Money Never Sleeps

The newsletter for the informed investor

Wealth Management
Dominion Securities

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Exiting easy money

Hard landing, soft landing ... or no landing?

Markets are hard.

For the past two years, the S&P 500 has made little progress and remains about 20% off its late-2021 all-time peak. While investors continue to debate interest policy, it always seems to be this week's data point, or next week's data point, that is promised to be "the next most important ever data point" that will reveal the path forward and tell us whether or not a recession is actually happening. The dilemma for investors now, after watching and waiting with bated breath for two years, is seeing most results come to the same conclusion.

Equity markets have remained in a very narrow trading range, and it appear something has "broken" with the U.S. regional banks and, perhaps, the credit markets overall. The focus lately has turned to the commercial real estate market and commercial real estate loans. The rate hikes have succeeded in causing a huge credit contraction already. The leading economic indicators, along with the bond market, are signaling a broadening economic slowdown, although the depth and duration remain to be seen.

US Bank Lending Slumps by Most on Record in Final Weeks of March

- Loans by commercial banks declined by nearly $105 billion
- Deposits at US banks decreased for a 10th-straight week

(Source: Reuters https://www.reuters.com/article/sppage012-n05528226-oisbn-idUSN0552822620080505)

It's easy to be confused. Fourth quarter data points, retail sales, industrial production, and other data, suggested the economy was hitting a wall. Then, in January, nonfarm payrolls, retail sales and manufacturing production all surged. Maybe the unusually mild weather for January had an impact, maybe because of COVID-19, the global shutdowns, and the fiscal and monetary policy responses, the

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"normal" seasonal patterns of economic activity have been distorted even more. In which case, the numbers may have adjustments in the future.

The latest inflation data and interest rate policy will continue to dictate the overall direction of financial markets. While inflation has seemed to be steadily receding since its peak last June, prices are still growing well above the central bank targets of 2%. The U.S. jobs market remains remarkably resilient, riding a 53-year low unemployment rate of 3.4%. If this persists, expect interest rates to remain restrictive for longer, but once the central banks abandon the inflation fight (likely too early), expect inflation to remain higher for longer.

If the pessimistic narrative is wrong, and the U.S. isn't headed for a hard landing (i.e. recession), maybe it is headed for a "soft" landing, which would mean prolonged, but low, economic growth. Perhaps it's possible we see a "no-landing" scenario where the U.S. economy reaccelerates from here and does OK. The problem with the latter scenario is that inflation remains a major problem. Combine that with the economic equivalent of morphine wearing off as the high from free government cheques and loose monetary policy become a thing of the past, and there you have it.

Add to this an extremely dysfunctional political environment where politicians on all sides aren't concerned about the country but instead winning elections at any cost (i.e. "we can fix it later" thinking), and this increases the risk of policy errors and unintended consequences, exponentially.

This is why inflation will most likely remain persistent, and will keep coming and going in waves, similar to the early 1980s when I started in finance. Here is the rub though: The U.S. Federal Reserve (the Fed) cannot fix this problem.

The Fed's zero-interest rate policies over the past decade likely short-circuited the natural market's reaction to the fiscal recklessness we've witnessed in so many asset classes – recklessness the Fed and global central banks have enabled. And worse: No one seems to be standing up for fiscal rectitude anymore.

The connection between taxpayer and the national debt has come completely untethered. So governments could just run tabs until the bond markets fully crowd out private investment (for starters). This may suggest, by logic, that we could experience a window ("no-landing") where the economy is screaming higher, and the Fed (and other central banks) fall even further behind the curve. Then inflation related trades should work well.

