Weekly Commentary 1 – Jan 2023

Insights for 2023

Trading activity during the first week of 2023 revealed that investors are full of uncertainty about the direction of markets in the new year.

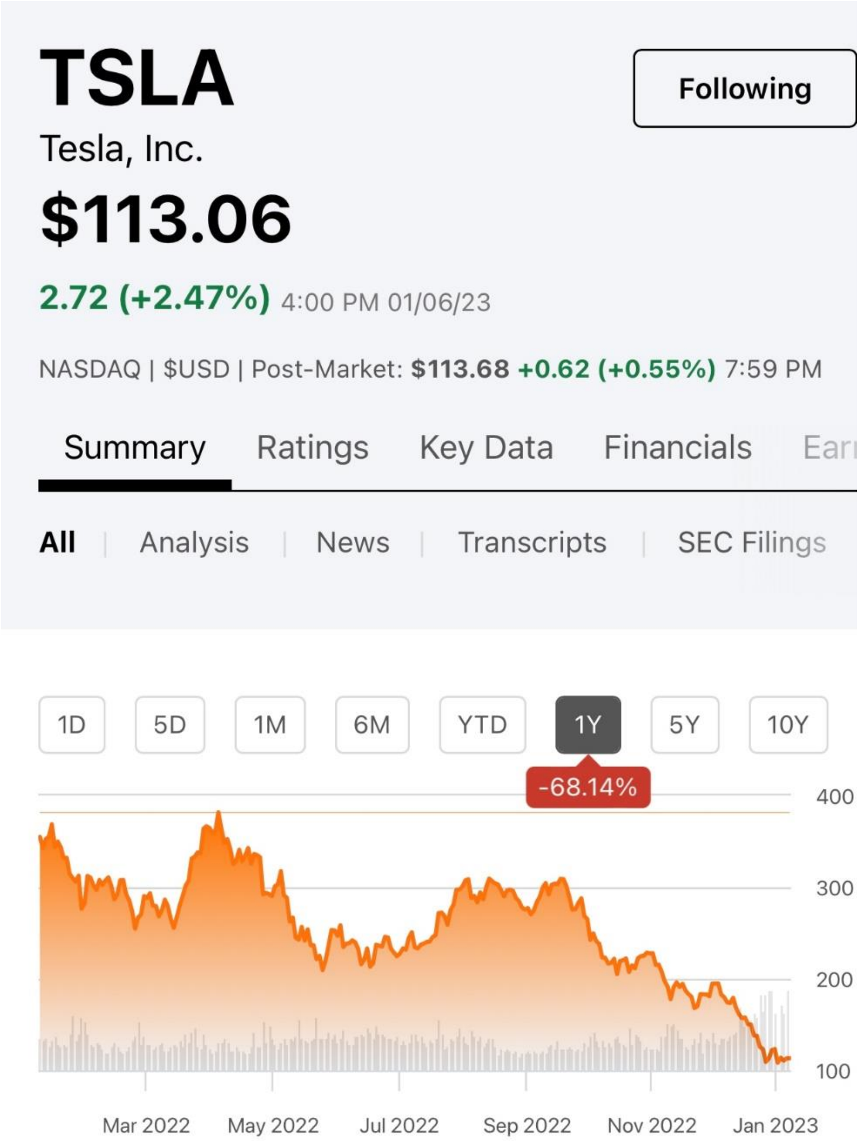
This is markedly different from what we saw last year at the start of 2022, when stock markets around the world were coming off a fabulously good year, and stood at all time highs. US equities were particularly bullish, and was soaring high in the stratosphere. The mood among investors in January 2022 was confident, even ebullient.

What a year it has been since then. Within days of the New Year celebrations, the markets topped out. Most financial markets in the western ecosystem have imploded disastrously in the subsequent 12 months.

The biggest crash was seen in the tech sector of the US. It is down 34% in one year. The general stock market is now down about 20%. And the ever trustworthy bond market which is supposed to protect capital effortlessly, has been in negative territory since the summer of 2020 for so long that it isn't funny. And given that the rest of the world is correlated with, if not dominated, by US markets, most financial assets in the world have suffered deep retrenchments from their post covid highs. The average set-back is probably around 20 percent, if you exclude the tech sector everywhere.

Technology which made some billionaires nearly trillionaires in the bull market Covid had wrought did not become a brave new world, and have in fact boomeranged during 2022 and bloodied everyone who wanted to reap riches all the way to the moon. Some instances of this destruction of greed can be seen in the charts below.

