The Most Wonderful Time of the Year

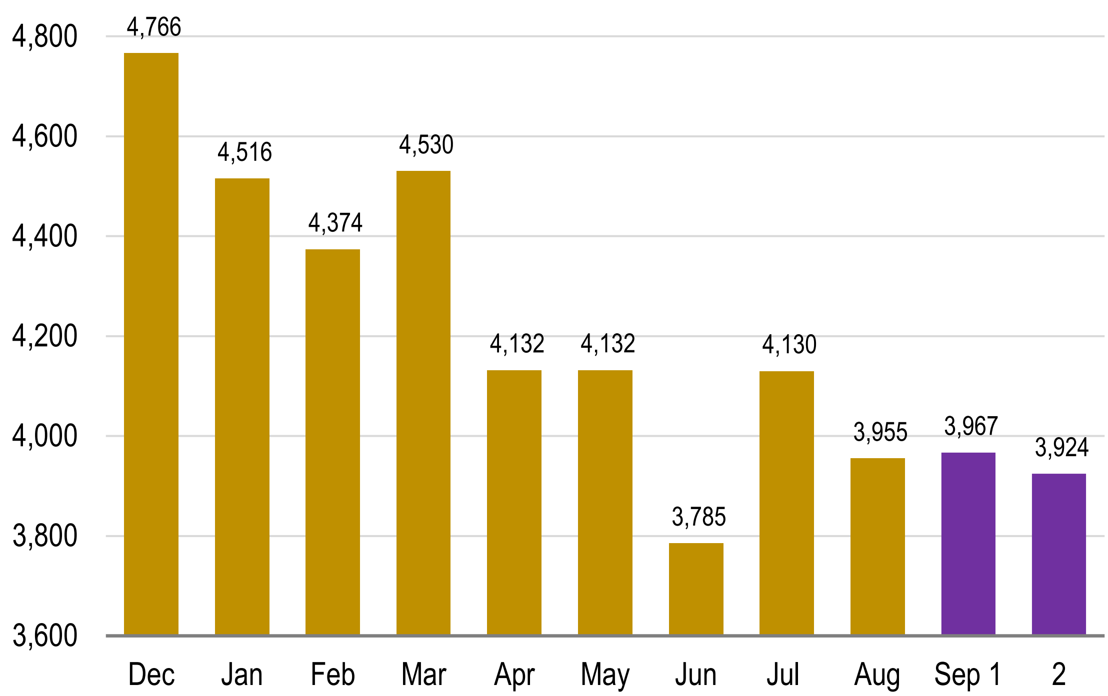
Weekender

September 3, 2022

Good morning and welcome to the Weekender for Saturday, September 3, 2022. Labor Day is shortly upon us and most US financial markets will be closed. Daylight hours are getting shorter, and despite the current heat wave, temperatures are beginning to moderate. Fall is not yet in the air, but we are close. Children, and in our case grandchildren, are back in school. It's the most wonderful time of the year. Pumpkin spice has returned to Starbucks.

S&P 500 Monthly and Daily Levels

December 2021 - September 2, 2022



Apple's biggest event of the year is just a few days away. The iPhone 14, an upgraded Apple Watch Pro, and new AirPods are all on the menu. Expect everything to be faster and clearer. Nothing revolutionary is likely. But, still exciting to see.

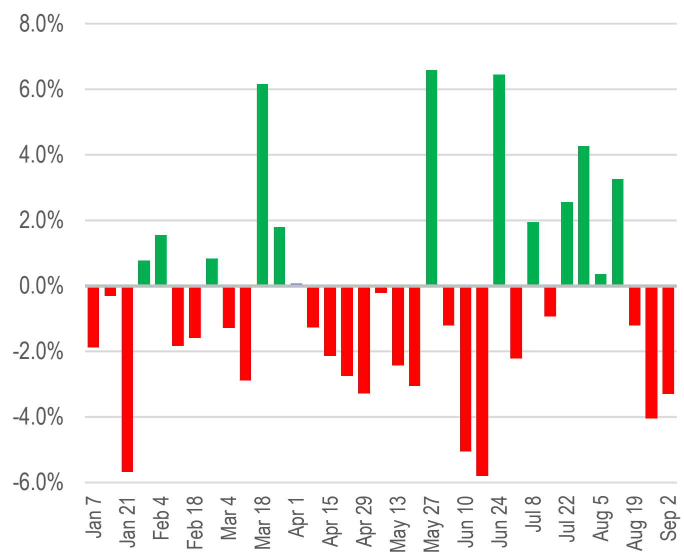
After three years of pandemic tragedies, it feels like we are getting back to normal. But it's a new normal, nothing like the one we left at the end of 2019. What we expect from the new normal will be the subject of our September House View, published next week. If you are not on the distribution list, be sure to email me.

