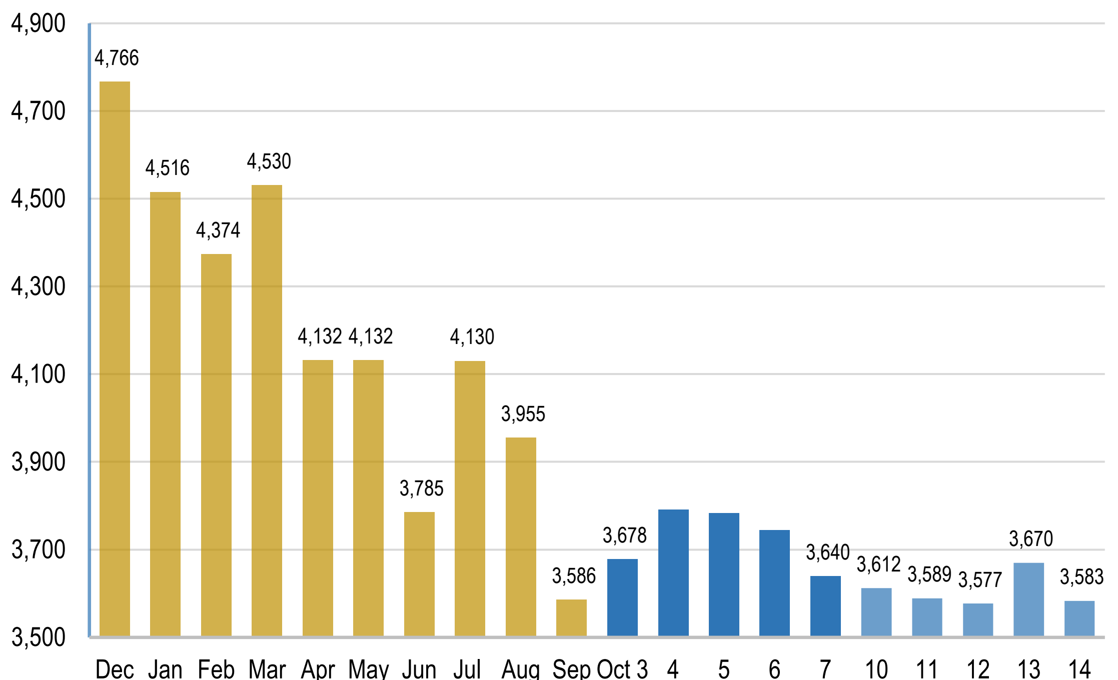
# Easy Come, Easy Go Repasse

*Weekender*

October 14, 2022

US equity markets, as manifest by the S&P 500, closed Friday at 3583.07, below the technical support of 3600. Last week was full of economic and market drama that forced markets into a violent whipsaw. The week's extreme moves were accentuated by large positioning and hedging moves as much as altered fundamental states. Economic data show that inflation remains untamed although no longer accelerating.

On the week, the S&P 500 was lower by 1.6%.




Market narratives try to give voice to disparate economic and market data by creating a neat and tidy story. Tied up with a bow if possible. We entered the pandemic from a Goldilocks environment where everything was just right. The pandemic altered circumstances that we had taken for granted for the past three decades. Now coming out of the pandemic, the economy and markets are struggling to cobble together a narrative that articulates the characteristics of a new normal.

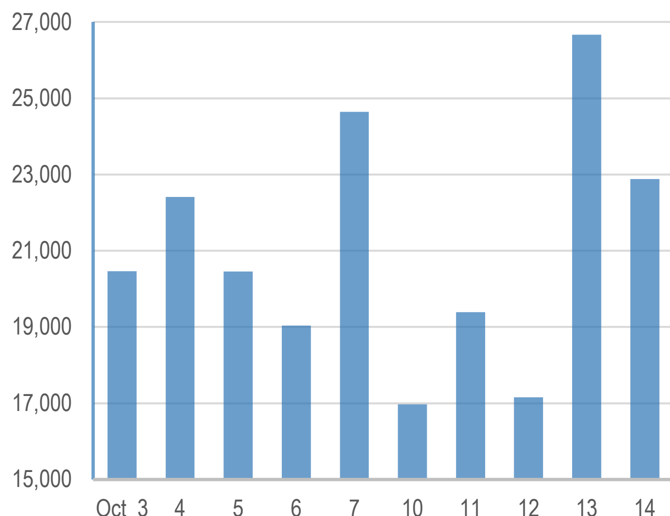
From Monday through Wednesday, US equity markets were trending lower. In Thursday's pre-market hours, consumer price index (CPI) data was released. It was hotter than expected. Markets fell initially, then bolted back on a combination of hedge and short covering and

a sense that maybe inflation had peaked. Some investors wanted to get back in and beat the rush.

