Let the Bending Begin

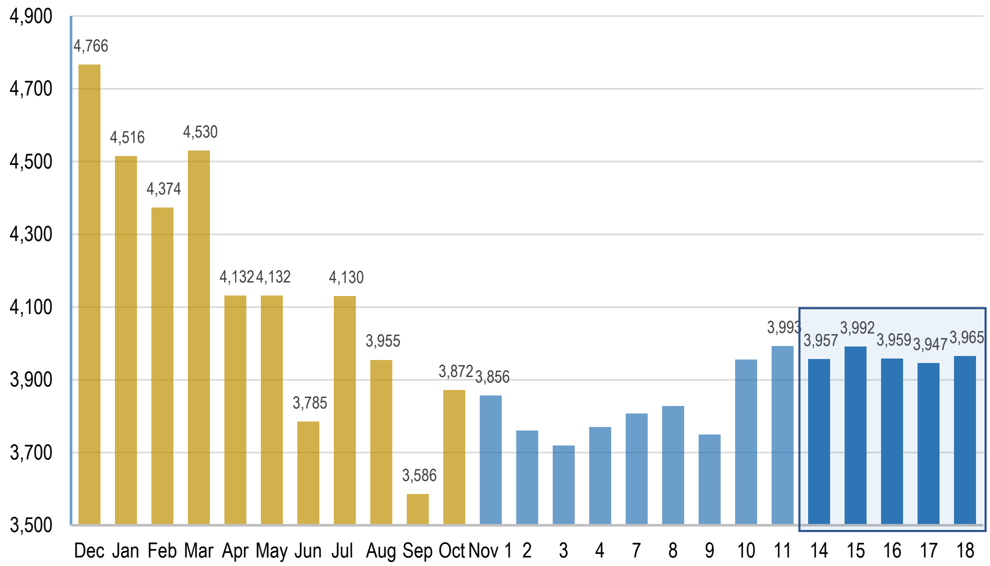
Weekender

November 19, 2022

Good morning and welcome to the *Weekender* for Saturday, November 18, 2022. US equity markets didn't do much this week. As measured by the S&P 500, they were lower by -0.69%. Mostly flat. However, despite the relative calm, a lot of market and economic data was released that is worth considering. Inflation data at the producer level, PPI, showed a similar decline to the previous week's consumer data. Economic softness is becoming wider spread suggesting the extreme softness, already taking over the United Kingdom and Europe, is making its way to the United States and Asia.

S&P 500 Month-End Levels

December 2021 - November 18, 2022



While price inflation in most areas is coming down from peak levels, inflation is still more than three times the Federal Reserve's target level of 2%. We believe the Fed will continue to raise rates, although in smaller steps, until the first quarter of 2023 when they will pause to survey the economic damage wrought by their actions. In some areas, like real estate, we expect the damage to be deep and poignant. Other interest rate-sensitive areas will decay more slowly and recover more quickly.

Despite the Federal Reserve's dramatic interest rate moves, the labor market refuses to budge. It remains strong, consistent, and remarkably tight. While the cadence of corporate layoff announcements has certainly

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increased over the past few weeks, in general, jobs remain plentiful if not a little harder to find and secure.

Corporate earnings reports continue to meet diminished expectations while forward-looking expectations are being ratcheted lower.

Over the next three weeks we will cobble together what we believe will constitute the dominant economic and market narrative for next year. It will be published as our *December House View* on December 16, 2022.

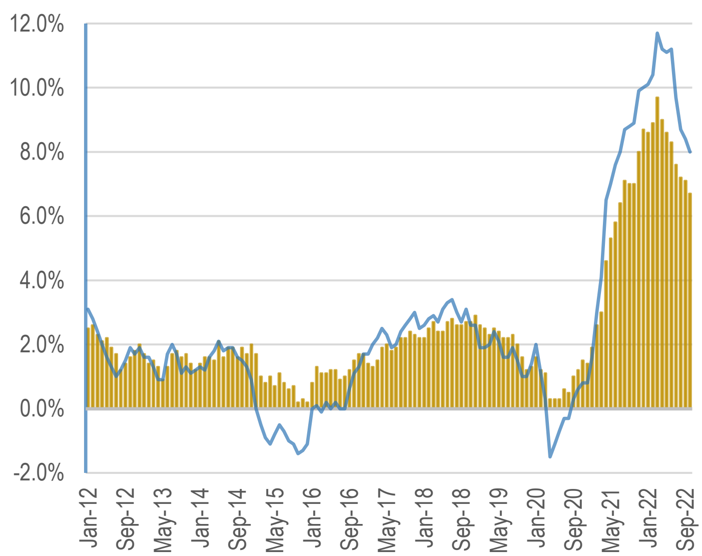
In this *Weekender* we will wax forth on recent inflation trends combined with some anecdotal observations from recent company earnings releases.

