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QFC's Insights

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Market Outlook

Maintaining Long-Term Focus While Taking Advantage of Opportunities, Part II

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Economists, Federal Reserve Board, and investment managers all look to historical periods and trends to find insight, steps, actions, or reactions which could be valuable today. While our economic history is important and meaningful, it rarely matches current issues; and without accurate current data trends, applying past solutions to current situations may not work.

Here are the facts as I understand we are currently facing.

- Inflation—Highest inflation in food, energy, transportation, housing…seen in 40+ years caused by a combination of events: CoVID impacting the supply chain, trillions in aid sent to businesses and individuals creating excess capital for some, easy liquidity for years allowing for greater expansion, and the Ukraine war impacting supply.
- Tightening Economic Conditions—The Federal Reserve is now liquidating or allowing certain bond purchases over the last decade to mature. This is taking money out of the market, resulting in a reduced money supply and driving up interest rates.
- Rising Federal Funds Rate—The Federal Reserve Board is also increasing the Fed Funds Rate in the effort to reduce demand and thereby reduce pressures which drives up prices.
- Consumer Confidence—The University of Michigan consumer sentiment survey for June was revised to a level of 50, reflecting a low level not seen since the 1970's.
- Broken Supply Chain—This is not only the movement of goods from major exporting countries like China which had closed some ports/manufacturers due to CoVID, Ukraine due to the war, or through our receiving ports, but also the politically and economically driven decisions to relocate sources of raw materials or manufacturing from one country to another or to the United States. This is not flipping a switch, but can involve building new manufacturing facilities, setting up transportation channels, warehousing, and many other factors which require time to complete.
- Political Polarization—This most likely is the most important; as without bi-partisan leadership and legislation, with each swing in political control, prior legislation is reversed/modified creating more animosity and polarization.

The tightening of financial conditions and increasing Fed Funds rate are the tools the Federal Reserve have to combat inflation. The balancing act to apply the correct amount and not too much will be discussed later along with the impact these tools may have on our energy costs. Time may be the essential item to repair the broken supply chain. As CoVID diminishes, new supply sources get established, or plants built, the supplies will work their way into the economy. When supply meets demand, pressure on increasing prices lessens. I am not sure of the solution for political polarization, since there is *not* a magic pill that can be taken.

Insights Continued:

Having what we hear through the media be accurate and fairly represented is important as that information is used to form opinions and in my case, investment decisions. Misinformation about inflation or the economy can misdirect decisions made by Americans when they are attempting to protect their financial assets. Recently there were two quotes which caught my attention. The Administration highlighted Exxon implying this large energy company could be the cause for the high prices at the gas pumps. It was said, "Exxon made more money than God last year." Having worked in the industry on rig sites as a pipe inspector, controller of a small Louisiana refinery, assistant controller of an operating/production company and a drilling company, part of an audit team of various oil companies, and assisted in preparing tax returns for oil and gas companies, I have a strong understanding of this industry and this statement peaked my interest. Per Yahoo Finance, Exxon's profits were $23,040,000,000 for the year ending 12-31-2021; yes, that is in the billions. Clearly an astounding amount. To put this in perspective though, there are over 4 billion shares outstanding owned by consumers, individual investors, and institutional managers found in pension funds or 401K plans, and the billions in profits equate to $5.39 per owner's share. Making a return of $5.39 per share value of approximately $69, or 7.8% is not unreasonable. Exxon is very large, worth $360 billion, and is expected to make this size profit. The Administration added it should be Exxon's patriotic responsibility to assist the American people by lowering its prices. Here is the rest of the story, for the year ending 12-31-2020, Exxon's profits were non-existent. Due to the US economic shut down, Exxon lost $22,440,000,000. During part of 2020 a barrel of oil could not be sold and producers were seeking all available sources to store produced oil until it could be sold and delivered. Daily oil production fell significantly in 2020 and still exceeded demand. How times have changed.

If Exxon made more money than God, I also looked at Apple and Google for comparison. For Apple, its fiscal year ends on 9-30-2021, and they reported profits of $94,680,000,000. Google's profits for its last fiscal year on 12-31-2021 were $76,033,000,000. If Exxon's $23 billion is more than God, I am not sure what Apple's $94 billion or Google's $76 billion equates to. Should we ask these companies to lower their prices, since they made so much more money? And for these companies, their last fiscal year did not follow a year in which billions were lost.

