Grist from the Mill

Cycles are Ubiquitous

September 2022

Insights from Howard Marks, co-founder and co-chairman of Oaktree Capital Markets and certainly one of the most esteemed investors of our day, have often been cited in previous editions of *Grist from the Mill.* His periodic epistles, known as "Memos" are widely read and respected among Wall Street's institutional investment community. They are perhaps best known for their objectivity and candor about investing and investor behavior. In Mastering the Market Cycle (2018, Houghton Mifflin Harcourt), Marks compiles over thirty years of client memos into succinct insights.

To paraphrase, despite massive efforts to the contrary, it is virtually impossible to predict the future, particularly where that relates to the markets. As one strives to be successful in investing, Marks concludes the best one can hope to accomplish is to have an objective perspective on the prevailing investment environment, be disciplined as to the price to pay for an investment, and try to have a knowledge "edge" about the basics of the investment (the industry, competitors, financial condition, etc.)[i] Discipline and fundamental analysis have been central tenets of investment management forever. It is the first point about the investment environment that is often missed as we readily tune in to market forecasts and prognosticators or become captivated by a "story stock" that promises to be next 1985 Apple!

Often, the periodicity of the investment environment is referred to as the "market cycle". Cycles indeed ubiquitous. Every year caterpillars evolve into butterflies and on French Creek, near my home, nymphs evolve into mayflies. Tides ebb and flow. Weather has cycles. So do cicadas, the moon, and the change of seasons. New automobiles were usually introduced in the Fall. Even Apple has a Product Cycle, which is anticipated each autumn. And, of course, there's our digestive system! When that cycle is out of kilter, there is no mistaking what's happening!

With markets, it is somewhat more challenging to understand where one is in a cycle. Often, they evolve slowly and we are constantly looking for the turning point. Other times, exogenous events can interrupt or even cause a cycle (like eating a bad oyster can start THAT cycle!)

Business schools and publications make reference to the "business cycle", which loosely runs from expansionary to peak; contraction and trough, and then resumes. This judgment is predicated on a series of economic indicators.[ii] Marks takes a more refined, yet pragmatic approach to understanding the relative position of the "cycle", specifically the credit cycle.

Marks seeks to understand better than most the prevailing stage of the credit cycle with the anticipation that this knowledge will allow him to be better positioned for what is **likely** to come next. That's right, its about how probabilities change as we move through a given credit cycle. These are among some of the questions he might pose in his assessment:

- Is the economy vibrant or sluggish? Are investors optimistic or are they reluctant to buy?
- Are Lenders willing to lend? Are terms loose or restrictive? Are capital markets operating smoothly or is capital scarce?
- Are interest rates low or high? Are credit spreads narrow or wide?
- Are asset prices high or low?
- Is the market characterized by aggressiveness or caution and discipline/

Credit (or, if you prefer, capital) is the lifeblood of commerce. Companies cannot grow without funding to expand their business. If their business slows dramatically at a time when interest rates are high and credit is tight, there is likely tough sledding ahead!

Keep in mind, the cycle is only one part of the equation, along with thorough analysis and disciplined execution. The state of the credit markets is highly informative with respect to the absolute level of prospective investment returns and is indicative of sectors and industries more inclined to benefit of suffer from the next stages of the cycle.

Most of all, cycles take time to develop and progress – months if not years. Less relevant for the short-term trader (except perhaps for reversion to the mean) but absolutely critical for investors.

With the foregoing as a framework, the view from the Mill is that we are in a difficult phase of the credit cycle. Rates are rising, credit costs more, investors want higher premia for assuming investment risk, and Initial Public Offerings have dropped dramatically. On the other hand, investors are reticent about the markets (a contrarian indicator); and the economy seems reasonably stable for now. Absurd levels of inflation month-to-month are falling as supply chain bottlenecks begin to wane, but by no means is this constraint no longer a factor. The trend toward higher inflation than we have experienced over the past decade is here to stay.

In short…

We're going to have a bumpy ride! Higher than normal levels of volatility are likely to continue into the foreseeable future in stock, bond, and commodity markets. Mid-term elections will give rise to lots of jawboning about social programs, energy prices and mud-slinging, but the outcome in Congress is not a certainty. As the U.S chuggs along, Europe's economic prospects are more dismal, principally as a result of Russia's politicization of the Nord Stream gas pipeline. It is probable that the U.S. economy will slow, contributing to lower expectations for future returns. But cycles come and go. We just need to try to be positioned for what comes next….