Market Narrative

Following on welcome consumer inflation data released two weeks ago, producer price index (PPI) data for the month of October printed this week with half the expected increase. The lower-than-expected headline PPI data (blue line) was repeated in the core PPI (gold bars), which takes out food and energy. Data confirm that producer inflation is no longer accelerating. However, when compared to last year, producer inflation remains much higher than acceptable although it's moving in the right direction.

Headline PPI (Blue) and Core (Gold)

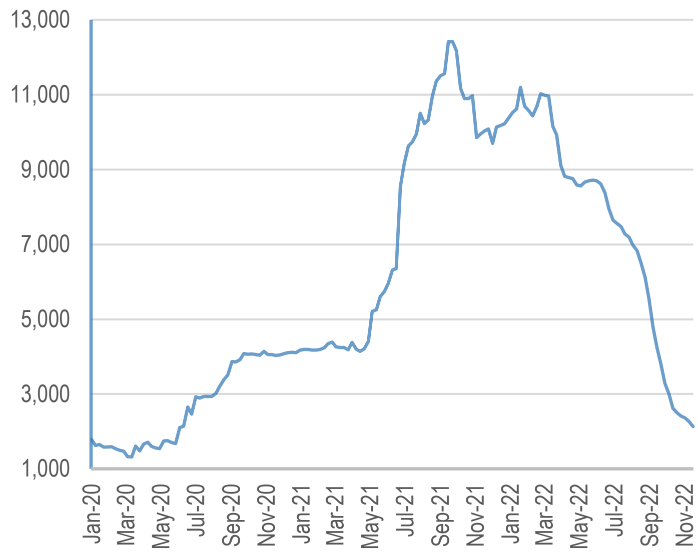
January 2012 - October 2022



Import price inflation, when petroleum is taken out, fell month over month. On a year-over-year basis, import prices, rose by 4.2%, which is considerably lower than September's import inflation reading of 6.0%. Import price softening comes, to some degree, from dramatically lower container shipping costs. The cost of shipping a forty-foot container from Shanghai to Los Angeles is very close to its pre-pandemic level. Congestion at Long Beach and Los Angeles has eased by -21% compared to last year. This is partly due to an increase in shipping to East Coast terminals instead of the West. The remaining decline comes from a drop in US orders for imported products.

Shanghai to Los Angeles Shipping Cost

January 2, 2020 - November 17, 2022

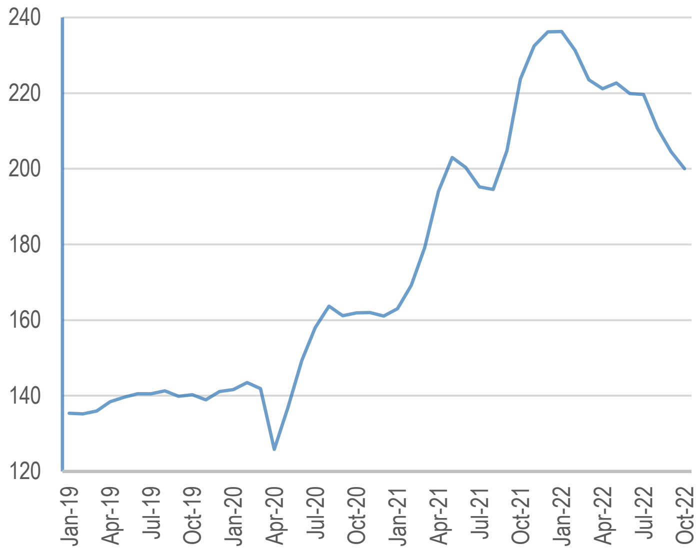


Fresh off pandemic shutdowns, working from home, and online education, consumers took to the skies last summer and splurged on high-end travel. Now that everyone is back, air and hotel bookings are falling. On softer demand, prices for air fares have come off significantly from their peak, approaching their pre-pandemic levels.

