Haven Global Partners, LLC.
Market Outlook: 1Q 2023

Volatility Rears its Head… Again!

In order to try and make any sense of what is going on in the world's financial markets it is essential to have a sense of history, both long term and recent. Just last year, global stocks suffered substantial losses when interest rates moved higher as concerns about inflation gained more and more adherents. In 2022, the annual inflation rate in the US was 8% after having spent decades right around the Federal Reserve's goal of 2%. Market observers with long memories were reminded of The Great Inflation, a period from the late 1960's until the early 1980's characterized by inflation that went as high as 15% and required interest rates to be ratcheted so high by the US Fed that it took decades for them to come back down. Fears of a similarly painful central bank response had driven stocks to their lowest point of the year last October as interest rates peaked. Just then stock markets bottomed and rallied back as participants anticipated at least a pause and perhaps even a pivot from the Fed's hawkish position on interest rates. That did not happen, but stocks still rallied into the New Year. This seemed to be yet another example of what Alan Greenspan, Fed Chair from the '80's into the early part of this century, labelled "irrational exuberance". Coined during the dot-com bubble, the term described a situation where investors in the stock market seem to ignore important information that should make them cautious and instead almost recklessly drive stock prices higher. Rational or not, stock bulls were rewarded when the first employment report of 2023 from the Bureau of Labor Statistics gave the Santa Claus rally more staying power. It seemed to be providing just what the market needed. The news that the US companies had added 223,000 workers but had not raised pay so much as to create a wage-price spiral, seemed exactly the type of scenario which could lead to a mythical soft landing where the Fed is able to slow the economy just enough to reduce inflation while not causing a recession. Inflation fears were unleashed anew a month later when the employment report for January's blockbuster headline (over a half a million new jobs) seemed to convince investors that Fed rate hikes were not going to slow anytime soon and that interest rates might wind up staying higher for longer than markets were currently discounting.

If some of this sounds familiar, it should. Investors have had a particularly difficult time trying to figure out which way to go. The global economy is complicated and difficult to decipher, but it seems lately that between the list of negatives facing the global economy, like the war in Ukraine and its negative impacts on Russia, one of the world's major oil exporters, the higher interest rates that the world's central banks introduced into the equation in an attempt to stamp out inflation's stubborn embers and an underlying angst about the safety of banks brought on by recent headlines, have all done the job of driving equity markets lower. On the positive side there is the relative resilience of business and consumer activity. An extremely mild winter in Europe and China's decision to suddenly and aggressively abandon its zero-COVID policy. It seems that as soon as a body of investors get their minds set on moving in a particular direction, something happens to cross them up. For example, European banks were on a great run from the market's bottom last October until the second week of March they were leading market performers. But then a little-known bank in California collapsed, that caused a panic, Credit Suisse was absorbed with government assistance by its competitor UBS and European banks have cratered underperforming the European market by 11%! It doesn't stop with the banks, either. At one point, last spring, JPMorgan called Chinese internet stocks un-investable, only to see them lead the rally that began in October of last year. One pundit actually went so far after assessing the crypto crash followed by the collapse of two US banks to wonder if the US might deserve to be called un-investable!

This situation also applies to macro analysis. Last year, predictions of a recession by the middle of this year were common. A strong labor market which fueled resilient consumer spending quashed that view. Stocks rallied as recession fears diminished and traders bet on an end to Federal Reserve interest-rate increases.

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There seems to be no end of situations where a position is assumed by some investors, the foundation upon which that position was taken is shaken and losses pile up. Volatility, as measured by Wall Street's fear gauge, is higher. It has been resting at around 20 for a while now and that is not high compared to 80 the level it reached at the height of the pandemic and the Global Financial Crisis. But the VIX average around 15 during the decades since the GFC, so to be a third higher now is a noticeable increase.

We have learned over the years and been reminded quite recently, that whether it be US banks, UK pensions, exotic cryptocurrency exchanges, family offices or hedge funds, there is always going to be someone out there looking to make a big score by taking a contrarian position. Such stances do not often work out favorably for the risk-taker, but once in a great while, especially at times when liquidity gets scarce one excessively aggressive risk-taker can be the one who drops the match which starts a fire that might result in a systemic failure which puts more than just one company or even one sector at risk.

Today, tighter credit conditions, brought on partially by higher rates but also more likely because of bank loan officers' desire to rein in risk, are causing businesses to re-evaluate their decisions. This may well trickle down to consumers also. That would strain the belief that the hoped-for soft landing might still be possible. Scenarios like that often can become self-fulfilling. This is at a time when business and consumer spending are one of the few pillars holding up in this economy.

Also, it would behoove savvy asset allocators to keep an eye pointed towards the far east. At one point in time, China's economy could regularly grow at more than 10% per annum. That was enough to add a percentage point or two of growth to global GDP. As China's economy reopens after two years of COVID-containment policies many investors are looking for China to re-take its position as a global leader in economic growth. The truth is China's GDP growth is unlikely to boost global growth by very much, and it shouldn't be expected to start anytime soon, anyway. We have all seen that the rebound from a COVID outbreak happens in fits and starts and ought to be measured in quarters, not months. When China's economy does rebound, growth is more likely to disappoint than amaze, and with its collapse in population growth, China's growth potential is not what it once was.

So, what does all of this mean for investors?

There will always be disagreements; differences of opinion are, in fact, what make markets possible. The violent swings from one period to the next can be disconcerting, but through the volatility there are signs one can follow. Maintaining a long-term perspective and consistently practicing one's process does seem to work over time. Buying, owning and holding high-quality stocks which have been purchased at a discount to their underlying value has dependably beaten benchmarks over time. We remain confident that it will continue to do so.

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