Told You So

Weekender

September 24, 2022

Good morning and welcome to the Weekender for Saturday, September 24, 2022.

Financial markets around the world fell in a coordinated response to cyclical and structural issues. The US Federal Reserve delivered on its promise to continue leaning into inflation fighting monetary tightening. Markets seemed spooked by the move, although it had been telegraphed for a couple of months. For financial markets globally, it was a week fraught with fulfillment of prophesies. Inflation is deeply seated and persistent, although softening. Most central banks have chosen to fight inflation with higher interest rates. Not the best tool for combatting supply shocks, but when all they have is a hammer, everything looks like a nail.

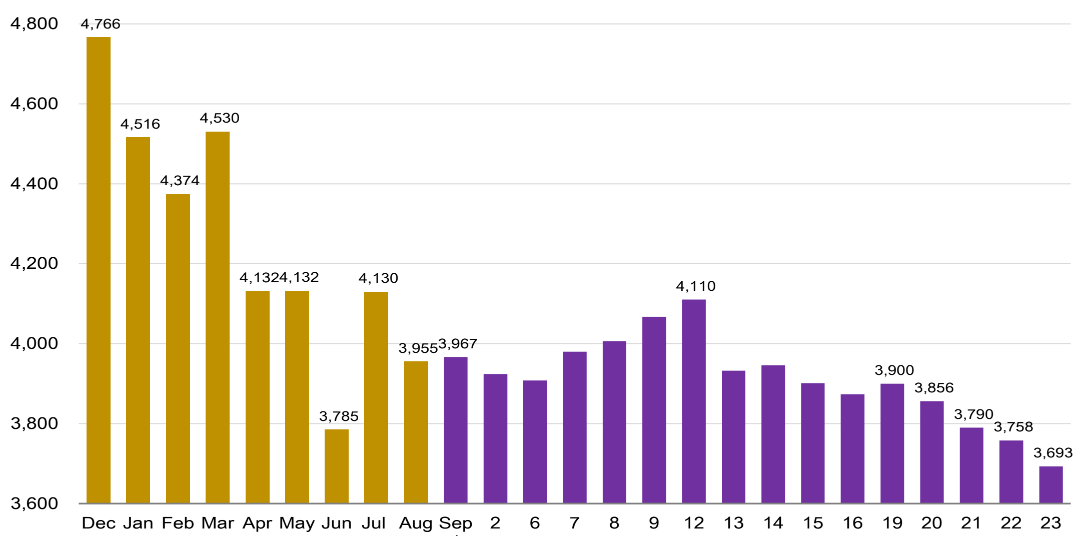
Financial market responses seem disproportionate to the causes. The primary reason is lack of liquidity. In addition to unreasonably low interest rates since the pandemic began, the Federal Reserve, along with other central banks, have been the cover bid for low yielding securities. Binge buying of government securities has now turned to selling as the Fed trims its balance sheet. This is causing a significant drop in market liquidity, resulting is price swings that are more pronounced.

We expect uncertainty to continue its reign of terror on financial markets for the next few weeks, until third quarter earnings are tucked in. Additional uncertainty from psychopathic authoritarian regimes and a bevy of economic data are likely to keep things interesting through October.

Equity markets, as measured by the S&P 500 were lower by -4.6%. For the month of September so far, the same index is lower by -6.6%.

Standard and Poor's 500

Monthly and Daily Levels

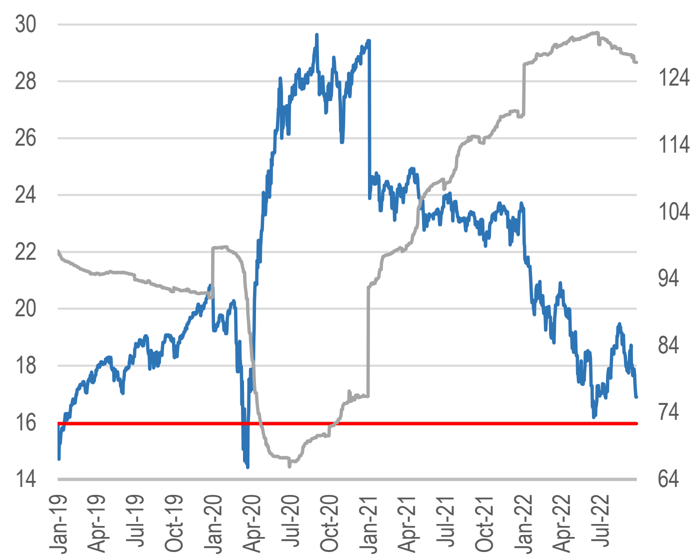


For the past two years, we have written skeptically about the government-fueled rise in asset prices. As we exit the pandemic and enter a new-normal, articulation of a true and lasting market narrative, that tells the story we believe will unfold, is critical. Creation of such a narrative is the job of our House View.