One of the most powerful drivers of pandemic inflation has been used car prices. Semiconductor shortages brought new car production to a standstill during the pandemic pushing used car prices significantly higher. As semiconductor shortages ease and new car production picks up, used car prices are beginning to fall. Looking forward a little, by the end of December year-over-year used car price comparisons will be negative, providing a powerful reversal to price pressures as measured by the US consumer price index (CPI).

Manheim Used Car Index

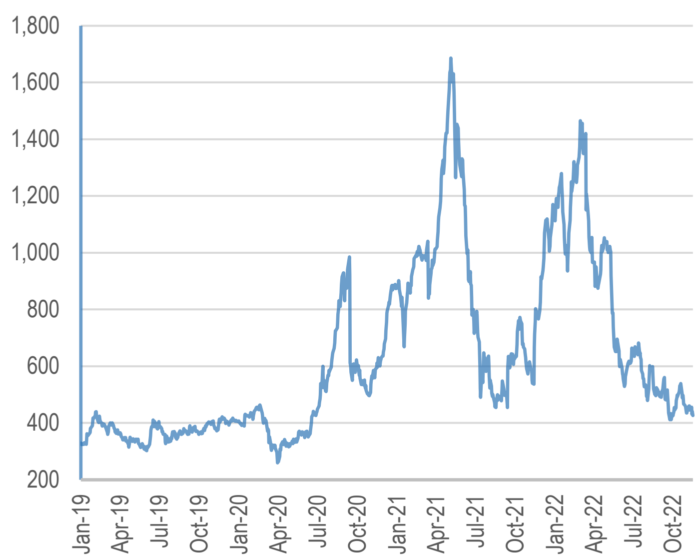
January 2019 - October 2022



Another pandemic poster child is lumber prices which rose from $400 per one-hundred board foot to $1,686 at the peak in May of 2021. As the graph shows, prices have made a full round trip.

Lumber per 100 Board Feet

January 2, 2019 - November 17, 2022



The national price for a gallon of gasoline has come down significantly from its pandemic high of $5.02 per gallon in June of this year to $3.64, a drop of -27.5%. If the trend continues, consumers will be relieved and so will the Fed. Now that President Biden has effectively absolved Saudi's Crown Prince Mohammed bin Salman of ordering the brutal killing, dismembering, and dumping of detractor Jamal Khashoggi's body parts, perhaps the Saudis will stop pushing OPEC+ to reach for the stars on oil prices. Oil prices will continue to reflect manipulated supply conditions but are likely to remain within the range of $65 – $90 per barrel. Now that we have caved on our principles maybe the Saudis will do the same.

Gasoline Prices

January 2, 2019 - November 18, 2022

The take home message from the litany of price graphs is that inflation is bending, almost everywhere. Within six months year-over-year price comparisons are likely to be much more stimulative than they are at present. This, combined with economic softness will put the Fed on its heels.

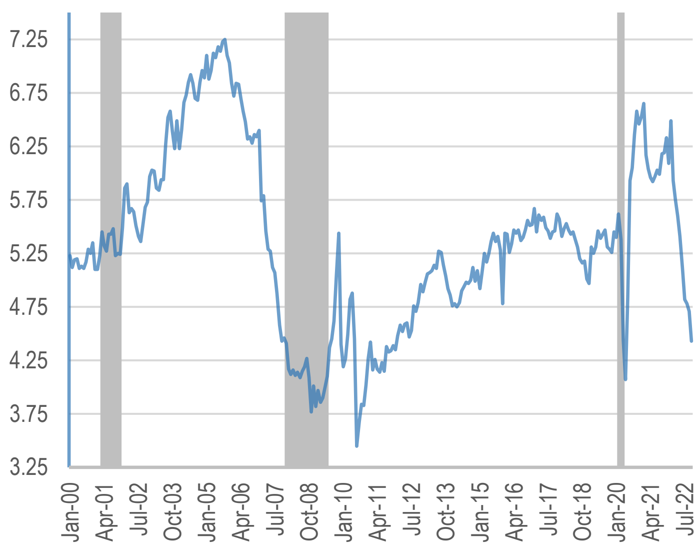
An index of leading economic indicators released on Friday confirmed a growing consensus that the US economy is on the verge of contraction which is itself disinflationary. All in, we expect inflation to continue to soften. Not necessarily in a straight line down but the general trend will be to lower and lower price increases. Expect the Fed to continue raising rates for a few months.

