PORTSIDE
INVESTMENT ADVISORS

Synthesis

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

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The Good News about Bad News

It's quite easy these days to see news headlines, especially about financial markets, and get deluged with negative topics. Many of the negatives, though, need to be put in perspective as being far from the worst things that can happen. Additionally, there are actually a lot of positives that we see emerging from the turbulence.

<u>The Headwinds</u>
After having to deal with the COVID era and related impacts, the last thing anyone wants to deal with is a financial crisis. The reality is there are many challenges, and we have to be aware of them. Previous and ongoing COVID disruptions have caused intermittent shortages leading to price increases. Over-stimulating the economy also led to excessive risk taking and a dislocation of labor. This combination has led to the largest inflation rates since the 1980s. Central banks had a major role to play in this by keeping interest rates too low and printing too much money. They now know this and are trying to play catch-up by aggressively moving policy the other direction. Monetary policy is the single largest driver of financial markets and right now it is working as a drag.

High interest rates will undoubtedly start taking a toll on consumption in many forms including housing, credit card payments and corporate investment. Higher rates also start to pressure government budgets that borrowed a lot during the last few years. The US economy is fairing relatively well considering the headwinds. The consumer is spending more but gets less in exchange. Corporate revenues are growing but can't keep up with higher operating costs meaning net profits are flat to down overall. There are plenty of jobs and wages are increasing, but again, that has not been enough to keep up with price increases of goods and services.

The economic picture outside the US is much worse. China is in the midst of a significant slowdown. This is mostly self-induced through an intentional stoppage of real estate development and continued large-scale COVID lockdowns. Europe has to contend with the uncertainty of war and the somewhat related energy shortages. Additionally, the US dollar has risen sharply against most currencies which creates difficulties for other countries who pay debt in dollars and companies who transact in foreign exchange.

US friction with China has continued to accelerate and will likely set us on a long-term path of fewer economic linkages. This is difficult for certain companies dependent on new growth markets and certain supply chains. This issue has become one of national security and quite bipartisan at this point. The largest foreign risk, albeit with a smaller probability, is a serious escalation in war with Russia.

PORTSIDEIA.COM
262 518 0347
INFO@PORTSIDEIA.COM
1045 WEST GLEN OAKS LN, STE 103
MEQUON, WI 53092

The Context

When it comes to times of volatility in the market it's really important to not get lost in day-to-day gyrations. There are real challenges, no doubt, but in today's case we have a lot of intentionally induced impacts, especially those brought by the Federal Reserve. At some point, if the damage caused was too much to bear, the Fed can undo or slow down the restrictive action.

Additionally, the energy challenges we have in the US are mostly self-induced (corporate investment and governmental policy) in contrast to other countries who don't have as many options as we do. There's no guarantee that energy issues are resolved favorably but at least there are options.

It is also important to remember we are currently at a point of full employment and the economy is relatively stable at the moment. This is much different than 2008 or certainly the 1930's where the economy did not offer everyone a chance to earn a living. We have become used to stock market drops coinciding with severe economic downturns rather than being independent or leading the current situation.

Geopolitics are a concern and by nature unpredictable. But this is always the case. Not a year goes by where we don't have some global tension to be worried about. In general, though, it is very hard to invest specifically in light of these sort of risks. An escalation could be negative, but a resolution could also be positive. History doesn't show a strong correlation between conflicts and market returns one way or the other.

The Positives

As a team who likes to acquire assets at attractive price levels, we see this current market period as a welcome reset to a lengthy period of inflated valuations for both stocks and bonds. There's certainly risk and it's impossible to predict outcomes with absolute uncertainty. But we have many reasons to embrace the changes in the market.

We now have the highest interest rates in over a decade and are able to buy some equities at lower prices than have been seen in many years. For many investors, the hardest question in recent years was how to add income producing assets to portfolios. The large drop in bond prices means much higher yields on everything from US Treasury Bonds to corporate debt to risk-fee Treasury Bills. We can't be sure that interest rates won't go higher, but at least there's some cushion allotted to investors at this point for owning bonds. This can help many different types of investors including retirees who want more stable income and for more aggressive portfolios which may own government bonds that could act as diversification to equities if unexpected risks happened.

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Stocks are now trading at valuation multiples that are arguably more in line with history. At the beginning of this year, the US stock market was worth about 22 times expected earnings, now it is worth about 15 times earnings. That may or may not be the best valuation level we get but it certainly is more in line with where it has traded historically. The dividend yield is also much higher than just a year ago.

A lot of the work by the Fed has been to drain excess liquidity from the markets. This will hopefully quell some of the large speculation that caused increased volatility in recent years. Generally investors prefer more stability. While we're not there yet, we are hopeful this will come in time.

The improved attractiveness of bonds and stocks and the strong fundamentals of many commodities makes for good opportunities to create diversified portfolios. Since there are still significant headwinds and there are many different potential outcomes, diversification is key even in a period where most assets have become attractive as investments. We will keep focusing on whether to buy into certain markets and also the most effective way to construct a diversified portfolio.

As always, we welcome your comments and questions.

Your Team at Portside