US equity markets, as measured by the S&P 500 were lower by -3.3% last week—following a drop of -4.0% the week previous. Markets are finally taking Jerome Powell's commitment to do whatever it takes to bring inflation to heel seriously. His recent statements should be old news because he has been saying it for months. But market pundits, observing recent declines in crude oil and other commodity prices combined with a full stall in residential housing, expected the tough talk echoing in speeches of almost every Fed leader, would lead the Fed to pivot away from their tightening ways. We believe a pivot is assured. But there is a lot that needs to be broken first.

US equities posted their third week of losses. On Friday, August's US employment data was released. To some degree, good news for the economy was bad news for markets. The labor market remains robust. That's good. The economy is strong. Too robust for the Fed. That's bad. Interest rates will rise.

Weekly Gains for the S&P 500

Week of January 7 - September 2, 2022



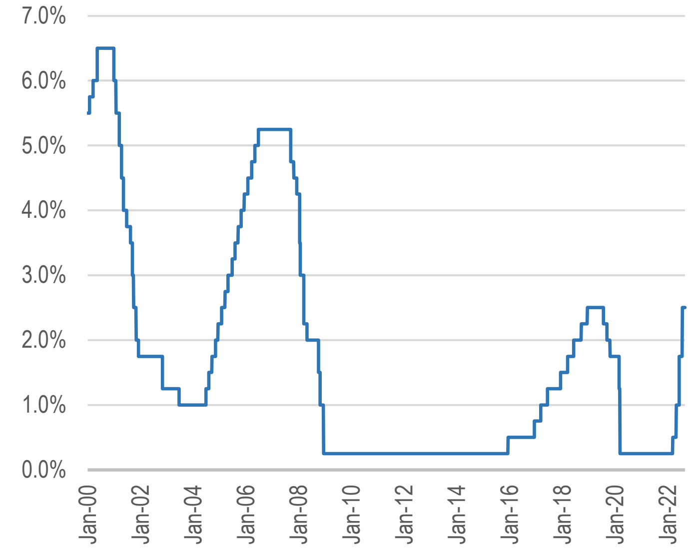
Market Narrative

Friday's US unemployment report confirmed strong momentum in the US labor markets, despite some of the most aggressive Fed interest rate actions in history. In March, when inflation was still transitory, the Fed's target rate was 0.25%. It is now 2.5%, a 900% increase. If the target rate rises to 4.0%, as expected, it will mark a 1,500% increase from the bottom.

This is a graph of the Fed's target rate since January 2000. By comparison with previous periods, the Fed's actions in the current cycle look quite aggressive.

Federal Reserve Target Rate

January 3, 2000 - September 2, 2022

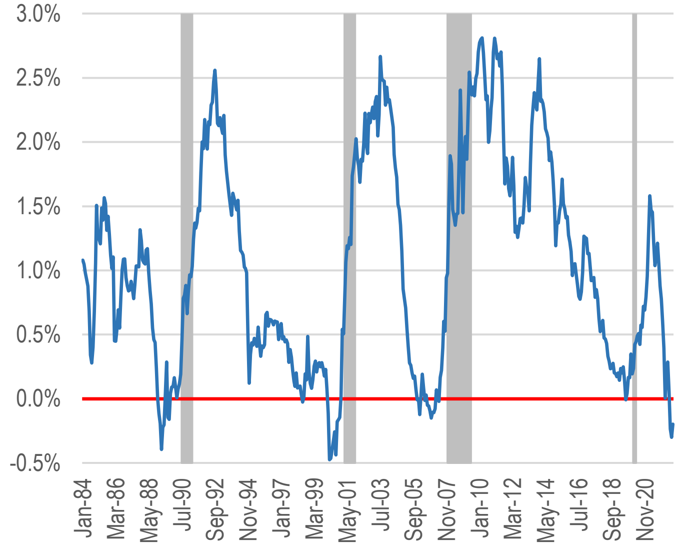


Looking abroad, Russia's Gazprom announced Friday that it would not reopen the Nord gas pipeline that is essential to Europe. This singular decision has increased the odds of a European recession to certainty. The British pound joined forces with the Euro plumbing new levels that have not been seen for a generation. Meanwhile, global central bankers have been talking yields higher in an attempt to assure financial markets that they are serious about fighting inflation.

