November House View

Weekender

November 12, 2022

Good morning and welcome to the *Weekender* for Saturday, November 12, 2022. This *Weekender* serves as a summary of our monthly *House View.* The *House View* is designed to provide a recap of general investment and economic trends.

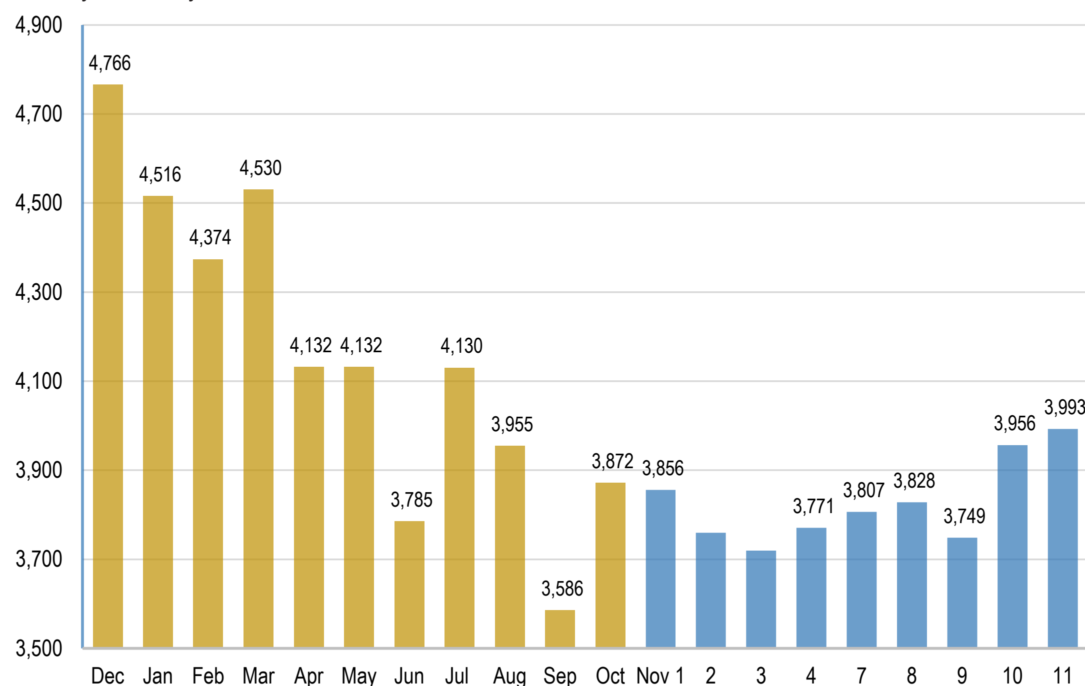
Since January 1, 2000, the S&P 500 produced an annual return of 6.5%, including dividends. From its high at the beginning of 2022, the S&P 500 has fallen by -16.2%. Despite this year's fall, the S&P 500 is still higher by 29.2% from when measured from the beginning of the pandemic on January 1, 2020, generating an equivalent annual return of 10.3%, well above the annual return generated by the index since the beginning of the century.

Despite pandemic-related volatility, the basic principle of buying into markets as they fall and holding on through uncertainty remains in play and is paying back handsomely. Warren Buffet's advice to be greedy when others are fearful and fearful when others are greedy remains a phrase to invest by.

Over the last week, US equity markets, as measured by the S&P 500, were higher by 5.9%. Following release of inflation data that showed an undisputed bend in the price curve, markets likely overtraded the death of inflation staging powerfrul gains on Thursday and Friday. We believe inflationary price increases for goods and services are on a concerted path southward. This will enable the Fed to slow its rate increases and begin planning for a pause. This idea was fuel for equity and debt markets last week.

Standard and Poor's 500 Index

Monthly and Daily Levels

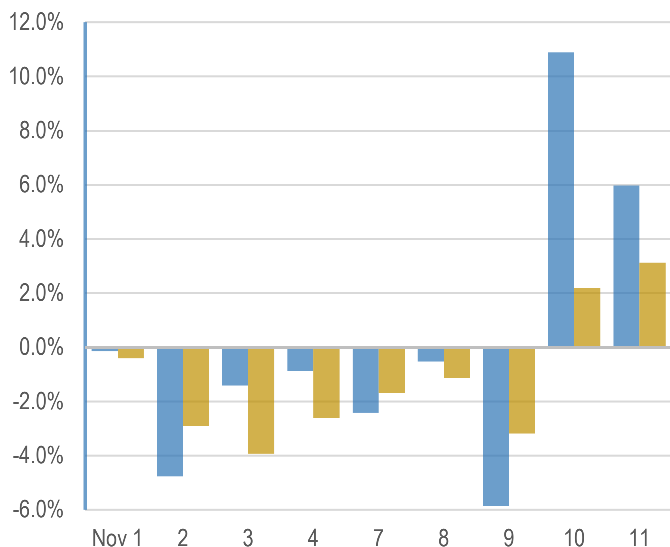


The detritus of any war, even a war on inflation, lines and defines the path of recovery. Thursday's release of Consumer Price Index (CPI) data suggested that the tide in the short war on inflation is shifting. This week the excitement of a looming inflationary détente overshadowed the heavy lifting remaining for the economy. It seems likely that peak Fed hawkishness is at an end. A plausible terminal Fed rate, the point at which a pause may occur, is now at or below 5%. With the policy rate currently set at 4%, the end of rate increases seems visible on the horizon.

