"Paradigm Shift"

April 28, 2022

The following are the Exclusive and Sole Opinions of the Author.

Overview

The Great Recession of 2008 was the genesis of long-term bull markets in equities and bonds and a long running deflation of commodities. In retrospect, the equity bull market may have ended in 2019, ***before*** *COVID scrambled the economy. The FED had raised interest rates seven time trying to achieve a soft landing. More than enough to slow the economy and lead to a stunning market selloff from October to December 2019, from 3040 to 2440 on the S&P 500. The FED responded lowering interest immediately; the market rallied 40% until the onset of COVID in March 2020. This extraordinary market oscillation set the stage for even more volatility as the market crashed again as Covid spread. The emergency restrictions were widespread and haphazard and maintained far too long, in retrospect. Mortal fear makes people do foolish things, obvious after a crisis has passed.*

The financial response to the Covid emergency was more of the same[1] – massive injections of liquidity – increasing the money supply 40%. From the Covid panic low in March of 2020 the equity markets rallied over 100% to recent top at 4820. Interest rates and commodity prices also began rising, going exponential in the last year. Current levels are even more extraordinary given the strong US dollar – which has attracted foreign capital at the same time depressing import price inflation.

Markets were flooded with liquidity both by printing money and buying debt securities. ***These measures were explicitly intended to increase inflation*** *above a hypothetically beneficial neutral level (2%) and then* ***let it run hot****.[2] The FED and the Treasury provided* ***far too much liquidity for far too long*** *supporting this poorly conceived fiscal policy. The result: inflation is too, too hot; it will take considerable economic pain to bring it under control. Insanity – doing the same things and expecting a different result – is on full display.*

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[1] 2001, 2008, 2019

[2] https://www.businessinsider.com/fed-inflation-markets-regime-change-strategy-stocks-bonds-economic-recovery-2021-3

In this volatile environment it is difficult to discern primary trends. Are stocks in a primary bear market? Bonds in a primary bear market? And commodities in a primary bull market?

Summary

Major market trend changes are infrequent. *A trifecta even more so. Yet this moment has arrived – as the equity, debt and commodities markets have experienced long term trend reversals. The short-term moves are astonishing, a counter trend reaction is becoming more likely. Starkly, the internal indicators of equity market direction appear to be rebounding. This is potentially the magic moment when sentiment overshoots and prices reach important lows. The yield curve also contains hints of a peak in interest rates. Demand destruction should eventually lead to lower commodity prices.*

Unfortunately, price patterns are bearish across many sectors, offering little support for this positive interpretation. Note well the long term up trend line at around 8,000 on the Nasdaq Composite, ***40% below the current level.***

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EQUITIES

A secular bull market is based on higher price earnings ratios applied to growing earnings. This multiplier is a subjective number reflecting the amount, timing, and certainty of expected future cash flows discounted to present dollars. *An educated speculation*. Many factors go into the forecasts, and these are constantly undergoing revision as information is updated. Slightly more often than stopped clock, the expectation and pricing align precisely. More often than not the market is "discovered" to be undervalued or overvalued as expectations materialize, resulting in adjustments – corrective price trends. The discovery process is one of the market's inscrutable mysteries. No way of telling when accumulating evidence produces a paradigm shift. The long-held beliefs in sustainable world growth, modest real interest rates and stable prices cannot be maintained, and a new investment gestalt develops. The foundations of the bull market are swept away. New metrics are applied.

A multiplication table is one way to visualize this dynamic. The price earnings ratio is on the vertical axis, a range that encompasses most historical market valuations. The earnings line, across the top represents a 10% band around the current consensus earnings estimates for 2022 of $225. The 2023 projection is for continued growth, to $250.[3] Bullish forecasts (outcomes) are in the upper left quadrant in green. A bear market produces the prices in the lower right corner. The recent high, near 4,800 is about 21 times 2022 consensus earnings of $225. High P.E. ratios depend on strong growth and low inflation, the opposite of the current economic situation. The current price 4392, is in yellow.

