In the Arena

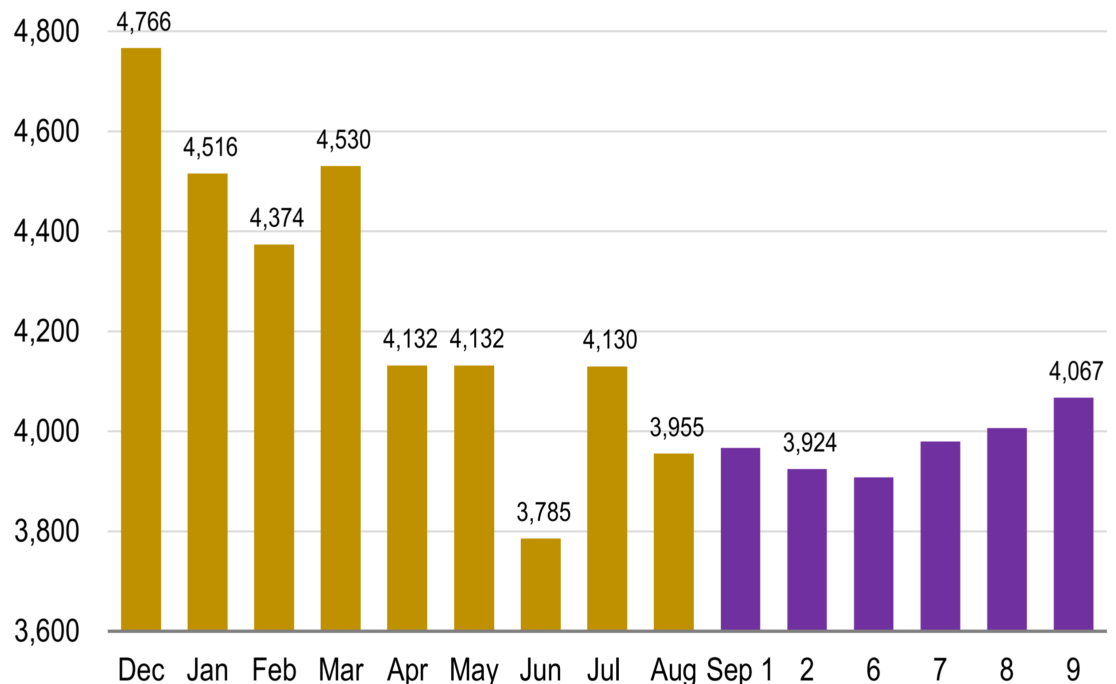
Weekender

September 10, 2022

Good morning and welcome to the Weekender for Saturday, September 10, 2022. From an equity perspective, as measured by the S&P 500, markets in the United States were higher by 3.6% for the week. It was a classic short squeeze.

S&P 500 Monthly and Daily Levels

December 2021 - September 9, 2022

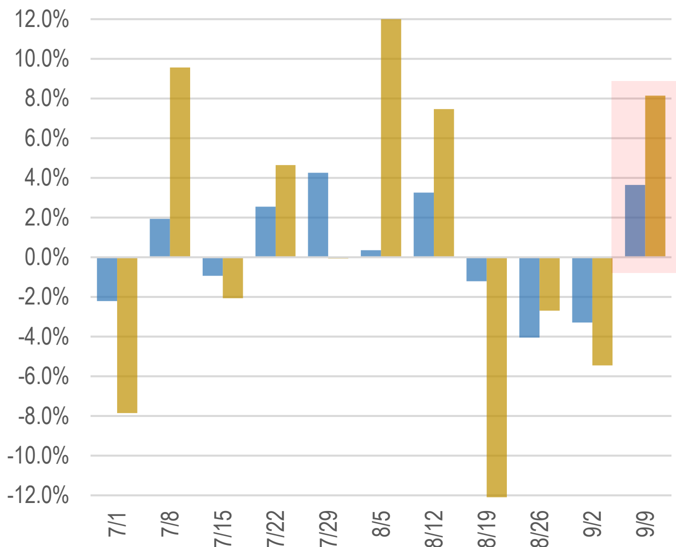


Last week was characterized by a retail buyer retreat from risk assets, like equities. Equity prices rose as short-sellers rushed into the market to cover bets made that markets would fall. Options traders were active in the equity market, purchasing shares to cover their hedges. Quant traders were also active as their models suggested, at least in the short-term, equity markets were oversold. Combined, all three of these factors the weekly rise in equities.

