

Strategy & Observations – A Red Wave?

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Is a Red Wave Coming? For the Market, We Hope So...

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The mid-term elections are around the corner and the key question is – Will we see a red wave? Will it extend to the senate? Inflation is real, as is a recession. Crime is becoming pervasive and messages like defunding the police have done their damage. School board meetings are now critical events watched by parents, and of course the threat of nuclear war has never been more real. What does this mean for the market and how might this all play out?

Strategy Highlights

Will we see a red wave? It appears that Congress is likely to flip from Blue to Red. The key question then becomes the senate. Four critical seats control the balance. Gubernatorial races are also essential and will be telling as Americans question the federal government's role versus the state government. States like NY, typically blue, could flip to red in a rebuff of NY policies like bail reform and left prosecutors who seem more interested in criminals than victims. **The market likes gridlock.** A red wave, control of Congress and possibly the senate translates into a lame-duck presidency for Biden. The market tends to like gridlock as it means radical policies get blocked, and change is minimized. So in this column we score a red wave as likely, and that's a positive for the market.

Inflation and Its Source. Government spending is certainly a source of inflation. Supply chain disruptions as a result of Covid related shutdowns are too. Corporate America is adapting to these disruptions, and covid itself is abating. As a result, we do believe that inflation today is different than the energy shock inflation of the 70s and can be worked out over time. The issue then becomes how much higher rates might go. A red wave that pulls back on excessive government spending should be an additional factor to put inflation into check. As a result, we may see rates peak in 1H 2023.

Russian and Ukraine. The war in Ukraine has shed a lot of light on the state of Russia. We grieve for the loss of life. Shocking to all has been the enigma that the Russian army (which is more of a group of thugs) appears ill-equipped with outdated weapons. Reports of World War II era equipment and lack of supply of basics such as fuel and food have shed light that Russia appears to be more of a paper tiger, albeit a nuclear one, than a modernized army. There seems to be no letup in support of Ukraine from the west in supplying modern weaponry. This is a dangerous situation and is beyond our ability to predict an outcome; suffice to say, we hope for regime change in Russia. If that were to happen, it would be a significant structural positive factor for global markets. The use of a nuclear option is unthinkable.

What about China? China has been positioned as the new global threat, with Taiwan in the crosshairs. We note that China has never invaded another country, but this time may be different. What we do know is that China has other problems, from its own "zero Covid" policy to trillions of dollars in failed real estate that the country and its people face today. The effect is slowing economic growth, which impacts not only China but the world. We believe, at least in the short term (next five years), that China is more focused on restoring economic growth than on a war with Taiwan. Especially in the wake of the Russian invasion of Ukraine and the impact it's having on Russia. We conclude that Washington is now more tuned into the China threat, but we see few reasons for the threat to escalate in the near term. No news is good news for the market regarding China.

Back in November 2020, we wrote: "I'm concerned as fiscal stimulus, the government printing money, must at some point trigger inflation, which suggests a lower market. Structural changes in how we do business will need to be resolved, and that ultimately sets the stage for future growth. So even in a republican win, I'm concerned about the market outlook in 2021. In a Democratic sweep, we should expect Congress will try to print its way out of the economic chaos. That is sure to trigger inflation, and I fear could fail to address the structural changes needed for the country to prosper".

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