The first chart is of Tesla, the e-car maker of Elon Musk. This was one of the most amazing fairy tales of the Covid era when there seems no end to rising prices for technology stocks. How a global pandemic should benefit e-cars I don't know, but TSLA escaped gravity for nearly two years. The company was once thought to be the future of one of the most important industries of modern times – cars – even though as recently as two years ago, its output was less than a small fraction of the five largest carmakers combined. Musk was valued at US$450 billion at one point, the richest man in the world. But it was unsustainable. With the sharp decline in Tesla's price this last year, with the stock down 68%, since one year ago, Musk has lost 2/3rds of that wealth. Tesla is a story that fundamentals do matter. A business cannot produce 5% of the output of all its competitors combined and have a value greater than all of them. When investors take flights of fancy, only common sense will preserve your money.



Given the technical direction of prices, it is clear that Tesla's problems are not over. It has probably some ways to go – downwards.

Related to the collapse in prices, the hedge fund that made its mark by being long Tesla since Covid began, the ARK fund has similarly collapsed. This is a fund managed by an obstinate ox, Cathy Woods, an investment manager who was regarded as one of the best in the business by keeping to the view that technology shares are the best things since sliced bread and when the fund keep rising during 2020. Well, she has been horribly wrong since the middle of 2021. The fund's biggest holding is Tesla, and Woods keeps buying that as well as a number of other flaky counters that are purely speculative on how their technologies will change the world, with no sense that she can be wrong. This is not brilliance; it is arrogance. As it turns out, the fund is down more than 63 percent in 2022 alone. And since Woods keeps adding to the Tesla position, it is going to go down so more.

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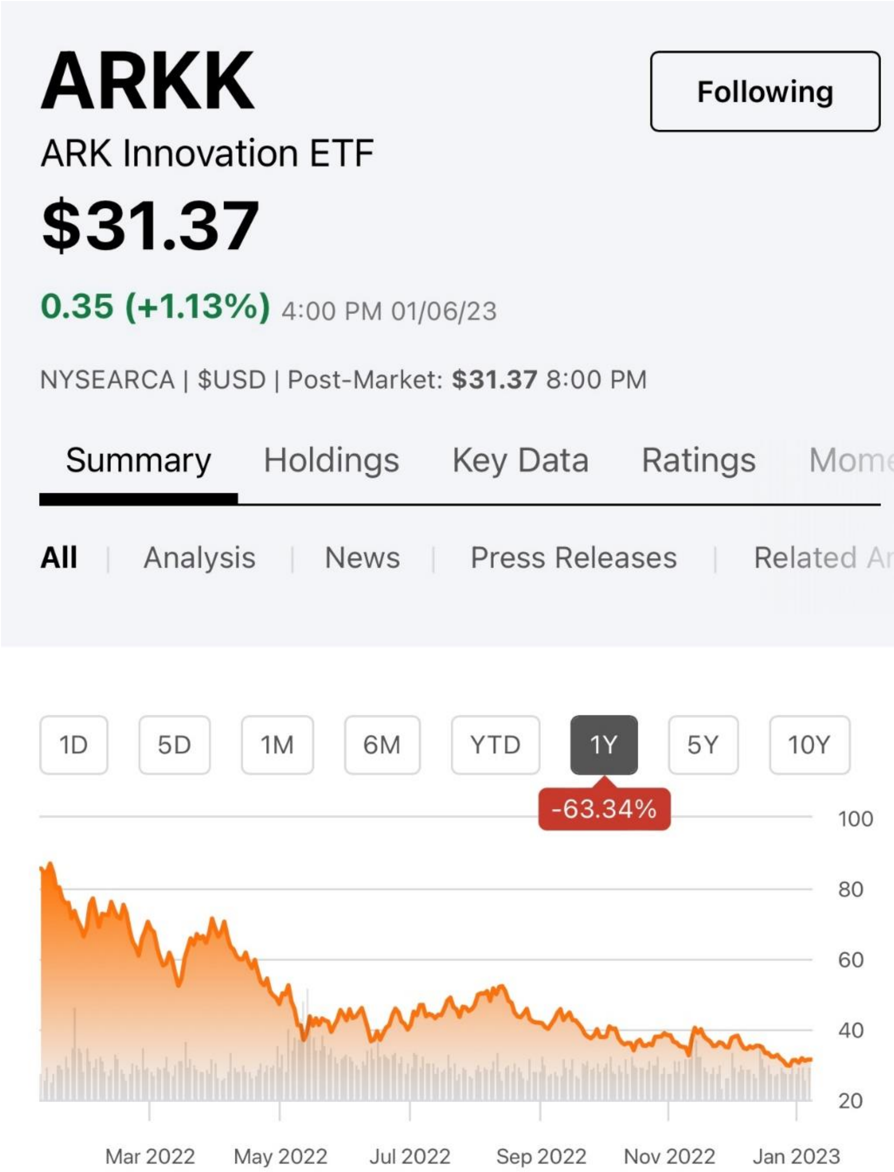

