Market Viewpoints

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Lost in the turmoil of the 1970s, is the fact it was a decade full of breakthroughs in electronic, data-processing and medical technology. The email, the floppy disk, the first real video game, the personal computer all came in 70s. The 70s game us Microsoft, Apple, Oracle, Visa, Federal Express, Nike, Genentech, Starbucks and Home Depot.

Summary

The 1970s get a lot of bad press. It was however a decade not just about gloom, economic crises, bell-bottom trousers and thick sideburns. It was also a remarkable decade, full of breakthroughs in electronic, data-processing and medical technology, including email (ARPANET), the floppy disk (IBM), the first real video game Pong (Atari), and the personal computer (Apple). The 1970s gave us companies like Microsoft, Apple, Oracle, Visa, Federal Express, Nike, Genentech, Starbucks and Home Depot.

So, you see, lost in the turmoil of the 1970s, is the fact that the US economy was going through a painful, yet necessary, transformation. New ventures formed, that in years to come would radically change the US and the world economy. The changes and innovation of the 1970s set the stage for a new type of economy in the future – less manufacturing more services, less labour intensive and higher productivity. Anybody can brand the prevailing economic problems in the 2020s as a "crisis," raise the flag of fear and get bearish. It takes however a mixture of intellectual boldness and gritty determination to see the ongoing innovation in the economy and hence the future.

The equity markets are in oversold territory, however, it's the US Federal Reserve pivot on interest rates and inflation that the market is waiting for, in order for a sustainable rally to set in. For the Fed to do this, it has to see the inflation data start falling measurably. If economic data continues to worsen (and they are), inflation will slide and then one can expect Fed talk to change tack and indicate a desire to slow down or pause tightening. Until then, keep your seat belts fastened, volatility will abound.

Were the 1970s really that bad?

Of all the post-war decades, the 1970s is seen as the worst. A decade full of economic woes, sandwiched between the swinging Sixties and the go-getting Eighties.

All you ever read or hear about the '70s is – double-digit inflation, high unemployment, and mortgage rates as high as +20%. The decade witnessed two US economic recessions, at least two severe global energy crises, the unprecedented peacetime implementation of wage and price controls in the US, and the abandoning by the US of the global monetary system established during World War II.

The "energy crisis" played a key role in the economic woes of the 1970s. In a televised speech in 1977, then US President Jimmy Carter donned a sweater to put across his message of "energy conservation" and in doing so became the first US President to make an official appearance before the nation wearing a sweater. The fear of energy shortages, which necessitated production cuts and job cuts, was making things worse. The impact of higher prices would be felt in rising inflation and falling business confidence, which plagued the entire decade.

However, just because inflation is today at +8.3% in the US and talk of 1970s-like economic woes fills the airwaves, I am not writing this newsletter to add to the noise. In the paragraphs below, I intend to dwell on: Were the 1970s really that bad or, were there redeeming features and events that we can take comfort from?

Old Shell Petrol Station 1970s

Today, we do not have an energy shortage. We have an excess of it, if only we could ship it to where it's needed. The shortage of energy or "peak oil," has often been used as a bogeyman by energy producers and traders, to drive energy prices higher, which in turn drives up input costs for almost everything we produce and consume and use to get around. Energy is the lifeblood of our economy.

Daniel Yergin's book *"The Prize: the Epic Quest for Oil, Money, and Power"* is a fascinating read as to how the old-fashioned "energy crisis" has travelled through time, since the oil industry came into existence in the 1890s.

In 1920, the head of the US Geological Service warned that US reserves would be depleted in exactly nine years and three months. In 1930, just as the feared date of exhaustion arrived, the industry was rocked by the discovery of the huge East Texas field. The ensuing flood of oil sent prices crashing down to 10 cents a barrel during the Depression. A similar fear of shortage after World War II led to new technological developments and the opening up of the huge oil fields of Saudi Arabia, Kuwait and elsewhere in the Middle East. Fast forward to the 21st century and we know what "shale oil" has done for the energy market and geopolitics. The US has become energy independent and its influence on global geopolitics has been enhanced. On the other hand, Russia, the largest energy exporter has seen its standing and influence slump.