Last week's equity trading was defined by a shift from the old guard to the riskiest names that had been shorted the most. In the graph below, the blue bars are the daily returns of a Goldman Sachs created basket of the most shorted stocks in the S&P 500. The gold bars are the daily returns of the S&P 500. Notice the incredible gains of the most shorted stocks after the CPI data was released on Thursday (10 November) morning.

Most Shorted (Blue) and S&P 500 (Gold)

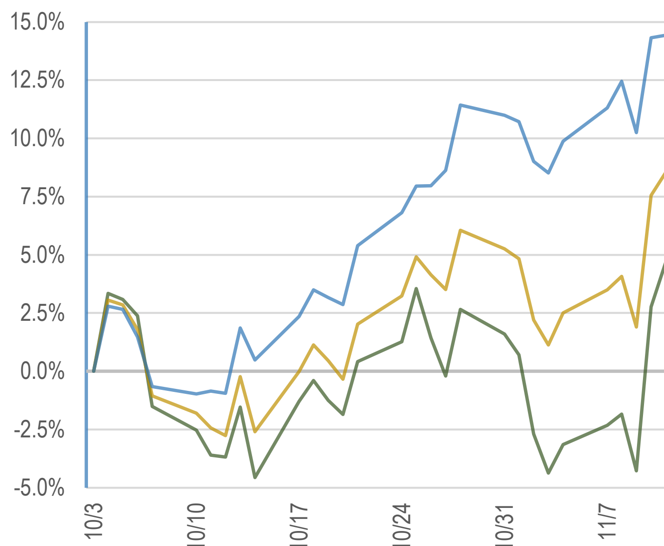
Daily Percent Gains, November 1 - 11, 2022



As equity markets have melted up through most of the month of October, index leadership has been somewhat atypical. The Dow Jones Industrial index, created in 1896 as a technology index tracking railroads, the newest technology if its day, has lead for the whole month of October, the blue line, with a stunning 14.4%. The S&P 500 index (gold) is in second with an October return of 8.5% while the tech-heavy Nasdaq (green) is bringing up the rear with a 4.7% return.

Dow (Blue), S&P 500 (Gold), and Nasdaq (Green)

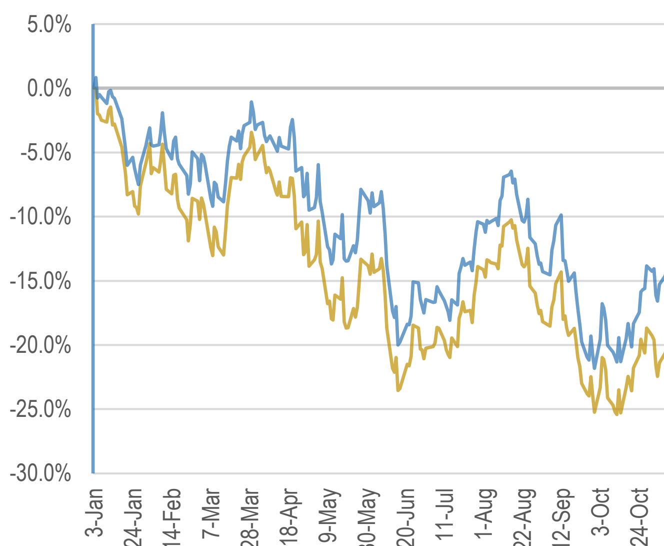
Cumulative Percent Gains, November 3 - 11, 2022



Stocks that led markets over the past decade, Apple, Microsoft, Amazon, Alphabet, and Meta, have lost a combined $3 trillion in market value over the course of the year while slowing revenue growth and higher interest rates eroded their lofty valuations. Their combined weight in the S&P 500 has fallen from 24% at this point last year to 19% on Friday, even after last weeks remarkable rise. Adjustments in market leadership and weight have pushed the Equal Weight S&P 500 to overtake the Traditional Market Value Weighted S&P 500.

S&P 500 Equal (Blue) versus Market Weight (Gold)

Cumulative Percent Gains, January 1 - November 11, 2022

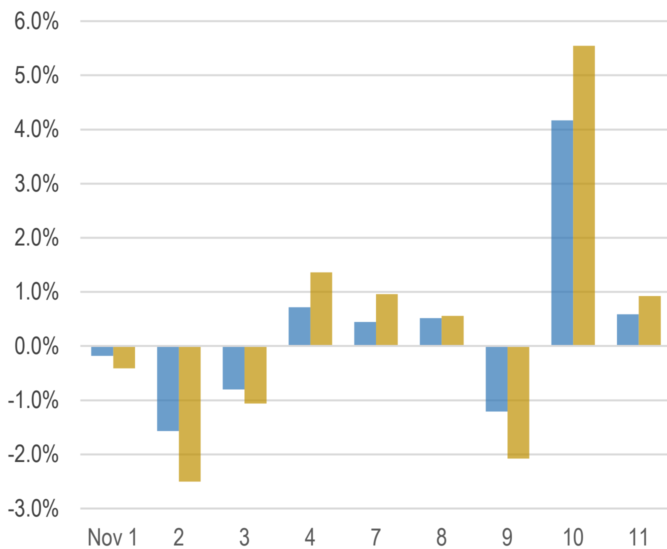


In the higher interest rate environment, bonds have retaken their historical role of providing risk moderating protection in a mixed instrument portfolio. That's significant. Since the Credit Crisis, bonds yielded their protective role. The blue bars are the daily returns of a 60% equity and 40% bond portfolio. On down days bonds buffered the

down-side. When equities rose, they softened the gains. We believe bonds will, once again, prove to be a useful investment tool for the next five years.

