

TIDES, WAVES, AND CURRENTS



Capital, and the market in general, is like water in that it continuously flows to the most welcoming place to find its natural equilibrium. We will extend the analogy to include types of movements: tides, waves, and currents. As an investor, it's important to know the difference between the three and where to focus one's efforts. Investing is incredibly difficult, and it is not easy to identify where capital is or will be moving. In fact, as a long-term investor, one should generally ignore waves, whether they be the buildup (an irrational bubble) or the crash, because a well-diversified portfolio and disciplined focus on the long-term will withstand these phenomena and still compound over time. It may be tempting to try to call everything a bubble and constantly call for the crash of a wave, as many pundits do, but the broken clock that is right twice a day still doesn't work over the course of time.

What is important to observe and study are the tides and the currents. A change in tides in capital markets mark a turning point in what had been a sustained flow of capital and can impact long-term investors, especially those without the proper asset allocation. Currents are much more subtle and lurk beneath the surface, gradually consuming a greater share of an industry, sector, or asset class. Currents can generate a substantial impact on a portfolio over a long enough time frame and have the potential to morph into something greater if the conditions are right.

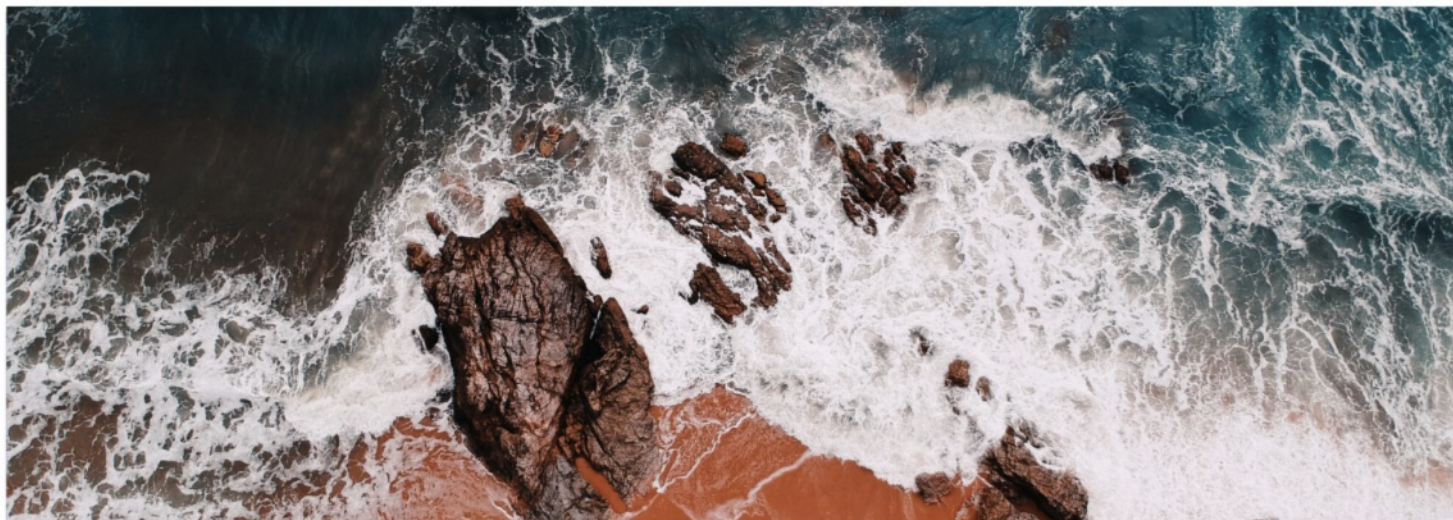
The past two years have certainly seen choppy waters. COVID threatened to be a change in tide, but thanks to mostly effective vaccines and the luck of mutations into weaker variants "knock on wood", it appears there may just be some strong currents like remote work and just-in-case inventory that emerge. However, the first quarter of this year has certainly made a splash and has spotlighted several currents that threaten to morph into a more dramatic flow of capital.