Call option contracts exploded which pulled the cash market along with them. But the gains were short lived, just like the week before. Such moves are consistent with a market that is trying to find a bottom. Consumer prices (CPI) and future inflation expectations released in the University of Michigan survey supported the view that inflation is not as likely to leave the stage as quickly as it came. A Fed pause or pivot seems a couple of months away at best.

### US Daily Call Option Volume

*Contracts*



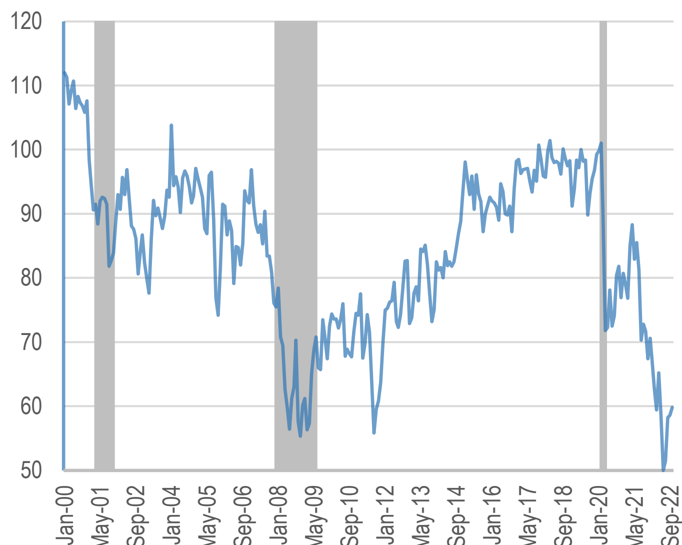

We expect the Fed to raise rates at both its November and December meetings, which will add significantly to the Fed's current target rate of 3.25%, lifting it to 4.5-4.75%. Thirty-year mortgage rates will move from their current 7.2% perch to approximately 8.5%. Residential mortgage volumes, already at lows not seen since 1980, will all but evaporate. Yields on US government bonds, which are above 4.1% on the ten-year bond, will eclipse 5.5%, a rate not seen since before the credit crisis.

The oncoming recession is not being caused by typical debt-driven demand forces. Instead, this time, it's a supply-driven recession, made worse by rudimentary policy errors from monetary and fiscal authorities. The Fed's recession-battling tools are designed to battle inflation by reducing aggregate demand. They possess no tools that can effectively increase supply.

The University of Michigan's (UofM) consumer sentiment data lifted a little, after bouncing off the lowest reading in the data's history recorded two months ago. Despite the recent lift, consumer confidence data remains in territory consistent with past recessionary periods. The UofM data set includes consumer inflation expectations for the next five to ten years. The survey suggest medium-term inflation will be fall to approximately 2.9%. This inflation survey has a history of being accurate. With the CPI and UofM data suggesting persistently high inflation, the proximate hope for a Fed pivot came off the table.

### Consumer Sentiment

*January 2000 - September 2022*

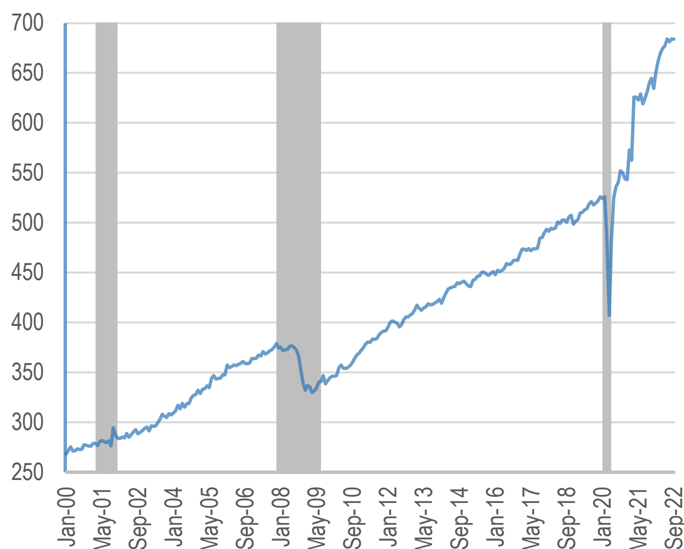



At present we believe low consumer sentiment is being driven by inflation. As inflation peaks and begins to soften, consumer sentiment will rise, but it's likely to stay well below the level consistent with a growing economy.

Retail sales for the month of September were released last week. They were flat. Even before any adjustments for inflation.