Equity and bond markets lay down different narratives that are sometimes at odds with each other. Inasmuch as all returns are predicated upon the risk-free US government bond yield, we will look at the bond market narrative first, then close with what equity markets are telegraphing.

Over the past month, the yield curve has inverted in a powerful way. The yield curve inverts when yields on ten-year US government bonds are lower than equivalent two-year notes. An inverted yield curve, the blue line, typically precedes an economic recession. Notice how the curve inverts prior to recessions, indicated by the grey shaded areas.

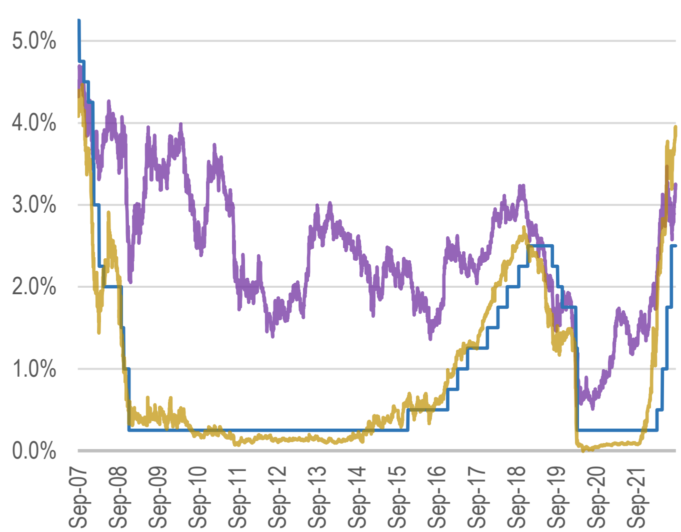
US 10-Year Yield Minus 2-Year Yield
January 1984 - September 2, 2022



We believe that inflation is in the process of peaking. However, it's likely to bounce around a bit before beginning to fall. Two upward sticky inflation metrics continue to show strength. Although residential real estate is experiencing death by a thousand cuts, we are unlikely to see a dramatic drop in real estate prices unless the labor market bubble is pierced.

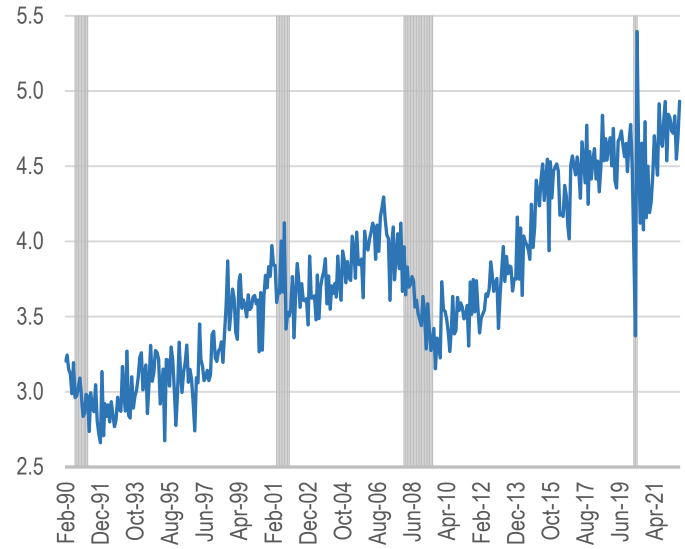
Financial markets suggest that the Fed's target rate needs to go to 4.0%, according to the interest rate swap market (gold line). By necessity, such a move will push the government 10-year yield (purple line) close to 5.0%. Mortgage rates will be approximately 7.5%.

US Government 10-Year Yield (Purple), Fed Target (Blue) and Swap (Gold)
September 7, 2007 - September 2, 2022



Deep inside the labor data for August, released Friday, the labor force participation rate jumped to 62.4%, which pushed the unemployment rate off its low or 3.4% to 3.7%. An increasing number of those entering the job market were not able to find work. Even though there are currently more job openings than unemployed, the fact that it's harder to find a job suggests the labor market is beginning to cool. Below is a graph of the ratio of those coming into the labor market who are finding jobs to those that are not.