60 / 40 Portfolio (Blue) and S&P 500 Index (Gold)

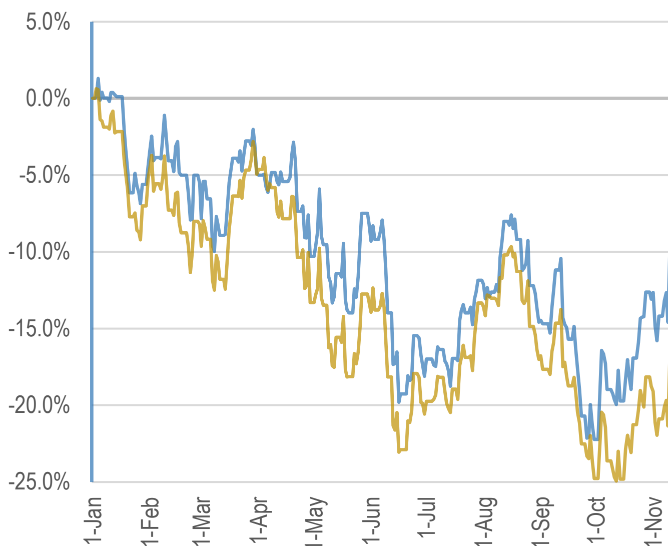
Daily Percent Gains, November 1 - 11, 2022



One last trend that has shifted. For most of the year, the equity returns of companies that are engaged in aggressive buyback programs have been mostly undistinguishable from the broader market. This changed at the beginning of October. Since then, an index of members of the S&P 500 that buyback their shares has dramatically outperformed the S&P 500. Buybacks are lower by -8.6%, the blue line, while the S&P 500 is lower by -16.2, the gold line.

S&P 500 Buyback (Blue) and S&P 500 Index (Gold)

Cumulative Percent Gains, January 1 - November 11, 2022



So where from here? Some obvious countervailing forces must be reconciled. A future prospect of lower inflation and interest rates would certainly be positive for equity and fixed income valuations. Meanwhile, economic softness will lead to lower earnings. Consequently, we believe the most likely investment strategy to outperform is one that includes short-dated fixed income and stocks of companies that grow unit sales and whose products enjoy pricing power driven from a strong balance sheets. These characteristics have been shown to significantly outperform during periods of declining transitioning interest rates and economic softness.

Market Narrative

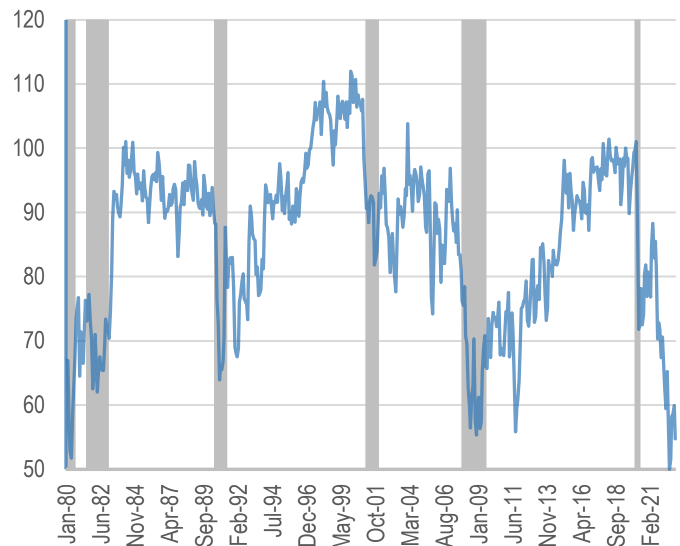
In this Weekender we will refresh our views of the nature and state of elements we believe will drive investment returns in the coming months and years. These elements include: 1. Consumer resilience; 2. Economic recession; 3. Corporate earnings growth; 4. Inflation; and, 5. Interest rates.

Consumer

The University of Michigan's consumer sentiment indicator turned south again and once again hovers near its all-time lows. Oil and gasoline prices have gone back up after a sharp decline. Inflation in most other areas, although slightly lower, remains painfully high and wage increases are not matching price increases.

University of Michigan Consumer Sentiment

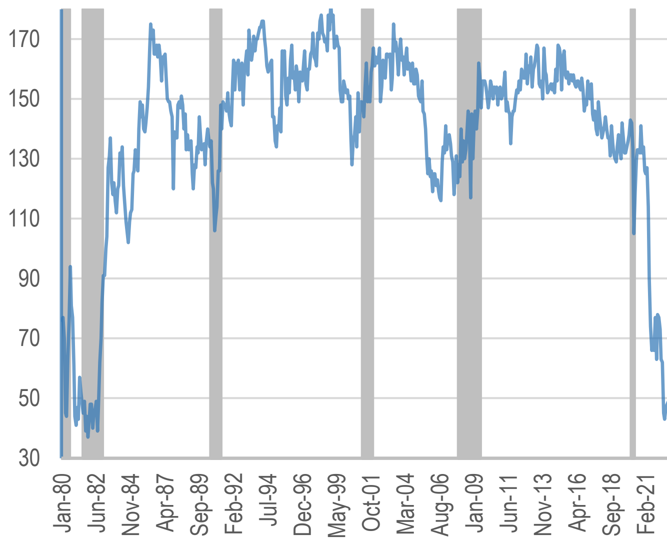
January 1980 - November 2022



In addition to tracking the general sentiment of US consumers, the University of Michigan's indicator also surveys a number of components that make up the broader indicators. Consumers were surveyed as to whether the current environment presented a good environment to purchase a home. The survey result was the lowest in a generation. Approximately 34% of survey respondents cited high interest rates as a primary reason for believing that now is a bad time to purchase durables, cars, and homes.