Clearly, the technology bubble has burst, and it was easy investing in fluff when interest rates were at zero, given that there was too much money slushing around and had to find a home. It was an environment in 2020-2021 that any new widget that can be dressed up to claim that it would change the world deserves to have its shares bought. ARKK is the classic example of that. It was an example of pure greed full of hubris, and zero risk management.

The technology bubble turned out to be a half-assed chase for "the next big thing" without any regard that the investment can go to zero. This has spawned a futile chase for investments that could go to the moon, whether or not they were mounted on rockets. There was just too much liquidity in the system and people just wanted to make money the easy way – which was to listen to some story about a new technology that would change the world as proclaimed by some false prophet on Youtube - and you rushed your money into that.

The result inevitably ended up like what happened in Coinbase :

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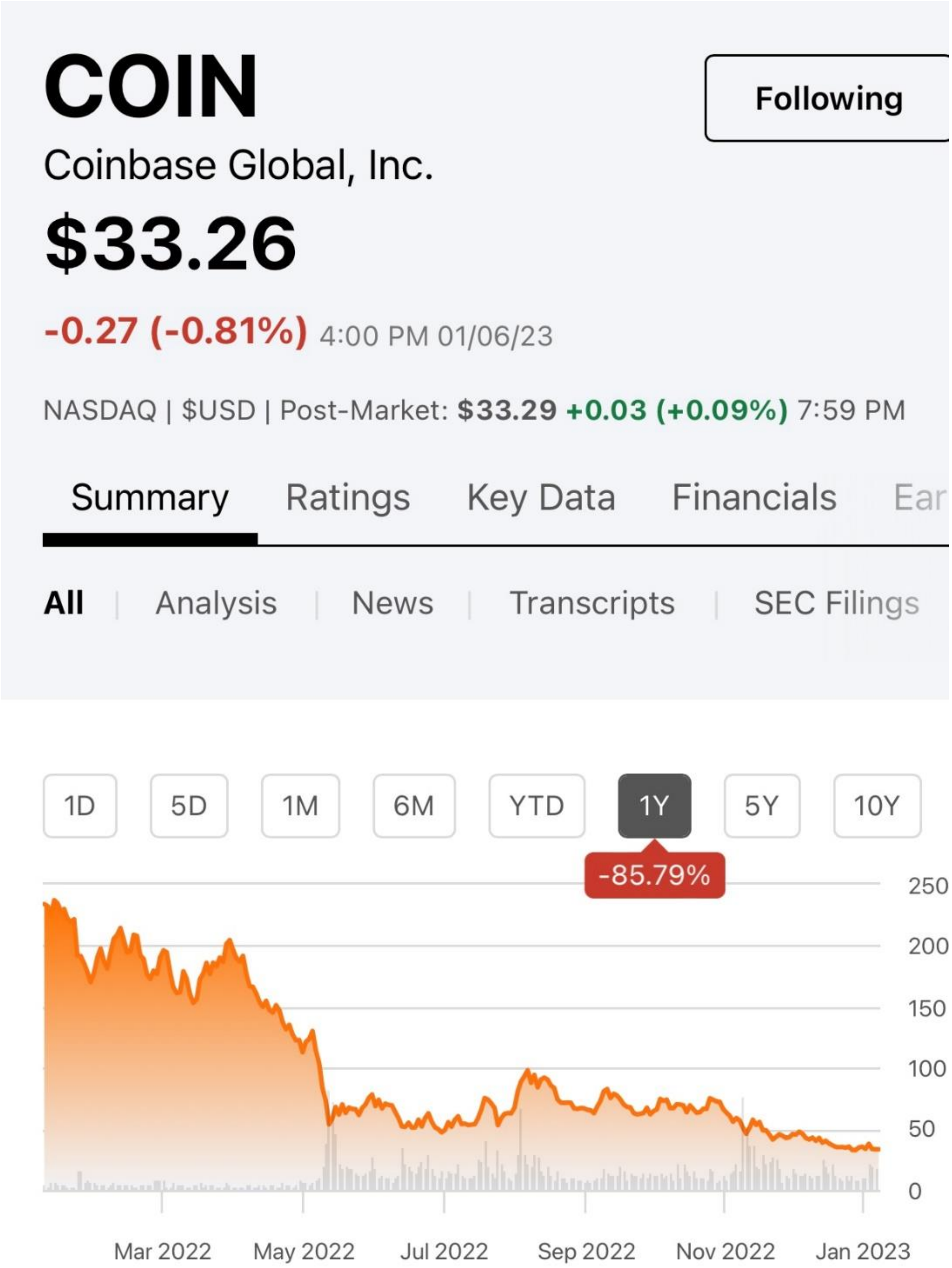