US Labor Market In and Out Ratio
February 1990 - August 2022

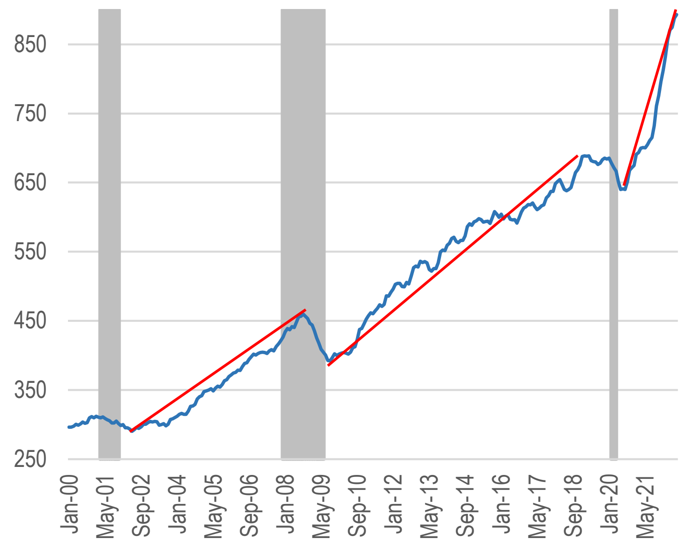


If labor force participation continues to rise and supply chain issues mend, inflation may begin to soften. That is, as long as an increase in labor participation is followed by a softening in the rise of labor costs, which have been rising. In another report released by the Labor department earlier in the week, average hourly earnings are slowing and the percent of Americans who quit their private-sector jobs in July sank to the lowest level in a year, which should help lower wage pressures.

Fed Chair Jerome Powell recently said, "there is clearly a job to do in moderating demand to better align with supply." This view holds supply as the given and demand as the variable. Demand is certainly the variable the Fed has some control over by adjusting market interest rates. However, supply is not a given. In fact, supply is increasing dramatically. This is a graph of wholesale inventories that have not yet hit retail shelves. Wholesale inventories are increasing at a rate not seen since soldiers returned from World War II.

US Wholesale Inventories

January 2000 - July 2022

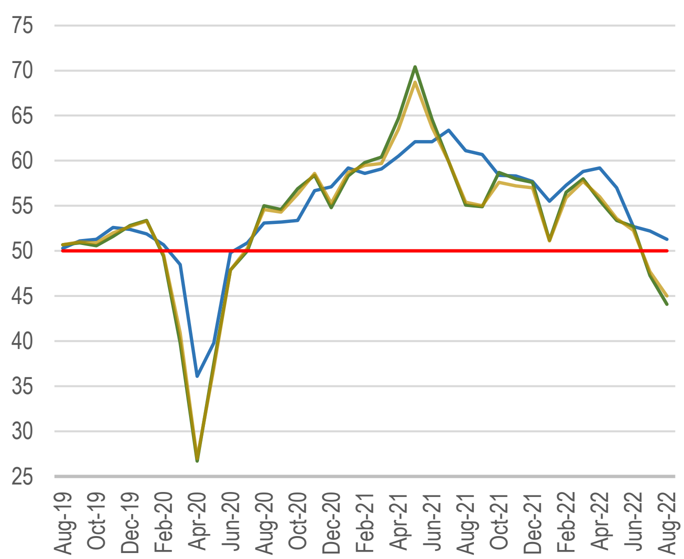


A host of economic measures are beginning to point to a general slowing of the global economy. We will discuss these at length in September's House View. As a peek into pending discussions, below is a graph of purchasing manager's data.

Composite PMI data for the US is below 50, suggesting contraction ahead. Services, after almost a year of extreme spending driven by the end of lockdowns, is registering a powerful contraction. Manufacturing is slowing, but not yet contracting. The US economy is slowing, and in some spaces, contracting. When the bubble in wholesale inventory is released on the retail channel, the labor market will get the memo.

US PMI Composite (Gold), Services (Green), and Manufacturing (Blue)

August 2019 - August 2022



Consider this. Amazon is the canary in the economic coal mine. As the pandemic burst on the world, homebound shoppers turned to Amazon for relief. A rapid buildout of warehouse space ensued. Now, the company is determined to reduce the size of its fulfillment operation in the face of slowing sales growth. They have abandoned dozens of planned facilities around the United States. MWPVL International tracks Amazon's real estate. They estimate that Amazon has shut down or halted development of 42 facilities totaling 25 million square feet. An additional 21 locations that are already built, are not going to be opened. It is also trying to sublease an additional 10 million square feet of warehouse space.

