08.25.2022 – To Pivot or Not to Pivot

I learned to play golf when I was about 8 years old. My Pop and I would drive to the course, my trusty cut down 7 iron in the trunk, and he would tell me to "keep up" as he took his long strides down the fairway. I learned to hit the ball quickly. There was no whining either. And no riding in a golf cart. As time went by and my Dad taught me the game, something that was important was a big "pivot," which is to say, a full shoulder turn so as to hit the ball farther and more consistently. I would hear the words, "take a full pivot," as a practice shot would veer wildly to the left.

Anyway, that came back to my memory as I've been reading lately about whether the Fed is going to "pivot," which is to say, not raise short term interest rates as much and perhaps start cutting them in the middle of next year because inflation rates are coming down and economic data has been poor. If this were to happen, it would have huge implications, as we've already seen the past few couple of months in the stock and bond markets. While the stock market has been down the last week or so, it is up considerably on this "hopium" of lower rates in the future. Lower rates being the nirvana of all the companies that have crashed because their cash flow isn't enough to cover what will soon be much higher interest payments on their debt that was previously borrowed at ridiculously low rates. The answer will be here on Friday (Aug 26) this week and I will be watching closely.

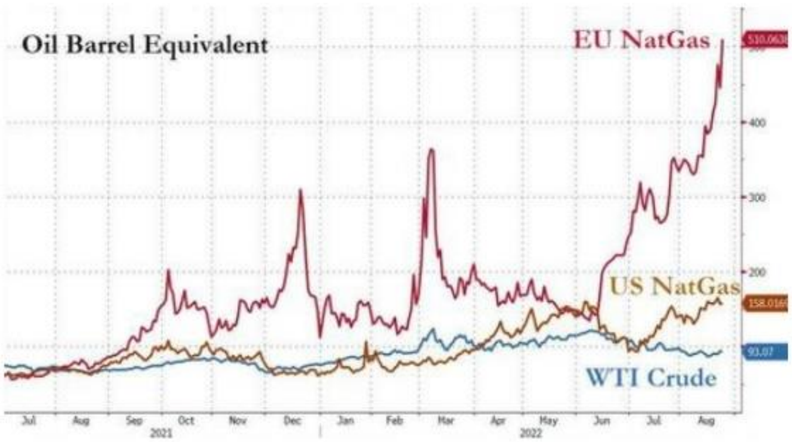
What's funny/strange about all of this is people were jumping out of windows when inflation recorded 8.5% in the spring and now, they are jumping for joy when it's the same number for July. I get that the perception now is that inflation is dropping vs going up, but 8.5% is still pretty darn high. And if you buy any groceries, inflation in July hit 13.1%, which is the highest since 1979.* I've certainly noticed the cost of eating has jumped, especially eating out. "Street" meals at Thursday's Farmer's Market in San Luis now cost $40 - $50 for 3 people. A couple years ago it was $30 or $35. At a nice sit-down restaurant, meals (no drinks) for 2 people can easily be $80 - $100 or more. I just got my PGE bill. My usage was almost identical to last year and yet the bill was up 40%. I've got to believe these rising costs of living will have a huge effect on what people buy and do in the future. I understand that people have wanted to have fun because of the shutdowns. I just don't see how people won't be cutting back on discretionary purchases soon. And, assuming that happens, and we've seen evidence of this in bad earnings reports from Walmart, Nvidia, and others^, it's hard to imagine this current rally continuing much farther. Simply put, rising equities imply several things:

- Stocks don't care about higher rates & inflation
- Fighting the Fed is now a great strategy.
- Even though QE (quantitative easing) inflated assets, QT (quantitative tightening) won't deflate them.
- Global political risks don't present a material threat.

*https://www.zerohedge.com/political/grocery-inflation-hits-highest-level-43-years-despite-bidens-zero-inflation-messaging
^https://nvidianews.nvidia.com/news/nvidia-announces-preliminary-financial-resultsfor-second-quarter-fiscal-2023
^https://www.forbes.com/sites/sanfordstein/2022/05/18/walmart-and-target-miss-quarterly-estimates-dramatically/?sh=49fda3f60591

Perhaps of greater concern, is the massive housing downturn. Sales of homes in California are down 50%* from last year and 43% nationwide.^ Prices are still up considerably, but, most likely, they will be falling fast as sellers realize their hopes of selling at top price are gone. Over the last 80 years, a down housing cycle has preceded every recession, other than the dot com bubble and one in 1963.^ Housing is a leading economic indicator and affects so many sectors that when the number of homes sold goes down, lots of other sectors follow.

