Commodities such as gold, oil, natural gas and copper have fallen dramatically below their highs from earlier this year and well down from the peak of the last commodity cycle in 2014. We are also seeing inflation relief from the reduction in shipping costs as measured by the World Container Index. Last month, the shipping cost of a 40 ft. container was $5,986 U.S. as of September 29th, it had dropped to $4,014 U.S., with the cost dropping over 10% from the previous week, down 33% for the month and trending downward over the last 31 weeks. This drop is being driven by the normalization of the global supply chain as well as a marked drop in the demand for goods. The problem with inflation currently rests with agricultural commodities such as wheat and corn. Both have continued to trend to multi year highs with the U.S. harvest coming in below expectations and the continued disruption of the Ukrainian war. Here is our concern about how the Fed will react. The Fed monitors two key inflation measures: the Consumer Price Index (CPI) and the Personal Consumption Expenditure Index (PCE). The two primary components of CPI are food and housing when combined represent 56.5% of the Index, with housing being over 42% by itself. With the Fed raising interest rates, they have actually fuelled this measure of inflation and could make it worse by going further. We have until November before the Fed meets again so further data could help ease the situation.

Similarly, the PCE includes food and housing but also adds in what we spend on services, travel and leisure. Demand has risen considerably for services and travel as Covid restrictions have lifted so this type of inflation might be with us until pent up demand has been met and consumers go back to their normal spending patterns, as they have largely done with goods

purchases. Unfortunately, unless and until demand slows down, prices could remain elevated and the Fed would see that as a reason to continue increasing rates until things normalize.

However, there are a number of factors which could slow the Fed. First is the pending U.S. mid-term elections in November. As the polls stand, the Republicans could win control of both the House of Representatives and the Senate, resulting in political gridlock. The Biden government has been quiet about the state of the economy but with an empowered Republican party in equal control, we expect some political pressure to come to bear on the Fed if a recession seems to be on the horizon. Next has been the surge in the U.S. dollar. U.S. rates have risen so far and fast that the U.S. dollar has advanced to record levels against all global currencies, allowing the U.S. to import deflation due to the higher purchasing power of their dollar. This ripple effect in the global economy has been powerful enough to help force the United Kingdom, the world's sixth largest economy, to once again start back its own bonds to support the Pound, as it was on course to trade at par with the U.S. dollar. The U.S. sneezes and the world catches pneumonia. China and Japan are content to let their currencies depreciate as they get the benefit of their exports becoming cheaper, allowing them to sell more. On the other hand, the European Union (EU) does not enjoy such trade surpluses and as most international trade is denominated in U.S. dollars, we suspect there is a strong possibility the EU may have to follow England in buying back bonds to support the Euro since they still face a possible energy crisis this winter and are dealing with over 10 million Ukrainian refugees. If the EU or any other country is forced into a similar position, political pressure would definitely be on the U.S. to slow down their rate increases.

Next is the U.S. third quarter earnings season which has started this month. Markets will be closely watching both actual earnings and projections for next quarter to gauge the strength of the overall economy. Normally, we would want a strong quarter but it might actually be better if earnings are weak across the board as this could also slow the Fed.

Finally, we have consumer spending. It has slowed in the U.S. to 2019 levels, with a huge shift away from goods to travel and leisure. Spending over the Christmas season on both presents and travel will give us further guidance.

Given the variety of possible outcomes for inflation in the short term, our best defence is to try to shelter our portfolio as much as possible but with the view that we want to benefit from inflation if it lingers as we expect it might.

Our overarching goal is to achieve total return by maximizing dividends and call premiums where possible. We made two changes to the portfolio this month. We sold our Cargojet position, as we expect that even this strong company will be hurt by decreased volumes and moved into Waste Connections, a leading provider in the recession resistant waste

management business. We also sold out of Baker Hughes and moved to Archer Daniels Midland, a global leader in the production of agricultural products such as corn and wheat, which should benefit the stock if food prices remain high.

Strategically, we will also be realizing available capital losses in our taxable portfolios so we can recoup capital gains tax paid in the last three years or to carry forward to shelter future gains. As we continue our ongoing review process, we will keep you apprised of any further changes.

Market conditions remain difficult but any of the factors we have identified could improve and change the market's direction. Our goal remains to position your portfolio in the best alternatives possible, with a view to maximize cash flow and minimize downside where we can.

We will keep thinking independently and look forward to better days ahead. Until next month, we wish you continued health and happiness.

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

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

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