In case you don't remember what Coinbase is, it is one of those new-fangled crypto currency exchanges. The one that everyone remembers these days is FTX which went to zero, just like a fancy currency called Terra Luna and a crypto "bank" called Celsius did, both of which went to zero first before FTX. Those were declared bankrupt by their sponsors In the case of Coinbase, it has lost 83% in 2022. But that's not the worst of it. It got listed in the NYSE in the year before at $420, so at the current price of $33, it has lost 92% of its IPO value. How different is this performance from FTX, Terra Luna or Celsius? And Coinbase was once touted as the "blue chip" in the flaky world of crypto currencies!

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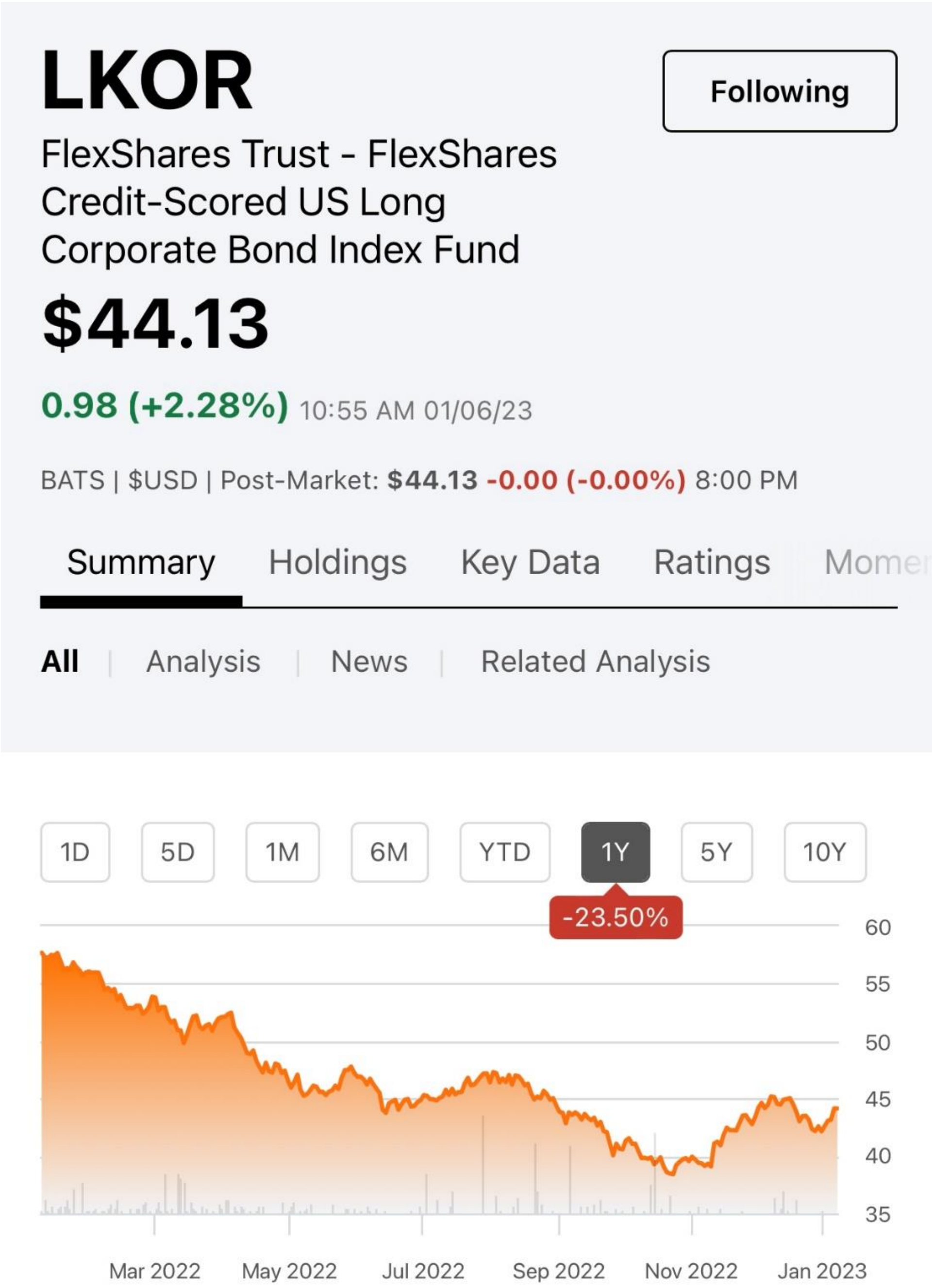
These three examples of "investment" in the world of technology are particularly noteworthy, because during the era of easy money, they were claimed to be beacons of brilliance. I mean, their promoters made them out to be household names. In this blog, we had disagreed with that assessment and pointed that out regularly in the last two years, and well, given their path to nothingness, it showed that there are fools out there who preferred to listen to other idiots, cheats and liars rather than logic. What can I say?