In the graph on the next page, the blue columns are the weekly returns of the S&P 500. The gold bars are weekly returns of the most shorted stocks in the S&P 500. Notice that last week, shaded in red, the most shorted stocks more than doubled the

return of the S&P 500. The point. Last week's gains were paid for by short covering and risk mediation practices.

Weekly Returns for S&P 500 (Blue) and Shorts (Gold)
Week of July 1 - September 9, 2022



One essential function of an orderly market is price discovery. As disparate buyers and sellers engage with one another, fair value is marked at a price where buyers and sellers are satisfied and the market for a particular product or service clears. With the S&P 500 down -14.5% on the year and the tech-heavy Nasdaq lower by -22.5%, it's a worthy exercise to what market drivers are currently priced in and which are yet to be discounted. The point? Is it time to begin wading into equities?

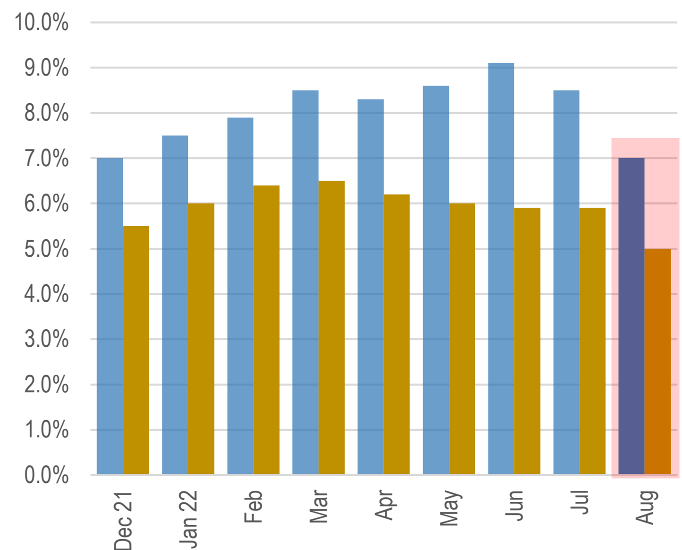
We expect the Federal Reserve to move their target rate's upper bound to roughly 4.0% before they are finished. The rate is now 2.5% and will possibly be 3.25% at the end of their next meeting, so we are getting close. A move to 4% will certainly push inflation lower over the medium term (2-3 years). Probably in the 3-4% range. Still well above their target of 2.0%.

The labor market is very robust and will likely remain so through the course of the Fed's tightening. Certainly, the unemployment rate will rise, but the labor force, those who are employed, is also likely to rise as workers who are currently on the sidelines come back into the labor force. This has already begun to happen.

As consumers struggle to afford life in an emerging inflationary environment, more consumers are entering the labor force. While the net effect is an increase in the unemployment rate in the short-term, the reality is that the labor participation rate is a sign of normalization. Normalization is the "best case" scenario if the Fed wants a soft landing after inflation has been tackled.

If inflation persists above the Fed's target over the near-term (1-2 years), which we expect, they will not be able to return to the degree of extreme pandemic-era accommodation, regardless of how much they may want to. August inflation readings will be released next week. We expect some moderation in the numbers, the red shaded area, but not enough to make a difference in the Fed's aggressive stance.

