BETTER TOO EARLY THAN TOO LATE

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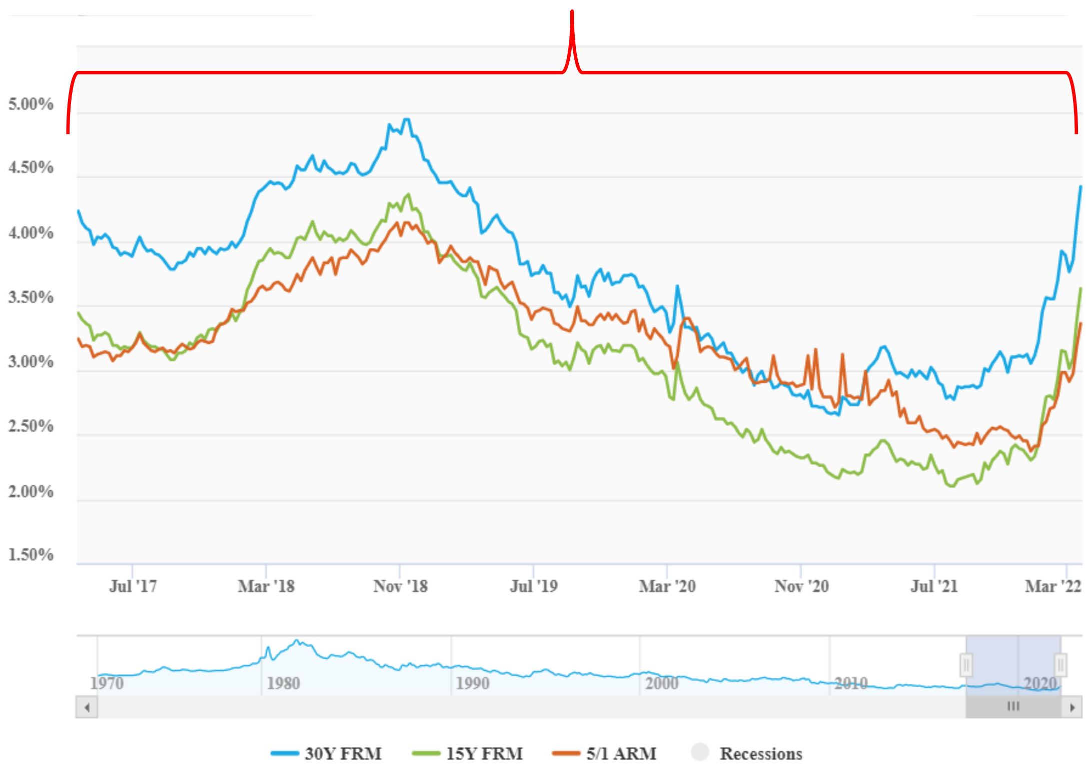
By Brahm Satov

I know for some 2007 was a lifetime ago, but for me, I will not soon forget, those days. In 2007, the stock markets crashed, some lost 50% or more in that downturn. It was a severe correction -by most standards. I was fortunate to be well positioned in that downturn and unlike many, did not suffer from the financial losses or sleepless nights many in our profession endured. I am thankful for that and consider myself lucky. However, back then, as the indicators starting pointing to a greater probability of economic and stock market turbulence, I started shifting to reduce risk. I was not 100% certain that the markets would crash, in retrospect, I'd say I was probably 85-90% certain. So I positioned accordingly. Although, I think that the probability of an imminent severe correction is unlikely, the probability of such has been rising and in terms of positioning, we would say, “better too early than too late”.

In North America, we have begun to see the raising of interest rates, and that alone would be reason to be more cautious. However, coupled with a reduction in the amount of stimulus being injected, this only adds to the probability of correction. I have been saying over the past many months that I expected more volatility, and we are seeing that currently, not just in the stock markets, but bond and currency markets as well. This phase of volatility usually lasts for some time, but it is often followed by a correction. Not all the time, but often enough that investors should consider being more cautious. So I continue to suggest a more defensive positioning in terms of the equity markets. As my buddy says, “better safe than sorry.”

