

The theme of ongoing weakness in foreign currencies remains one of the centerpieces of the portfolio. With the Euro and Yen sitting near their lows, we could be in for a period of consolidation, but remain patient for lower levels. For Europe, the reasons for ongoing weakness are: high inflation, deterioration in trade balance, and high energy prices. While high energy prices have afforded the initial bump to inflation, we are now starting to see second-order effects; namely when companies pass through their higher costs in finished goods prices. The higher prices cause workers to push for higher wages which can lead to a wage/price spiral. The chart on the bottom left is inflation, bottom right is trade balance.



As you can see, the trade balance has shifted sharply with the increase in energy prices. With Europe highly dependent on imported fossil fuels, the balance of payments should continue to erode. In addition to the high price of import fossil fuels, the cost of electricity has skyrocketed. Between shuttering of nuclear power plants, low river water levels diminishing hydro generation and nuclear generation, and ongoing maintenance of major nuclear reactors in France, electricity prices had risen to over 10X normal. In the chart below, you can see that electricity prices in Euros/kilowatt hour were stable for years, but have gone skyward since mid-2021.



With all of these headwinds, it is hard to see how the Eurozone escapes a recession which should lead to ongoing weakness in the currency. In Japan, the argument is less nuanced and more straight-forward. Simply, the Bank of Japan continues to employ yield curve control. With the BOJ continuing to hold interest rates low and print money to do so, there is little room for the Yen to sustain a rally.

The other main theme has been bullish energy. Governments around the world have been throwing just about everything but the kitchen sink at the petroleum markets to get prices lower. Between doubling down on “green energy” policies and coordinated releases of government owned crude oil stocks, they have done a pretty good job as prices have retreated to pre-war levels. However, those reserve releases will quickly be coming to an end. Despite unprecedented sales of reserves in the US, commercial stocks are basically unchanged all while the Strategic Petroleum Reserves have fallen to the lowest levels since 1984. It begs the question: what will happen when those releases cease in November? While the data is two months old, US oil demand in June was the highest since 2006. So, while future supplies will be shrinking, demand doesn’t seem to be falling. This sets the price risk firmly to the upside. The biggest risk to the bullish thesis is economic activity. The biggest two to watch are Europe and China. Economic indicators out of both will be scrutinized for hints that demand will be curtailed sharply.

Sincerely,



Stephen Davis
September 2, 2022

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