Good Time to Buy a House

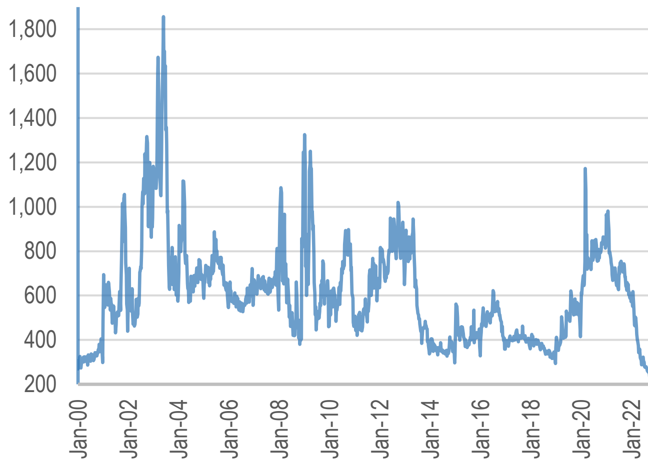
January 1980 - November 2022



Weekly mortgage applications continue to plumb depths not seen since the turn of the century. Thirty year fixed rate mortgages are 6.9% on average which compares poorly against their levels of 3.2% only a year ago. Residential borrowing costs have more than doubled in only twelve months.

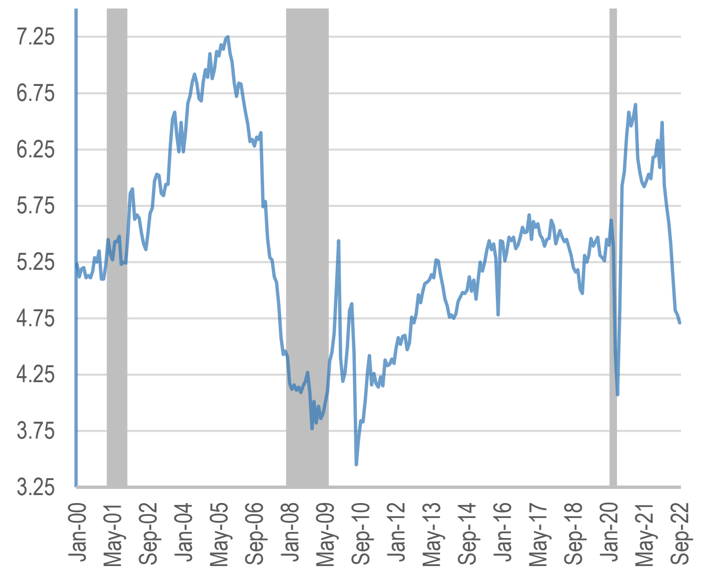
Weekly Mortgage Applications

January 2000 - October 2022



Existing Home Sales

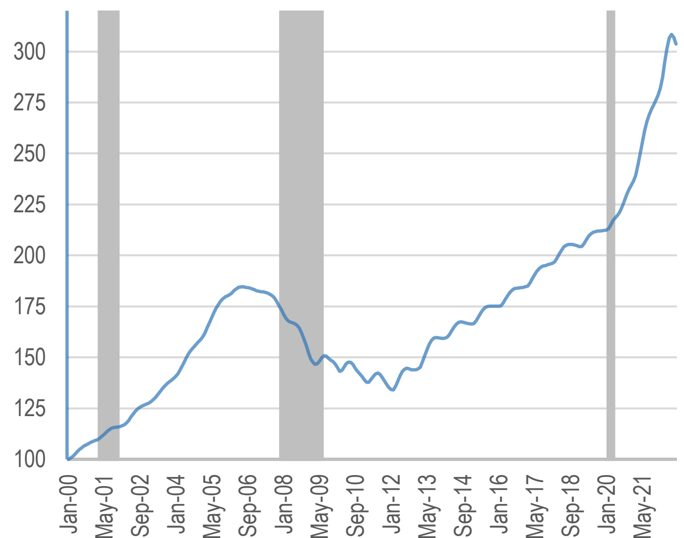
January 2000 - October 2022



Only recently have tighter residential real estate conditions led to a fall in house prices. But the price froth of pandemic demand has a long way to go before affordability is restored. Since the Credit Crisis, a relatively robust residential real estate market has been a primary source of consumer liquidity and wealth. This will not be the case for the next two years at a minimum. Instead, residential real estate is likely to act as a primary consumer constraint as higher prices and rates act as a tax on income and reduce the wealth effect.