A reduction in the P.E. ratio to the long-term averages – 15-18 applied to flat earnings of 210 suggests potential lows for a bear market – 3,200 to 3,800. (Red)

The current upside/downside band is around 3,500 on the bottom to 5,200 on the top.

[3] https://www.yardeni.com/pub/yriearningsforecast.pdf

					S&P 500						
	EARNINGS										
P.E. RATIO	250	245	240	235	230	225	220	215	210	205	200
25	6250	6125	6000	5875	5750	5625	5500	5375	5250	5125	5000
24	6000	5880	5760	5640	5520	5400	5280	5160	5040	4920	4800
23	5750	5635	5520	5405	5290	5175	5060	4945	4830	4715	4600
22	5500	5390	5280	5170	5060	4950	4840	4730	4620	4510	4400
21	5250	5145	5040	4935	4830	4725	4620	4515	4410	4305	4200
20	5000	4900	4800	4700	4600	4500	4400	4300	4200	4100	4000
19	4750	4655	4560	4465	4370	4275	4180	4085	3990	3895	3800
18	4500	4410	4320	4230	4140	4050	3960	3870	3780	3690	3600
17	4250	4165	4080	3995	3910	3825	3740	3655	3570	3485	3400
16	4000	3920	3840	3760	3680	3600	3520	3440	3360	3280	3200
15	3750	3675	3600	3525	3450	3375	3300	3225	3150	3075	3000

A version of this table works for individual stocks as well. Many have moved from the upper left quadrant to the lower right rapidly. Prices on select issues are probably "fair", if not "cheap"[4].

FIXED INCOME

The long-term decline in interest rates began in 1981. There were periods of higher rates within the downtrend that led to many incorrect predictions of the imminent end of the bull market in bonds. The parable of the boy who cried wolf is apt, so a major change in the direction of rates had been discounted, despite temporary surges in rates. Not so today.

The peak of interest rates in 1980 was clear on the charts, but it was considered a minor pattern, not a significant top. High interest rate expectations were firmly imbedded, diminishing the understanding of the major changes underway. Investors were slow to embrace the new trend – waiting 10, or 20 years to recognize that double digit interest rates on Government bonds would not return. The low-rate experience of recent years had created complacency, now replaced by alarm. The rise in rates over the last two years has led to a far more rapid recognition of a potential long term trend change.

There are many indications that secular bull market in bonds has reversed. However, bond markets are manipulated by central banks. As a result, price signals are distorted, clouding analysis.

[4] Home Depot, (HD), Meta,(FB, Microsoft, MSFT - earning expectations and PE ratios have declined into the lower right quadrant.

Chairman Powell and the Board exercise nearly dictatorial power to alter short term price of money. They can change the supply of money in many ways. Interest rates are the price of money – which reflects the supply/demand balance. The FED is now aggressively reducing the supply of money causing rates to soar. The very same governors who insisted inflation was transitory enabling profligate spending are now among the harshest of the inflation hawks. (Never mind the material increase of financing costs on government borrowings.)

The FED and the Treasury conspired to print money out of thin air – quantitative easing. It was an extraordinary measure that lasted too long and was wildly successful at stimulating inflation. Interest rates soared when this helicopter money stopped raining down. The impact was far more significant than many had expected. Regardless, the FED is still committed imminent and rapid run off of the balance sheet.