Mortgage rates still are low by historical standards and for those rolling over their mortgages from 5 years ago, they are probably paying about the same rate upon renewal, so housing could continue to stay frothy for longer than some expect. However, as rates continue to rise, the cost to would-be homebuyers rises; and as these rates rise, the probability of a correction in what some have deemed the forever, hot, housing market, becomes more likely. Real estate, like other sectors goes through cycles, this has already been an unusually long cycle, please make no mistake, that corrections are a part of that cycle.

Mortgage Rates 5 years

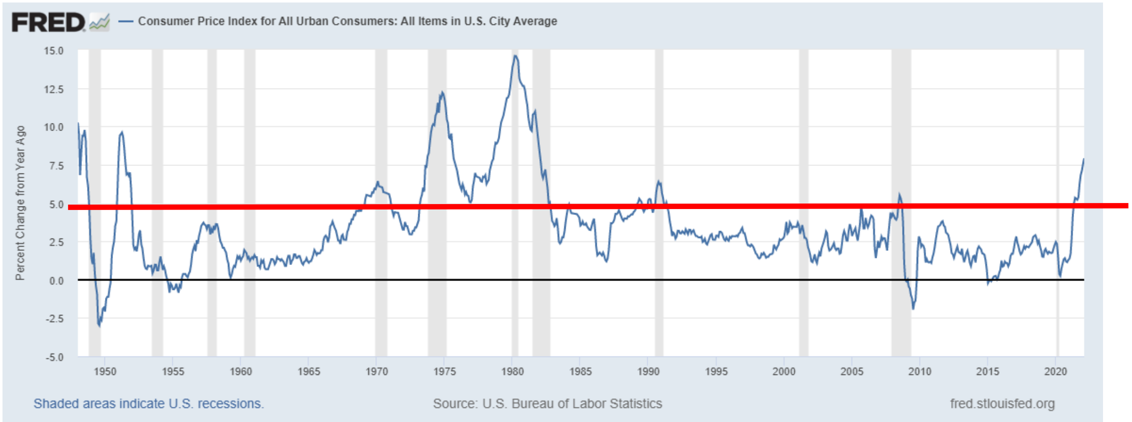


Source: https://www.freddiemac.com/pmms

We are not yet seeing a fall in housing starts, (the number of new residential construction projects started), in my opinion, a great leading indicator. This coupled with the fact that the yield curve has seen parts of the curve inverted, not a good sign, and yet other leading indicators having not yet rolled over, leads me to believe that we are still in what I call, the volatility phase, whereby markets go through tough corrections followed by reflexive rallies.

Housing Starts

Source : https://tradingeconomics.com/united-states/housing-starts



In the chart above, it shows inflation on a year-over-year basis, and most already know that inflation is high. However, some may not know that over the past 70 years, every time inflation got over 5%, except once in the early 1950's, a recession followed. In other words, of the 7 times CPI was above 5%, 6 times, a recession ensued or over 80% of the time. And inflation is now well above 5%.

David Rosenberg wrote in his March 29, 2022 "Breakfast with Dave" newsletter, "Of the 11 Fed tightening cycles of the past seven decades, 8 landed the economy into recession". Given this, one could ascertain that based on a 70 year history, the Fed has a slightly better than 25% chance of creating a soft landing, a 73% chance of recession. Now that the Fed is once again on a tightening cycle, this alone should garner some degree of caution in terms of risk taking. Keep in mind, stock markets generally do not do well in recessionary times. So, we have ultra-low interest rates moving higher, coupled with the possible shrinking of the Fed's balance sheet at a time when the economy is already showing signs of slowing, creating some serious headwinds for the stock markets. We have war in Ukraine which adds to uncertainty and inflationary pressures that were already persistent before it started. The ending of this war could certainly create a rally, and on rallies investors may want to consider lowering their exposure to risk given the probability (not certainty) of a correction. In addition, and I say this with some trepidation as I, like most, have had more than enough of this global pandemic, but the BA.2 sub-variant, only adds to uncertainty and markets generally do not like uncertainty. It continues to be my opinion that we make decisions based on probability, and it is likely that we are still in this period of volatility, and if you have not already at least started raising some cash, one thing for sure, if we have a correction, stocks become cheaper and it is always nice to be able to buy when assets are on sale.

Sincerely,

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