Amazon is leaving vacant positions open, slowing hiring, and tightening productivity standards. During the second quarter of 2022, Amazon shrank its workforce by 100,000. The largest quarter-to-quarter contraction in the company's history.

We continue to believe there are two powerful forces likely to bring inflation inline. Certainly, higher interest rates will cool overheating in real estate and capital goods. Supply chain bottlenecks are slowly mending and inventories will turn from shortage to surplus. But inflation will not come to heel without ramifications. The excesses brought on by excessive government fiscal giveaways and a 1,000 year flood in the money supply will cause level of retrenchment not seen in a generation. More on this in the September House View.

Countries

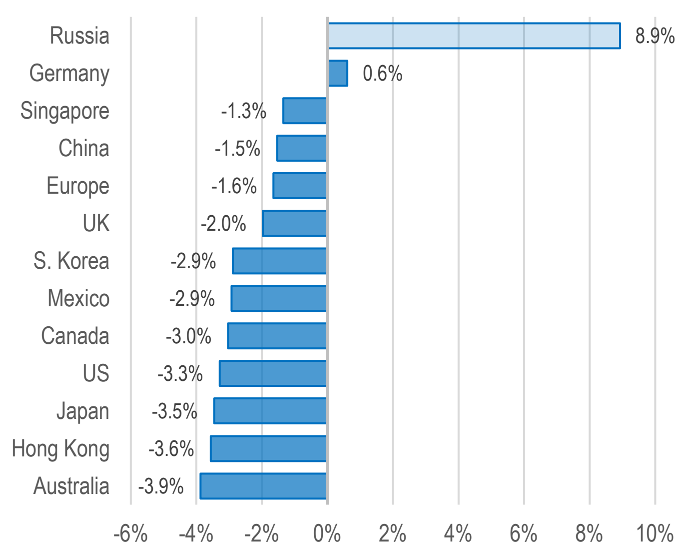
Drought conditions continue to plague the world from the farm belt in the US Midwest to China's Yangtze River basin. In the Midwest, corn is so parched there is no grain in the mature ears. At a time when grain reserves would have been lighter anyway due to the Russian invasion of Ukraine, global drought conditions are keeping prices elevated. Drought conditions are also at extreme levels in Europe and India. An index of grain and soybean commodities is almost 40% above its five-year average, although it has come off its highs.

For the first time in more than twenty years, a weather pattern called La Nina, which cools the Pacific waters and creates severe drought conditions, has been weighing on traditional weather systems for three unprecedented, consecutive years. Europe is experiencing the worst drought it has seen in 500 years.

Germany was the marginal winner for the week, having eked out a small gain. Most other countries were negative. Un-investable Russia, who we would like to ignore, is the spoiled child who didn't get a candy, throwing tantrums at the checkout counter. It continues to impose its will on its sovereign neighbor and any country that does not come to heel with them is a subject of recriminations. After a period of "maintenance", the Nord gas pipeline, which provides a significant portion of Europe's energy needs, was shut down. Prospects for a cold winter are bleak. Russia's actions are part of a general trend of economic de-globalization which began with Brexit and continues unabated.

Country Returns

August 29 - September 2, 2022



The result of de-globalization will be wrenching. Since 1990, global economies have imported deflation by choosing to make their products in China and other Asian Tigers. China's stand with Russia and insistence on eventually integrating Taiwan as a part of the Middle Kingdom will force OECD member countries to take sides either mentally or militarily.

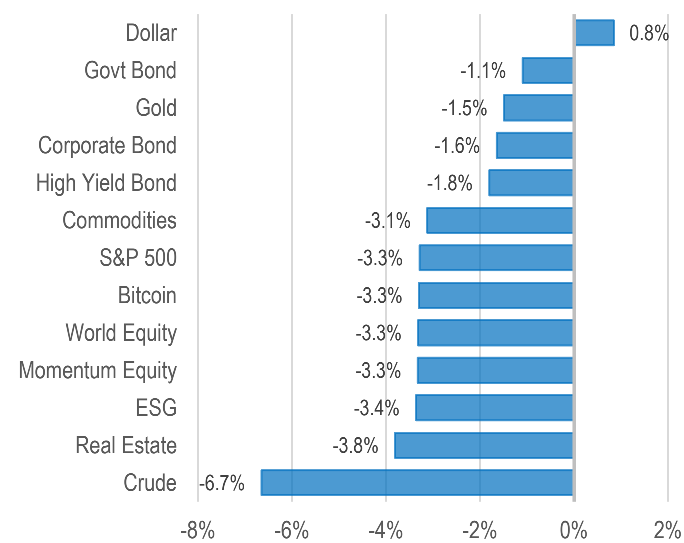
Looking at the purchasing manager index from around the world, the vast majority of countries are in contraction. India is an exception worth noting.