Case-Shiller Home Price Index

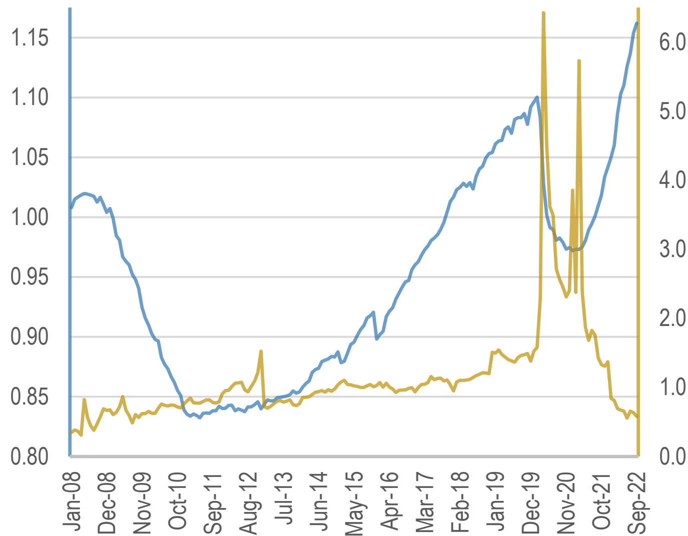
January 2000 - October 2022



Consumers around the world are finding it difficult to adjust to a higher interest rate environment. The result will be slower consumption. Clearly music to the Fed's ears. However, in the mean time, consumers are draining their savings accounts to record levels, the gold line, and adding credit card debt at the fastest rate in history.

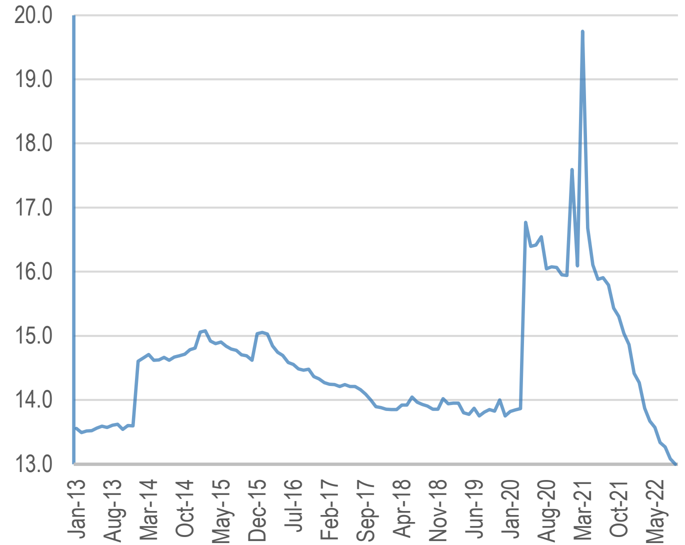
Credit Card Debt (Blue) and Savings (Gold)

January 2008 - October 2022



Real Disposable Income to Credit Card Debt

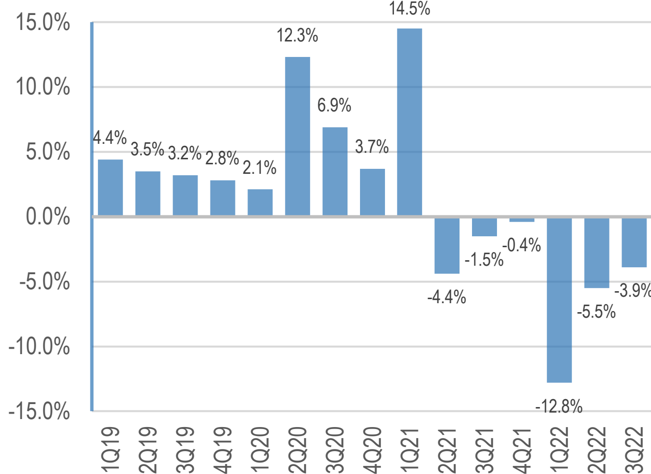
January 2013 - October 2022



Disposable income, when adjusted for inflation continues to be negative, but less negative than previously. As broad inflation falls over the next six months, we expect consumer purchasing power to slowly become positive. Going into the holiday season, we expect consumers to continue to spend freely using credit card balances and egged on by the enticing discounts that are already showing up at almost every retailer, whether online or brick and mortar.

Real Disposable Income Growth

1Q 19 - 3Q 22



We do not believe the US consumer will retrench until they are forced to cut spending and divert resources to debt payments. This usually occurs when the fear of job loss is top of mind. Only recently has the cadence of corporate layoffs increased significantly. The time required for fired employees to find and secure alternate employment has also risen. It is likely the US labor market will soften significantly going into the new year which will compel consumers to pull back.

Recession

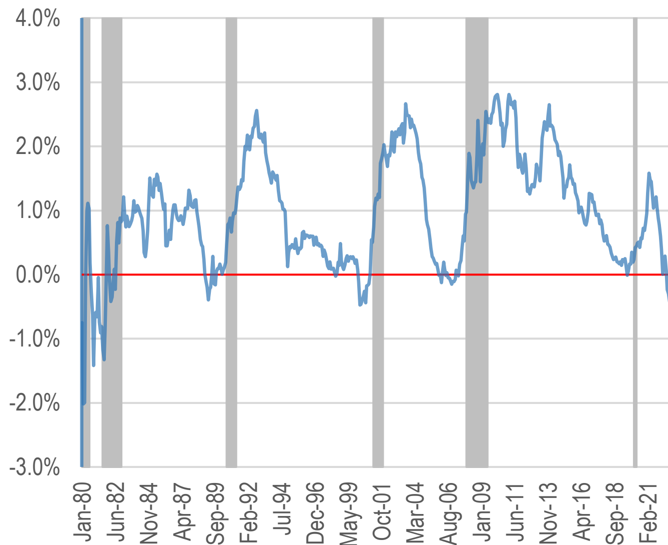
A textbook definition of recession may be "a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters." Most recessions are tied to debt cycles. Increases in consumer debt drive demand for products and services which, in turn, drive prices higher. A period of retrenchment follows where debts are slowly repaid and demand for goods and services falls. Retrenchment drives softening of demand resulting in a shrinking labor market. Fewer jobs means less demand. Demand destruction continues until a new equilibrium is reached.