One of the most powerful manifestations of higher rates comes from the residential real estate market. With mortgage rates now close to 7%, mortgage applications have ground down to levels not seen since the beginning of the century.

The unsurprising result of higher mortgage rates is a record plunge in the sale of existing homes, which accounts for approximately 80% of all homes sold.

US Existing Home Sales

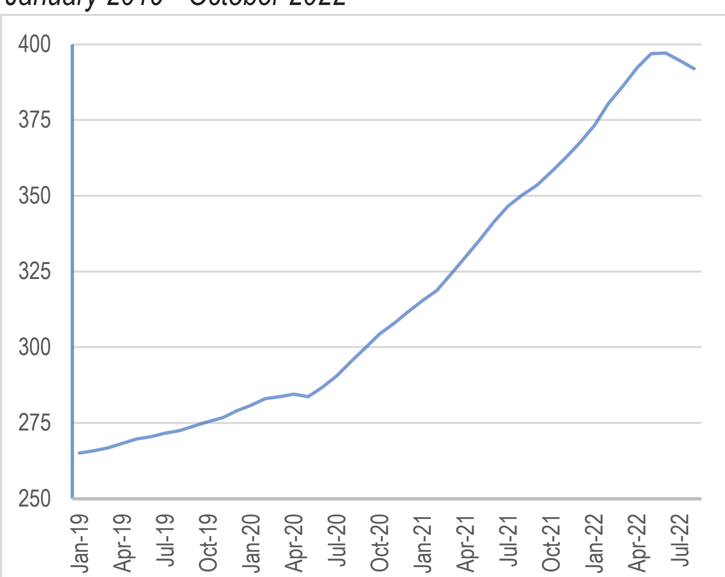
January 2000 - October 2022



Fewer mortgages and fewer sales is even bending housing prices. Although they are still well higher than their pre-pandemic levels, prices are beginning to fall.

House Price Index

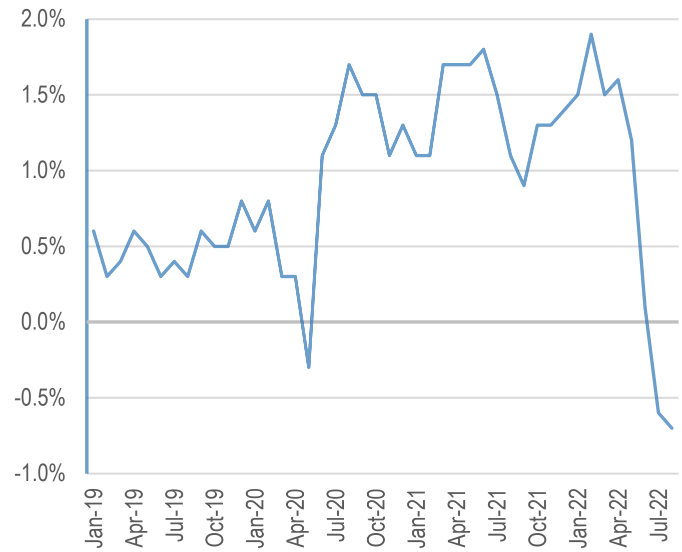
January 2019 - October 2022



In fact, when the percentage price change is considered, the drop in house prices is remarkable. Rental prices are next.

