THE KWAMMENTARY

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ODLUM BROWN
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Double Dutch

When I was a child, jumping rope was a popular way to pass the time, and also show off your timing and coordination abilities. Double Dutch was particularly challenging, navigating multiple ropes! Naturally, I had none of the aforementioned talent and was scared of being hit by the rope. I agonized over timing my entry: rocking from side to side, trying to get the rhythm right and thinking to myself, "Now? No. What about now?" However, once I got the hang of the entry, I learned that staying in was equally rife with danger! Markets have felt a lot like Double Dutch these days, where investors are considering the options of when to hop in and when to hop out. Many have opted for the latter.

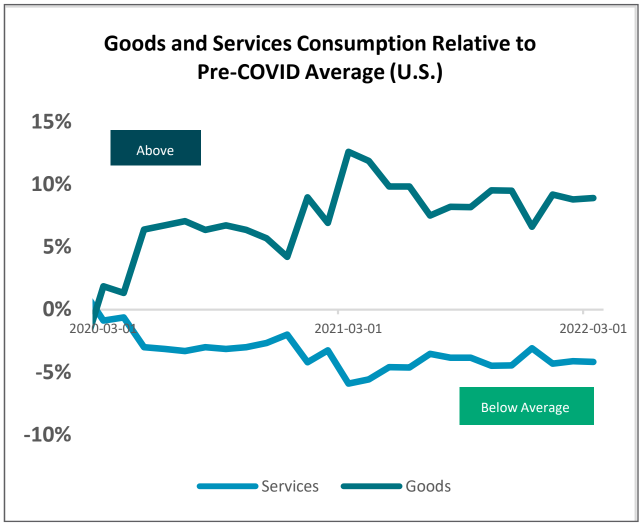
The first five months of the year have been marked with a steady barrage of news, ranging from concerning and complex to outright abysmal. The conflict in Ukraine has shown little sign of reaching a peaceful resolution; China (functioning as a large part of global economic activity) has enacted citywide shutdowns across major centers as it continues struggling to contain the COVID-19 spread; and inflationary forces have intensified across developed and developing countries. Central banks have moved away from their decade-long accommodative posture towards higher interest rates and less liquidity support for the financial sector in response. Because of this paradigm shift, major indices across the globe have moved down sharply,* and the prospect of difficult times to come continues to grow. Businesses with strong balance sheets and durable prospects have sold off alongside less attractive peers, and the prevailing feeling is similar to the beginning of 2020. However, I do not think the data supports this level of pessimism.

Rope #1 – On Inflation

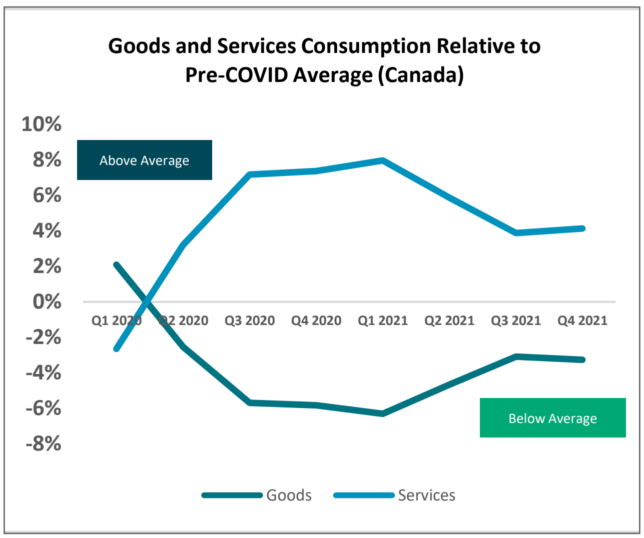
Recent measurements of inflation have shown acceleration through the beginning of 2022. These developments are understandably disconcerting, and central banks across most developed countries have started to raise rates and curtail pro-liquidity activities. It remains to be seen how much more will need to be done in order to reduce inflationary pressures, but expect higher-than-average numbers for the next little while. Interestingly enough, some inflationary pressures are actually showing signs of abating.