For today, let's start with a slightly confusing graph which will provide some grounding on what the market is currently pricing. The blue line is the forward PE ratio for the Russell 3000 equity index. In this graph we use the Russell 3000 because it represents the broad US equity markets, including large, mid, and small capitalization companies. The red line is the PE ratio at the beginning of 2019, before we had a whiff of the pandemic and when the economy and financial markets were in their Goldilocks state—everything was just right.

Russell 3000 PE Ratio (Blue) and EPS (Grey)

Daily Levels



From a valuation perspective, after a fall of -22.5% from the beginning of the year, all equity markets have done is blow off the froth of the pandemic excess. We have given back a degree of excess valuation that was never really earned or warranted.

The grey line is the earnings per share for the Russell 3000. It remains 28.7% above its pre-pandemic level and has not yet come down by much. We expect that the next phase of market calibration, to our new normal, will be lower earnings expectations.

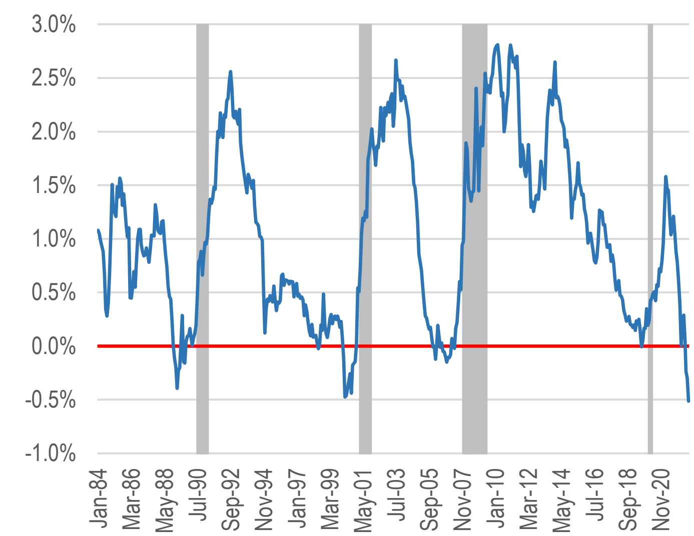
Lowered projected profits are a function of a return to non-pandemic normal earnings growth rates and the effect of a fall in commodity prices which have been the primary driver of the equity moves in industrials, materials, and energy sectors for the past two years. In addition, as supply chain constraints mend and excess inventory hits the retail channel, just in time for Christmas, final product prices will fall, compressing record profit margins that have been a primary driver of stock market gains over the past two years.

Market Narrative

On the heels of this week's rise in the Fed's target interest rate came a jump in almost all other market interest rates, especially on the short end of the yield curve. A reliable, and often cited, indicator of recession is an inverted yield curve, in which the yield on a two-year government bond is higher than its ten-year equivalent. The US yield curve is currently the most inverted since 1984.

US 10-Year Yield Minus 2-Year Yield

Shaded Areas Represent Recessions



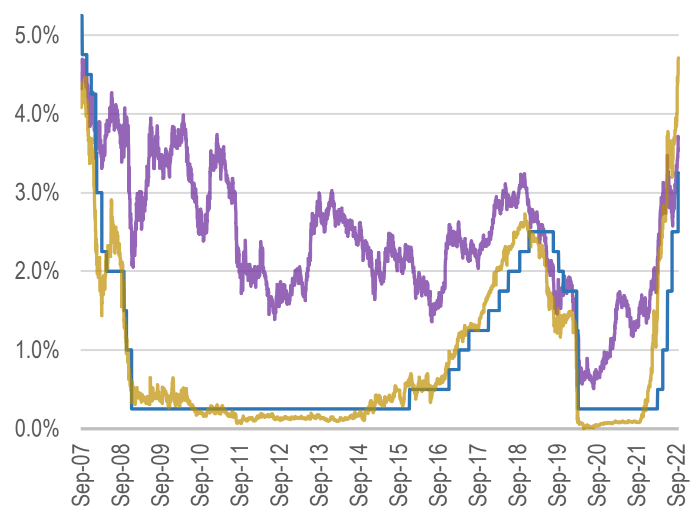
We expect the Federal Reserve to continue lifting interest rates until their target rate approaches 4.5-5.0%. This is a graph of the Fed's target rate, in blue, the yield on the US government ten-year bond, in purple, and the forward rate swap expectations in gold. We do not believe a terminal rate close to our expectations and the swap rate, as currently trading, is fully priced into the equity or fixed income markets.