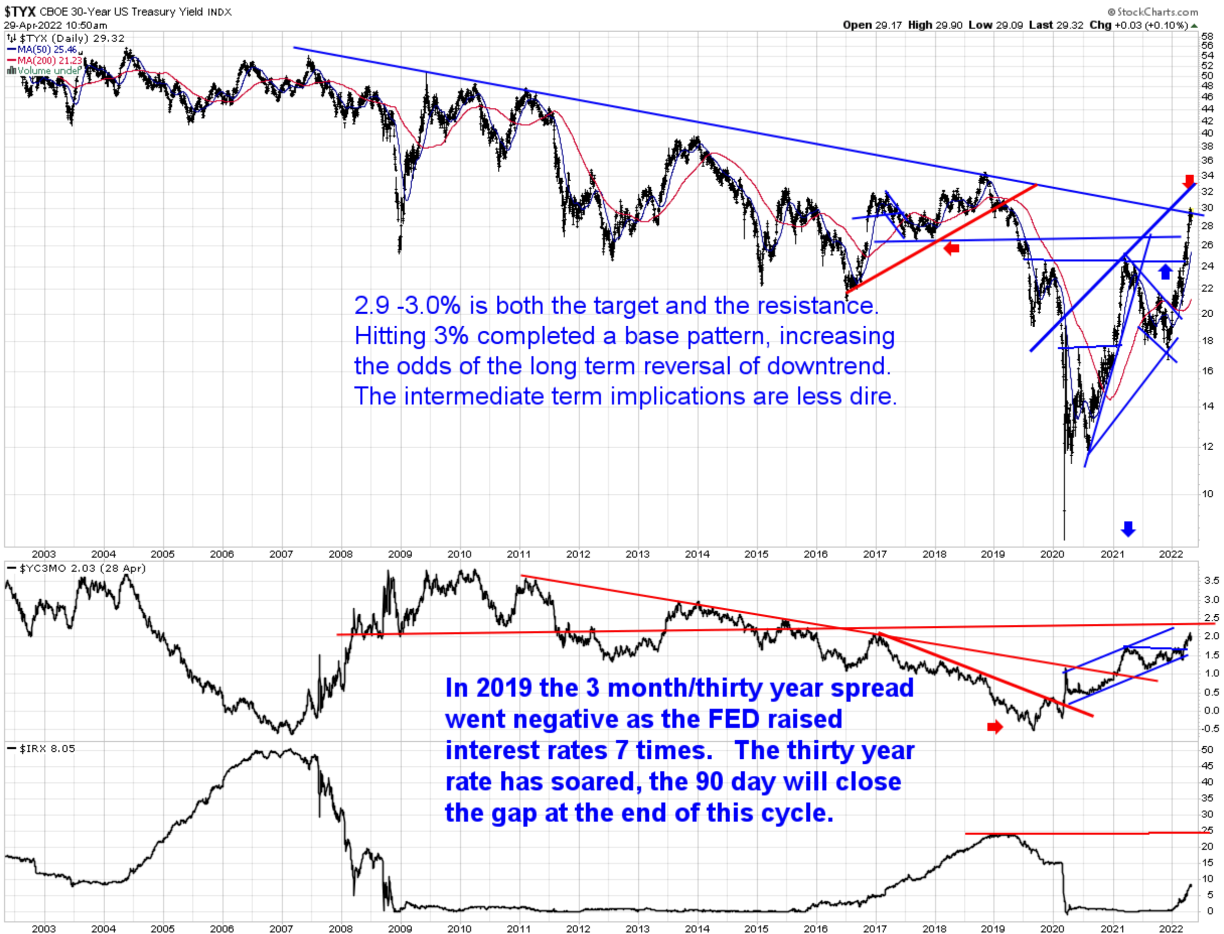
Demand is being destroyed at a furious pace. Recognition will be shocking as the economy accelerates to the downside. Rosy forecasts are being questioned and replaced by portents of the grim realities on the horizon. First quarter earnings show clear deceleration, the lowered GDP growth forecast of 1% was far too high – it came in at -1.4%**.** The first quarter below zero since the Covid shut down. Ratchets up the prospects of a recession. There is some credence to believing this overstates economic weakness, for now.

While the near-term signals from the bond markets are alarming, soaring rates - the long-term signals are different - a dramatic change is embedded in the yield curve suggesting that a recession is inevitable.

The long-term trend to lower interest rates is over, has been over, but that does not mean rates are going much higher from here. The economy is slowing dramatically, private credit demand is ebbing, making room for financing the huge Federal budget deficit. In the absence of government borrowing crowding out other participants, **rates should peak around the long-term downtrend**.