GEOPOLITICAL AND COMMODITY INSTABILITY

Hardly anything can be more destabilizing to a country than war, and this unfortunate fact is facing Ukrainians. It is also facing Russian citizens, even though they are not being physically displaced. The invasion of Ukraine has set off a series of extraordinary events in capital markets. The West, after a brief period of staying arm's length, has become quite engaged in the war – in a financial sense. Sanctions targeting individual people, individual companies, entire sectors and even the country's central bank began raining down on Russia and wreaking havoc in currency and commodity markets. The Russian ruble dropped almost 45% in two weeks. Due to Russia's large role in global commodity supply, commodity prices spiked. Wheat jumped 60%, crude oil continued its brisk ascent, and the London Metal Exchange had to close due to a short squeeze that caused nickel prices to temporarily double!

Supply chain problems lingering from COVID were persistent, causing inflation to stay high to start 2022. But the U.S. consumer started showing some signs of pushback against the consistently higher prices toward the end of 2021 and the beginning of 2022, offering hope that inflation would start to cool off and supply chains would heal. The Russia-Ukraine war has turned that hope on its head. The cure for high prices may be higher prices, but commodity inventories were so low that this commodity surge will take time to resolve and therefore cause inflation to stick around even longer.

The outcome of the Russia-Ukraine war is undetermined at the time of this writing, but this event is a significant change for capital markets to digest. There were immediate waves created, but for investors, there exists the potential for a change in the tides of global trade. When the tragedy of war comes to an end, investors must closely watch the resolution. An extremely punitive stance from either side could beckon an extended period of unstable commodity supply and bouts of inflation. Furthermore, this geopolitical instability could leak into relations with a huge trading partner for everyone around the globe: China. It is not difficult to imagine a realignment of global trade into blocs, and deglobalization is likely to be inflationary. However, one must be patient before claiming the ebb of the tide of globalization because the pull of the status quo, or at least a desire to get close to what was the status quo, is a powerful force. This may be particularly true in Europe, where broad double-digit inflation may be possible, stemming from reliance on Russian oil and gas. Regardless of the outcome, the currents of change in global trade that were already present are likely to grow stronger.



THE FEDERAL RESERVE AND A 40 YEAR BOND BULL MARKET

The Russia-Ukraine war has thrown fuel on the fire of inflation in many economies across the globe, including the U.S. To fight inflation, the Federal Reserve has, belatedly, started to raise interest rates. Although we'd argue Federal Reserve chairman Jerome Powell has shown some brief moments of hesitation, the latest communication from Mr. Powell showcased a stern resolve to raise interest rates and stop inflation. With the CPI (Consumer Price Index) likely to climb over 8% due to the commodity spike; estimates of the "neutral rate" (the short-term interest rate above which economists believe the economy will tip into recession) around 2-2.5%; and the Federal Funds rate (which the Federal Reserve controls) at 0.50%, Mr. Powell has a ways to go.

If the markets are the ocean, the Fed plays the role of the moon. Changes in Fed policy are often a change in the tide. Rates rise, making bonds more competitive as an investment option and therefore lowering (or at least putting a ceiling on) equity valuations. Furthermore, Fed interest rate cycles usually end in recession. So if this is typically a tidal event, then investors should simply exit equities and sit in cash or buy bonds, right? Not necessarily. There are several reasons for this. First, as long-term investors, the outlook for equity returns over the next decade plus still beats bonds and cash at the moment. There will inevitably be a bear market – or multiple – in the next ten years, so bonds and other asset classes absolutely have a place in portfolios. But it is important to stay invested for long-term growth that equities offer.

Second, it is possible that the Federal Reserve could manage a "soft landing," in which they raise interest rates far enough to cool off inflation yet not too far to cause a recession. Let's be honest: this is not the base case. More often than not, the Federal Reserve goes a little too far and sends the economy into a recession.

Historical examples of soft landings, while real, are rare. Furthermore, there are too many imbalances and too much inflation in the post-COVID economy to think Mr. Powell can pull off a soft landing.

Third, the chances are high that the next recession does not follow the traditional playbook in structure, depth, or duration. The same post-COVID issues that will give Mr. Powell night sweats could also be a reprieve when he does cause a recession: several areas of the economy could actually grow during the recession and the stock market would likely look right past a brief, mild recession.