If we look at something such as historical consumer spending habits (goods versus services), we can see a reversion back to the historical average. For the past eight years, before first contact with COVID-19, consumers would allocate roughly 68% of spending on services and the balance on goods in the U.S. In Canada, the ratio is roughly 55% to 45%. Through the first year of COVID, these numbers moved significantly outside of their historical averages, with higher demand for goods (service-related activity had largely shut down), putting even more strain on a broken supply chain. This is naturally inflationary, and will continue to persist as long as money is flowing towards a space that is not semi-operational. It is akin to putting constant pressure on a bad knee – it cannot heal until you shift more weight away from it.

*S&P 500 Index: -15.8% YTD, Dow Jones Industrial Average: - 11.22% YTD, NASDAQ Composite Index: -26% YTD, FTSE 100 Index: -4% YTD, CAC 40 Index: -16% YTD, all as of May 9, 2022.



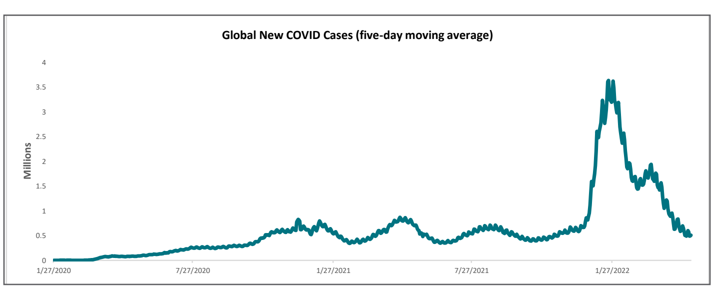
Source: Federal Reserve Bank of St. Louis



Source: Statistics Canada

Rope #2 – On COVID-19

With all of the news around inflation, interest rates and geopolitical upheaval, COVID-19 has seemingly taken a backseat. I will leave determining whether this is a good or bad development to you, but the numbers around new cases and mortality have thankfully moved away from their peak during the winter months.



While new case rates have decreased overall, largely in response to vaccination efforts, various factors have caused disruptions to continue. China, with their "Zero COVID" initiative, has been grappling with a surge in cases as a byproduct of poor vaccine efficacy and even poorer incentive for inoculation for the elderly. Consequently, major cities have endured wave after wave of lockdowns, which has further exacerbated global supply chain issues. So long as these dynamics are in play, it is tough to see an immediate resolution to some of the issues plaguing supply lines.

