A Stock Picker's Market

At the end of last quarter, we questioned whether global stocks had seen market conditions become as favorable as they possibly could…and apparently, they had. Stocks were down during the third quarter. As is often the case when stocks stop going up, interest rates were a part of the cause. In this case, the US Federal Reserve got the attention of market participants by hinting loudly that this is the year the Fed will begin to taper its program of bond purchases. The Fed is currently buying $120 billion of bonds every month ($80 billion in Treasuries and $40 billion in mortgage-backed securities). This effort keeps interest rates artificially low, but it has other effects.

The Fed's constant bond buying has intentionally forced rates lower than they might otherwise be and these lower interest rates have, in turn, sent some investors who are seeking income which they might once have gotten from more reasonably priced bonds, to eschew bonds altogether, forcing them to buy other riskier investments instead. This may be one of the reasons global stocks have set records. The Fed is not alone, however, in its desire to move monetary policy back closer to where it was back in more normal times before the pandemic. The airwaves seem to abound with those venturing opinions about how interest rates need to be higher and quickly so. In the meantime, the US Treasury 10-year note has a yield of 1.5%. A level lower than the last time the Fed tapered its bond buying spree in 2013.

The third quarter began with Chinese tech stocks plunging on concerns over a regulatory assault which drove some stocks down as much as 90%. This situation led some pundits to question whether China under this more activist and perhaps anti-capitalist Communist Party had become uninvestable. Calmer heads soon prevailed as references to the Brexit vote in the UK five years ago, reminded investors how anti-capitalist that bolt out of the blue had made even London seem. Markets will receive shocks; such events are by their very definition unpredictable. Our job as investors is to act in a calm, composed manner and identify buying opportunities as they present themselves. In this situation broadly, Beijing is concerned about four pillars of stability: banking, anti-trust regulation, data security and social equality. All of Beijing's major interventions reflect these concerns. Investors can decide how they feel about the opportunities which are being created in China right now with some of the most successful companies trading at valuations which do not seem to reflect the successful businesses they represent.

Another major issue facing investors today is the disconnect between the relatively high levels of unemployment which are occurring at the same time that businesses are looking to hire large numbers of people. The question facing business leaders is, "What it will take to get people back to work?" For the time being would be employers are trying higher wages, flexible work schedules, more benefits; in short whatever it takes to get workers back into the jobs that these companies need so desperately to fill.

The global semiconductor chip shortage has raised yet another very important question which business leaders today will have to answer. That question is about inventory, and more broadly how to manage their supplies and the manner in which those needed items are brought into their companies. The global supply chain has over the last twenty years become nothing short of a marvel of human interaction. It is a testimonial to what can be accomplished with people working together to achieve a common goal. Sadly, the pandemic revealed all of the weaknesses in the global supply chain. Now, businesses are asking themselves whether they can afford just in time inventory, versus just in case inventory, which is something altogether different with every bit of the redundancy that name implies. Redundancies are the antithesis of what the current global supply chain is built on.

Companies are experiencing difficulties in finding workers and are having to pay more to get and keep them, they are experiencing increased costs for raw materials, for intermediate goods and increased costs for transportation of their finished products. All of these things are making it more difficult to accomplish their main goal which is to generate profits.

What does all of this mean for investors? The stocks to own are going to be the ones that can justify their place in a portfolio because they can generate earnings equal to or perhaps even above what the market's expectations are. That has not changed…and it will not change. What is particularly challenging right now is that it may be harder to identify which companies are going to be able to overcome the obstacles they face.

That's because in the current environment the way to predict which companies are going to do better or worse than their peers and their histories is not a case of a rising tide lifting all of the boats. Rather, individual companies' successes and failures are going to determine winners and losers. That's what is often referred to as a stock picker's market.

Nicknames are given: will it be Growth as in Quality Growth or Value as in Value Cyclicals? But the ultimate winners will be those companies that can bring in new employees when they need them, or even better, the winning companies will be those that can keep the valued employees that they already have. Keep those employees who they have trained, bring back the people who left during the pandemic, and put them to work. The companies that are great with their people, those that hire and train and keep great people will win because their people will make the clients come back. We look for companies that have great products and can command a high price for their goods and services and the those that can cut costs to preserve profits and maintain margins. All of that is a function of having great people. Identifying which companies will be able to do that is going to require a significant amount of fundamental analysis. Successful fundamental analysis is most likely to carry the day. A stock picker's market indeed!