CPI (Blue) and Core CPI (Gold)
December 2021 - August 2022

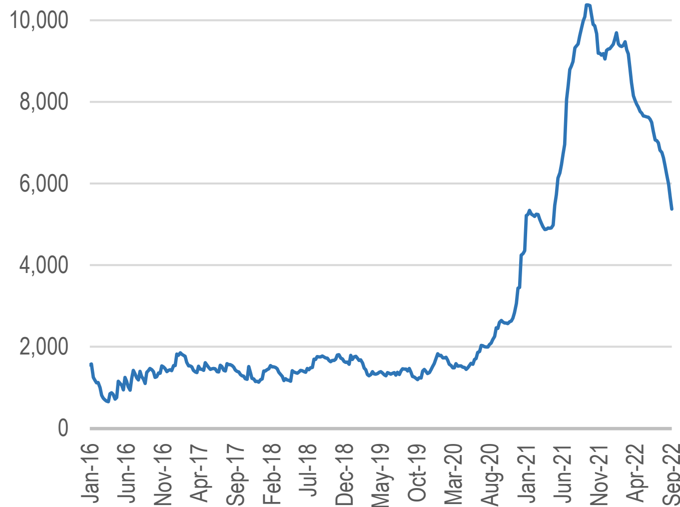


Meanwhile, the bond market is sending signals that inflation will come to heel over the medium-term (3-5 years). Demand for inflation-protected treasury debt continues to fall. The five-year expected inflation rate has fallen to 2.6%, down from a peak of 3.8% in March. If the bond market's current tells are not a bluff, a soft landing is possible.

Lower inflation expectations are brought to you by a general softness in commodities, crude oil, and softening of supply-chain pressures. For example, while still higher than pre-pandemic levels, the composite cost of shipping a 40-foot container is approximately $5,378 per day, down 48.1% from its September high of $10,377. Such a precipitous fall in container day rates is a powerful sign that trade-related supply chain tightness is beginning to thaw. By this time next year,

supply chain pressures are likely to be gone in most areas.

Composite 40-Foot Container Day Rate
January 2016 - July 2022

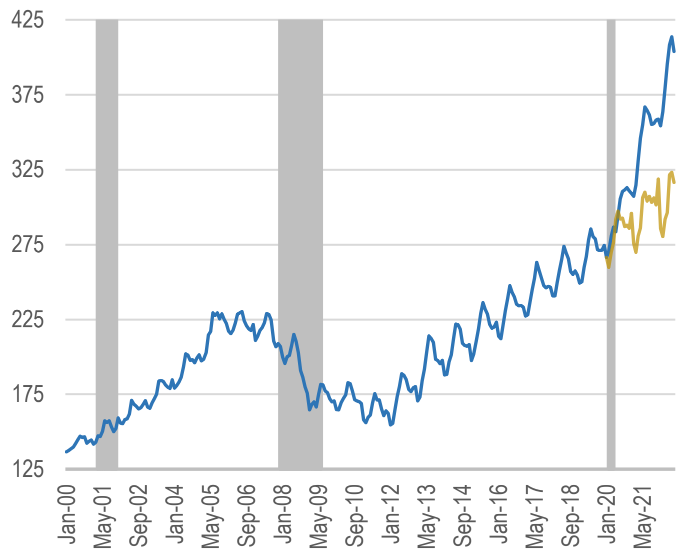


Commodity prices, including shipping, are often volatile. What goes up one day is lower the next. But sticky or persistent inflation is worth worrying about. Sticky inflation comes from areas where prices do not immediately respond to changes in demand and supply. Housing prices are considered upward sticky. Wages are as well. Especially in a tight labor market.

Approximately 70% of homes listed for sale in Boise have had their prices cut. Other hot markets, like Denver, Salt Lake City, and Tacoma are following suit. We believe residential housing, although regional by nature, is entering a national recession. Supply, although at historically low levels, is rising slowly as buyers leave the market and builders finish unsold homes already planned.

We believe the US, generally, and the intermountain area, in particular, particularly, are in the early stages of a residential housing recession. This is a graph of sales of existing homes in the United States. A consistent seasonality is evident in every year until the pandemic hit, when mortgage rates held under water by fiscal and monetary stimulus drove existing home sales to unsustainable levels, the blue line. The gold line is a representation of where existing home sales would have been had historical trends persisted. Property markets are returning to trend and its going to be painful.

US Existing Home Sales
January 2000 - July 2022



Faced with weak buyer demand, home builders and sellers are increasingly deciding to rent. Mortgage rates are pushing up past 6% for many would-be buyers, roughly doubling monthly payments from pandemic levels.