House Price Index, Percent Change

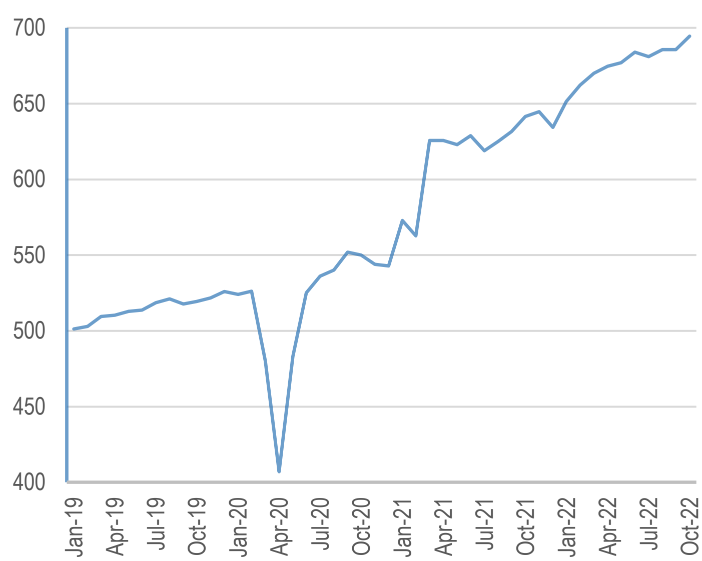
January 2019 - October 2022



As inflation softens, consumers will feel the benefits. Lower gasoline prices provide an interesting anecdotal insight. As gasoline prices fall, consumers don't save the excess. They spend it. And they have been spending it. However, because wage increases are trailing inflation, consumers have been dipping deeper into their savings and racking up credit card debt to keep their pandemic standard of living intact.

US Retail Sales

January 2019 - October 2022

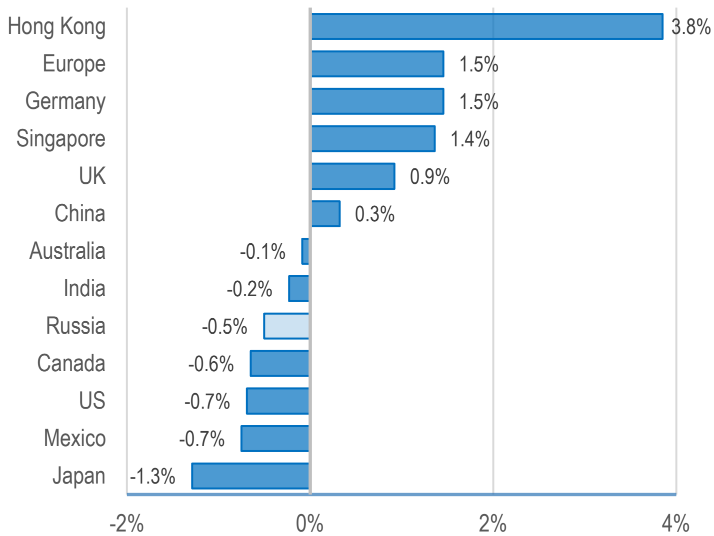


Countries

For almost a month, Hong Kong has been the best performing equity market. It continued the streak this week. For market and economic news, we are entering a relatively quiet period. Most companies have reported third quarter earnings and market moving economic data for the month of October is mostly out. In the United States, the holiday season begins next week, which usually begets what is euphemistically called a Santa Claus rally through the end of the year.

Country Returns

November 14 - 18, 2022

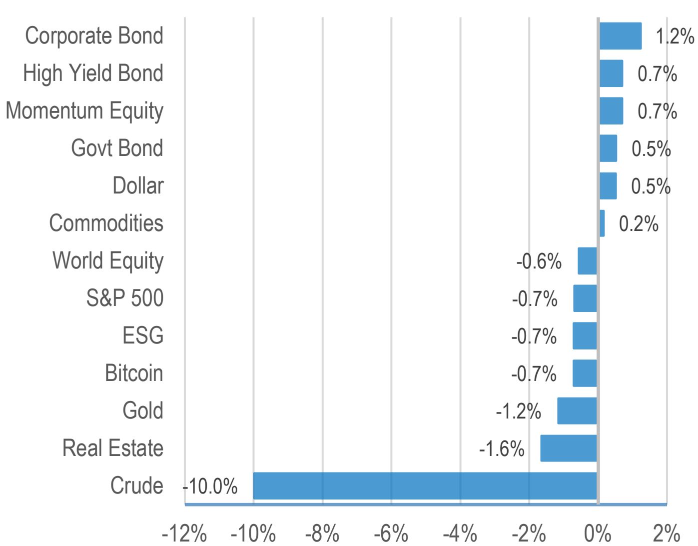


Instruments

Crude oil was the worst performing investment instrument last week. Now that economic softness is consensus, portfolio managers are trying to gauge how much demand destruction will result. It's anyone's guess. Without a deteriorating labor market, demand destruction is likely to be light.