The second fact shared is that the United State's oil production is at record highs. Unfortunately, this is false. Per the US Energy Information Administration, oil production was higher in 2019 with 12.289 million barrels per day. In 1970, the US's production peaked at 9.637 million barrels per day followed by lower production levels until 2018 when it reached 10.941 million barrels per day. The current average of 11.188 million barrels is high, but not the record as portrayed. It was confirmed by CNBC reporting on June 29th, this amount was a record since this Administration has taken office.

It is unclear why these statements were made or Exxon's profits highlighted. In addition to food, most citizens are feeling the pain at the pump when they fill up. But, are the 2021 Exxon profits the cause of high gasoline prices at the pump? In my opinion, no. Should Exxon and other oil companies lower their prices as a patriotic duty? It would be nice, but it seems to be an unreasonable request. Oil companies like all other companies are facing increasing costs, and their boards and managers have obligations to their owners, the millions of shareholders in the case of publicly owned firms. Oil is a international commodity and the price is set by global demand, not just US demand. It is unfortunate the crude oil supply shrank due to CoVID's economic impact in 2020 and policies of the US and Allies applied sanctions on Russian crude due to the Ukraine war at a time when US demand was increasing resulting in upward price pressure.

I am not sure if the shortfall of 1.101 million barrels per day were produced, the US has the refining capacity to distill it into the various products which gasoline can account for approximately 40% of each barrel. The daily production of oil in the US, our refining capacity and location of our refineries, current demand all are key factors of the cost of gas at the pump. But, so is the lack of pipelines in key areas, where drilling can take place, and numerous US laws directly impacting exportation and importation of crude oil and products.

Regardless of the Administration or the politician, accurate and truthful information would be helpful. There is no doubt similar misstatements have occurred in every past Administration, some perhaps more egregious than others. Our government over many years has permitted many companies to become extremely large for a variety of reasons. One to keep them in the US for our own economic benefit, the defense of our country, employment of thousands of Americans, and perhaps through size, better quality of service and lower prices. All of this can be debated, but presently we have what we have.

The question is what steps can be done and how does the government proceed? Our economy is very much like an orchestra, and too many fail to understand that concept. One item cannot be changed without impacting many others either positively or negatively. Remove one instrument and the melody is damaged. Changing one note may require changes in other areas to remain in harmony. For our economy, so many of the changes are not instantaneous, but require time to implement or to see the results. Changes in the Fed Funds rate generally requires six to nine months before its impact can be seen in the economy. Therefore, if the Federal Reserve is not careful, they could be seeing the desired results in economic data following earlier increases in the rate, but there could be additional rate increases already implemented for which their impact is not yet reflected in current data. Thus, raising rates too high and too quickly can potentially lead to a recession. It is a balancing act and one which requires patience, timing, and experience to even get close to hitting the mark, a soft landing.

The Gross Domestic Product (GDP) for the first quarter of 2022 was recently revised down to a negative 1.60%. Generally by definition, a *recession* is where the GDP declines in two successive quarters. There are those who believe the US is already in a recession. Should the second quarter reflect a negative GDP, then by definition the US would be in a recession. While the US is presently not showing increasing unemployment, a symptom of past recessions, millions of Americans are feeling similar financial constraints a recession imposes due to higher prices, hence the very low consumer sentiment reading for June.

On the morning of June 30th, the latest data was released on inflation. While the data still reflected high inflation, it also indicated there were areas of softening. This follows the two prior Fed Fund rate hikes, and two more hikes are expected in the coming months. It appears the moves by the Federal Reserve are impacting inflation. Many of the commodity prices are also off from their previous highs, like copper, wheat, lumber and even oil. When the GDP data is released for the second quarter, I believe it will confirm we have been in what will be classified as a mild recession. Also, one that may avoid the typical significant rise in the unemployment rate.

Volatility is expected to continue, and for now the markets appear to be oversold with many quality companies share prices being valued less than their revenue and profits deserve. As the outlook becomes more clear and inflation is truly being tamed, opportunities for recovery will be available and potentially significant for those who are still in the market and holding quality positions. Remember, you are investing for the next five, ten years or more in the future and not for next week or month.

Citations:
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https://www.macrotrends.net/2562/us-crude-oil-production-historical-chart