Instruments

On the back of higher interest rates in the United States and a general tendency for capital to flow to safety, or the cleanest dirty shirt in present economic conditions, the US dollar continued to strengthen. Crude oil was lower on expectations that a softer global economy will hurt demand. That said, OPEC+ nations will shortly meet to discuss trimming supply to support prices. We expect crude oil to stay within a trading range of $70-110 per barrel. More than enough to generate remarkable profits and dividends for the foreseeable future.

Instrument Returns

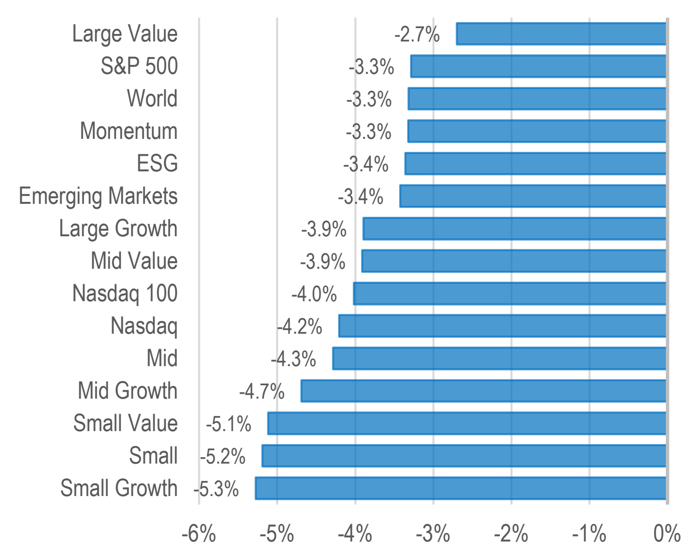
August 29 - September 2, 2022



Among equity instruments, all were lower, but the small side fared worse than larger players.

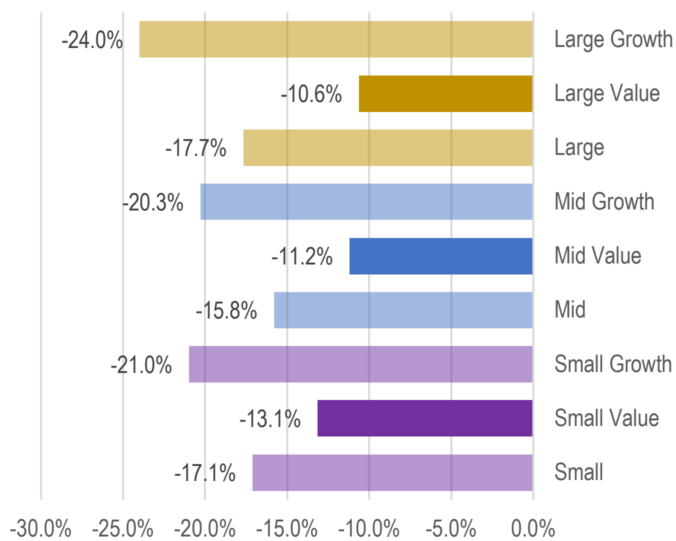
Equity Instrument Returns

August 29 - September 2, 2022



Within their size cohorts, growth has fared much worse than value since the beginning of the year even though all returns are negative. Among general equity categories, as we discussed at the beginning of the year in the Weekender, being overweight value has been a successful defensive strategy.