For more specifics regarding our observations, please see below.

Economics

High frequency Data provided by First Trust Advisors L.P. indicates fundamentals continue to improve:[iii]

- Initial Jobless Claims are a touch below 2019 levels and down 12% month-over-month.
- Continuing Unemployment Claims are below 2019 levels and down 3% month-over-month.
- The American Staffing Association's Staffing Index is significantly higher than 2019 and climbing.
- Rail Car traffic and Steel production are 5.0% to 7.0% below 2019; however, Rail Car traffic is up 3% month-over-month.

Joppa Mill Advisors Ltd.

Wall Street Analysts are forecasting earnings growth of 8.1% for 2022 and again for 2023 with anticipated S&P 500 earnings of $243.61 for a forward Price/Earnings ratio of +/- 16x.[iv] Not extreme, but not exactly a bargain.

Interest Rates and Monetary policy

The Federal Reserve has been very clear about their focus on taming inflation and the danger of mitigating that effort too early (amply demonstrated during the late 1970s and 1980s – *see last month's Grist from the Mill.)*

For perspective, Chart #1 illustrates the 3-month U.S. Treasury yield from 1981 to September 2022. Cycles are readily apparent during the period. More significant is the potential of a higher degree, longer-term cycle that may have bottomed from 2010 to 2015; re-tested that low as a result of the exogenous shock of Covid and is now tracing an upward path within this higher degree cycle.

The Fed's initiative to reduce the holdings of securities on their balance sheet – a result of Quantitative Easing during Covid, began in June and will double commencing in September. Chart #2 from the St. Louis Federal Reserve Bank illustrates, not only has this just begun, but Quantitative Tightening has a long way to go to revert to more normal levels!

Credit Markets

The most direct observation of the state of the credit markets comes from the yield premium investors demand to accept credit risk. This is illustrated through the Investment Grade and High Yield Bond yield spread versus U.S. Treasury bonds. High Yield spreads have been steadily rising for the past year. (see Chart #3.)

Initial Public Offerings in the first half of 2022 was the weakest six-month period in five years with 92 companies raising roughly $9 billion. This compares to 2021's record year of 1073 companies raising $317 billion.[v]

Geopolitical

This is the real wild card. Russia's continuing assault on Ukraine and corresponding sanctions and embargoes continue to have serious implications for the energy markets and commodity prices. With additional sanctions scheduled to go into effect in December, it's anyone's guess how Putin will respond. Should the global food situation deteriorate, social unrest in third-world nations is not beyond possibility. Further, with Chinese growth slowing, the incorporation of Taiwan may look increasingly attractive to Mainland China. Recent saber rattling over U.S politicians' visits to Taiwan suggest this is still a hot button. Forthcoming energy crisis in Europe. Interest rates are rising globally, as is inflation.

As always,

Jim

James W. Graves
Managing Director

JOPPA MILL ADVISORS LTD.