Even though inflation continues to play large on the stage of economic and market concerns, our biggest concern is earnings. In the United States, earnings downgrades have outnumbered upgrades for the past thirteen weeks. We are still a month away from the beginning of the third-quarter earnings season, so corporate news is a little light. We are entering the doldrums.

We believe earnings growth will continue to slow and poor earnings guidance for the rest of the year and into next year will necessitate a re-rating of many stocks. That said, we expect the next three months to provide some incredible buying opportunities. More on that in the House View.

Our first *House View* will be published on September 22. Our quarterly virtual magazine, *Bucket List*, will be published as the quarter closes on October 1. Please be sure you are on the mailing list if you are interested.

Market Narrative

There are three bears, as Cameron Crise of Bloomberg suggests, that are currently chasing the market—war, inflation, and slowing growth. Positive news on any of these will be a support to equity markets. In Europe an energy crisis is combining with a millennium drought, record inflation, and a rigidly aging economy to push the continent toward certain economic recession. As these elements play out, the European Central Bank (ECB) is raising interest rates in a laser-focused attempt to control inflation. As a recent European refugee, the United Kingdom, is likely to be a beneficiary of softer economic consequences from many of the factors plaguing Europe.

China, the world's second largest economy, ended its contractionary policies last year and has been trying to stimulate its property and export-driven economy. However, the property sector, which accounts for approximately 29% of the country's economic output, is in a depression that will require large government support. Despite their accommodative stance, China's economy is slowing dramatically and is likely to post growth of 2% this year, which is a recession when compared to its typical growth rate average of approximately 6%.

In the United States, the cleanest dirty shirt among nations, inflation hovers close to historical highs, economic and earnings growth are slowing, and the dollar is too strong. But the US economy is the most resilient economy in the world. A characteristic that has dominated since the end of World War II.

War in Ukraine is going against the invaders at the moment. Even in the case of an eventual victory or draw, an enormous geopolitical cost will be exacted. New economic and political lines are being sketched and borders are likely to be altered in many points of interest around the world. The kumbaya of a new world order is ending. So is the global trade system.

Inflation, at least this time, is caused by supply and demand factors. Supply problems will slowly mend over the next 12-18 months. Demand will be curtailed by monetary contraction. As mentioned, medium-term inflation is likely to remain above pre-pandemic levels, which will drive slower growth in the economy and corporate earnings. It will also shave a few points off valuation multiples.

Growth is the boogeyman. Economic growth will be tempered by a build in inventories. Earnings growth will fall from margin compression. Margin compression is a function of pandemic shut-downs and excess demand. During the first three months of the pandemic, international trade as well as domestic production ground to a halt. At the same time, consumer preferences shifted toward work-from-home and stay-at-home products and services. Meanwhile, federal and state subsidies, mortgage payment and rental moratoriums, and student loan deferments A mismatch between demand and supply created pervasive shortages and rampant inflation. Shortages gave corporations incredible pricing power. Prices for products and services rose as did margins, to record levels. The margin pendulum is now swinging the other way. From margin expansion to margin contraction.

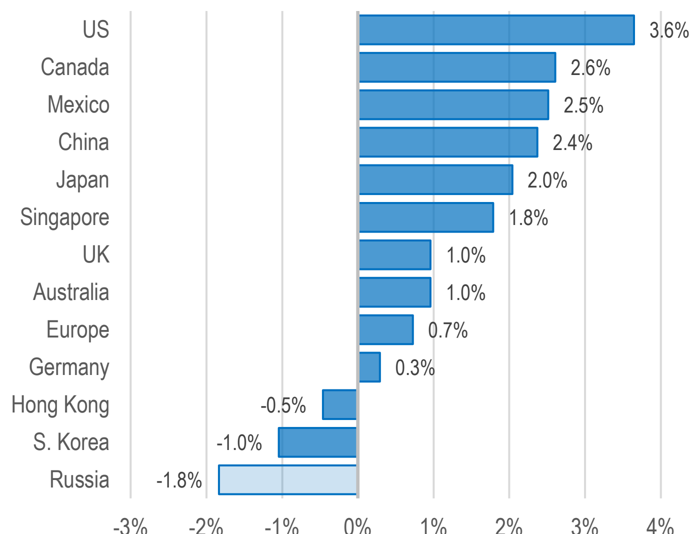
We continue to believe that the greatest risk to equity markets is a downward revision in earnings expectations. Our investment strategy remains the same. Focus on companies with: 1. Purchasing power; 2. Unit sales growth; and, 3. Strong balance sheets.

