PORTSIDE
INVESTMENT ADVISORS

Synthesis

A composition that pulls together the primary themes, analysis, and views from Portside Investment Advisors

July 2022
The high price of high prices

By many measures, financial markets as a whole had the worst first half of a year ever. There are many crosscurrents, but the primary problem has been high inflation. Generally speaking high inflation leads to lower stock and bond prices by hindering the consumer, reducing profit margins and forcing a move to tighter monetary policy.

Over the past couple decades, financial market returns were more balanced (stocks versus bonds) even during the worst of times. During the technology bubble collapse, the financial crisis and the initial COVID panic, stock prices dropped but interest rates also fell which helped push bond prices higher. This dynamic helped sustain truly diversified portfolios and provide opportunities for gains even in the midst of volatility.

During 2022, having any exposure to stocks or bonds meant a high probability of losses. Some segments such as energy linked assets have done better but even those suffered a large drawdown in recent weeks on economic slowdown fears. The high-quality bond market, as commonly measured by the US Aggregate Bond Index, returned -10% in six months. Stock index returns were starkly negative, with the S&P 500 returning -20% and the NASDAQ Composite returning -30%. These are very large drops, especially considering they all took place in just half a year and across asset classes globally.

The best outcome has been to limit portfolio declines and to maintain the capacity to buy quality assets as valuations become more attractive. Of course, in times of great volatility this is never an exact science. Understanding the causes of the current environment and the key factors going forward aids in this decision making.

The causes of inflation have been varied. COVID-related disruptions and associated stimulus are the greatest of the causes. Having shut down many parts of the global economy, policymakers wanted to limit the damage by printing money and distributing it far and wide. History has shown that some stimulus can help mitigate economic cyclicality, but it cannot make up for lost production. Over the last two years, there was a lot of supply disruption but there was also an increase in demand for goods and services. This was a toxic combination. It is not hard to argue that the stimulus was overdone both in size and scope of distribution. Many individuals and business were better off from a cash flow standpoint than they otherwise would have been. As a result, too much money has been chasing too few goods.

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There certainly have been other presumably unrelated impacts to consider. Globally, energy production was underdeveloped for many years, and this has coupled with policymaking designed to move towards cleaner but less efficient sources. Throw in geopolitics and this will likely be a continued source of cost pressure unless the economy slows dramatically.

The role of China in the current set of challenges cannot be understated. After a quarter-century of massive building in residential complexes and urban infrastructure, there was a screeching halt recently with some of the largest building-related firms going bankrupt or scaling down considerably. The government is no longer endorsing unabated building expansion. This alters the global growth equation since China was the primary driver of economic expansion in the last few cycles. Additionally, China continues to lockdown large segments of its population due to the zero-COVID policy. This means less consumption but also adds supply disruptions for the rest of the world. A shift away from US free trade with China, an issue with bi-partisan support now under a second consecutive administration, is likely still in the very early stages. A period of de-globalization may be a sustained source of inflation for many years ahead.

It's generally easier to understand what has already transpired versus predicting the future. But, looking at the current dynamics leads us to see an increased likelihood of a low growth, higher inflation environment (stagflation). We certainly think inflation rates will come down but structural factors (e.g. commodity supply shortages and de-globalization) are likely to keep price levels above what we have been used to. Additionally, after many years of central banks trying to get higher inflation rates, it is unlikely they will allow inflation to disappear altogether.

It should be noted that while this market volatility has been highly uncomfortable. We believe there are some very positive developments. First, there was a lot of wild speculation that had entered the markets which needed to be purged. This was a result of excess stimulus and the large number of people who had started working and trading investments at home. Segments of the market were looking more like gambling outlets than financial markets. A return to true fundamentals is important to regain stability. Second, higher interest rates are good news for many investors and the stability of markets. For investors who want or need stable income, the recent period of near-zero interest rates meant a struggle to get returns unless taking additional risk. The ability to have a diversified mix of investments with higher yielding fixed income and lower equity valuations will help build a more solid foundation to markets for the coming years.