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Market Update

In the stock market, there are times when an investor's outlook for equities becomes more divergent thereby leading to more volatility. I believe we currently are experiencing those conditions. The main reason for this is investors' expectations for inflation. Simply put, more uncertainty creates more volatility. I believe this trend will continue for a while. Right now, the trend for inflation is certainly up. Some think it is out of control due to the Federal Reserve's miscalculation of it being transitory for too long plus supply chain issues which still linger.

How did we get to this point? The Covid crisis is the primary reason for the economy to quickly contract. Consequently, the Federal Reserve reacted immediately by pumping in liquidity. There are similarities between inflation today versus the late seventies and early eighties. However, I believe they are different in two ways: 1) The pandemic 2) Increased demand and supply chain issues. One must remember that in the last 30-40 years we shifted several of our manufacturing facilities overseas to combat inflation and switched to "on-demand" manufacturing. This has resulted in less reliability and supply chain issues throughout the world; thereby, intensifying the problem we have today. In addition, the dramatic increase in demand for products and services both domestically and internationally has overwhelmed the supply chain in many ways.



In fact, in Barry Ritholtz' s interview with Rebecca Patterson, she said "If you look at the supply of goods for U.S. consumers that comes from around the world — so produced everywhere in the U.S., China, outside, et cetera — it's running about five percent above where it was before the pandemic. So, the supply of goods has increased on that. But then look at the demand side, the demand from U.S. consumers today is about 20 percent higher than the end of 2019. And you see similar patterns across a lot of things, whether we're talking about industrial metal where supplies today are high, but the demand is much higher. That's pushing down inventories. Ships, we have more ships on the ocean today than we did pre-pandemic, but it's just not enough. Labor markets, we've got no shortage of jobs today, we just had such high demand for jobs. And so, yes, there are supply constraints here and there. I'm not saying there aren't. I'm just saying the bigger deal this time and what makes us so different from the 1970's is this absolute boom and demand."¹

Investors are worried about increased inflation and companies are increasing prices due to higher input, labor, and transportation costs. In addition, many companies will raise prices in anticipation of inflation which causes a panic reaction. Companies do this to protect their margins and earnings per share because sales are somewhat inflated due to inflation and costs may be rising at a more rapid rate than revenues. Some investors feel the Federal Reserve will have to play catch up and raise interest rates faster and further. This could cause a severe slowdown or recession which would likely result in lower profits and stock market declines. On the other hand, if the Federal Reserve does not do enough to slow down the upward inflationary trend, then it can get out of control. Inflation impacts everyone but especially the lower and middle class which further exacerbates the wealth disparity and inequality in our country thereby causing potential ramifications.

Energy Price Inflation

To add fuel to the fire, significantly higher energy prices have substantially impacted our domestic and international economies, although I believe the ramifications do not have the same impact as in previous economic cycles. This energy price inflation is accelerated by a potential escalation between Russia and Ukraine. Russia is a significant supplier of energy to many countries, especially in Europe. One can see the quagmire that develops here. For years, several European countries have been trying to adopt cleaner forms of energy. But I believe European energy policies are severely flawed due to lack of natural resources, new energy growing too quickly, inadequate backup plans and too much reliance upon the weather. Europe is going through an energy crisis while many countries are clamoring for natural gas which is dramatically escalating prices. On the other hand, the United States is blessed with great natural resources. However, I believe our energy policy is also flawed. In my opinion, we are transitioning to cleaner fuels too fast while having to maintain our existing infrastructure without a sufficient backup plan. For example, President Biden denied the Keystone Pipeline with Canada (a friendly country) and ironically authorized the Russian Nordstream 2 pipeline to Europe (a not so friendly country).



Many people do not remember Ukraine giving up a giant nuclear arsenal 30 years ago. Obviously, there are regrets today. William J. Broad wrote in The New York Times, “At the end of the Cold War, the third largest nuclear power on earth was not Britain, France or China. It was Ukraine. The Soviet collapse, a slow-motion downfall that culminated in December 1991, resulted in the newly independent Ukraine inheriting roughly 5,000 nuclear arms that Moscow had stationed on its soil. Underground silos on its military bases held long-range missiles that carried up to 10 thermonuclear warheads, each far stronger than the bomb that leveled Hiroshima. Only Russia and the United States had more weapons.”²

The hostility between Russia and Ukraine has political and economic issues, not to mention President Putin’s ambition to bring back the Soviet Union, his ego to make his mark on history, and his drive to keep energy prices higher which obviously benefits Russia. Ukraine is rich in natural resources and agriculture products (i.e., corn, wheat). President Putin has seen China take over Hong Kong and other similar dictatorships utilizing the power under the President of China, Xi Jinping. President Xi Jinping was able to install a puppet regime in Hong Kong which allowed them to significantly influence that country. In my opinion, President Biden has done a good job handling the difficult situation between Russia and Ukraine. I believe the United States cannot afford to let China gain control of Taiwan which could significantly affect our national and global interests. That’s not to say that Ukraine is not important, but I believe it does not carry the same weight as Taiwan does for the world economies. Furthermore, I believe Putin is testing President Biden to see how he will react to a crisis. In addition, Ukraine thrives under democracy which could threaten Russia and President Putin’s dictatorship power since it is a former Soviet satellite country. But Putin may not want to attack Ukraine because their citizens are very similar to the Russians in many ways both culturally and historically. So politically, it may be difficult to attack your comrades in a different country. But if President Putin can establish that they are saving Ukraine, it gives them reason to interject their power. Obviously, there are many reasons why Russia is trying to ‘protect’ their country and is enraged by NATO’s expansion.

Conclusion

In conclusion, investors must deal with two inflection points. First is the potential war between Russia and Ukraine which could escalate well beyond the borders and cause a massive oil price spike, deaths, refugee crisis, and potential world economic crisis. History has taught us that small conflicts can escalate into large conflicts but hopefully this will not be the case. Second is inflation which has not been at this level in nearly 40 years. Investors believe the importance of inflation lies with the perception and trend of it and quite frankly neither are in the right direction. However, if the economy can remain robust and we get a productivity boost along with the Federal Reserve having an organized structured response regarding interest rates then investors might have a different perception of inflation leading to a trend that is lower. This could lead to a potential second leg up for the stock market. Right now, there are a lot of uncertainties and timing, as always, plays a role in each event. I believe the United States is fortunate to still have very low interest rates, good corporate earnings, a robust economy, high employment levels, and optimism in so many ways but there are still many things that we will have to watch. In the meantime, I believe we will see more volatility and have positioned our clients' portfolios for current and future expectations.

Optimistically Yours,



Raymond F. Saleeby
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Footnotes

1. Ritholtz, Barry. (6 Feb 2022). "Transcript: Rebecca Patterson". Ritholtz.com. Retrieved from <https://ritholtz.com/2022/02/transcript-rebecca-patterson/> 14 Feb 2022
2. Broad, William J. (5 Feb 2022). "Ukraine gave up a giant nuclear arsenal 30 years ago. Today there are regrets". Retrieved from <https://www.nytimes.com/2022/02/05/science/ukraine-nuclear-weapons.html> 14 Feb 2022

PRESIDENTS DAY

*Change is the law of
life. And those who
look only to the past
or present are certain
to miss the future.*

JOHN F. KENNEDY

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