### US Retail Sales

*January 2000 - September 2022*



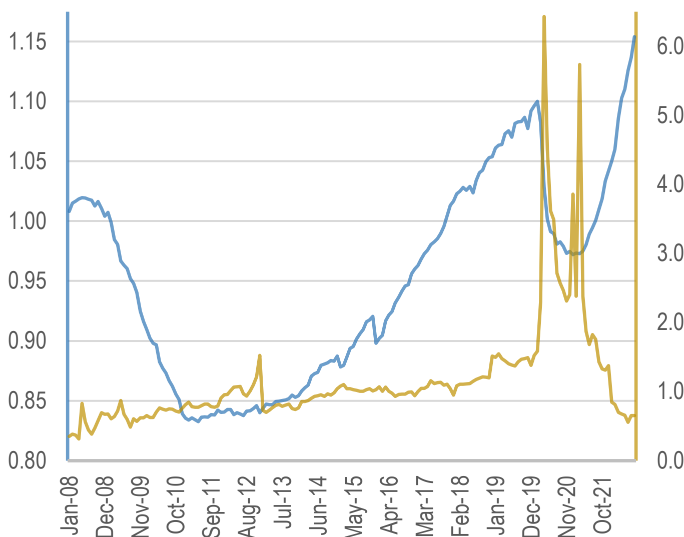

Retailers continue to struggle with excess inventories and are set up for massive discounts as the holiday season approaches. Earnings for the last quarter of the year will be driven by an interesting tradeoff between lower prices and higher volumes. While volumes are still uncertain, the discounts required to drive them are not. At the beginning of the pandemic, shortages enabled strong pricing power driving higher corporate profit margins. Now the tables are turned. Shortage has turned to surplus.

Adobe released its online shopping forecast for the 2022 holiday season (November 1 – December 31, 2022). Adobe Analytics data calls for holiday sales to hit $209.7 billion, higher than last year by 2.5%. But, considerably lower than inflation of 8.2%. Because retailers are stuffed with product, Adobe expects them to offer record consumer discounts of up to 32%, compared to 10% in 2021. Discounts are also likely to start earlier. The largest discounts are expected to come between Thanksgiving and Cyber Monday.

A strong labor market has been the foundation of what, up to this point, has been a resilient consumer. We believe the consumer may be reaching the end of their rope. At the beginning of the pandemic, revolving consumer credit, mostly credit card debt, the blue line, began to fall as consumers used government payments to pay off their debt, the gold line. At the same time, consumer savings skyrocketed as the ill-gotten booty was tucked away. Both of these early-pandemic trends have reversed course. Credit card debt is now at all time highs and growing faster than at any point in history. Excess savings has vaporized.

### Consumer Credit (Blue) and Savings (Gold)

*January 2008 - August 2022*



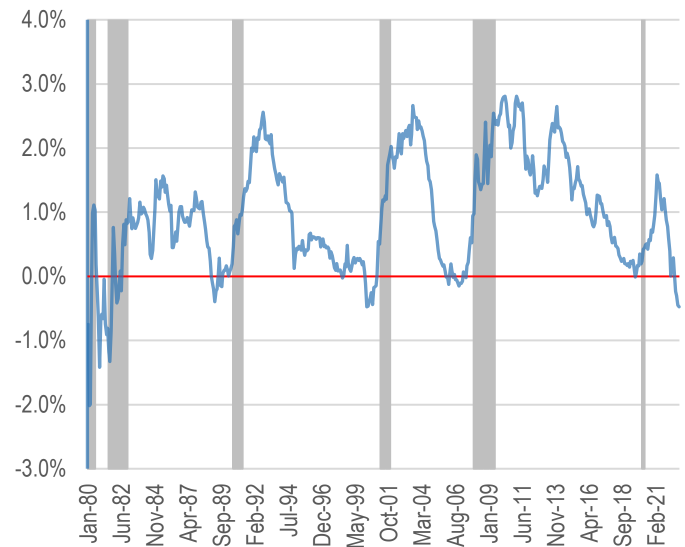

For the consumer to continue spending, they will need to rely on their inflation-strained incomes. It's not going to be enough. We expect coal for Christmas. For planning purposes, coal is almost 500% higher than its pre-pandemic price, depending upon where you need it.

## Market Narrative

An inverted yield curve has been a prelude to all previous US economic recessions. At present the inversion, pitting ten-year yields against two-year yields, is the deepest inversion since the early 1980s. In preparation for this *Weekender*, we analyzed market valuations during inversions that preceded recession in 1989, 2000, and 2006. Current price-to-earnings, price-to-sales, and enterprise value-to-EBITDA multiples are all within a tight range compared to previous inversions. Price-to-free cash flow is at a 50% discount to previous inversion periods for the S&P 500 and Russell 300 and at parity for the Nasdaq.