In his book, Yergin reminds us that the consequences were the same as in virtually every other "energy crisis" since "Colonel" Edwin Drake struck oil in western Pennsylvania in 1859 – smaller companies slashed spending to survive, larger companies postponed new projects, people were let go, human ingenuity prevailed, new technologies were again deployed, new territories were opened up, and new supplies came through.

The reason I highlight this, is to make just one point – never underestimate human ingenuity in solving a problem to come out of a crisis. In the immortal words of US President Franklin D. Roosevelt – "The only thing we have to fear is fear itself.” Those words and the sentiment they convey have and will continue to find an echo in many a bosom for many years to come.

It was not just the US, but the UK too that had its pessimism and gloom in the 1970s. In November 1974, then UK Foreign Secretary (and later Prime Minister) James Callaghan said this to his colleagues – *“Our place in the world is shrinking: our economic comparisons grow worse, long-term political influence depends on economic strength – and that is running out. If I were a young man, I should emigrate.”* Yet, what followed the winter of discontent, was over a decade of glorious growth and prosperity under Prime Minister Margaret Thatcher.

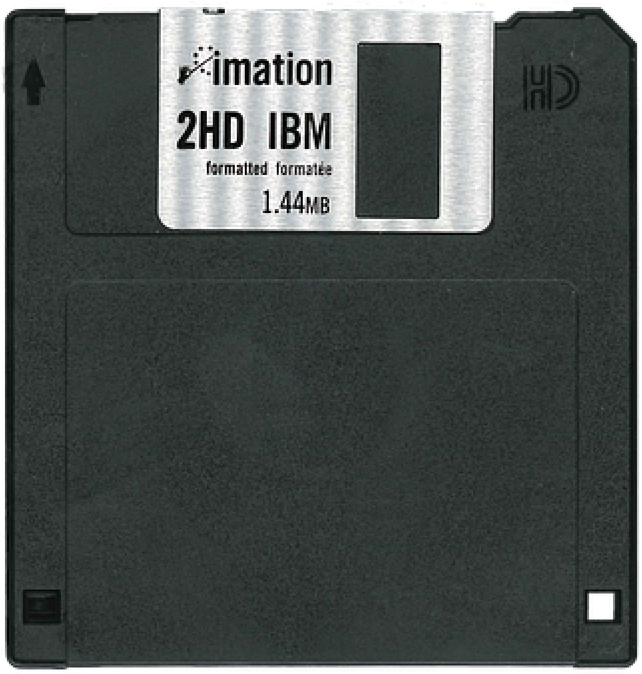
Today, we do not have the unemployment problems of the 1970s. The US and the UK have more jobs than the number of people looking for employment. The unemployment rate in many a country is at historical lows and speaks of economic growth and consumption that lies ahead when we are past the headline inflation scare that abounds.

The 1970s were not just about gloom, economic crisis, bell-bottom pants and thick sideburns. They were a remarkable decade full of breakthroughs in electronic, data-processing and medical technology.

From the first mobile phone to the Rubik’s Cube to barcodes, some of the world’s greatest inventions emerged during the 1970s. The Email (ARPANET), the floppy disk (IBM), the first real video game Pong (Atari), the personal computer (Apple), the cell phone (Motorola), the video cassette recorder (Philips), the digital camera (Cromemco), the Global Positioning System or GPS (US Navy), the portable music player or Walkman (Sony) were all innovations of the 1970s.

The floppy disk may be a largely obsolete technology now, but its legacy remains. I wrote this newsletter in Microsoft Word and each time I wanted to save the document, I clicked on the floppy disk symbol in the top left corner.

An IBM floppy disk



The 1970s gave us companies like – Microsoft, Apple, Oracle, Visa, Federal Express, Nike, Genentech, Starbucks and Home Depot, to name but a few. If you were not a doom-monger in the 1970s and looked on the bright side (as I always advocate readers of this newsletter to do), you felt as though the future was now. Storied Venture Capital firms – Kleiner, Perkins, Caufield & Byers, Sequoia Capital, Apax Partners, New Enterprise Associates and Oak Investment Partners – all were founded in the 1970s. These firms made some of the most notable investments in Tandem Computers, Genentech, Apple Inc., Electronic Arts, Compaq, Federal Express and LSI Corporation to build the technology future that we so take for granted sometimes.