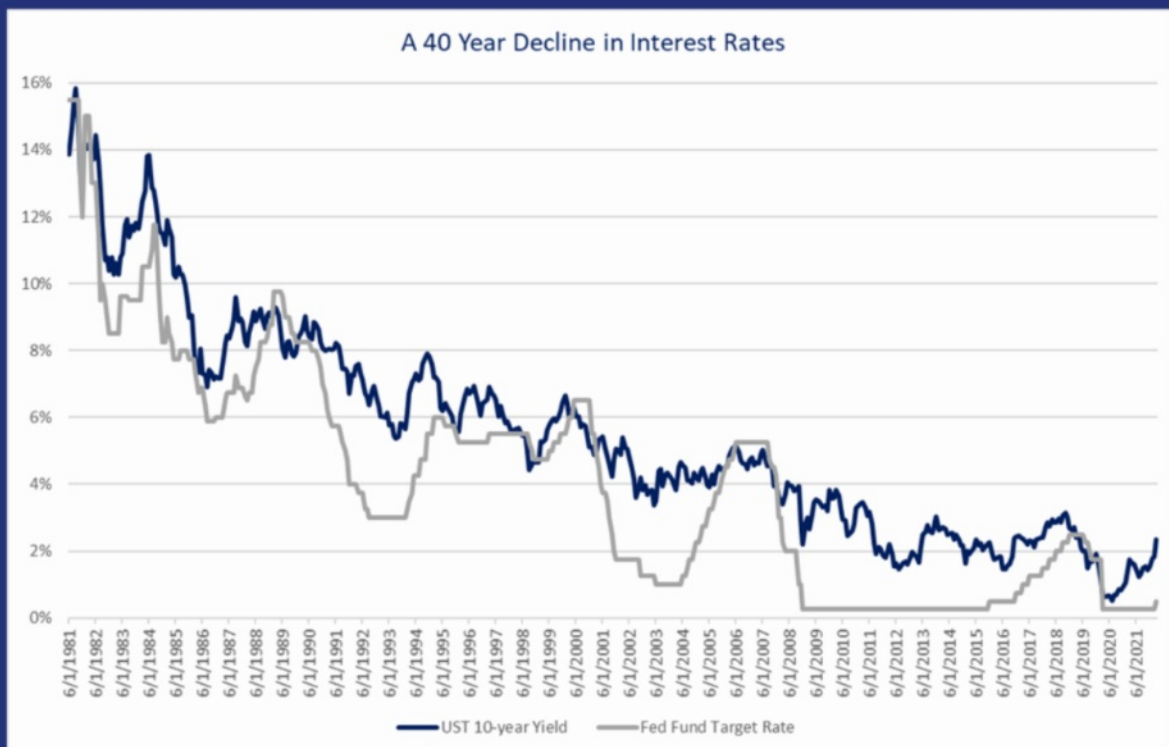
Finally, and perhaps most controversially, Mr. Powell could succumb to fears of recession – or getting fired – and allow inflation to continue to run hot. There are examples of this policy: essentially "inflating away the debt." In the 1940s, the United States kept interest rates well below the rate of inflation to finance war efforts. During the inflationary cycle from 1941 through 1951, inflation ran at 5.9% annualized. Equity annualized returns in the same time frame were 7.5%.

The United States has not seen this level of inflation since the 1970's, the end of which marked the beginning of one of the most powerful secular trends in modern finance: the 40-year bond bull market in long-term U.S. Treasuries (UST-see chart below). There are many calls for the secular bull market to end with this level of inflation, but those forecasters, in our opinion, are inherently betting on Mr. Powell letting inflation run hot. High debt levels tend to put a lid on interest rates, and the United States has plenty of debt. Should Mr. Powell be successful in snuffing out inflation, the long-term bond bull market is likely to stay intact. However, the risk of "inflating away the debt" being the implicit policy has arguably never been higher after a massive COVID spending spree by the government.

Additionally, oil and gas shortages and inflationary changes in global trade could hinder the Fed's ability to stamp out inflation.

Should this perfect storm gather steam, then the bond bears could have their generational win.