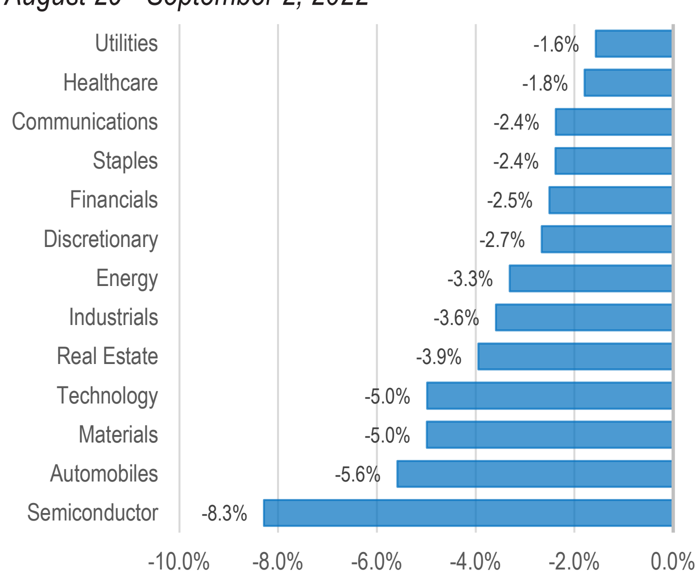
Equity Size and Method Year-to-Date Returns
January 3 - September 2, 2022



Sectors

All sectors were lower on the week with semiconductors leading the pack. Automobiles were also lower, but within this category are disparate industry players. Certainly, Tesla is the sector darling but the company's stock is the talisman of overvaluation. Tesla currently trades at 65.4 times next year's earnings

Sector Returns
August 29 - September 2, 2022



estimate. By comparison Ford trades at 7.3 with a 4.6% dividend yield and GM is at 5.6 times next year's earnings with a 0.94% dividend yield.

For the month of August, Ford's US auto sales were higher by 27%. The company has been posting strong year-over-year gains as it sells more electric vehicles and as supply chain issues are slowly remedied. Its new electric truck is being sold, on average, eight days after arriving on dealership lots. Most of its EV offering are still being sold on a pre-order basis.

In the communications sector, where media and entertainment live, the streaming wars continue. Tighter household budgets are making consumer more selective about which streaming services are worth keeping. Over the medium- to long-term, success of any media franchise, streaming included, is about content. A head-long push into producing content has resulted in a lot more content available online. But most of it is not worth watching. Disney has the advantage of a proprietary content vault dating back almost a century. A lot of their content elicits a type of comforting nostalgia that drives high reengagement levels among subscribers.

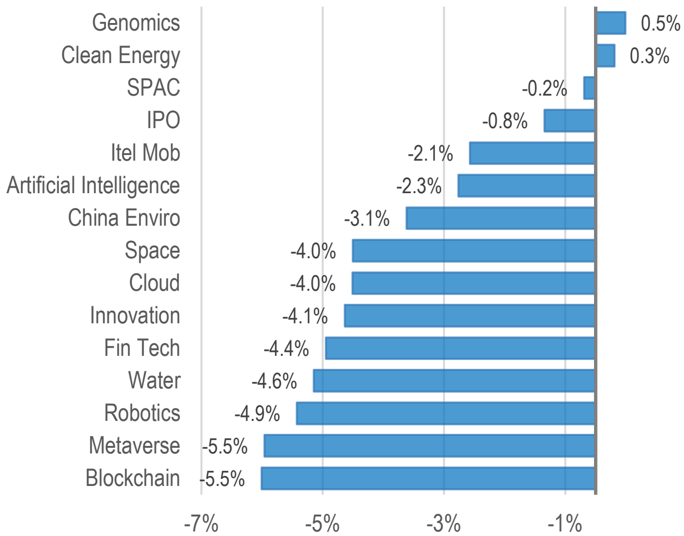
Amazon is a relative newcomer to the content business. But as their product sales growth slows, their internet-related offerings, AWS and streaming, become more important. Last week the company released Lord of the Rings: The Rings of Power, a prequel, set a few thousand years before the events of The Hobbit. It was the biggest-ever debut of the Prime Video service, drawing 25 million viewers on the first day.

Amazon invested heavily in the project. It is a serial with new episodes released through October 14, 2022. For this project alone, Amazon invested more than $1 billion, including $250 million to secure the rights for the franchise. We expect, over the next few years, niche content providers will consume those that remain standing. We expect those to be Disney (ESPN, Disney+, and Hulu), Netflix, and Amazon.

Themes

Most themes were lower, some significantly. Themes generally represent the riskiest allocation buckets of a portfolio. As such, they tend to move with market sentiment. This week was no different.

Theme Returns
August 29 - September 2, 2022



Conclusion

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

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