The Atlanta Federal Reserve tracks current economic data in an attempt to provide a real-time forward-looking view of future US economic performance. The data set is called GDPNow. Its model estimates fourth quarter annualized economic growth of 4.0%, an upgrade from 3.6% previously. The proximate cause is consumer spending which remains robust on the back of higher consumer debt loads.

Despite Fed predictions, the bond market is predicting recession in the near future. An inverted yield curve, where the ten-year bond yield is lower than the three-year yield, is a relatively reliable tell of future recessions. The current inversion is the deepest in a generation.

US Governement 10-Year Minus 3-Year Yield

January 1, 2008 - November 11, 2022



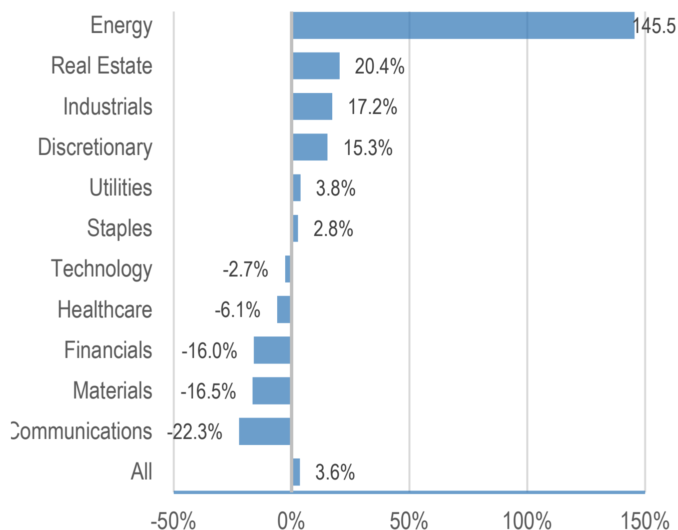
Broad economic data also confirm that a general degree of economic softness, bordering on contraction, is settling on the US economy. Other global economies, particularly in the United Kingdom and Europe, are already in recession. Asian economies, particularly China, are slowing dramatically and their central banks have already begun implementing stimulative policies.

Earnings

As of Friday's close, eighty-five percent of all publicly listed US companies have released third-quarter earnings. Looking at the numbers generally, earnings grew by 3.6%, compared to the same period last year. However, this result is completely warped by profits from the energy sector. The previous graph shows earnings growth by sector. We continue to expect considerable margin compression over the next two quarters, which, combined with softer sales beginning in the first quarter, could push corporate earnings lower by 10-15%.

3Q 22 Earnings

Percent Growth by Sector, Year-Over-Year

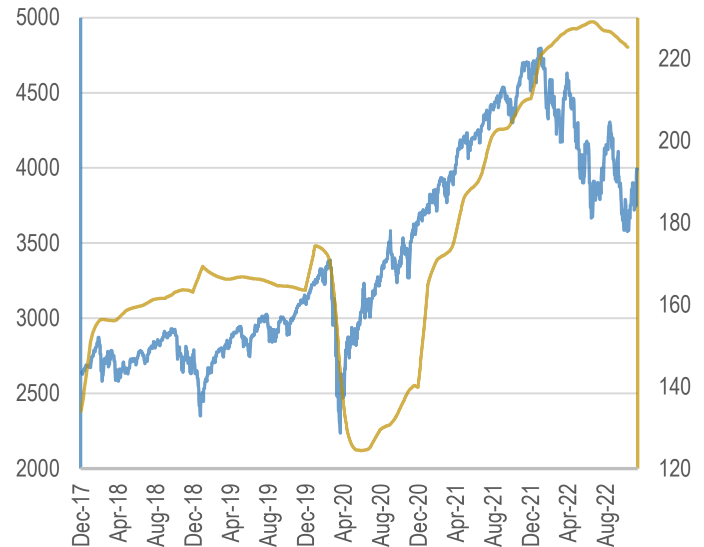


As of Friday's close, the S&P 500 was valued at 18.0 times 2023 earnings estimates. An 18.0x multiple is slightly higher than its ten-year pre-pandemic average. Consequently, any reduction in earnings estimates for 2023 is likely to be met with lower stock prices.

Present global equity prices reflect a change in the macroeconomic inflation and interest rate environment. We do not believe the markets have discounted lower earnings estimates that are likely in a recessionary environment. However, earnings revisions are a function of individual company dynamics and are not generally the province of broad market dynamics.

S&P 500 Earnings (Gold) and Daily Levels (Blue)

Percent Growth by Sector, Year-Over-Year



Inflation

Inflation is bending. The news is not particularly surprising. Headline inflation, at 7.7%, is still much higher than the Federal Reserve's 2.0% target. Core inflation, which removes food and energy fell to 6.3%. Neither of these provide comfort that inflation is where it should be.

Inflation expectations, as measured by the University of Michigan, suggest that inflation will fall to 5.1% over the next year and then settle at 3.0% for the next 5-10 years. If these expectations follow through, both stocks and bonds will thrive.

