A New Reality

January 2023

In our somber-minded daily world of earning a living we occasionally wander into a dreamworld of a living earned for us. This has led us into historical financial fantasies such as the South Sea Bubble, the Dutch tulip craze, the gold rush, the internet mania etc. etc.

Over a decade ago we embarked on a contemporary version of the pursuit of El Dorado, a mythical world of plenty, a virtual world of everything.

It was a voyage like few others. It began most humbly. It grew out of the financial carnage of the great recession of 2008. But soon the powerful forces of monetary and fiscal stimulation started to make themselves felt and they propelled us forward at increasingly dizzying speeds. The stock market was going up, the bond market was going up, we were getting rich. The wind was at our backs. To be sure there were squalls on the way (the European banking crisis, the energy crisis, the Brexit crisis, the Covid crisis etc. etc.) but throughout it all we were scudding forward with ever-lower interest rates.

It was a trip that gave us glimpses of a magic kingdom called WeWork (that, according to one investment bank, was worth US$90 billion). There were sightings of splendid electric vehicles noiselessly floating on valuation clouds never seen before. There were creations such as Nikola, a truck company that, motorless, rolled along on valuations in the billions. There were SPACS galore, shooting stars splendid to behold in their temporary glimmer of tinsel wealth. What a glorious period to venture forth and follow the rainbow of venture capital. Fiscal and monetary winds moved us ever forward in our voyage towards untold riches. We had a vision of money from heaven and called it cryptocurrency. The rainbow was ours to touch.

It was a year ago, January 2022, that our financial voyage to a meta universe started to reverse direction. The stock market stopped climbing, interest rates began to go up, bond prices declined, and unexpectedly inflation became a topic of concern. Growth stocks started to come under pressure and venture capital projections began to be questioned. Suddenly, the assumptions of just a few months ago no longer seemed that relevant. Increasing numbers of financial experts started talking about profits, cash flows and price earnings ratios. It was hard to believe and difficult to digest for so many whose minds were programmed to buy on dips. Retail buyers continued to be bullish and were net buyers of some 100 billion in US equities in 2022.

Last year witnessed a sharp correction in both equity and bond markets. This was followed by a relief rally in the last few months that retraced almost half of the losses experienced earlier in 2022. Optimism started to reappear as we received comforting news that inflation may have peaked, that recession may be avoided and that the Fed may be moderating its tightening policies.

It is impossible to predict short term market turns but we need to understand that we are in a period of major transition, a period of change and greater unpredictability. More than a decade of very low inflation and interest rates has come to an end. Our world of ever greater global inter-dependence linked together by smooth flowing international supply chains is changing. Onshoring or nearshoring will play a much greater role in the future and will result in higher underlying prices. Our energy landscape, due to evolving political and climate change priorities, is changing and will result in higher underlying energy costs. Our increasing socio-political emphasis on reducing inequality will lead to higher minimum wage structures which, in turn, will lead to higher prices. The struggle of the previous decade to fight disinflation and get inflation higher to a goal of 2% will now turn to a struggle to control inflation and get it down to 2%.

We must approach this period of transition with care and prudence. We must adapt our investment attitudes to reflect these new circumstances. Markets will need some time to adjust to a new reality. It seems too early to go back into yesterday’s strategies of growth equities and longer-dated government bonds. We must be particularly careful of duration risk since higher underlying inflation will erode the purchasing power of our portfolios. We should keep duration relatively short and focus on better-quality credits in the BB/BBB area. We believe there is only modest risk of significant spread widening. We believe default rates will stay relatively constrained since many companies were able to refinance at very attractive rates over the last few years. We believe portfolios with significant participations in floating-rate and short duration credit strategies will prove to be particularly rewarding in this period of transition and uncertainty.

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