Instrument Returns

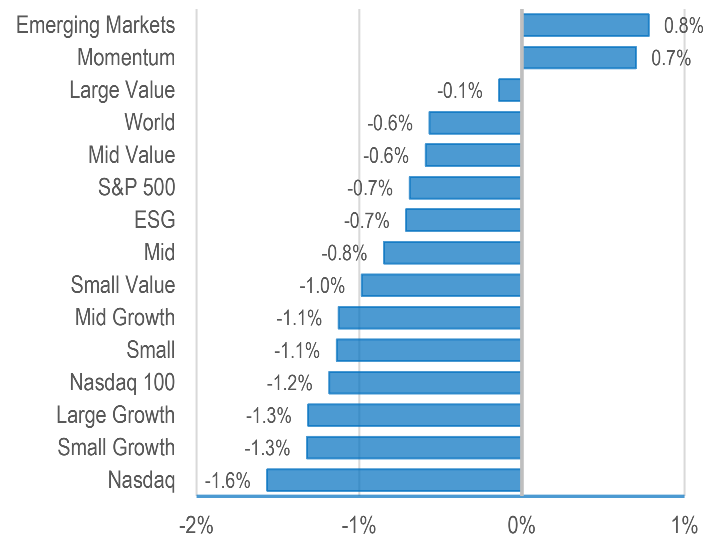
November 14 - 18, 2022



Emerging markets were higher on a softer dollar. Momentum was also higher in a return to risk. Technology continued to underperform as the majority of tech companies report diminished future earnings expectations.

Equity Instrument Returns

November 14 - 18, 2022

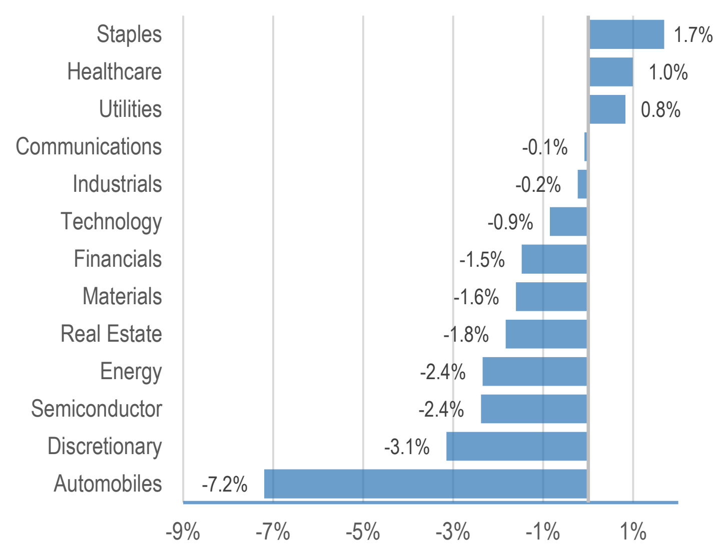


Sectors

Broad equity markets were only mildly lower on the week, but sector returns showed a noticeable preference toward the protective side with staples, healthcare, and utilities higher and risk sectors lower. The automobile industry group was the poorest performer on the week thanks to Elon Musk's Twitter tantrums and the knock-on impact on Tesla.

Sector Returns

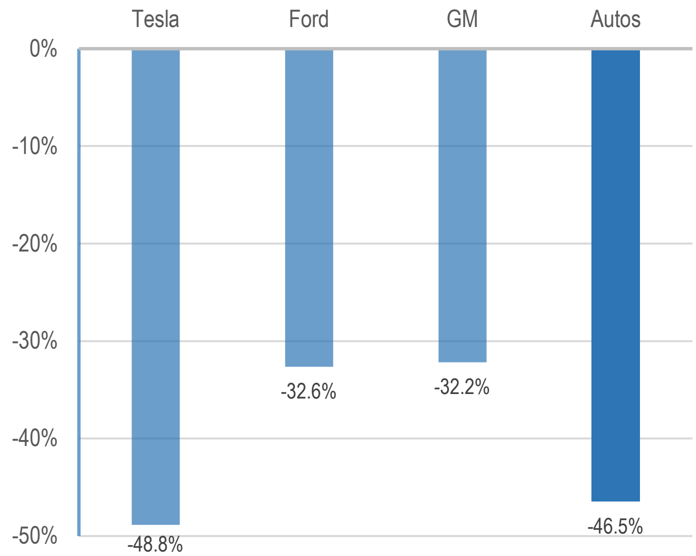
November 14 - 18, 2022



The automobile industry sub-group includes Tesla, Ford and General Motors. The group's index performance is weighted by equity market capitalization, which means Tesla has an 83% weight and the other two are about 8.3% each. Whatever happens to Tesla reflects heavily on the Automobile sub-group.

