



FFM GESTION

Geneva, July 22, 2022

“The first half of 2022 marked the end, for the time being, of a long period during which the shares in our companies benefited not only from their underlying business performance but also from falling interest rates and thus rising valuations. Not only did this tailwind disappear but a significant headwind materialized in short order in the form of rising interest rates combined with fears about the impact of inflation and a possible recession.”

Terry Smith, fund manager of Fundsmith

Dear Sir, Dear Madam,

It seems that, since March 2020 and the beginning of the global pandemic, we truly have entered a new age of chaos. In the past two years, we have witnessed the global economy shutting down almost completely from one day to the other, today, we are witnessing an all-out ground war in Europe, emerging markets descending into chaos (Sri Lanka and Lebanon being the firsts), and a former Japanese prime minister shot to death.



We also have a new bogeyman: inflation. For the first time since the early 1980s, fears of persistent and high inflation have scared both markets and central bankers. Markets (both bonds and stocks) tanked from the first day of the year and have yet to recover in any meaningful way. Central bankers, having been caught slightly off guard by the return of inflation, are now trying to show that they are ready to do whatever it takes to nip it in the bud. In the US, the Federal Reserve raised interest rates by a whopping 0.75% in June (after having leaked the decision to the Wall Street Journal) while the Swiss National Bank hiked rates from -0.75% to -0.25% in a move that surprised everyone. The European Central Bank had to create a new program to limit the widening government bond spreads between northern and southern members of the Eurozone, eliciting bad memories of 2011-14.

having leaked the decision to the Wall Street Journal) while the Swiss National Bank hiked rates from -0.75% to -0.25% in a move that surprised everyone. The European Central Bank had to create a new program to limit the widening government bond spreads between northern and southern members of the Eurozone, eliciting bad memories of 2011-14.

We would like to take the opportunity of this new letter to tackle the many questions asked and comments on possible comparisons of the current situation with similarly difficult past situations.

First, is today similar to the 1970's because of the high levels of inflation? This is the most common comparison that we are seeing today. Back then, we had the Israeli-Arab wars, the oil embargo (and therefore oil shooting up) and the beginning of high and persistent inflation. Superficially, this looks quite similar to today's situation, with the Russo-Ukraine war and energy commodities shooting up (natural gas in particular). Scratch a bit deeper, however, and the situation back then was very different. The roots of high inflation in the US had been sown much earlier, as early as 1965, when President Lyndon Johnson decided to pursue both the Vietnam War and ambitious social welfare reforms while lying to Congress about the true cost of both, therefore leading to record budget deficits. This in turn led to the end of the Bretton Woods currency exchange system and the beginning of free-floating currencies, in 1974.

On the other side of the world, OPEC countries suddenly had huge USD windfalls from higher oil prices and nationalized oil facilities, which they recycled via European banks, thus creating the Eurodollar market. This in turn meant the Federal Reserve did not have full control over the US dollar anymore since European banks, flush with USD, could lend wildly to sovereign and private debtors (leading, further down the road, to the Latin American debt crisis of the 1980's, but that is a story for another time).

So no, the current situation is not much like the 1970s. The current high inflation is not due mainly to oil (or natural gas). It is due to our new age of chaos, as mentioned above. In March 2020, the global economy, which functioned mostly on a just-in-time basis (read: no inventories), was shut down because of the global pandemic. Shutting it down is easy, just like an oil refinery. But restarting it, just like an oil refinery as well, takes a very long time. This has been even more so since China has continued to pursue its nonsensical Zero-Covid policy, which has shut down wide swaths of the Chinese economy.

It has now been more than two years since March 2020, but we are still experiencing the aftershocks of all this and one of the aftershocks is the current high levels of inflation. To understand why this is so, one must realize that, for the past two years, consumers have been able to buy mostly goods and very few services (since travel and even going out of one's home were strongly curtailed). Since these goods have been in very high demand and there were no inventories, prices for these goods could only increase until production caught up to demand. Hence, inflation. Now, at the same time, demand is abating and production is back on line. People now crave services (mostly travel, as witnessed by the incredible difficulties faced by most airports and airlines to meet demand). Hence, goods inflation is slowing down at the same time services inflation is picking up.

It will take time for the global economy to go back to the pre-2020, normal, levels without all these aftershocks. In our opinion, this could happen in 2024/25. But it seems incredibly unlikely inflation will persist at current levels, especially as the global economy is slowing down. And, here as well, the common explanation (less accommodating monetary policy and rising interest rates) for the slowdown is probably less than accurate. Monetary policy is much less powerful than most commentators would have you believe. Much more potent is fiscal policy, and we had expansionary fiscal policies during the pandemic at levels not seen since WW2 (the US, at USD five billion, spent more during the pandemic than during the whole of WW2). This has clearly ended now (and gone into reverse) and is probably the main reason for the slowdown.

Could this be just like 2008, when we experienced the biggest financial crisis since the Great Depression? Again, the comparison doesn't hold, in our opinion. Interestingly, though, the losses on the indices as of June 30 of this year are already bigger than they were in 2008 just before Lehman Brothers went bankrupt. Yes, today's situation is not pleasant, but it has nothing to do

with the amount of stress the financial sector was experiencing back in 2008. Banks were overleveraged and stuffed with bad debt (subprime mortgages) and this allowed for a full-blown financial crisis because the whole financial sector was rotten to the core. Contrast this with today, with the overwhelming majority of financial institutions in perfect financial conditions (because of new regulations put in place after 2008 in order not to repeat the same mistakes).