Overall, the tech sector has not seen the bottom yet after this last year of retrenchment up to this first week of the new year. It is now down by more than one third of its high, and it has got some ways to go. The last time a crash of this magnitude happened was in March 2020, upon the world becoming aware of Covid 19. But that recovery came quickly. This sharp rebound will not happen again, because the circumstances of the current downtrend are entirely different. It is more like the dot com crash of 2000, when the Nasdaq fell by nearly 80 percent from its highs. How deep will the current crash in Nasdaq go cannot be speculated upon, because that would be a foolish endeavour in trying to peer into a crystal ball. I can only say it is not over, but it is impossible to tell how much more devastation would be incurred.

The other market crash in Year 2022 was in the trusty bond market. Bonds are not supposed to behave as they did in the last year, but there is always a first time. The chart below shows an index of US bonds – LKOR – which represents the performance of USD long corporate bonds:



After two months of rebound in Nov and Dec 2022, this bond index is still down by 23.5 percent in 2022. This is dramatic.

If you read the professional literature that tries to give an explanation of how all the above disasters happened, you will find that most analysts will blame the US Fed Reserve. From a position of total toleration of zero interest rates, they pivoted to extreme concern over inflation and committed to a policy of interest rate hikes without end. In short, free money disappeared overnight. And anything bought on free money would now have to be paid for. That includes free plays on technology, crypto currencies thought to change the fiat currency

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system and even the debt of a bankrupt United States government which is now owing $31.5 trillion, a sum that can never ever be repaid.

In other words, the main reason why these new fangled “investments” cratered so quickly is not because of any change in economic and financial conditions, but due to the same old, same old reasons why speculation fails. It is greed getting over-extended and there comes a point in time when it would have to be reckoned with. It is the same tulip bubble we saw in the 18th Century, and we cannot blame the Fed for that.

As such, the reason why money has been lost is NOT because the Fed changed the liquidity conditions that enable these ideas to be sustained. The investments bombed because they were NOT investable ideas in the first place and were merely wild speculation going wrong and without the benefit of hindsight, we had said the following in past Commentaries:

1) Tesla – you cannot have an outsized valuation for a company which produces 5% of the total output of all other big reliable competitors and be valued the same;
2) ARKK – here is a fund without risk management, and a belief they cannot be wrong. WTF?
3) Coinbase – a self-proclaimed blue chip of the crypto industry but it is no different from an FTX or Luna Terra or Celsius or of the thousands of crypto currencies that have vanished into thin air. Crypto is not a currency but a just an unproven technology with a dubious use, and certainly even if there is case for a new decentralised currency, the creator’s idea is that it is supposed to be peer to peer, not based on idiotic variations of brokerage which Coinbase essentially represents.
4) Bonds – a ten idea investment that yields ½ a percent at the height of its bull market cannot be sustainable and it has come back to reckon with reality.
5) Technology stocks – technology is great but when these stocks have no proof of success, such as if they have no profit, they cannot be invested in except by insiders, fans and professional VCs or fools; a rather obvious point once it crashes back to earth.