S&P 500 Autos, Year-to-Date Returns

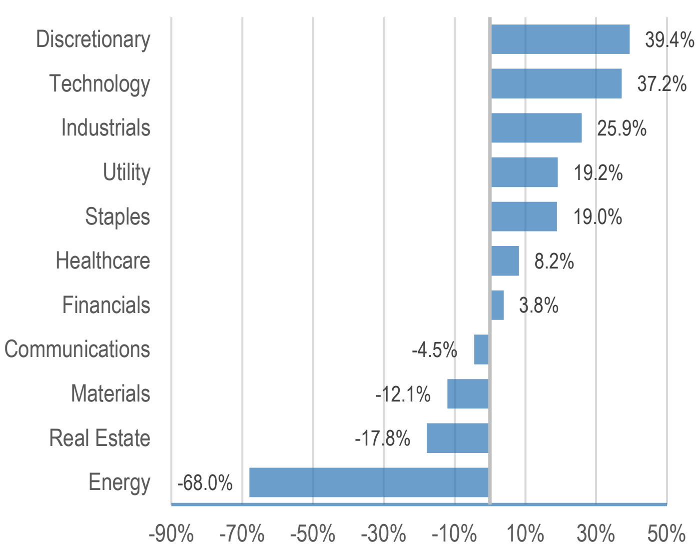
January 2 - November 18, 2022



Despite drops from their highs at the beginning of the year, most sectors are not a bargain compared to their historical levels. Some sector bargains that do exist include energy, real estate, communication services, materials, and heathcare. Despite a remarkable rally this year, energy is the cheapest sector. After the tech selloff that has bludgeoned most sector members throughout the year, communications services, is now inexpensive with a PE ratio of 14.9x compared to its pre-pandemic, post-internet bubble average of 15.6x. Communication's modest discount is relatively unremarkable when compared to almost a seventy percent discount for energy.

S&P 500 Sector PE Premium

Compared to Post Crisis to Pre-Pandemic Averages



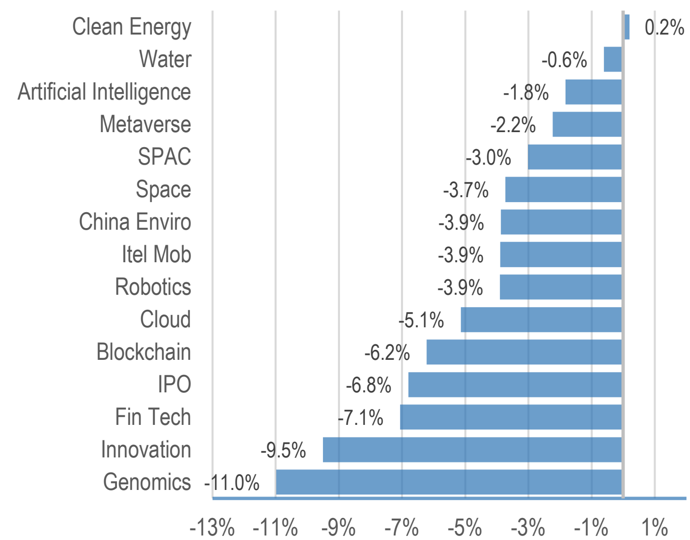
Protection from market downside, remains expensive as illustrated by their premia to historical averages. Sectors are broad categories and within sectors are more discriminating industry groups which, each, have unique operating characteristics and valuation parameters. We are currently engaged in a white paper on sector investing, scheduled for release in late December, that provides a targeted strategy for making sector asset allocation decisions.

Themes

Almost all sectors were lower. Nothing new here.

Theme Returns

November 14 - 18, 2022



Conclusion

That's it for this *Weekender*. Next week is a holiday weekend. We will have a *Weekender* but it will be primarily philosophical in nature.