Fed pivots and the lessons from the 1970s

NCM Small Companies Class commentary

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In June 1969, Fed Chair William McChesney Martin stated "We're going to have a good deal of pain and suffering before we can solve these [high inflation numbers]", referring to the Feds attempts at lowering the then 6% plus inflation rate. Today, the Federal Reserve is driven by a commitment to "whatever it takes" and has pushed interest rates to levels not seen in some time.

And it hurts today just as it did back then. Asset classes have come under pressure. From January 01, 2022 to October 12, 2022, the S&P 500 is down 25%, Nasdaq is down 34%, MSCI Emerging Markets -30%, Meme stock ETF -57%, Bitcoin -60%, the Austrian 100 year bond -54%, ARK Innovation ETF -60% and Cannabis (YOLO) -66%. Ouch.

The good news is the Fed pivoted as soon as inflation peaked and the market bounced back in June 1970. If goods inflation has not already peaked, we anticipate it shortly. There is plenty of evidence of high inventory levels and container freight rates are down approximately 70% from the peak. Expect to see significant markdowns this holiday season.

The weightier services inflation numbers will take time to roll over due to rent increases that lag the broader move up in inflation. Recall that goods inflation was influenced by supply chain issues. The covid-19 pandemic turned out to be more of a supply shock to the economy than a demand shock. Something businesses were ill prepared for, and why onshoring and freight management will be a theme in 2023.

What we saw in the late 1960's, 70's and early 80's was a pattern of market troughs at the point inflation rolled over. This green-lighted the Fed to cut rates and stimulate the economy. Labour unions and oil prices carry less weight today than they did back then and as a result this should help the Fed push the inflation lower.

We are expecting the ISM PMI Non-Manufacturing Prices Index to drop below 50 in the not-to-distant future, following the Manufacturer Prices Paid index. This will signal, as Dr. Copper did recently, a contraction in the economy. Remember that every post war Fed Chair, except Volker, has cut rates after the ISM New Orders declined below 50.

The best opportunities to buy stocks are during recessions, and we don't get many recessions in our lifetime. Next year will be characterized by lower bond yields, accelerating earnings towards the end of the year and an increase in multiples in my opinion.

The winners as we transition through the trough will be pricing power leaders, capex leaders and supply chain leaders. Companies such as **Descartes Systems Group**, a leader in providing SaaS solutions for logistics intensive businesses. They automate the increasingly complex and regulatory driven logistics market.

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Tecsys Incorporated is a supply chain management company for some of the world's most complex supply networks. They have already become dominant in the Healthcare Systems market with a leading market share – and their future looks increasingly bright.

Major Drilling Group International is yet another example of a company that fits the above themes. They provide specialized drilling services to the mining industry with a fleet of over 600 drill rigs. Being the contractor of choice, Major Drilling tends to service larger, investment grade customers in an industry that has been short of new resource discoveries.

All of these are core holdings in NCM's Small Companies investment product. Further, growth and profitability of the portfolio looks very attractive. According to CPMS at the end of September 2022, the Trailing Return on Equity (ROE) was 17.9%, the Return on Capital was 17.2% and the

Quarterly Earnings Momentum was 10.7% - all much better than the S&P TSX Composite Index and the BMO Small Cap Equity Index. Valuations look attractive as well with a Trailing Price Earnings ratio of 10.9x and a Trailing Price to Cash Flow ratio of 4.8x.

No one knows when this "pivot" will happen. The key metric to watch is the 10 year U.S. government bond yields – it needs to stop rising. The bond market leads before the Federal Reserve moves.

Advisors should be thinking of putting some excess cash to work and buying in periodic small chunks. We have all experienced how quickly and powerfully the market can and will move. Too much cash or too defensive a portfolio will drag down returns.

It is psychologically more difficult buying after a 25% plus bounce. Using the 1970s as an example, the sectors that performed the worst were (1973-1980): Real Estate - 36%, Consumer Discretionary -34%, Health Care -19% and Consumer Staples -18%. A properly diversified portfolio of quality stocks and investment funds will help clients stay on the long term trajectory of achieving their financial objectives.

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