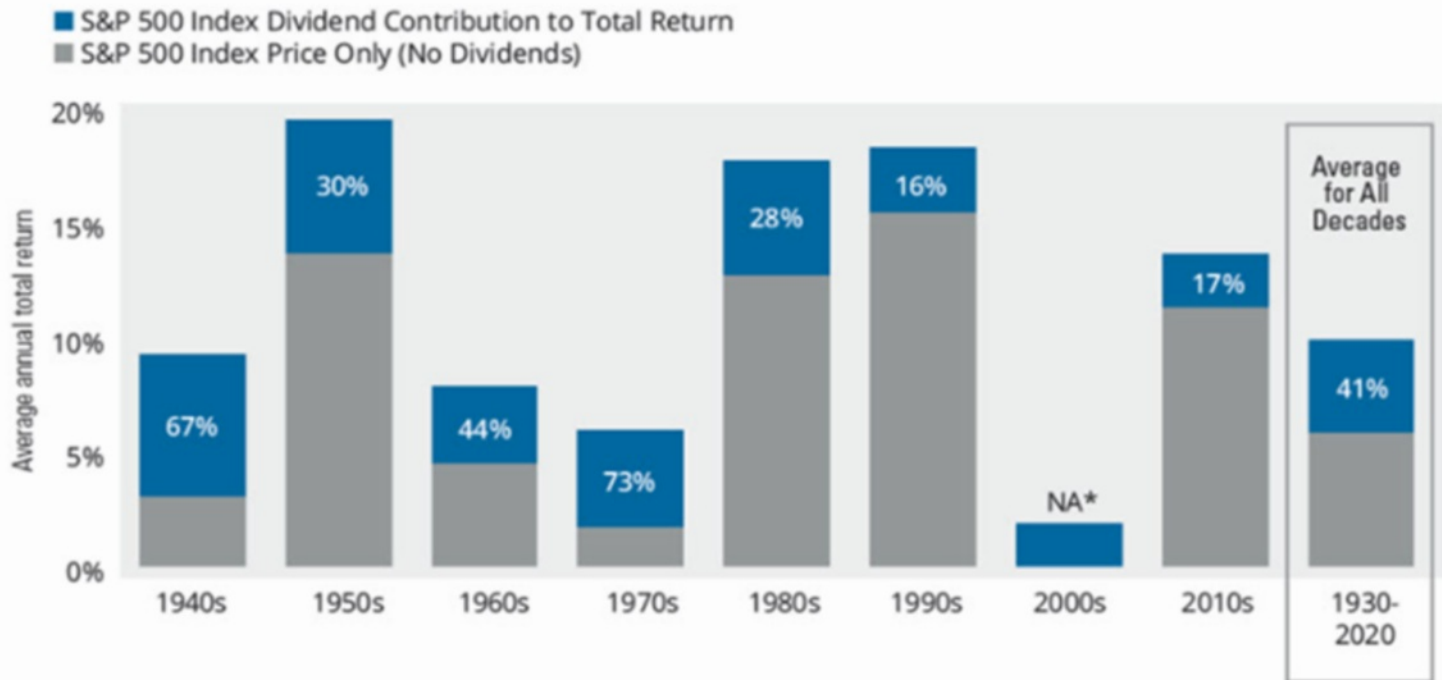
Much like the geopolitical uncertainty, monetary policy uncertainty requires patience for the time being. As we said, the movement of the Federal Reserve is a tidal event, but the speed at which the tide turns back the other way is often unpredictable. The Fed's own forecasters and the bond market are expecting interest rate cuts as soon as 2025. One of the more famous Warren Buffet quotes - "only when the tide goes out do you discover who has been swimming naked" - does not apply to every interest rate cycle, as the tide can quickly reverse before exposing too much.



Source: Bloomberg

WHAT DOES THIS MEAN FOR PORTFOLIOS?

We believe in focusing on the long-term when investing, but changes in the tides and currents can impact long-term returns so investors can't fall asleep at the helm. However, the waters are simply too muddy at this exact moment, so patience is the best course of action. For clients of First Bankers Trust, the consistency of our investment philosophy will not change even if we sense movement in the water: we continue to focus on high quality companies with dividend growth potential and strong management teams that can thrive in changing currents. Another calming fact: dividends have been a significant part of total equity returns during prior inflationary decades (1940's and 1970's), so we believe we are fishing in the right waters (past performance is not a guarantee of future results).



Source: Morningstar. *Total Return for the SP500 was negative for the 2000s. Dividends provided a 1.8% annualized return over the decade

Within bond portfolios, our message remains as boring as it has been for almost a year: limit interest rate sensitivity and stay short in bond maturities. The Treasury yield curve is essentially flat from two-year maturities to ten-year maturities, so the reward of investing in longer-dated securities is minimal for buy and hold bond investors. If the Fed proves unable or unwilling to stamp out inflation, allowing short-dated securities to mature could allow for better reinvestment opportunities at multiple parts on the yield curve in the future.

Sincerely,

Your First Bankers Trust Team



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