A View From Here - May 2023

"Investor's feelings and reactions regarding inflation are probably more the result of the stock market action that they have recently experienced than the cause of it."

- Benjamin Graham

Is inflation factored in?

It has been over a year since inflationary pressure likely brought on by pandemic supply constraints and strong economic activity led to price increases. Perhaps it took a pandemic to bring out this circumstance, as policy makers as far back as 2018 had wanted to pursue a policy of increasing rates that was ultimately reversed during the unique conditions, we found ourselves in 2020.

As the economy surprisingly raged throughout 2020-2022, the Federal Reserve deemed it necessary to increase interest rates in an effort to combat inflation. While the intended effect of cooling the economy takes time to work into the system, markets reacted by shooting first and then asking questions. As such, stock markets moved into a 'prepare for recession' mode that has kept investors awaiting economic contraction which has yet to emerge.

Historically, by the time a recession occurs, markets begin to factor in an economic expansion which is ultimately expected to follow. As such, it's possible that at the height of economic weakness, markets will begin to ascend. Offsetting this would be an extended period of economic weakness.

I'm often presented with the dilemma of taking a stance on the economy as a pretense to making investment decisions. While there is some part of a changing environment that factors into this equation, I ultimately know that no one knows how the economy will play out so it's heroic or foolhardy to make investment decisions based on what has never been consistently predicted. What we do know is that markets adjust to prevailing themes - which at present include inflation, war and geopolitical tension - so it stands to reason that what is feared is likely already factored in.

Remember its surprise, not consensus, that is going to move share prices and ultimately the markets. What we can affect is how our investments stack up against their peers, the market's current temperature for the industry they operate in and what could possibly happen to them based on this information.

While there are a few challenges in our portfolio currently, I remain confident in the investments we hold and the prospect for continued growth in our investment accounts over the long term. Given our track record, it makes sense to stay the course. In the end, it is all about performance over the longest period.

Investing themes, art & luck

Part of the anguish currently residing in the markets has been oil and gas shares which have been declining since the early stages of the war in Ukraine. This is reminiscent of the first Iraqi war where oil & gas prices had increased dramatically in a lead up to the war, but subsequently sold-off as soon as war broke out.

Investing themes can take hold of a sector and take it for a run well beyond expectations. Take our holding in Hammond Power; we purchased the shares at much lower prices and with the electrification of everything, the share price has gone up the proportion of growth it achieved during this period.

Interestingly, the valuation to its cash flow and earnings is lower than when we first purchased it. What is that saying? Seemingly, the market doesn't necessarily believe the sustainability of growth the company has achieved, as it trades at a low single digit multiples and the company is well represented by a few analysts around the country, so it stands to reason that it is no longer an overlooked entity.

This presents us with the challenge of how to proceed. If market view is correct, the growth is not sustainable. Selling an investment holding requires fundamental analysis mixed with a little bit of art and some luck.   Making the right call on this fantastic investment (to date) demands we visit those things.

Electrification of all things is a theme, yet the share price reflects only the growth achieved to date, but not its future.   Given this current circumstance we are thinking of taking a stand - perhaps a bold one.

I have found that our best investment returns come from companies that are purchased in apathy - that is to say, overlooked and void of any market theme whether it be down from highs (oil and gas) or in the now - electrification of everything. The idea - which maybe Hammond has presented to us is that then the market becomes familiar with its theme, it can lead to profit.

The challenge/opportunity is where we are now on the growth curve and how to best maximize our returns. We didn't buy Hammond because we thought that the electrification of everything is the future, but we did think that it could be a catalyst for a change in valuation. The company has grown, the valuation has contracted. Now what to do?

Art & luck - they are tangible reality of investing

Thanks for taking a look, and as always,

All Good Things,

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