



Thoughts to Think

“Be not the slave of your own past – plunge into the sublime seas, dive deep, and swim far, so you shall come back with... an advanced experience that shall explain and overlook the old.” – Ralph Waldo Emerson

In an anxiety inducing year, where we’ve pushed and pulled waiting to see what comes next, we still have so many unknowns and contentious points from political postulating to COVID-19 to the markets. However, uncertain times provide opportunity to enrich our understanding of what has happened, why it has happened, and what routes we can take in the future. Rather than focusing on any one single topic, which would be heavily influenced by other competing topics and create webs of confusion, a broad look at a few current topics might reduce the bedlam. These topics are in no way exhaustive, and a full assessment of each would span a century’s worth of Bull and Bears. By bullet pointing the topics into categories, we can have a much better conversation of what outcomes may come next.

FED vs Fiscal Policy – The FED controls monetary policy, which is money supply and short-term interest rates, while fiscal policy controls government spending within the economy. FED policy has been incredibly supportive in times of duress over the past decade, greatly increasing the assets/liabilities of central banks. For example, while investors backed away from corporate bond risk in March, the FED opened up its balance sheet to purchase corporate bonds (via ETFs) for the first time to provide support, although the amount actually purchased was quite minimal. With these accommodations baked into the markets, some investors speculate on how much longer these actions can be continued. On the fiscal side, some argue government spending hasn’t pulled its weight or used targeted spending enough (e.g. stimulus checks and unemployment expansion), while others say the budgets have become so bloated in other areas that dynamic support can’t be conservatively administered. In summary, economic support is being passed between monetary and fiscal support and if either/both wish to stop, the economy needs to be flourishing on its own or markets could suffer (e.g. October 2018, FED balance sheet reduction/reduced flow led to an -18% pullback in the S&P 500).

Domestic vs International Growth and Trade – With the shock of lower oil prices, supply chain disruption and structural headwinds, international and emerging markets are at a crossroads. The current administration has been upfront about challenging China on multiple fronts, but if China’s export engine and credit impulse is curbed, someone else, such as other Asian countries, would need to take its place. Additionally, the drop in oil prices have strained emerging markets and the European banking sector, especially as it relates to the petrodollar. If the dollar weakens considerably, import demand skyrockets, and/or international economic output increases, specifically relative to U.S. GDP, domestic outperformance could be reversed.

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Inflation vs Disinflation vs Deflation – A topic of concern and contention over the past decade has been inflation/disinflation/deflation (higher prices/slowing but higher prices/lower prices), and investors see the “post-COVID-19” world as another decision point. The traditional definition of inflation and its counterparts is a broad, sustained rise in prices, but we have lately experienced a world of all three types simultaneously: tuition and housing/food/entertainment. Supporters of higher inflation point to new supply chains being developed, pent up demand, and continued central bank/fiscal support to lead the way to higher prices. Opponents point to ballooned debt levels, a long-run demographic shift, and challenge the idea that consumers can endure higher prices, which all can’t support higher prices. In the end, if inflation wins out, companies that can push costs to consumers and commodities should rise with bonds suffering from rising rates, and vice versa if deflation wins. If disinflation persists, the status quo is expected to continue.

Growth vs Value Valuations / Cyclical vs Defensive / Real Assets vs Financial Assets / Nominal Growth – These four, bulky topics are highly intertwined with the inflation debate, along with economic output. While nominal GDP has been suppressed relative to years prior, alongside historically low rates, non-cyclical companies and financial assets have vastly outperformed cyclical companies, which usually carry “value” valuations. As investors and the world are starved for growth, companies generating growth and assets supported by FED policy have found higher and higher bids. Again, the “post-COVID-19” world creates a decision point. Should pent up demand be unleashed, jobs recover, and businesses begin deploying cash for capital expenditures or governments spend more on real assets and activities, a rotation from growth and financial assets may begin. If that falters, via lack of demand or supply, it is expected that buyers will continue to flow into bonds and financial assets, regardless of their elevated valuations.

Flow vs Fundamentals and Market Mechanisms – Finally, the thread that brings it all together for us as investors is understanding what the market drivers have been and if that will change. There are much larger, sophisticated processes going on than just buying/selling stocks, such as a shorting and derivatives, which lead to short and violent movements. As a trend though, markets have accepted more passive investing flows and share repurchases via lower borrowing rates. These flows are supportive of a “momentum factor,” meaning the winners continue to win. If no catalyst forms to change current structures, expect the continuation of momentum assets performing. However, if a regime change occurs due to different employment situations, a return to cyclical growth, higher rates, or an unknown factor, a trend-rotation in the market could be started.

With only one month left in the year, uncertainty continues to be a driving force, but again, this provides opportunity for those willing to dive into the details! By aggregating all the points above and assigning probabilities to each, we can be more deterministic of eventual outcomes rather than relying on pure randomness. As investors, this is an exciting time to participate in a Bull and Bear market.

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