So, you see lost in the turmoil of the 1970s, is the fact that the US economy was going through a painful, yet necessary, transformation. New ventures formed that in years to come would radically change the US and the world economy. The changes and innovation of the 1970s set the stage for a new type of economy in the future – less manufacturing more services, less labour intensive and higher productivity. America, which was dependent on the large manufacturing companies for a large part of the twentieth century, underwent a transformation.

The Great Depression saw the birth of some massive US corporations – General Electric, General Motors, IBM, Disney, Hewlett-Packard (HP), Morgan Stanley, Texas Instruments, United Technologies, and Polaroid Holdings. Google, eBay, Bookings Holding, and Amazon, were created during the 1998 dot.com crash.

The entrepreneurial successes of the 1970s and the great Depression convey a fundamental message – hard times are good for business innovation. They lead to what Austrian economist Joseph Schumpeter (1883–1950) called “creative destruction” as talented people are shaken free from the clutches of old institutions and old thinking and the market for ventures and innovations booms. Technology has paved the way for economic transformation and improved quality of life and it’s not going in the reverse. You will see more and not less innovation going forward. You will not make money investing in companies of the future if you get shaken out by a correction. To make lofty returns in Yahoo (YHOO) one had to endure at least five -70% corrections.

The truth is that the 1970s were better than the decades before and the following decades better than the 1970s.

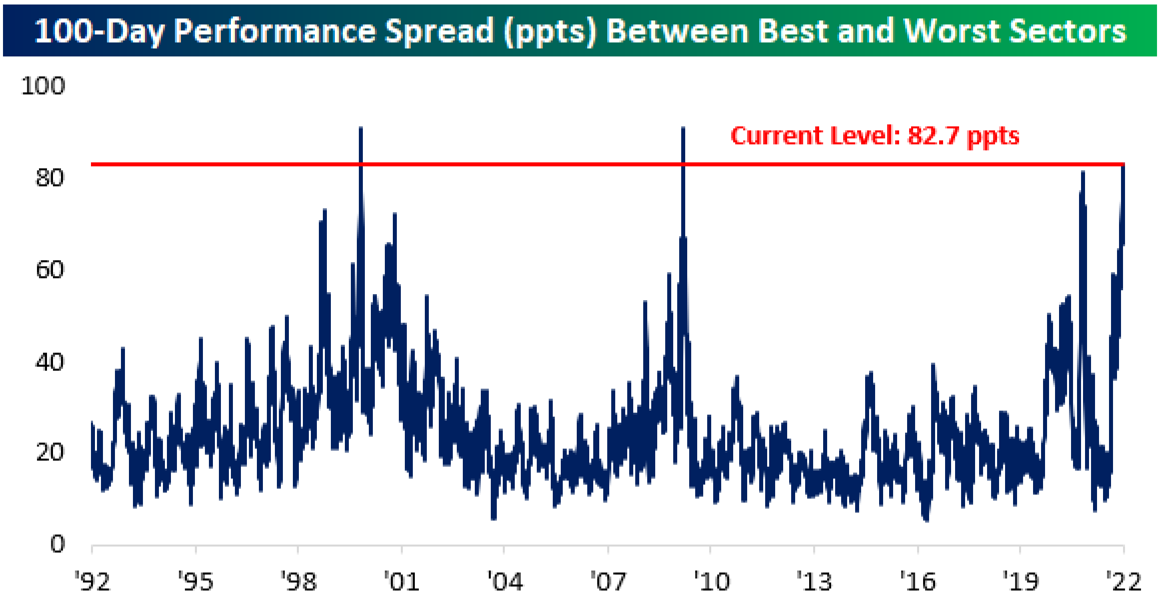
Anybody can brand prevailing economic problems a “crisis,” raise the flag of fear and get bearish. However, it takes a mixture of intellectual boldness and gritty determination to see opportunity. If you see things as the “beginning of something” rather than the “end of something,” you have a very good chance of seeing the future.