Interest Rates

Market 10-year government yields are sitting right atop the Fed's target interest rate. This suggests that markets feel a 4-5% yield over the near term may reflect fair value. We expect rates to continue to rise by 0.75-1.0% over the next couple of months at which time we anticipate a pause.

We believe the US economy will enter a shallow recession in early 2023. Earnings are likely to fall, in aggregate, by approximately 8% from current levels. Lack of demand will hurt top line growth with a general erosion of pandem-

ic-era pricing power. Cost push inflation will hollow out income statements resulting in margin compression. Core inflation, which is still heavily impacted by factors that take time to filter though the economy, like owner's equivalent rent, will continue to fall slowly for the next two months and then fall rapidly thereafter. Interest rates will follow inflation's downward path but at a slower cadence, waiting on the Fed to ordain the lower reference levels.

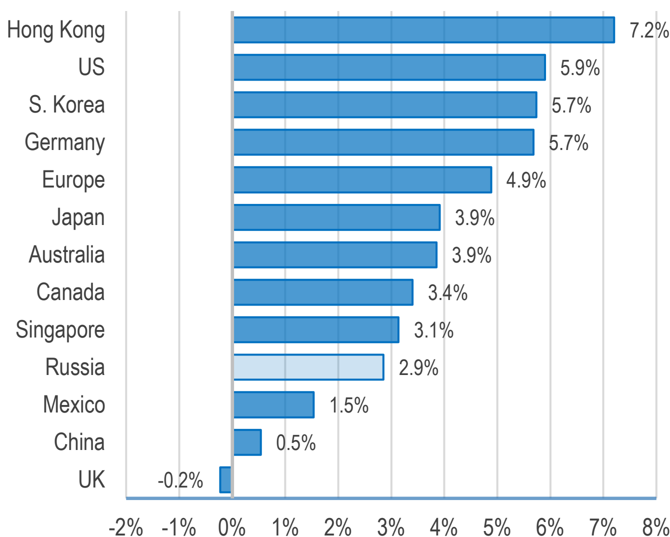
Countries

Last week, Hong Kong was on top the leader board again driven by a flood of foreign investor capital that generally prefers to get access to the Middle Kingdom through the historically safer route of the once British colony. Most other countries were higher in a week that was historic on many levels.

In the United States, the expected red wave in mid-term elections did not materialize. It is increasingly likely that the Democrat party will retain the senate while Republicans are likely to take control of the House of Representatives. With this arrangement in hand, continued dysfunction is a strong possibility which is a positive for financial markets.

Country Returns

November 7 - 11, 2022



Instruments

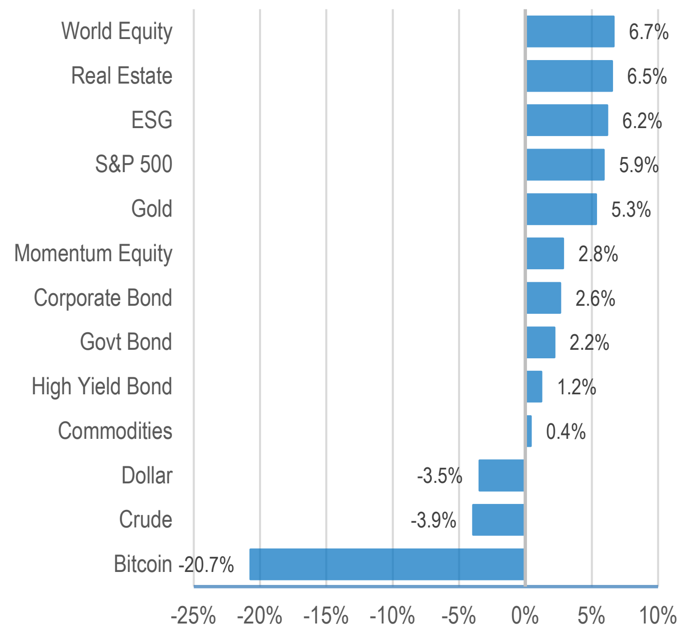
Among investment instruments. The worst performer was bitcoin in the face of another cryptocurrency blow up.

Sam Bankman-Fried was hailed as the next Warren Buffett. As of last week he was no longer a crypto billionaire and the firm he started filed for bankruptcy on Friday. Turns out, distributed ledgers are only as good as those who are responsible for them, watch over them, and keep unwatched animal spirits away from finding ways to exploit those who trust them. Recent crypto implosions and scandals have all but obliterated their potential role as safe havens in times of turbulence. TerraUSD, Celsius, and now FTX are raising concerns about the long-term viability of the digital currency ecosystem.

Only a year ago, investment managers around the world were trying to find ways to offer crypto assets to their twenty-something clients. Now they are protesting too much, feigning they knew all along that the emperor wore no clothes.

Instrument Returns

November 7 - 11, 2022



Certainly, many die-hard crypto enthusiasts remain and it's likely that virtual currencies will yet play an important transactional role in global financial markets. However, the prospect of considering cryptocurrencies as a valid and legitimate emerging asset class is fast evaporating. Bitcoin, the grandparent of cryptocurrencies, lost 60% of its value as of Friday.

But Bitcoin has resurrected before and there is sufficient risk capital on the sidelines held by "true believers" that could be redeployed to levitate the cryptocurrency from its doldrums. But it seems clear that the future of transactions not only doesn't require, and may not want to rely on, currencies controlled by teenagers operating from frat-like environments where no one ever leaves their pajamas.