Other than these remarkable bastions of stupidity and incompetence in the investment world that have now been splashed with cold water, the general decline in the investment climate has been due to the stupidity of governments in managing economies. This of course starts with the American central bank.

The failure of policy is stark. Firstly, we have had an American government trying to manage a public health crisis with economic policy through 2020 and 2021. Covid was thought to lead to a depression; and the US government threw everything it had to avoid it. And literally gave money away. Which found its way into stocks, bonds and real estate. When it became obvious that they gave too much money away, and that inflation would naturally follow, the same government then procrastinated about slowing down the largesse, saying that incipient inflation in early 2022 was just “transitory”.

That was really reading the tea leaves wrong.   As it turned out, the inflation that was caused by this loose monetary policy and other international supply chain problems, was far more serious, and leapt to forty year highs.   The US central bank then scrambled to unwind all the expansionary measures they took, by raising interest rates aggressively, and this pummelled the asset markets mercilessly.

Well, as famous investor, Jim Rogers, can be paraphrased to say in a recent TV interview, the above sequence of events just shows that bureaucrats are just kinda stupid.   In the last three years, the path of economic policy has been a roller coaster ride between boom and bust (or shall we say, government interpretation of what those are).   And that has resulted in stocks and bonds going to the moon and then crashing down.   If you are trading according to what the Fed is going to do and if your financial advisor, such as a banker, keeps telling you their views on Fed monetary policy, keep in mind what Mr Rogers say. You would just be interpreting what stupidity means…

And you won't hear of Warren Buffet saying what he thinks Fed policy is going to be and how that affects his investment ideas.

Our message in this first Weekly Commentary of 2023 is that trying to read the tea leaves of central bank interest rate policy won't make you rich.   Instead, as we have written before, forget about following the pundits on what central banks intend to do. Most of the time, they don't know what they are doing.   If you had followed Fed policy n 2022, or second guessed them or whatever else you did to be ahead of them, the only investment result you would have gotten is a flip-flopping approach to investing.   You would have been frustrated. And broke.

Instead, what you should have done is to first focus on risk management and then look for sensible ways to earn a regular yield, however Fed policy ends up.   In that regard, you would not have invested in bonds below 3 percent, or stocks that were already in the stratosphere and about to come back down to earth.   You would have kept out of trouble from the tremors of the last 12 months.

Well, that's over now.   It's now 2023. What do we do in the coming year?

I can go through all the consensus views that the investment industry likes to put out and see where we are at.   These views are:

1）Inflation has peaked, will soon settle around 4-5% in the US and the Fed will soon end its interest rate hikes with a cap at around 5%;
2）There may be a recession in the western countries but this will likely be short and shallow;

3）China is reopening and with the exit from zero Covid plus support for the housing industry, the economy will recover to above 5.0-5.5% in GDP growth in 2023 with the result that Chinese equities will do well;

4）Stocks in the US will bottom out from its setback in 2022 and help global markets recover;

5）Bonds will benefit from the end of Fed tightening and will provide a base for a return to traditional asset allocation of 40-60 equity-bond portfolios which will not simultaneously lose money on both sides;

6）The US dollar has peaked after the last year of relentless rises, and this may concurrently lead to recovery in the Japanese yen, the Pound, and the Euro;

7）Geopolitics in the west (ie Ukraine war) and in the east (Taiwan Straits) will not turn into nuclear war, nor will it drive oil prices into another frenzy leading to a resumption of galloping inflation.

All well and good. If these consensus estimates of how asset markets will behave in 2023 are 70 percent correct, it will be easy to structure an investment portfolio that on average will yield 5% return before taxes.

But honestly, what's the point of looking at consensus estimates? Last year, all the pundits in the world got it wrong, and a lot of people lost a lot of money. The point is, if investment is that easy, everybody will be able to make 5% return every year just by adhering to the consensus.

The difficulty is if this estimate is wrong, how will it affect our investments? In 2022, the events that turned out to displace the consensus outcome led to an average loss of between 20-50%. What if the consensus is similarly wrong again in 2023?

It is of course impossible to pin down how the consensus can be wrong. Or more pertinently, what would be the damage to a, say 40% equity-60% bond portfolio would be if things fall apart. Nobody can tell the future.