And, if the financial sector is in good shape, it is extremely difficult to experience a financial crisis. Yes, you can have an economic crisis, a recession, even. But the most dangerous kind of crisis is a financial crisis (again, see 1929 and 2008) because of the leverage inherent in the financial system. This is not a problem we are facing today. As we have written in the past, a financial crisis triggered by a huge real estate price implosion may currently be happening in China, but its financial impact will be minimal outside of China's borders as its financial system is closed off.

Others yet have asked us if the current situation could be compared to 2000-2003, during which the excesses of the telecom / internet bubble of the 1990s were unwound and the Nasdaq 100 index lost 85% of its value. Again, the answer is no, since we did not experience such a bubble this time. One could argue the worst excesses, this time around, occurred in the cryptocurrency space, which has come down from a global value of USD three trillion to a bit less than USD one trillion. Even at three trillion, it was never big enough to pose a systemic risk to the financial system, although it crystallized the worst excesses of this cycle. We are probably entering another nuclear winter that could last a few years for cryptocurrencies so, for the most aggressive among you, no need to hurry back in.

One could argue, however, that 2000-2003 has already occurred this time around, with the most speculative stocks (mostly in the technology sector) having already lost more than 80% of their value from peak to trough. Zoom Communications (ironically a very profitable company) is probably the poster child for pandemic stocks, and it has indeed lost 85% in a bit more than a year. The same is true of other, less profitable companies. Out of the ashes will rise the next winners, just like Amazon survived 2000-2003 to become a dominant platform.

So, if it's not the 1970s, not 2008 and not 2000-2003, can we still find an appropriate historical analog to today's situation? Well, there is one thing we have not discussed yet and that is the strength of the US dollar. To wit, it has just gone to parity against the Euro for the first time ever. In fact, the Dollar Index (DXY, a basket of developed market currencies weighted against the USD) is at levels not seen since 2002, and the spend and amplitude of the current move is impressive.



The same goes for the US dollar against most emerging market currencies, and that is where the problem lies: in such past episodes of US dollar strength, many emerging markets have suffered financial crisis and this is happening again (see Lebanon, Sri Lanka, Argentina, for now). So, an interesting analog could be 1997-98, which encompasses both the Russian debt crisis as well as the Asian currency crisis. We will see what happens in the coming months. The current emerging market crisis is somewhat different to the former ones because China has been one of

the biggest lenders and we don't know how it will approach the ineluctable debt restructurings.

Now, having said all that, we have been doing this job long enough to have witnessed a few of the crisis we mentioned before. Obviously, 2000-2003 was a huge bear market (although it centered on mostly two sectors, telecoms and tech) and 2008 was nerve-wrecking (the most brutal financial crisis since 1929, after all). The European sovereign debt crisis of 2011-2014, the Chinese slowdown crisis of 2015-16 and the tech recession of late 2018 were also pretty violent. But the past six months have really been brutal, both in terms of the speed and the amplitude of the correction.

Our equity investments have generally fared worse than the markets in general since the beginning of the year. This should not be a surprise as we have repeatedly stated in past missives that this was bound to happen (see our Tour de France analogy back in our Q2 2021 letter) and that, from time to time, value stocks also have their day in the sun. What is most interesting to us is that most of the underperformance has come before February 24, when Russia's invasion of Ukraine began. Since then, we are doing just as well (or as badly) as the markets.

It is in difficult times such as these that it pays to have a true investment philosophy, even though it might be detrimental to short-term performance. Had we pivoted to value stocks in early March (as a significant number of bank strategists and fund managers have done), we would have fared very poorly. Outside of the energy sector, all value investments (banks, miners, carmakers, utilities, etc.) have fared poorly to very poorly. For example, Freeport-McMoran, the largest copper producer in the world, is down more than 50% from its highs set in March of this year.

Even oil is currently trading at exactly the same level it was trading in early March of this year, despite the many predictions it was about to hit USD 200/barrel in short order given the war in Ukraine and the sanctions imposed on Russia.

So, what now? Honestly, most news items are bleak. Inflation is staying higher than expected (although CPI numbers are lagging in nature), the war is showing no signs of ending and it is not exactly clear how at least part of Europe will heat its buildings next winter. As we were entering 2022, our expectations for equity markets were for a year of consolidation after excellent gains in 2021 and we think this might yet happen. A lot of bad news is now priced in and it would probably not take much for markets to stabilize and go back up. The first signs of green shoots are that the most speculative parts of the market have already started to rebound, sometimes quite impressively. Zoom Communications, which we mentioned before because of its monster drawdown, is now up 25% from its May lows. The biotech sector, one of the worst hit since early 2021 (down 65% peak to trough), is up 35% since its recent mid-June lows.

The current situation is a good reminder that, in investing, you can choose either the path or the destination, but not both. In other words, you can either trade your way in and out of positions over the very short term and try to anticipate what theme the market will like next, or you can focus on the prize by investing, over the long term, in quality companies that generate cash flows that grow over time and not looking too much at the (sometimes wild) gyrations of the market. As you can guess, we favor the second option.

All the best,

Your FFM Gestion team