Markets and the Economy

If you are invested in the equity markets, then you know already that they have been extremely volatile this year.

The chart below from Bespoke Invest outlines how volatile, compared to prior years. So far in 2022, the S&P 500 (SPX) has averaged an absolute daily move of 121 basis points (bps). Although the broader index has been incredibly weak over the last 100 trading days (down -17.1%), performance among individual sectors has diverged widely, as Energy has gained +50.7% while the Communication Services sector has declined -32.0%. The +82.7% performance spread between the two sectors is one of the highest on record.

Only July of 2009 and March of 2000 saw higher readings.



Source: Bespoke Invest

On May 16th, America's largest retailer, Walmart (WMT) reported its first quarter results. It reported a strong +3% rise in US same-store sales for the first-quarter, spurred by higher sales of food and health and wellness products. Walmart also raised its sales forecast for the year from +3% to +4% and expects second-quarter sales to rise +5%.

However, Walmart stock declined -11.4% that day. The reason – Walmart missed its earnings expectations, due to elevated cost pressure from fuel prices, higher inventory levels, overstaffing, e-commerce fulfilment etc.

The following day, Target (TGT) reported its earnings and suffered an even bigger stock slump of over -20%. The company said comparable sales grew +3.3% in the quarter ended April 30, which was better than the +0.24% that analysts had expected, but while total revenue grew, net profit fell by more than half. Soaring fuel costs, supply-chain bottlenecks, and inventory growth of +43% were some of the reasons for the earnings miss.

Consumer staples like – Target, Walmart, Costco and Home Depot (HD) have long been touted as "defensive" shelters from the storm buffeting the growth/tech sector, but that levy seems to have been breached. The sell-off in retail stocks, in my opinion, is overdone and it caused the SPX to dip below the 4,000 level.

The most intriguing part of both the WMT and TGT earnings announcements, was the over +30% to +40% jump in inventories, which amount to tens of billions of US dollars. It's the same story at other retailers Kohl's and Abercrombie & Fitch. The main reason for this, is the lingering supply-chain issues that have resulted in many retailers pulling forward inventory purchases to ensure sufficient supply, whilst at the same time consumers unwilling to pay higher prices for essential (consumer staples) goods – thus leading to a pile up in inventories. Higher inventories – be they due to overstocking or fewer items sold – lead to higher operating costs, as inventories have to be stored, moved and managed with no impact to the bottom line.

This is going to serve as a key input to policymakers at the US Federal Reserve (Fed). If consumers start pulling back, a recession is a done deal. If staples see a decline, then discretionary spending – clothing, personal care and home furnishing, have little hope of holding on. How long could inflation hold up? The Fed will be mindful of not tightening into a recession.

Benchmark Global Equity Index Performance (2021 and 2022 YTD)

Ticker	Name	Country	2021 Performance (Lcl Ccy)	2022 Year-To-Date (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	22.8%	28.6%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	-11.9%	6.8%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	14.3%	3.1%
IBEX Index	IBEX 35 INDEX	Spain	6.9%	2.4%
NKY Index	**NIKKEI 225**	**Japan**	4.9%	-4.9%
MXIN Index	MSCI INDIA	India	27.3%	-7.2%
CAC Index	CAC 40 INDEX	France	28.9%	-8.2%
DAX Index	DAX INDEX	Germany	15.8%	-8.4%
INDU Index	DOW JONES INDUS. AVG	US	18.7%	-8.6%
FTSEMIB Index	FTSE MIB INDEX	Italy	23.0%	-9.5%
HSI Index	HANG SENG INDEX	Hong Kong	-14.1%	-9.7%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	21.0%	-10.6%
SPX Index	**S&P 500 INDEX**	**US**	26.9%	-12.8%
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	4.8%	-13.5%
MXEF Index	**MSCI EM**	**Emerging Markets**	-4.6%	-15.3%
CCMP Index	NASDAQ COMPOSITE	US	21.4%	-22.5%
IMOEX Index	MOEX Russia Index	Russia	15.1%	-37.0%

Source: Bloomberg

Last week, we saw the Richmond Fed composite manufacturing activity data for May 2022 and it was abysmal. The reading came in at -9, the first negative reading since September of 2021, and the lowest since May 2020. The shipments sub-index swung to -14 from 17, while the volume of new orders was at -16 compared to 6 in the prior month. All very dire.