Global economies are also reacting in concert with the US central bank. For the first time since the Financial Crisis the yields on five- and ten-year treasuries are above 4.0% and 3.7% respectively. Yields on two- and five-year treasuries rose by more than three standard deviations last week alone, using a five-year look-back. In the UK, yields rose by 10 standard deviations last week.

While the pain of higher interest rates hits US consumers in a noticeable manner, higher rates in Europe are particularly painful. Since the Credit Crisis, many European economies have benefitted from negative interest rates. Those days are increasingly a fleeting memory, and economies that have built their financial systems on negative interest rate expectations will now feel the pain of higher interest rates more acutely than others.

Fed Target (Blue), 10-Year Yield (Purple), and Swap Rate (Gold)

All Data in Percent



It is instructive to notice the steepness of the curves in the graph. Criticism that the Fed is not doing enough ignore the fact that the slope of current rate increases is the steepest in US economic history. At long last the Fed is no longer sitting on their hands and the Fed's dramatic moves are definitely going to break something.

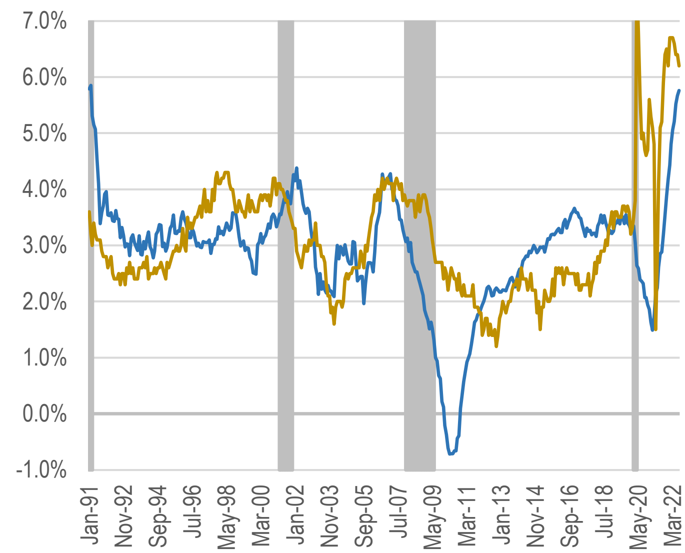
As US interest rates surge, demand for US government and corporate fixed income paper is rising, pushing the dollar higher. In response, Japan is intervening in their financial markets to prop up the yen. The UK government, acknowledging their economy is already in recession, announced a set of debt-funded stimulus that sent sterling to a 37-year low. The US and UK are among 16 countries that hiked rates over the past week. China and Turkey are among few countries that are responding to very real economic softness by being more accommodative.

Rental inflation is close to topping out after rising by 6% over the twelve-month period ending in July. The problem is that rents are upward sticky, meaning that rental rates are not likely to fall quickly. The stickier the big-ticket inflation drivers are, the harder the Fed will have to hammer the labor market to get them in line.

In the graph below the gold line is the annual inflation rate for wages, which have clearly bent and are now starting to soften a bit, although still well above the Fed's target of 2%. Rental inflation, the blue line shows no sign of moderating. Housing makes up approximately 33% of the CPI basket and fully 40% of the CPI core basket. Without a meaningful decline in both wages and housing, core inflation will warrant keeping rates higher for longer.

Fed Target (Blue), 10-Year Yield (Purple), and Swap Rate (Gold)

All Data in Percent



During the pandemic, prices for elements that have a smaller weighting in headline and core CPI played an outsized role in pushing up inflation because of their extreme moves. For example, as semiconductor shortages stopped production of new cars, demand for used cars pushed prices up by 87%. Now that new car inventory is rising, used car prices have been falling. From their peak in February, used car prices have fallen -12.9%.