Chart #1

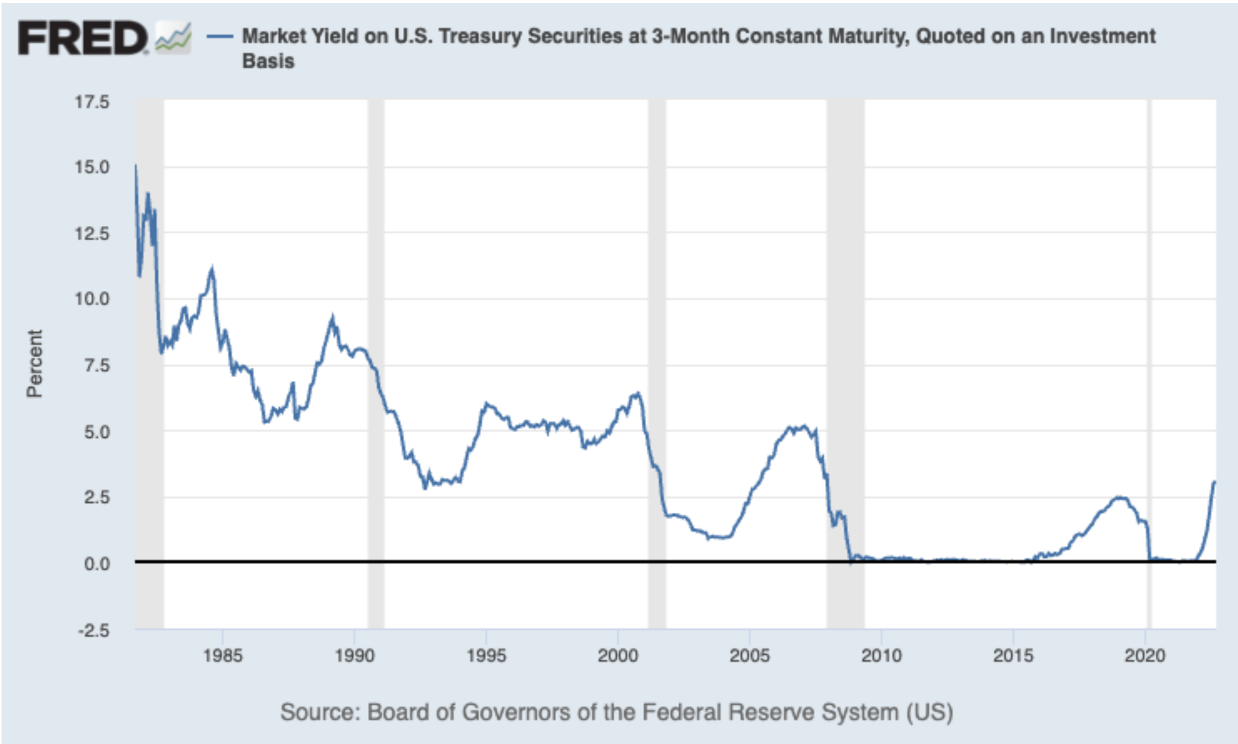


Chart #2

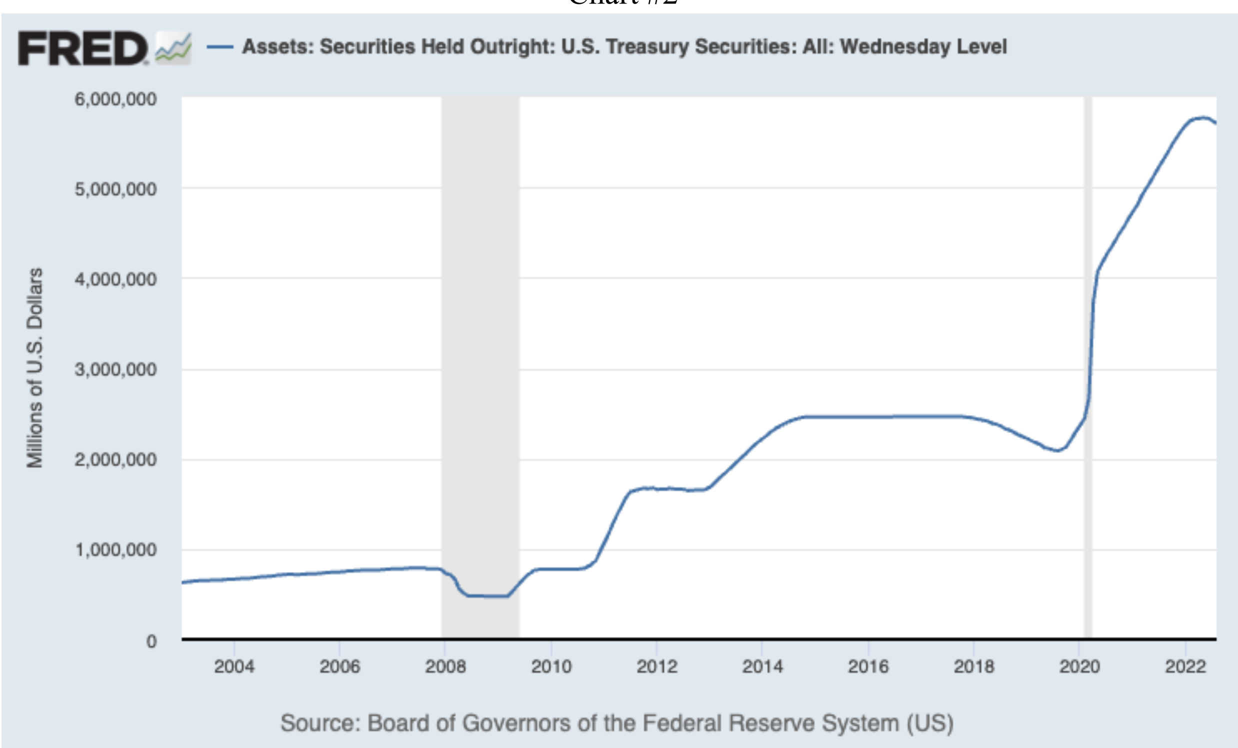
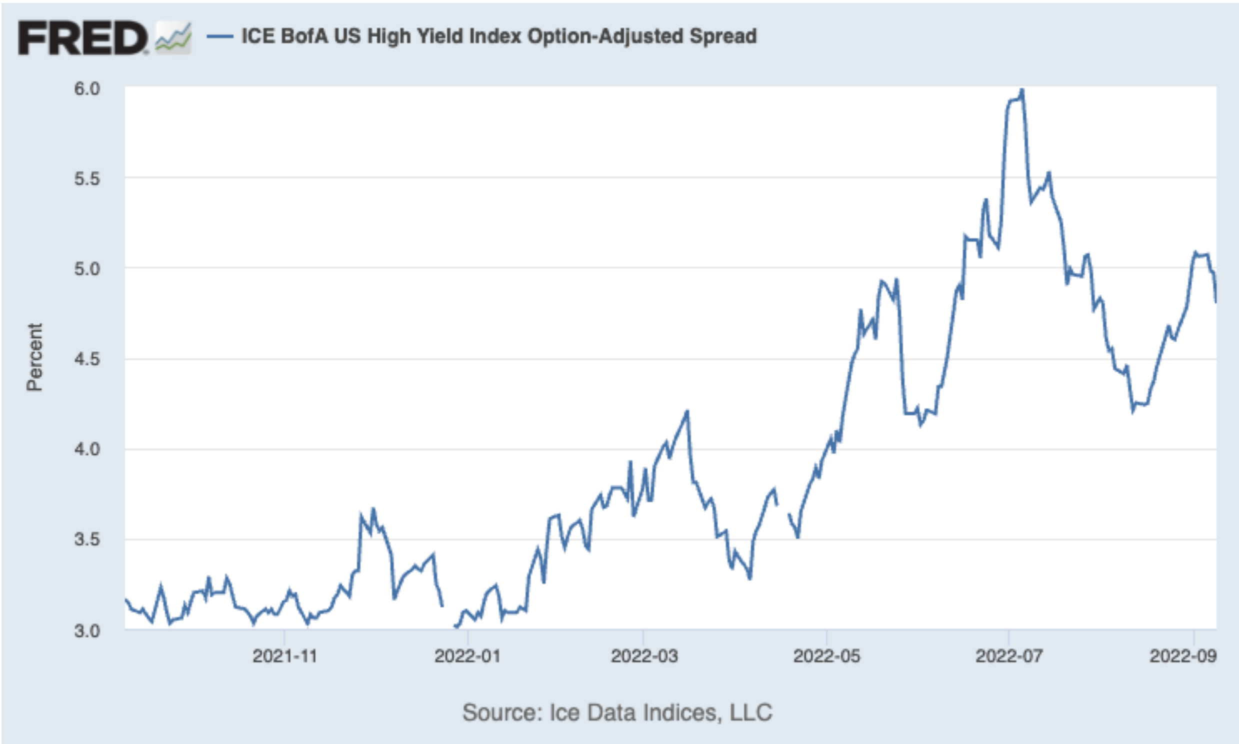


Chart #3



---

[i] Marks, Howard; Mastering the Market Cycle; 2018 ;Houghton Mifflin Harcourt; page 11
[ii] https://corporatefinanceinstitute.com/resources/knowledge/economics/business-cycle/
[iii] https://www.ftportfolios.com/Commentary/EconomicResearch/2022/9/9/high-frequency-data-tracker-992022
[iv] https://www.yardeni.com/pub/yriearningsforecast.pdf
[v] https://insight.factset.com/u.s.-ipo-activity-drops-dramatically-in-the-first-half-of-2022