Interest rates have soared higher – based on the premise of economic strength continuing. Rates are nearing an inflection point, as economic growth slows and eventually goes negative.

The bull market in bonds is probably over, but a persistent increase in long term rates is unlikely. Rates are now high enough to destroy demand across the economy. Falling sales, retail, homes, and autos are indicative of the coming economic slowdown, not extraordinary factors.



<u>COMMODITY PRICES</u>

"The cure for high prices is high prices" describes the function of free markets. Markets respond by adding supplies based on price signals and demand ebbs as buyers are priced out of the market or find substitutes. Balance is restored and prices stabilize or fall.

Free markets are an anathema to the current administration. High prices and scarcity are the result of imprudent market intervention.

The US energy market is highly regulated, far from a "free market". Current government policy is to constrain fossil fuel supply in any way possible distorting price signals. One of their few policy "successes" – if you can call the high prices of gasoline and a natural gas a "success". The economic impacts are substantial and impact Americans every day. These punitive policies discredit legitimate environmental concerns at the same time generating massive carbon emissions around the world, as cleaner fuels soar in price.

Regardless of the perverse outcome, the administration remains committed to their environmental policies that are losing support as prices rise. Investors should believe these policies will change – sooner or later as energy independence will once again be a priority.

Conclusions and Suggestions

Equities - Secular bull markets are driven rising price earnings multiples on rising earnings. Earnings projections are tumbling and multiples falling as the economy slows.

A soft landing is a remote possibility. It requires skillful and intelligent leadership conspicuous by its absence.

In this environment – **sell the rallies**. Invest cautiously and only with a clear purpose. Fundamentals matter – look for stable to growing earnings at reasonable prices with effective managements. Look for valuations in the lower right-hand corner of the matrix.

Interest Rates – The yield curve is distorted as a result of FED manipulation. The two-year / ten-year spread had inverted, the 3-month thirty-year curve is still quite steep but should flatten as the FED increases the discount rate. The specifics of the yield curve are less significant than the overall shape – essentially flat from 2 to 30 years. The 3-month interest rate could rise to nearly the thirty-year rate (2.75%) before the tightening cycle resolves into a recession. The FED has preannounced its intention to achieve this end, lifting short rates aggressively and repeatedly until the economy succumbs. Bond investors can anticipate a trend reversal to lower rates as this spread shrinks. There should be substantial value in fixed income as the yield top approaches and credit spreads widen (blow-out).

(Bad news for banks and other investment vehicles priced to perfect credit experiences.)

The cost of waiting is now too high to ignore - higher rates and lower bond prices change the calculus.

Selective buying in medium grade fixed income is becoming attractive. There are many preferred shares trading in the low 20s to yield approximately 5.5% in qualified dividends. The short end of the market also affords a haven for investors, as the two-year interest rate is only marginally below the thirty-year rate. The municipal bond curve is now at levels that haven't been seen for many years.

At current rates, fixed income can become a larger part of the investment mix. Medium quality, medium term debt can now be an increasing part of the portfolio, 6% at a 25% discount to face (i.e., $20 on a $25 face) reduces the needed equity contribution to total returns of a balanced portfolio.

Commodities

Individual commodity prices are sensitive to specific market factors. Some are transitory, supply interruptions arising from the European land war, others more long lasting produced by years of underinvestment, as in oil and natural gas. Some of the post Covid supply interruptions are easing, (e.g., lumber) while others face more substantial impediments to increasing supply.

The run up in prices may continue until a recession is more clearly in prospect. However, **current price levels should be adequate to reduce demand substantially in many commodities.**

Selectivity among commodities is important. Natural gas has a different profile than crude oil and prices have soared independent of oil prices. The futures curve suggests supplies remain inadequate far into the future. Investors are still slow to make the distinction, leaving many predominantly natural gas stocks trading at prices that do not yet reflect the futures curve of elevated prices, short and long term.