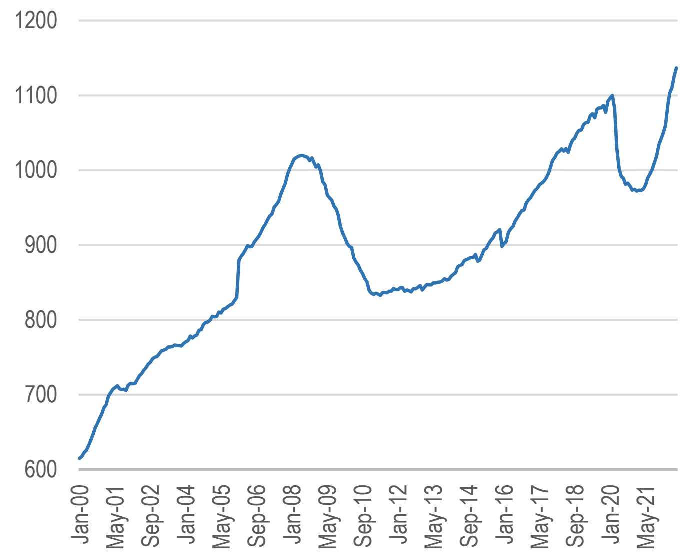
Something similar is happening to commodities. Having risen 83.4% from their pandemic bottom to their mid-2022 peak. Commodities, writ large, are -13.0% lower as of Friday's close.

A common contributing cause of recession is over-extended consumers. Consumer credit balances increased at a record pace in 2022, although as a percent of disposable income, interest expense is still relatively low. However, four of the largest increases in US consumer credit have come in 2022, with increases in consumer credit rising by an average of $33.1 billion per month over the last six months. The monthly average in pre-pandemic 2019 was an increase of $15.4 billion.

Revolving credit, mostly credit card debt, fell dramatically during the pandemic as consumers took the opportunity to use government stimulus payments to pay down their balances. Even though interest rates are higher now, credit card balances don't seem to portend a future cataclysm.

Revolving Credit

All Data in US Dollars, Millions



While revolving credit is often the primary indicator in consumer constraining debt loads, this time is different. Non-revolving consumer credit includes education, automobiles, recreational vehicles, and boats, among other miscellaneous items. This category was also hit by the pandemic but in a very different way than revolving debt.

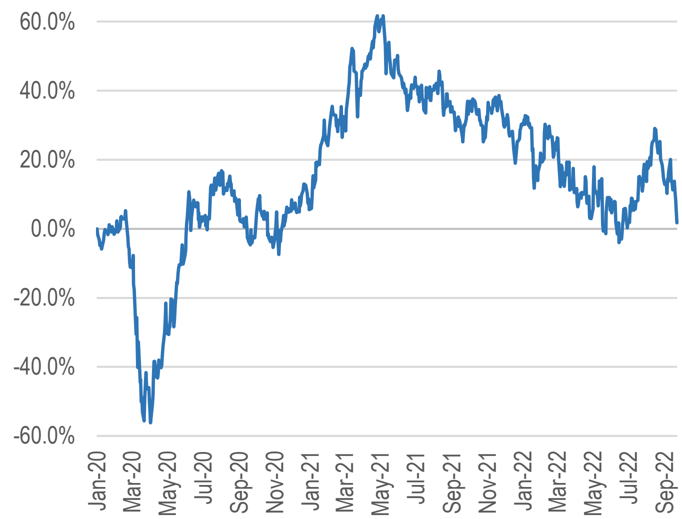
When the pandemic burst on the world, social distancing became a thing, which pushed leisure travelers and revelers into family cars, RVs and boats. Prices for such social distancing accoutrement products skyrocketed, shortages were prevalent, and margins for manufacturers expanded. Today, any casual observer will find RV trailer lots full to overflowing, although motorized RV demand still outstrips supply as semiconductor shortages persist. Boat ownership skyrocketed during the pandemic but has now returned to normal.

Used car dealerships dot the landscape, taking over stray parking lots around the landscape. Most of these products were purchased at abnormally high prices with debt. As the market value of these products come back down to earth, owners and lenders will be faced with upside down loans. As interest rates double their pandemic levels for such acquisitions, a buyer strike is happening.