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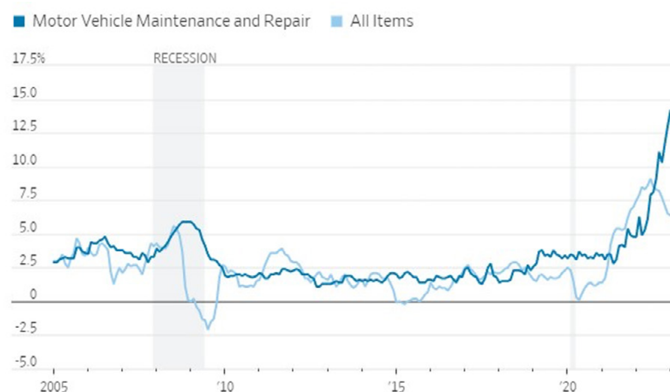
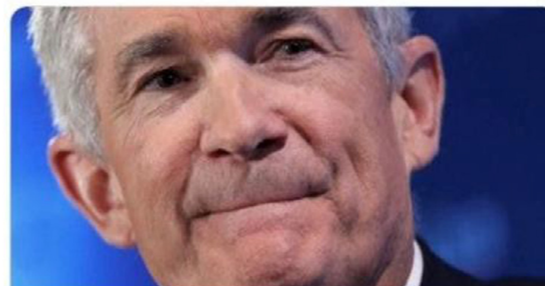


(Source: The Wall Street Journal [please provide the link])

Bloomberg @business · Apr 3, 2019
Low inflation is "one of the major **challenges of our time**," Jerome Powell says



bloomberg.com
Fed Risks Stoking Financial Bubble in Drive to Lift Inflation
The Federal Reserve risks stoking the same sort of asset bubbles that Chairman Jerome Powell has linked to the last two recessions with its ...

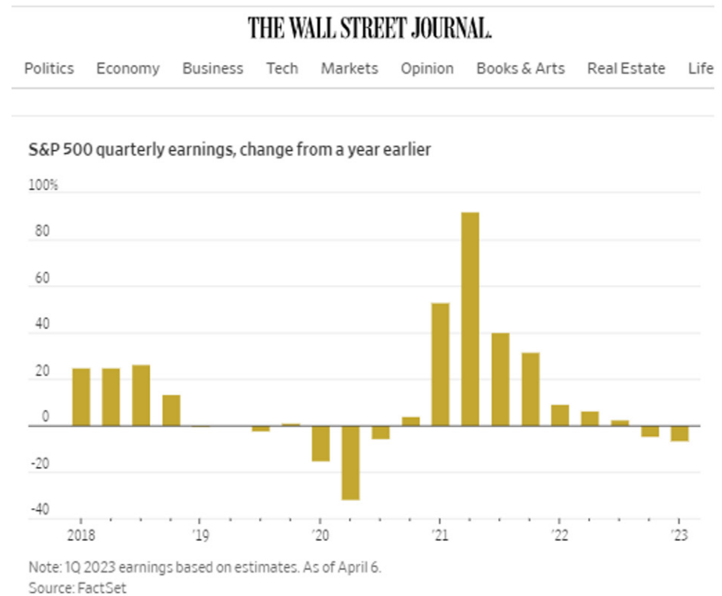
(Source: Bloomberg Finance 4.3.2019)

The main bottom line for us is that the bond yield curve remains deeply inverted, which has always been a sign for negative future growth. The broader money supply (as measured by M2) has slowed sharply. It's growing more apparent that it is not a matter of "if" the slowdown will occur, but rather only a matter of "when." We've already kept an underweight in equities, raised cash levels, locked some rates in, and extended some bond duration in anticipation. In terms of stocks, it is a conundrum: Equities rarely have two bad years in a row (since 1950, the S&P 500 Index has only seen consecutive calendar years of negative returns only three times) and last year's action may already have incorporated much of the bad economic news we see ahead.

Another market factoid that helps the bulls: The Presidential Cycle. Year three of the President's term has historically been the most robust, with an average return of 16.8% for the S&P 500 since 1950 and a win ratio (i.e . positive returns) of nearly 90%.

Canada may be done with its rate hikes, the U.S. may have one more time, another 0.25%, and that may be it. And then rate cuts will follow at some point. If the Fed ends up cutting interest rates early, our guess is commodities will rise big time.

We suspect volatility will remain, but that volatility is an inherent characteristic of owning equities, and always creates opportunities to invest in companies at attractive prices. The playbook for investing we've seen over the past decade will likely be different going forward, the "easy money" era is over. There will be new leadership and value, hard assets (commodities), stock picking, and short duration cash flows may come into vogue again – it's been some time for all of them.



(Source: The Wall Street Journal [please provide the link])

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