Countries

Country returns were led by the United States but most other investable countries had a strong week as well.

Country Returns

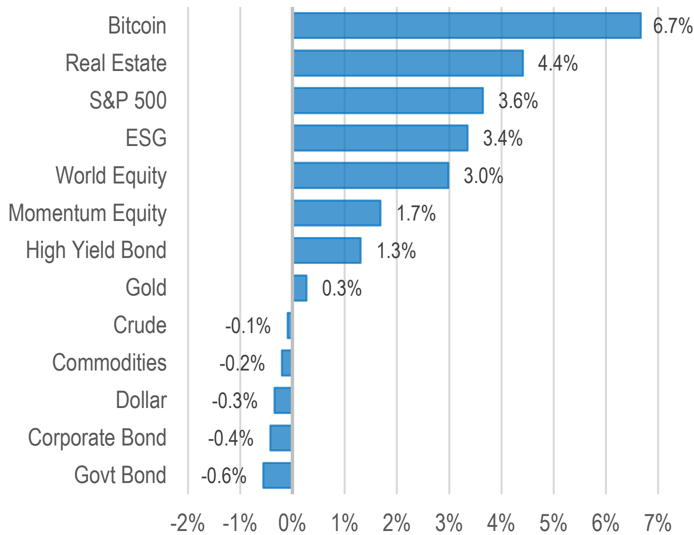
September 6 - 9, 2022



Instruments

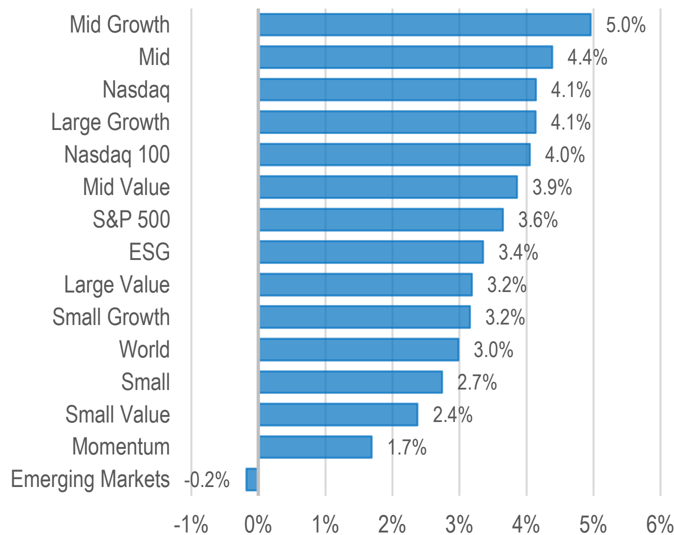
It was a parking lot week. Investment instruments rose where buyers could park cash safely.

Instrument Returns
September 6 - 9, 2022



However, drilling down into equity instrument returns, no real trend emerged.

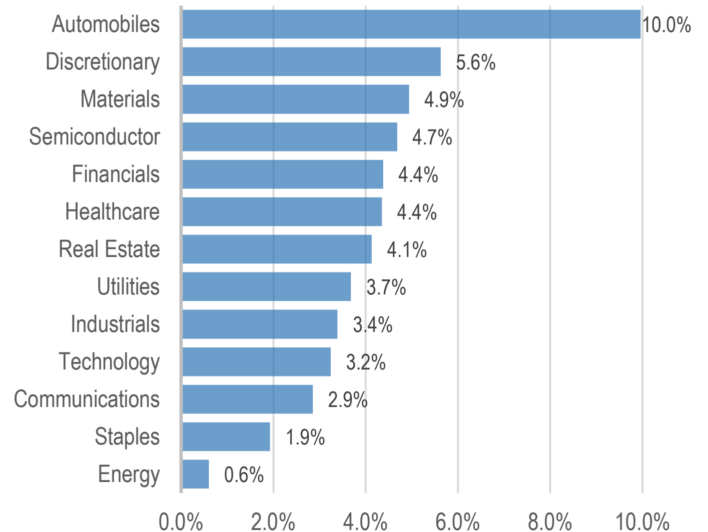
Equity Instrument Returns
September 6 - 9, 2022