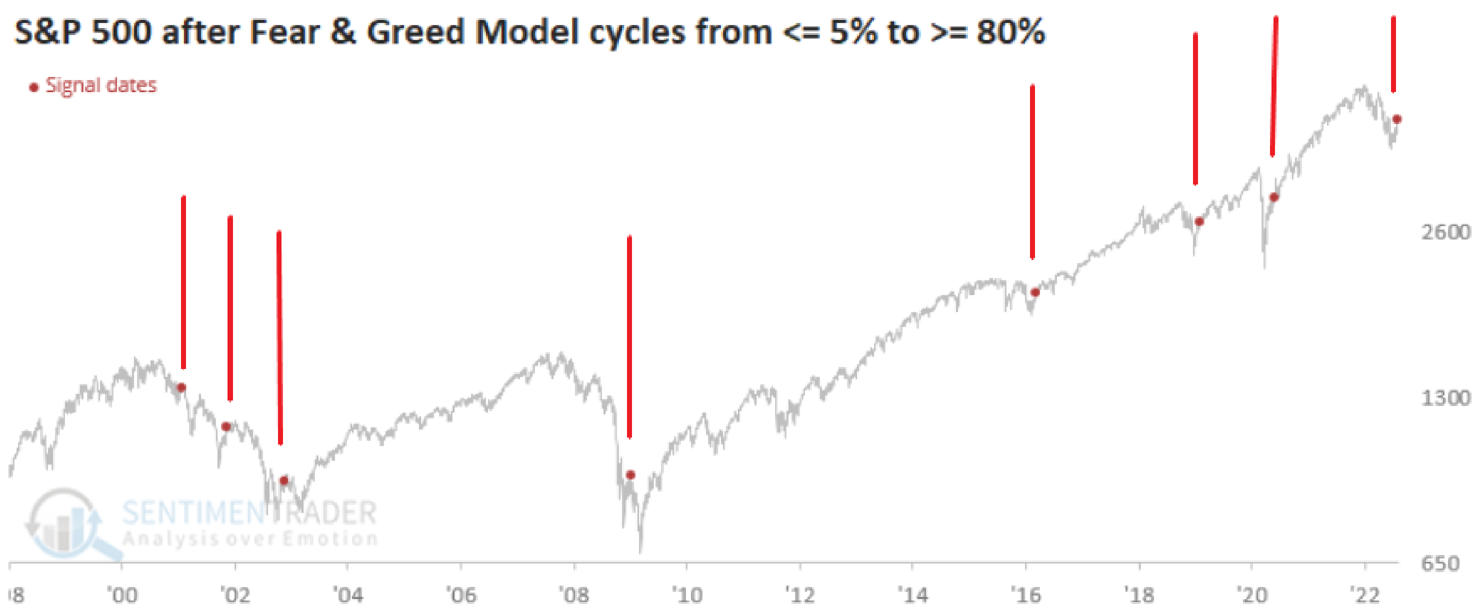
^https://seekingalpha.com/article/4535186-how-to-predict-a-recession?mailingid=28760080&messageid=2850&serial=28760080.1022&source=email_2850&utm_campaign=rta-author-article&utm_medium=email&utm_source=seeking_alpha&utm_term=28760080.1022
*https://wolfstreet.com/2022/08/23/sales-of-new-houses-collapse-in-the-west-by-50-inventories-supply-spike-to-high-heaven-worst-since-peak-of-housing-bust-1/



Finally, to round out the doom and gloom, the huge bear in the room is the continued war in Ukraine. The resulting sanctions on Russia have been largely responsible for natural gas prices in Europe to increase 6-7 fold. Imagine if your normal heating bill were $150/month and now it's $1000/month. That would put a serious dent in the old spending habits. This brings up an important discussion on whether the inflation we're experiencing is going to be "transitory" and is due mostly to the pandemic and "free" government cash or whether we are in a new world order where changes in energy supplies, manufacturing, labor, and war have created a significant baseline increase in future inflation, at least for the next few years. The "transitory" view assumes a stable world with no geopolitical risk factors and demand is more powerful than issues related to supply. The second view implies we live in an unstable world where geopolitical risk costs are rising and where production problems are more powerful than demand problems.^ If the second view is true, the Fed is far from "pivoting" and will have to continue to raise rates. The conundrum facing the Fed is they need to raise interest rates to stop inflation, but higher rates make it harder for companies to borrow the money they need to increase production to lower costs. Fed chair Jay Powell is "in a tight spot." https://www.youtube.com/watch?v=tPImdMknAO4 (video clip from one of my favorite movies "Oh Brother Where Art Thou")

^https://advisoranalyst.com/2022/08/03/zoltan-pozsar-war-and-interest-rates.html/

Of course, maybe all this awful stuff is already priced into the markets. There are several sentiment indicators that point to the stock markets having bottomed and that, while we may have some volatility for a bit, the future direction should be up. The Sentiment Trader fear and greed indicators had an unusually quick move from fear to greed (less than 5% to greater than 80%)* in the last couple of months and, as you can see in the graph below, other similar moves were split in direction. If we are in a true long term bear market, we just had a nice bear market rally, and some serious drops will follow shortly. If we have entered a new bull market, then great returns are ahead. For now, all risk models at Nationwide are as conservative as we've ever been (we did increase stock allocations during the recent run-up and then reduced them on August 19th). I will let the data dictate but, for now, I think a huge amount of caution is warranted.



If you've made it this far, thanks for reading. I haven't sent a note in a while and wanted to be thorough on what's going on in the world of investing. Thank you for allowing us to be of service. If you need anything, please let us know.

Enjoy,

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