MH & ASSOCIATES • SECURITIES MANAGEMENT CORPORATION

INVESTMENT VIEWS

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THE FED CUTS RATES

Inflation Still Lurking Says Stock and Bond Markets

We have previously written about how inflation is not dead but only "sleeping" for now. In a separate newsletter, we have also wrote about the difficult position that the Federal Reserve is in, having to balance both inflation and unemployment.

After a surge in inflation in 2021 and 2022, the comparative growth of inflation for 2023 and 2024 had to appear lower. Many investors are now assuming that inflation is not going to be any issue anymore. Recently, as widely expected, the Federal Reserve cut the benchmark overnight interest rate by 50 basis points, claiming that the risk of inflation is balanced with the risks of rising unemployment.

While the initial market reaction was negative, as some investors were "spooked" by Chairman Powell's demeanor, the market has gone on to rally, with broad participation across sectors.

Following on our narratives, many of the inflation sensitive sectors in the stock market have started to rise, as yields on longer term bonds have also risen. It is clear to investors that the Federal Reserve is in a tough situation and it will not be an easy road for the central bank or investors to navigate. We believe that the Fed will now error on the side of higher inflation, versus taking a chance at hurting the economy or employment, hence we are maintaining our positions in inflation sensitive investments.

FLASHING BULLISH SIGNALS

Is It Different This Time?

While there are definite headwinds for the market at present (geopolitics, economics, etc), there have been a couple recent internal signals which have very good track records of being harbingers of continuing bullish momentum. These indicators point to the market continuing its gains over the next several months to a year.

With September just closing the month on a positive note, that marks eight of the first nine months of the year where the index has been positive. This has happened nine other times in history and in each of those instances the S&P was up in the fourth quarter every single time. Average gains in those periods were near +7%.

An even broader market indicator flashed a powerful bullish signal this month which points to the market extending its bull run out for the next 12 months. The McClellan Summation Index, which measures market breadth/participation, cycled from below 100 to over 1000 since July 2024. This kind of broadening market signal in combination with the market being near or at 5 year highs has occurred 10 times since 1980. Six months and twelve months after this signal occurred, the market was up 100% of the time, with twelve month gains averaging over 16%.

On the flip side of this is the fact that the beginning of an interest rate cut cycle and the re-inversion of the yield curve tend to be negative for stocks in the short to intermediate terms. Therefore, while these bullish signals will keep our long term views positive, the idea of fighting the fed tends to have negative repercussions and remain cautious.

OIL UPDATE

In developed countries (US. Europe, Japan), consumption of oil has either flatlined or has been gradually declining for almost 20 years. Yet, in the rest of the world oil demand is booming with global demand hitting a new record high at over 100 million barrels per day. World-wide oil demand is growing at nearly double the rate projected last year (increasing from expected 1 million to 2 million barrels per day). Most of the growth has come from India and other emerging markets. China demand is still growing but not at the strong pace of recent years, however it is expected to pick-up with the new economic stimulus package announced this week.

On the supply side, Russian production continus to decline as western technicians are no longer allowed to maintain Russian oil wells. Shale oil production in the US has peaked in 3 of the four major shale oil plays. OPEC continues to be steadfast in holding down production but will have increase at some point as global demand is rising faster than non-OPEC production. Yet, the price of oil has declined from last year and has been stagnant this year. What gives?

Tail Wagging the Dog

The demand/supply outlook for oil continues to be positive and will only grow over time. Yet, as mentioned, the price of oil has been relatively flat all year, trading roughly between $70-$80 a barrel and down from the $90 a barrel last year. We believe that this is strictly a paper market phenomenon whereas the oil futures (paper market) is influencing the price. On average, on a daily basis a little over 3 million barrels are traded in the futures market against 100+ million-barrel global usage. Thus, what we have here is a case of the “tail wagging the dog” and a major incentive to keep the price down in order to lower inflation.

Influencing the price of oil through the paper market only works in the short term and is not sustainable. Furthermore, it also sends the wrong signal to oil producers not to invest, making the supply issue worse. Ultimately, reality will set-in and higher prices will prevail.

CHINA LOADS A BAZOOKA

The Chinese economy has been unstable and deteriorating for several years now, after a draconian COVID lockdown. The communist government had introduced several programs to try and get the economy back on a growth track, but to no avail. Last week, authorities launched the largest and most comprehensive program to date, lowering interest rates and injecting nearly $150 billion into the economy. While this effort is impressive, there are notable China watchers that predict this measure is only the beginning and to expect even more aggressive action. The last major stimulus resulted in an 80% gain in their stock market.

PAYPAL STARTS TO PAY OFF

We added PayPal to the portfolios about a year ago, after it had experienced a brutal decline from the post-COVID 2021 highs. From the high to the low, PYPL crashed an amazing 84% as investors realized that it had become very overvalued and that the high growth it experienced during COVID would not continue.

Near the lows, our team assessed the valuation of the firm and realized that in a similar manner that investors had driven PYPL to excessive highs, the payments company was now at a ridiculously low value, and we began adding shares. PYPL has very little debt, plenty of cash and despite the sell-off, earnings were still very healthy and growing…just not as fast as they had been.

Last year, the company made some important management changes, including a new CEO and CFO. They embarked on a turnaround plan, which at first was greeted with skepticism by shareholders and the PYPL stock price continued to frustratingly languish. However, their most recent earnings reports showed real progress, and PayPal has embarked on a fresh marketing campaign that should spurn stronger sales and gave the PYPL share price a nice lift. We will continue to hold PYPL shares and add on any weakness as the recovery progresses.

Recommendation List: A list of all previous specific investment discussions published over the past 12 months will be provided upon request. Please email lara@mhandassociates.com or call our office for this list.

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