The higgledy piggledy world of non-fungible tokens (NFTs) purchased to outfit one's personal fantasyland in the metaverse is likely to be nothing more than a prepubescent neverland that disappears once we all wipe the sleep from our eyes.

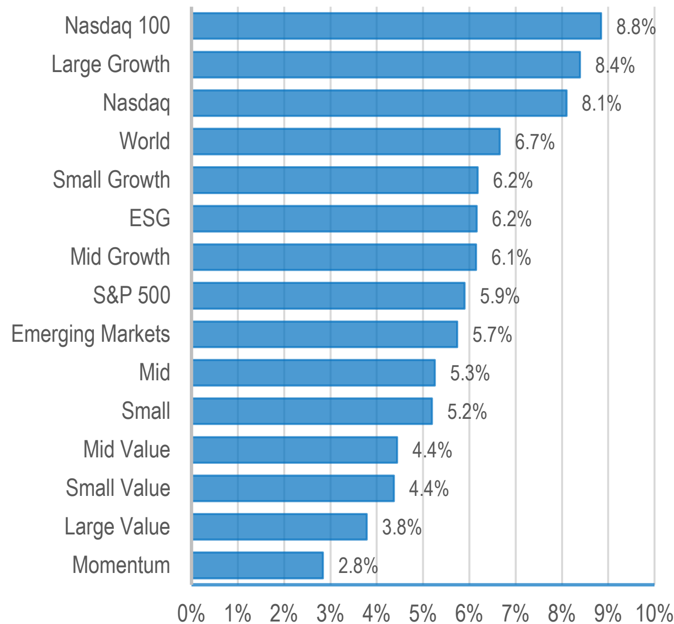
Meanwhile, back to the real world. As interest rates have risen over the past year, the bond market has been embroiled in an historic sell-off. Now, heading into a likely global economic slowdown, the $24 trillion Treasury market looks like a remarkable place to hang out. After inflation data showed consumer prices softening on Thursday, investors deployed capital back into fixed income in record

amounts. The defining economic narrative for 2023, a worsening labor market with low growth and softer wages, will reinforce fixed income as the preferred safe-haven.

Among equity instruments, the week belonged to the riskiest of equities. We do not believe this trend is long-lasting.

Equity Instrument Returns

November 7 - 11, 2022

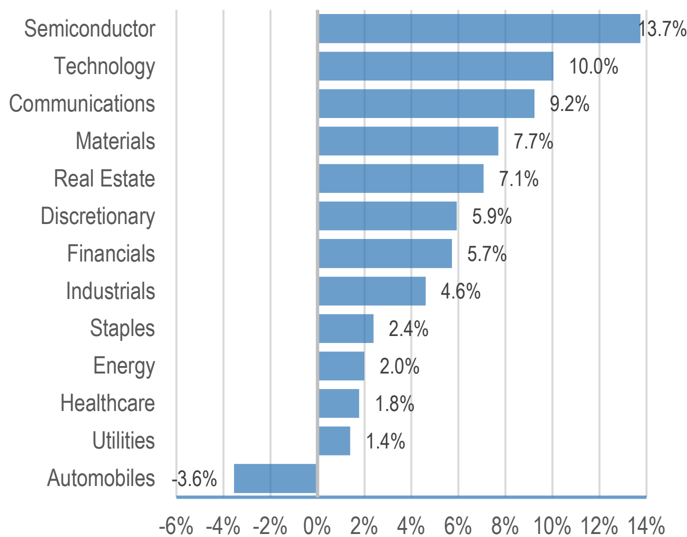


Sectors

Semiconductors, among the most beaten down in the face of recession, were the best performers. Defensive sectors, utilities, healthcare, energy and staples, performed well but yielded to more cyclical areas.

Equity Instrument Returns

November 7 - 11, 2022

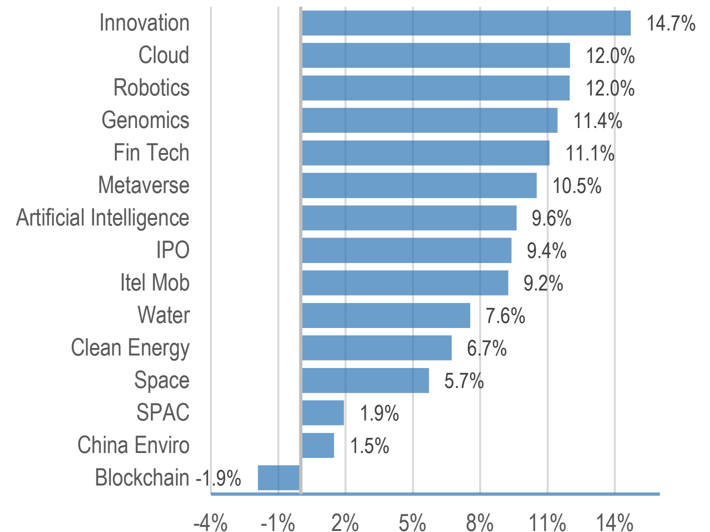


Themes

Themes followed through on the risk-on sentiment and delivered strong returns.

Theme Returns

November 7 - 11, 2022



Conclusion

That's it for this Weekender. Next week we will focus on equity valuaton, showcase a number of investment screens, and highlight some portfolio concepts we believe will help guide investors through the next few months and years.

Have a wonderful week.