The flash Purchasing Managers Index (PMI) readings also showed a sharper deceleration. While manufacturing activity fell to a 3-month low, what surprised many was an even larger deterioration in service sector activity. Weakness in manufacturing output was expected, but the weakness in services (which fell from 55.6 to 53.5, a 4-month low) came as a surprise. This is yet another confirmation that inflationary pressures are having a worse impact on the US economy and demand is weakening sharply. The Fed may have to start taking the risk of a recession more seriously.

There was no joy on the new homes sales front either, as the sales plummeted in April by the most in nearly nine years, dented by the combination of high prices and a steep climb in mortgage rates.

Purchases of new single-family homes decreased by -16.6%, the weakest since April 2020.

Freddie Mac data show that the average rate on a 30-year mortgage was +5.25% last week. In January 2021, it was +2.65%.

Meanwhile, in Europe, the European Central Bank (ECB) continues to emphasize that monetary tightening needs to proceed gradually. At the recent World Economic Forum (WEF) in Davos, Switzerland, ECB chief Christine Lagarde remarked – "I don't think that we're in a situation of surging demand at the moment. It's definitely an inflation that is fuelled by the supply side of the economy. In that situation, we have to move in the right direction, obviously, but we don't have to rush and we don't have to panic."

Speaking at the WEF, in a timely reminder to central banks, Nobel laureate and economist Joseph Stiglitz warned that the US Fed raising interest rates won't fix inflation and the US needs a different kind of intervention – supply-side intervention. I made a similar point in my newsletter last month. Higher interest rates can create a barrier to increasing supply and therefore the Fed has to move carefully. Fewer goods are being made globally due to Covid-induced disruptions and changes to production and supply chain, increasing the cost of capital may have the intended outcome of making supplies worse.

With Retail, Food and even Pharmaceutical stocks down for the year, it's only Energy and Utility stocks that are in green (see table below).

Benchmark US equity sector performance (2021, 2022 YTD)

Ticker	Name	2021 Performance	2022 Year-to-Date (YTD) Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	46.4%	59.5%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	14.2%	5.3%
XLP US Equity	CONSUMER STAPLES SPDR	14.3%	-2.7%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	25.2%	-3.6%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**24.2%**	**-4.9%**
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	32.5%	-8.9%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	19.5%	-9.8%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	41.7%	-13.5%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**33.7%**	**-18.6%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**15.1%**	**-22.5%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**27.2%**	**-24.8%**

Source: Bloomberg

The sell-off in US consumer staples (XLP) is overdone, and these remain good defensive stocks to hold in a portfolio.

The Technology (XLK) and the Communications sectors (XLC) are bottoming out, however, several growth stocks are +20% off their lows.

The key reason Consumer Discretionary (XLY) is the worst-performing sector, is due to two stocks – Amazon (AMZN) and Tesla (TSLA). These two stocks account for nearly 40% of the index and both of them are down a whopping -40% year-to-date (YTD).

The equity market is in oversold territory, however, it’s the Fed pivot on inflation an interest rates that the market awaits for a sustainable rally to set in. For the Fed to do this, it has to see the inflation data start falling measurably. If economic data continues to worsen (and they are), inflation will slide and then one can expect Fed talk to change tack and indicate a desire to slow down or pause tightening.

Until then, volatility will abound. In such market conditions, structured products are the perfect vehicle to monetise income and retain an upside in market performance. Structured products also help an investor clip coupons, if economic growth is going to disappoint, leading to the limited upside for equities.

For specific stock recommendations and structured product ideas please do not hesitate to get in touch.

Best wishes,

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