SV Wealth - Newsletter

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From Jackson Hole with Love

In the waning dog days of summer, Federal Reserve Chairman Jay Powell gave the markets quite a wake-up call with his speech on August 26. Inflation had been falling recently, and there was hope by market participants that perhaps central banks wouldn't need to raise rates as much or as aggressively going forward.

Jay Powell in Jackson Hole, WY. Source: Boston Globe

With the bucolic backdrop of Jackson Hole, WY where the central bank was holding its annual symposium, Powell disabused the market of the idea that the current interest rate tightening cycle might be over sooner than later.

He warned "the historical record cautions strongly against prematurely loosening policy" and explicitly referenced the Feds' experience in the 1970s, when the stop-and-start cycle of tightening made inflation difficult to tame.

"Far Greater Pain"

The markets have a long-held belief in the "Fed put", which is that the central bank won't raise rates so aggressively as to tank stock markets, the economy, or employment. During his speech, Powell went out of his way to show the central bank's resolve in tackling rising prices, hinting they're staying the course until inflation falls meaningfully back to two per cent.

Powell went even further by saying, "Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation."

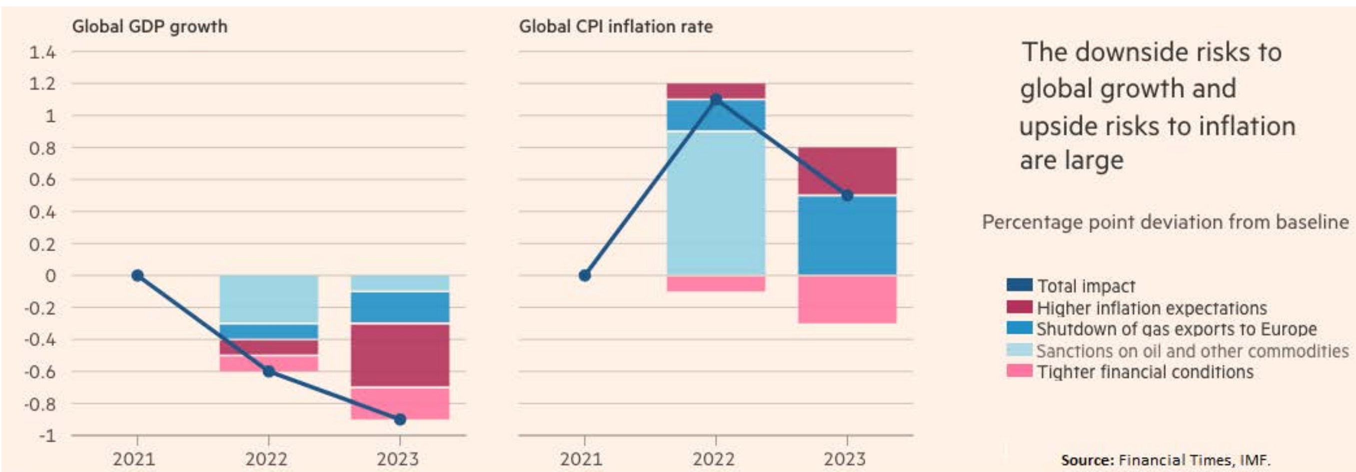
In case his message wasn't clear enough, Powell added that "a failure to restore price stability would mean far greater pain".

Quantifying the Odds of a Recession

The interconnected nature of today's modern economies means malaise in one corner of the world could cause a slowdown in another part. Today, two main events are threatening a global recession: Russia's ruckus in Ukraine and China's disruptive zero-Covid policies.

Russia's weaponization of oil and gas has caused havoc in Europe, especially in manufacturing powerhouse Germany. As energy prices remain high and supplies remain uncertain, Europe could be pushed into a recession if they're forced to start rationing energy. With energy scarce in the winter, industrial producers might find themselves idled, pushing down GDP.

China's Zero-Covid policy has pushed China's economic growth down from six per cent to a predicted 2.5-3 per cent for 2022. Because China is the world's second largest economy, the slower growth means it's importing less, leading to pain for China's trading partners, especially Germany. On the supply side, all the shutdowns are bound to slow exports as factories remain shut.



Thus, the odds of a recession in Europe are fairly high, especially during the winter months. If China insists on continuing their Zero-Covid lockdowns, the global economy could be in a recession at the end of this year or the start of next year.

Navigating the Choppy Waters

To get through the turbulence, we remain selective with our investments and continue focusing on owning high-quality securities. Those would be companies with pricing power and the ability to charge more without causing a big decline in demand.

On the fixed income side, we remain focused on assets with shorter duration and higher sensitivity to interest rates. We're also looking to pick up yield for our portfolio by finding floating rate instruments and preferred shares.

Most importantly, we remain invested for the long term. Remember, this turbulence too shall pass. The key will be positioning to minimize the decline and maximize the recovery opportunity for our portfolio.