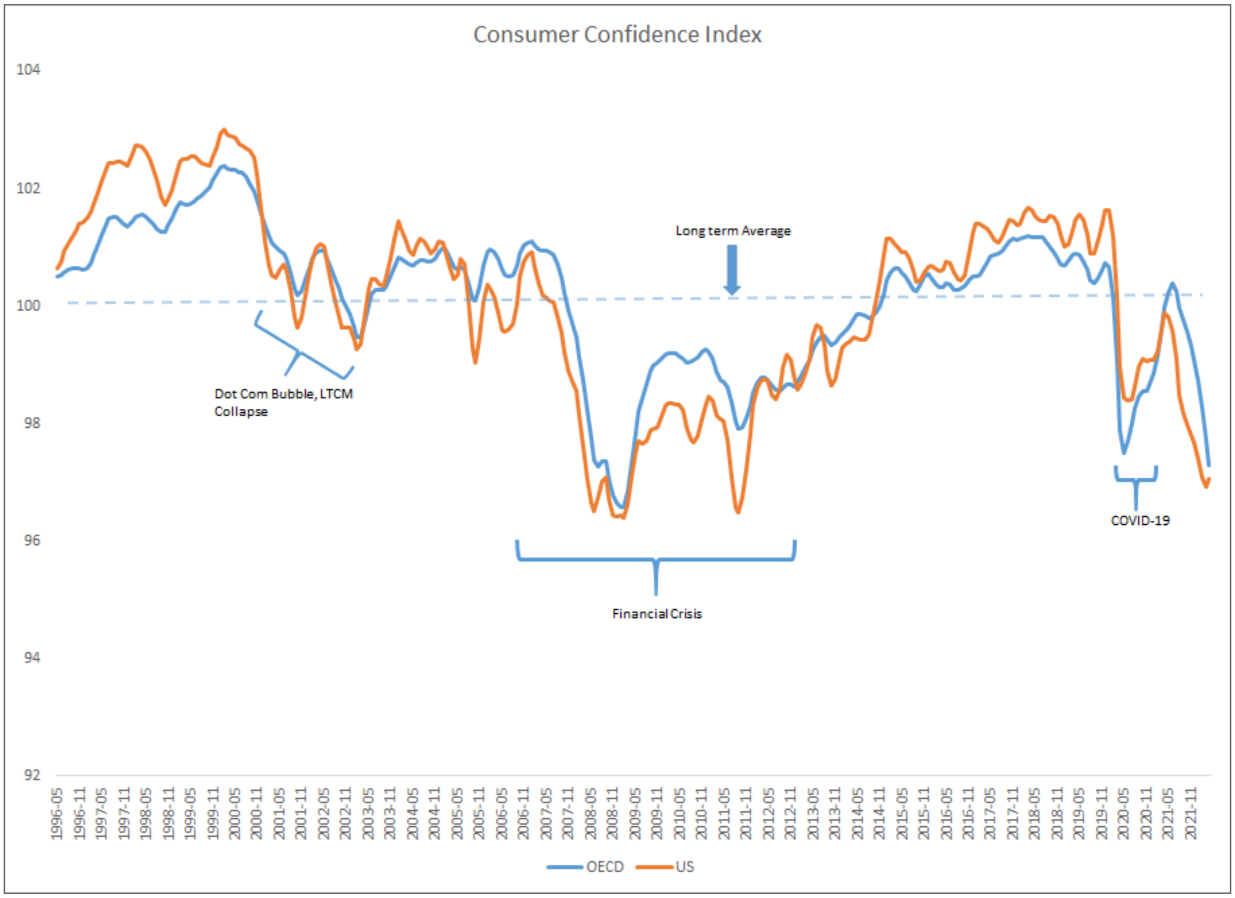
Rope #3 – On Interest Rates

This likely goes without saying – interest rates have gone up. In the U.S., Canada and most advanced economies, the expectation is for rates to increase further through 2022 and 2023, with the hope that inflation will cool off as a result. Many central banks have implied that a "soft landing" is still in the cards (i.e., low economic disruption as rates rise), but I am a little less sanguine on the likelihood of that outcome. In certain geographies (like Canada), debt levels are high ***and*** tied to assets that are priced high. While the asset values will move lower as rates rise, the debt levels will stay the same and cost more to finance. It is not an ideal combination, and this dynamic will lower the spending abilities of those with cash flow constraints. In the U.S., although this is less of an issue, things will likely slow down as well. The extent to which the slowdown occurs is dependent on what path interest rates take. Right now, that is unknowable, but expect it to be choppy.

Rope #4 – On Consumer Confidence

If we take a look at consumer confidence, that outlook seems out of place with the current reality. The Consumer Confidence Index establishes a measure of sentiment around future household consumption and savings, general economic outlook, unemployment and savings capability, based on a series of questions. A measurement above 100 signals optimism and high likelihood of spending versus saving, and below 100 signals the opposite. Current levels of confidence are close to being as bad as they were during the Great Financial Crisis; an environment that, I would argue, we are not close to.

During the Financial Crisis, liquidity had all but evaporated. Savings and retirement accounts were decimated, and financial institutions either collapsed or experienced significant stress. I cannot draw the same parallels today.



Source: Organisation for Economic Co-operation and Development

Putting it all together: Skipping isn't Easy

For those keeping count, you will notice that there are two more "ropes" mentioned above than is common in Double Dutch. As I have written in previous notes, the investment world is grappling with many complex questions (ropes) that do not have simple answers. I expect the volatility we are seeing today to persist, partially as a function of a slowdown, but also as a function of extreme pessimism and fear.

Take Amazon, for instance. One could make an argument that inflation worries will have an impact on their business and that they will be affected by a general economic slowdown. As such, the stock should be worth less. When it has sold off to the same price as its high point in 2018, having generated almost double the amount of EBITDA in 2021 versus 2018 (US$48 billion versus US$25 billion), it begins to look like a severe overreaction and an opportunity. I see similar disconnects from reality in the Energy space (still) and across some higher-quality Technology businesses, Industrials and some Consumer Staples, all of which have begun to look very attractive.

We may trip over some of these ropes along the way, but I believe some of them will begin to move less erratically as time progresses or simply disappear, making the environment easier to be in. In summary, there have been (and continue to be) opportunities to hop in.

Sincerely,

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