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OOPS!...I DID IT AGAIN’

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By Brahm Satov

March is the month of my youngest son’s birthday. He is turning 16 this year and his independence is right around the corner. As I get older, I realize more profoundly that time really does fly by. For those who remember March 27, 2000, it was the day Britney Spears released the song “Oops!... I Did it Again.”. Now I may not be a big Britney fan, or as they call them, the Britney Army. In fact I am thankfully not a part of any army. However, I cannot believe 22 years has passed since that day. Back then if memory serves me, the S&P had 3 straight years of negative performance. That’s right, three years in a row the S&P traded lower. It’s unusual to have 3 consecutive years of down markets, but obviously not impossible. According to well-known economist David Rosenberg, last year, in 2022, we had 8 bear market rallies. And, in each of those rallies, many investors believed that the bottom was behind us and were once again heading higher. They were wrong time and time again. I keep expecting more from equity market investors. I expect us to realize that this is not another opportunity to buy on weakness. I recall back in 2000, and then again in 2007, I expected investors to realize that the investing environment had changed. I expected it again this time around. However, this is another instance similar to the last many times, whereby it looks like retail investors will push up these markets in the face of an ever-increasing rationale to not do so. I keep expecting us to learn from our past mistakes by overestimating our ability to discern these financial markets. Oops!...I did it again’

I am not afraid to admit I am wrong. In my household, it's often a mechanism used to reinstate peace. Moreover, I strive not to be dogmatic, but as I see it, the likeliness of equity markets heading lower is exceptionally high at this time. I do realize that they may be right and many investors believe that the bottom has been put in and the markets will trend up from here. However, I think we need to look at what is going on with valuations, the economy, and the indicators.

Let's take a look at what some have deemed as the best leading indicator- the yield curve. In chart A, that is a normal yield curve, as you can see it slopes upward and to the right (red arrow). It makes sense that bonds with longer dated maturities, with a longer holding period, offer higher rates. Chart B is the current yield curve and as you can see, rates for longer dated maturities are lower than much of the shorter end of the curve. This is said to be an inverted yield curve and often is a harbinger of a recession in the future. It is my understanding that yield curves, that are both pervasive and persistent in terms of their inversion, are associated with a higher probability of recession. Let me just be clear, this inversion has been both pervasive and persistent! So, in terms of a coming recession, based on the yield curve, the probability is high.

Yield Curve

Chart A

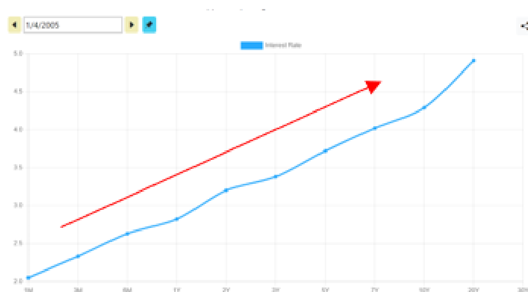
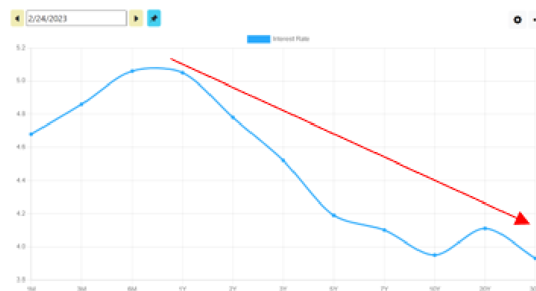


Chart B



Source: https://www.ustreasuryyieldcurve.com/

Many have asked why I believe that it's still likely that the stock market will trend lower, given the setback last year and that the markets are supposed to look forward. Essentially, two primary reasons:

First, is the cash flow or profits themselves, higher rates usually mean lower profits. When the cost of capital is higher, it constricts economic activity. There are less people buying new homes, while others pay more for their existing adjustable mortgages or lines of credit, and companies also pay more for debt – reduces disposable income and spending/sales slowdown. We have already seen many companies report lower earnings, even Warren Buffett's Berkshire Hathaway recently reported very disappointing results. With rates continuing to rise, the bite sort to speak, from those rate hikes takes a while to filter through the system and as such my expectations are for earnings to continue to be difficult.

Second, is the discount rate. Remember that the markets are just a market of stocks or companies. These companies each have a value based on their current and future earnings. However, when the risk-free rate rises, the value of all of these businesses falls. It's not that these businesses do anything different, but when a company is valued, you estimate its cash flow and discount it back to present. As that discount rate rises, the value of the businesses are lowered. In other words, companies are worth more when rates are at 1% then when rates are at 5%.

I should also mention that many seem certain of no recession, a mild one or some sort of soft landing, and yet I am less certain at this time. Just to be clear, I don't know yet how severe the recession will be or how long it will last, I just think it is highly likely that we will experience a recession and that lower rates will be needed to reinvigorate the economy and it will be difficult to lower rates until inflation settles. So for those restless to get back in the markets, I would suggest that they take their memories back to March 2000, 23 years ago so they can avoid saying, Oops, I did it again!

Thank you for taking the time to read this, please feel free to e-mail me any feedback or comments.

Sincerely,

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