The Russell 3000 RV and Boat Index has made a complete round trip to its pre-pandemic levels. Many other sectors find themselves in a similar situation.

Russell 3000 RV and Boat Index Return

January 2, 2020 - September 23, 2022



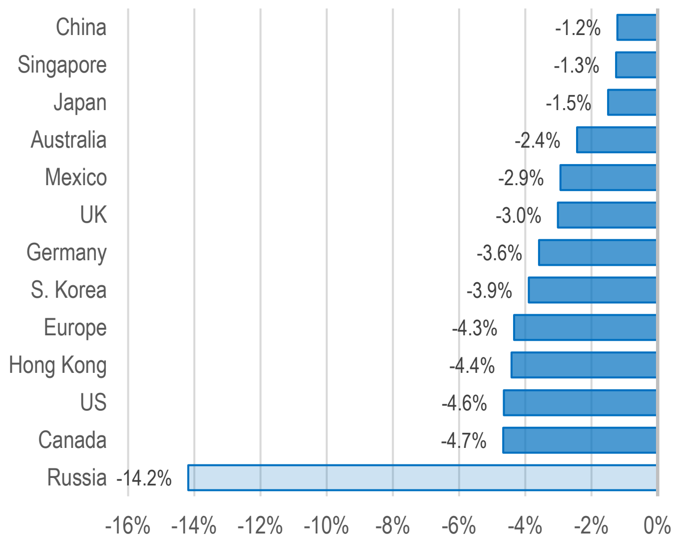
Countries

Russia was the poorest performer on the week-but we do not consider the country investable. The country's passive-aggressive approach to almost all other nations, in the midst of invading Ukraine, continues to have other nations, especially those on its borders, on edge, and rightfully so. However, as we have noted many times before in the weekender, the kumbaya of globalization that seemed cemented with the opening of China and the fall of the Berlin Wall is quickly coming to an end. Brexit seemed to have been a pivotal moment in the new, new-world order. And recent right leaning election results in the UK and Europe confirm the trend, suggesting the ideological pendulum is accelerating away from liberalism and toward nationalism.

On the week, countries with tight monetary policies fared worse than those that were leaning toward accommodation.

Country Returns

September 19 - 23, 2022

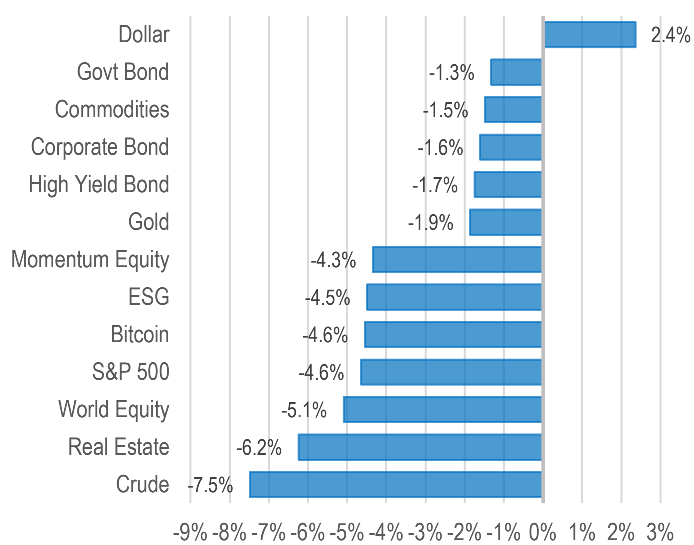


Instruments

Among broad investment instruments, the dollar was the best performer while crude oil was the worst. Dollar strength is beginning to be a concern. A stronger dollar will reduce the value of corporate profits earned abroad. It also makes exports from the US less attractive. From an optical perspective, the US dollar cross with the Euro and

