Quarterly Letter September 2022

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"Inflation is taxation without legislation."
– Milton Friedman

Nobel Prize winner Milton Friedman wrote extensively, in his career, about inflation. Indeed, his encompassing definition of it, "inflation is always and everywhere a monetary phenomenon," is still required teaching in just about every economic class.

Teaching about inflation in the last ten years really felt like teaching about dinosaurs as the problem, year after year, seemed quite the opposite or too little inflation. Then COVID came and the distortions that occurred globally in the supply chains in combination with excessive fiscal policy and monetary policy awoke an old foe.

The fight central banks, Federal Reserve in "primis", have been conducting against inflation is the reason behind the abysmal performance of most assets year to date, except for energy and some other commodities.

Inflation in the US is running at just above 8%, a level that is significantly above the Fed's stated target of 2%. The expectations are for a quick drop to around 4% by the beginning of 2023 and then a grind lower. The recent rally experienced by equities in summer was predicated on economic data that would show that peak inflation was behind us, and that the deceleration phase was taking shape. Unfortunately, the most recent data on CPI, published on September 13th, poured cold water on such expectations.

The road from here gets trickier. The Fed will be forced to either accelerate the pace of rate increases or keep the pressure for longer; neither of the two scenarios is particularly friendly for financial assets. On the positive side, we note that funds positioning is already quite bearish; JP Morgan reports that positioning for both systematic and discretionary funds is currently in the 10th percentile. This is a contrarian indicator that measure equity exposure for professional money manager; given the low exposure, a little bit of good news could spark a rally.

However, the new environment also shapes a different future for the investing landscape. Fiscal policy will probably continue to remain elevated as supply chains need to be fortified in a deglobalizing economy, the switch to renewables carries on, and defense budgets gets more attention.

A fragmented and less efficient world will produce a higher average level of inflation and generally higher interest rates. As previously discussed in other letters, this combination of factors will probably produce lower returns for the intermediate term.

From an asset allocation perspective, we reiterate our stance and see inflation protection as a must. US Treasury Inflation Protected securities still hold value and show positive real yields, while, in the riskier section of the spectrum, we can point to energy and health care as good values. We also reiterate our view that from a long-term perspective, water infrastructures retain “great expectations.”

As always, we would like to thank you for the renewed confidence in our work,

Youri Bujko

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