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MAS WEALTH

Rate hikes Cause Blunt Force Trauma

Dear Fellow Investors,

Those who are now in their late '60s or older would know that one of the chief features of the 1970s has come back. No, it is not the return of disco dancing or bell-bottom trousers, but inflation. As high single-digit inflation persists in the West and double-digit inflation rages elsewhere, it suddenly seems as though nations have lost control over accelerating price rise. Uncontrolled inflation is the ultimate nightmare of economists, politicians and investors everywhere. To control inflation Central Banks are rushing to tighten money supply (reducing liquidity and raising interest rates) and governments are simultaneously trying to tweak imports, exports and taxes to control prices.

They are facing two problems in doing so. One, after many year, the world is simultaneously under a demand and supply shock, with no immediate solution in sight to either. And two, and for the first time, inflationary expectations seem to be setting in, which is what policymakers dread the most. What is inflationary expectation? Inflation is as much a matter of perception as it is a matter of facts. If businessmen and householders believe that prices will rise (which economists call inflationary expectations), then their actions (such as hoarding to sell later or higher purchases to buy earlier) will further push up the price.

The key stock market indices are vacillating, unable to find an answer to one crucial question: can the Central Banks control inflation quickly by increasing interest rates and tightening liquidity? If yes, the market will go up. If not, the market will remain weak. One reason why we won't get a clear answer to this question very soon is that monetary tightening is the only tool that can be deployed easily in the short-term, but it is a blunt tool to control inflation. It has caused a blunt force trauma on the market.

To bring down prices, one has to increase supply, which seems impossible in the short term. So policymakers have to cool down demand to cut inflation, which is possible, or so Central Banks believe, with tighter money supply. Unfortunately, monetary tightening cannot cut down demand for products that are non-discretionary like fuel, fertilisers, edible oil and foods, which are the main cause of inflation now. Tightening can only affect inessential stuff like some risky and speculative investments, discretionary spending of the middle class and some asset purchases. This is why among the first casualties of inflation have been speculative "investments" such as crypto-currencies and loss-making tech companies in need of a perpetual supply of cheap funds in order to survive.

If monetary tightening mainly affects discretionary spending (of the middle class and the poor) and non-essential assets, how will demand for these essential items shrink? In the US they recorded the highest increases this year: natural gas (176%), heating oil (100%), gasoline (91%) crude oil (70%), cotton (66%), nickel (55%), wheat (54%), coffee (48%). However, if inflation does not drop, Central Banks will keep tightening liquidity, as long as that is the main tool available. This will destroy demand across the board, just like antibiotics, which kill both good and bad bacteria.

The danger is that these decisions have to be made on the fly, and with hindsight knowledge, the tightening can go also go too far. Such action could take even the US to the edge of a recession. As top US investors Bill Ackman and Stanley Druckenmiller say, there is no economic precedent for today's situation such as 200 to 300 bps of Fed funds addressing 8% inflation. In fact, in the US history inflation above 5% has never been accompanied by Fed rate of below 5%. And the current rate is only 1.6% when inflation is 8.6%. Inflation will probably come down a bit over the coming months but the Fed is long way behind the curve.

What does it mean for us? There is a strong inverse correlation between rising rates and emerging markets. Dollar may remain strong, rupee will be weak and margins will be under pressure. However, the fact is no one has exact answers, not even the central banks. As you know, one thing we try hard not to do is forecast. Analysts, economists and commentators repeatedly fail to make correct forecasts about complex macroeconomic events but never seem to learn from experience.

Remember, two years ago, when a pandemic hit the world, there was a consensus about economic doom. With movement of people and goods across the country completely shut down, it was expected that output would shrink, unemployment would be sky high and a recession would be inevitable. That was the popular consensus and it was hopelessly wrong.

Do we hear people talking about BRICS anymore? In 2003, Brazil, Russia, India, China and South Africa were touted as the new economic superpowers. Only China lived up to its promise. In 2007, the world was gripped by the “Peak Oil” theory and perpetually rising oil prices. It turned out to be false. Oil simply rises and falls on demand and supply like any other commodity. In 2009-10 a double-dip recession was considered inevitable after the global financial crisis of 2008. It did not happen.

When the Fed kept interest rates low for a prolonged period after the 2008 crash, Ray Dalio, founder of the world’s largest hedge fund, feared hyperinflation and his team was reading up about the German economy and markets in the post-World War I period when that country suffered hyperinflation. The same Bridgewater famously said cash is trash late last year. Turned out to be a terrible advice. In 2011, Portugal, Ireland, Italy, Greece and Spain (PIIGS countries) all seemed headed for insolvency. It did not happen. We do not know whether the current consensus about inflation will also be wrong but the more widespread the consensus the more likely it is to fail.

Meanwhile, macroeconomic conditions will continue to unfold in our lives with a lot of twists and turns. As we navigate choppy waters, there will be several such periods of relief when the tide would seem to turn for the better. If the central bank fears a sharp demand slowdown, it may be pause its rate hikes, which would fire up stock prices again. Finally, stock markets often presage actual improvement in economic conditions, while the reported economic data invariably captures the past. It may be worthwhile to pay attention to what the market is telling us, as it did during the pandemic, rather than rely on consensus forecasts.

A few words about our funds. We must be among funds with the highest amounts of cash levels. A month ago we had as much as 30% cash on an average. In new accounts, cash levels were much more. This turned out to be a correct call. We also had a good call on options in mid-June when the market declined. Our strategy remains the same as I have mentioned in earlier memos. To reiterate:

1. Diversify a lot (yes we are less smarter than others)
2. Increase cash levels when the market is bearish
3. Buy stocks with good fundamentals that are bucking the bearish trend
4. Hedge the portfolio with index puts index calls.

Happy investing

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