There are few companies in the current market with low price earnings ratios, increasing earnings and cash flows and returning capital in the form of dividend increases and stock buybacks outside of the energy sector. Yet valuations remain shockingly low, as investors remain enchanted by ESG mantras.

Energy, especially domestic and Canadian natural gas remain attractive, buy the dips.

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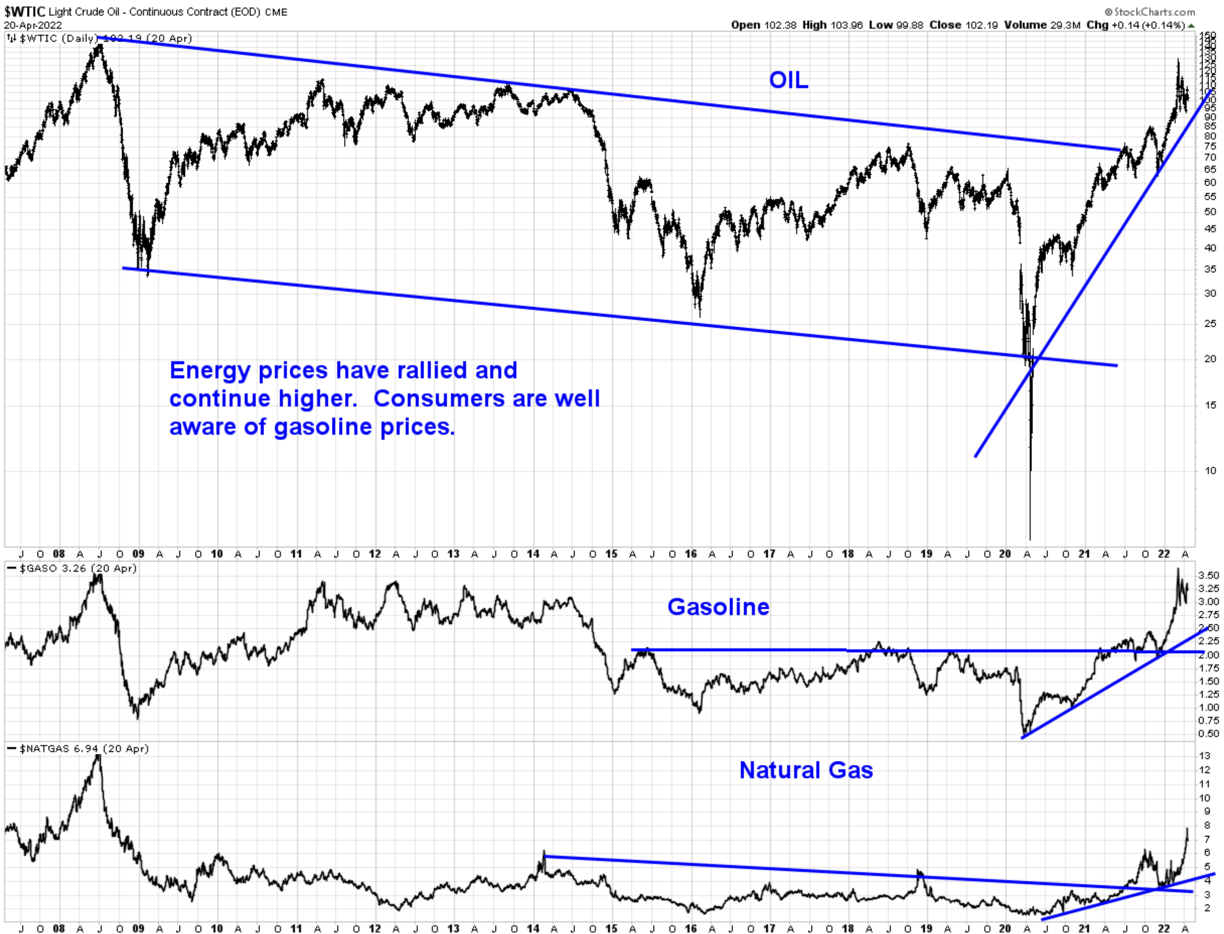

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