Sectors

It was in sector returns that the week's story can be told. Automobiles, which aside from Tesla, are among the cheapest stocks in equity markets, were the best performers. Other than autos, sector gains were strong and not in response to any fundamental data. Particularly notable is the strong gains from semiconductors, despite almost universal reports from semiconductor companies that chip demand is softening at a rapid pace. Without any fundamental direction evident, our initial observation is confirmed. Gains on the week have been a story of short-covering and hedging . among subscribers.

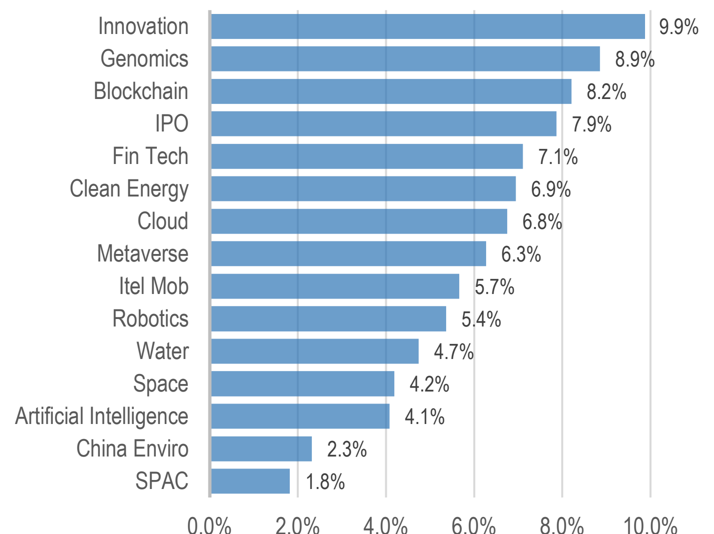
Sector Returns
September 6 - 9, 2022



Themes

Themes were broadly higher on continued short-covering.with market sentiment. This week was no different.

Theme Returns
September 6 - 9, 2022



One More Thing

One more thing. It seems en vogue among a common culture to decry existing institutions for their weaknesses. Justifications for jettisoning tradition, history, and culture on the basis of a past generation's error, sin, catastrophe, or harm is particularly common among those who watch from the cheap seats.

Winston Churchill once commented that "capitalism is the worst economic system, except for all the others." With the passing of Queen Elizabeth, who was universally admired and respected among those who truly knew her, many liberal pundits bore her good riddance and called for the end of her oppressive monarchy, return of all ill-gotten booty from centuries of colonialism, and reparations for any past aggression.

Theodore Roosevelt, a man who did great things and made remarkable errors, gave a powerful speech a year after he left the office of President of the United States entitled, Citizenship in a Republic. He said, "The poorest way to face life is to face it with a sneer. A cynical habit of thought and speech, a readiness to criticize work which the critic himself never tries to perform, an intellectual aloofness which will not accept contact with life's realities—all these are marks, not … of superiority but of weakness."

From this introduction he delivered an inspirational an impassioned message that drew boisterous applause. What is more, he said, "the credit belongs to those who are actually in the arena, who strive valiantly; who know the great enthusiasms, the great devotions, and spend themselves in a worthy cause; who at best know the triumph of high achievement; and who, at worst, if they fail, fail while daring greatly, so that their place shall never be with those cold and timid souls who know neither victory or defeat."

Queen Elizabeth lived a century in the arena. The world is much better for her life of duty, dedication, and decorum. What a debt we spectators owe to those who give their full measure, as she did, in whatever time and place they are appointed, whether in Buckingham Palace or the stairwells of the World Trade Tower.

That's it for this weekender. Have a wonderful week.