Instrument Returns

September 19 - 23, 2022

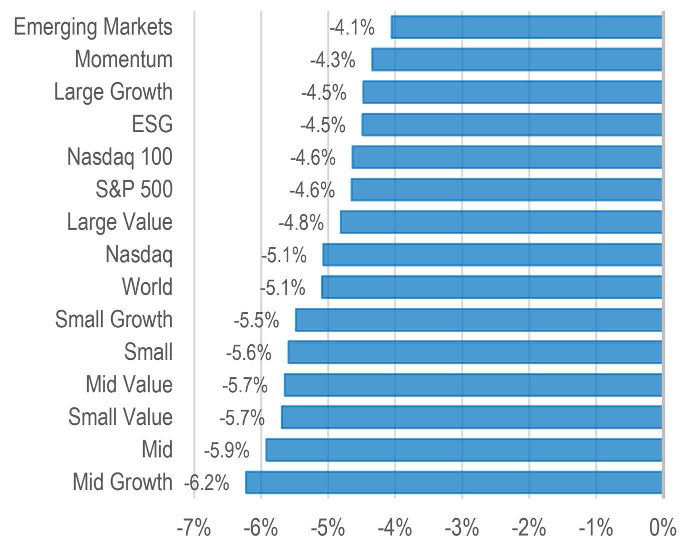


the British pound are close to parity. Truly amazing.

Commodities, in general, and crude oil, in particular, are suffering from a loss of investor confidence. Certainly, a looming recession would have a deteriorating impact of demand. Markets are anticipating this eventualit

Equity Instrument Returns

September 19 - 23, 2022



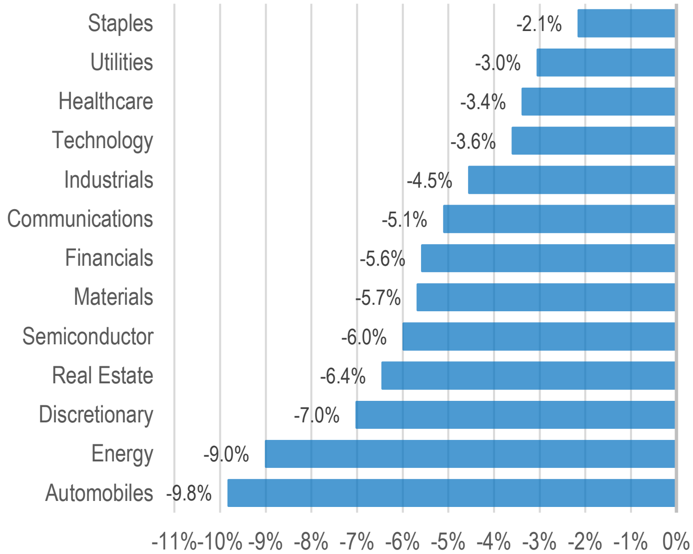
Among equity categories, there were no prevailing trends. Last week was more of a general bloodletting. For the year, value continues to beat growth, but the degree of outperformance is tighter than before.

Sectors

Among sectors, staples and utilities provided a modest amount of protective cover. Energy was down on the back of lower crude prices. Automobiles were the poorest performing sector after Ford announced that it was experiencing a shortage of blue oval Ford nameplates for its cars. Supply shortages continue to persist much longer than we expected. This phenomenon, combined with a rise in nationalism and general discord among nations, will push companies to re-think their global supply chains.

Sector Returns

September 19 - 23, 2022

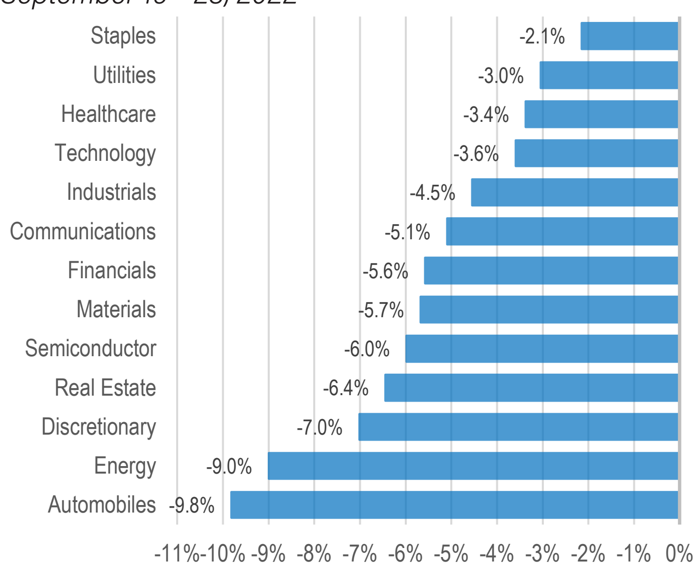


Themes

Another risk off week was characteristically bad for theme-related investments, but they fared better than expected given the degree of general market weakness.

Theme Returns

September 19 - 23, 2022



Conclusion

That's it for this weekender. Next week we will publish our House View. Have a wonderful week.