But what I would like to do is to spend some time to discuss where the consensus can be wrong; and you, as the chief investment officer of your own personal portfolio, can do to protect yourself from a similarly disastrous outcome that impacted all of us the last year in 2022. So here are my thoughts.

On the seven key views of the market consensus, here is what I think. I don't mean that what I write in the following paragraphs are going to happen, but rather, if the consensus could fail, how would it possibly happen? Here goes:

1) The peaking of inflation and interest rates. I think where this may go wrong is that inflation turns out to be more pervasive than anybody expects. Why would the experts get inflation wrong? One reason could be that they get the growth estimate for China wrong, and since energy prices are very dependent on how much oil a recovering China buys, it could upset these consensus estimates. There is pent up demand in China after three years of zero covid. Growth may surprise on the top side. The curtailing of inflation would also assume that geopolitics do not impact on the energy markets, and this is assuming peace on earth and all the good things religious people pray for.
2) The expected short and shallow recession is based on recent data that shows job growth in the US labour market to be strong. The risk to this view is that unemployment trends can end abruptly because the trade friction between the US and China can intensify and economic activity on both sides gets disrupted. The tech war may hit the tech sector in the US quite badly as these Big Tech (and Big Finance) are now retrenching more extensively than expected.
3) The dependence on a China reopening smoothly is standing on thin ice. Covid could mutate and pose renewed public health risks; property markets may continue to be weak, and even if I am also bullish on a 5.5% GDP growth in China, there is always a risk that this may not end up as good as expected due to the same old risk factors that were prevalent in the last three years.
4) Even if the consensus economic scenarios turn out to be correct, the question of whether global stocks have bottomed, especially tech stocks, remain to be seen. Given that US Big Tech has just started retrenching, there is a possibility this will continue through this year. If the market assesses that the bloodletting is done, then indeed these stocks will recover and NASDAQ will bottom out. But that's a big IF.
5) Bonds are completely dependent on the hawks at the Fed. They flip flopped three times in the last two years. You wanna bet they won't flip again?
6) The direction of the dollar depends on a) the speed at which the Fed will end its tough stance on inflation and the corresponding speed in following the Fed by the ECB, the BoJ and the BoE. Compared to a year ago, the Euro, the Pound and the Yen are still significantly lower than at this time last year. We can say that all three currencies have recovered only half their losses for the full year. The best way to assess this is that the dollar was far too strong, and some of the gains had to be given back towards year end. Now, we are into a new year, and the consensus is that some stability will return to the FX markets. This is going to be the trickiest forecast by the pundits. Given it is now exactly midway between 2022's highs and its lows, these three currencies have equal chance of going either way. I cannot be bullish on Europe and the UK, given the lack of competent government and I think these currencies will resume a long term decline in 2023. And I just came back from a holiday in Japan and in the ten days I was there, I saw no one with a spring in their step and things still look tired (infrastructure looks exactly like when I first went to Japan forty years ago)…The Yen is still likely to require the government to keep interest rates low and give the economy some spunk, and therefore, it will not likely appreciate very much. As such I am not a dollar bear.
7) The geopolitical situation is extremely volatile, and a black swan may emerge from the mess in Ukraine or the South China Sea. The consensus estimate is more likely

to be wrong than right in assuming things will remain as they are at this time in both conflicts.

All said, there is still a very high level of risk in the global financial system. In particular, the leader of the global economy, the US, is all tied up in massive domestic political problems. How can a country that got a simple thing like get a Speaker of the House elected only after 15 votes be said to be functioning properly? It is a damning sign of regression, and of the end of empire, and this will hinder the country from staying in the lead in the so-called rules-based-world. American leadership is out the window, if you ask me, given that Europe wants to work with China, Taiwan does not want to fight for its own independence (that's wisdom), Russia is not getting kicked out of Ukraine in spite of US$100 billion (that's a B) in aid already spent by America and its allies to bring that about, the Gulf states have broken up its bromance with the US, and BRIC countries are moving to break free of dollar hegemony. There are no good signs for the same old unipolar system anywhere to be found.

And in the early days of an emerging multipolar system, things will get messy. These are major risk factors and bear watching.

I would be the last to think that 2023 will end up in 12 months just as the consensus view which the financial industry currently predicts.

By:

Yeong, Wai-Cheong, CFA

Fintech Entrepreneur, Money Manager and Blogger

Un-Influencer in a World full of Hubris