### US Government 10-Year Minus 2-Year Yield

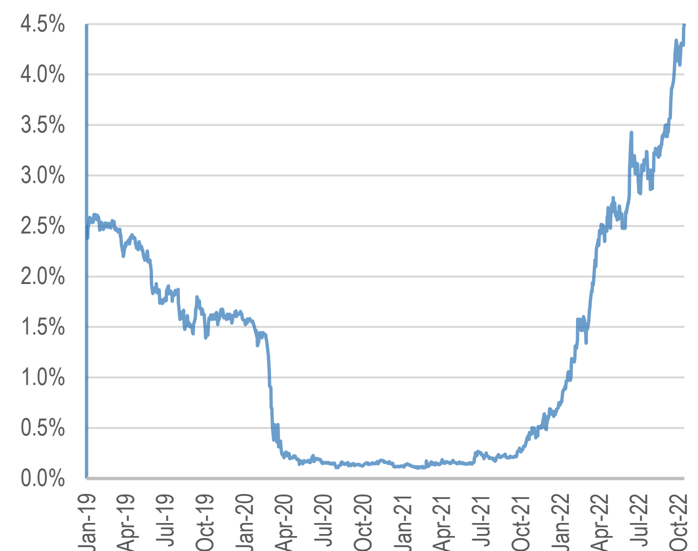
*January 2, 1980 - October 14, 2022*




The Federal Reserve response to rising inflation has been the most rapid in history. The result is higher market interest rates. This is a graph of the two-year US government bond yield from before the pandemic to last Friday. Government yields represent investment returns that can be earned without taking on risk. They serve as a foundation for investor return expectations.

### US Government 2-Year Yield

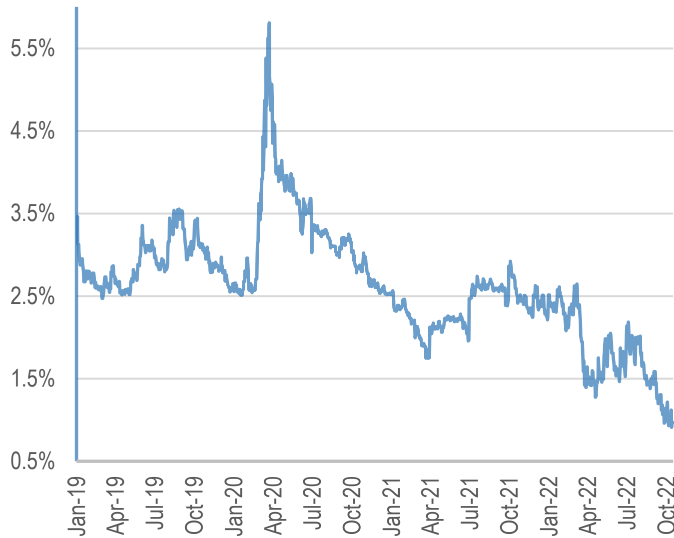
*January 2, 2019 - October 14, 2022*




Sticking with the pandemic time period, this is a graph of the excess yield earned by equity (earnings yield) compared to the US government five-year bond. From the beginning of 2019, the excess yield from equity hasn't been thinner. The point. Investors are not being rewarded for taking equity risk at a time when equity risk is high.

**Earnings Yield Minus US 5-Year Yield**

*January 2, 2019 - October 14, 2022*




Even after expanding the data range, the excess yield offered by equity remains the thinnest since the credit crisis. The point. Fixed income investments offer an attractive return relative to equity.

**Earnings Yield Minus US 5-Year Yield**

*January 2, 2008 - October 14, 2022*

Inasmuch as a meaningful proportion of companies within the S&P 500, a market capitalization weighted index, do not generate earnings, we compared the PE ratio of the market capitalization weighted S&P 500 against its equally weighted cousin. Both were slightly below the average PE ratio before the pandemic bubble.

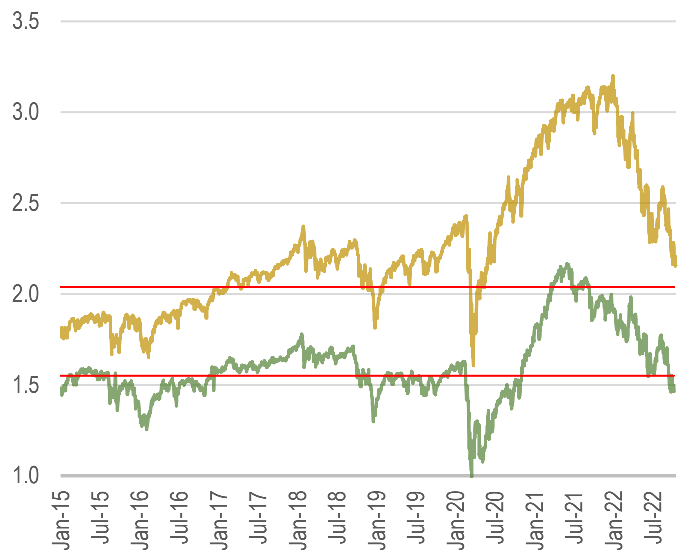
**S&P 500 Market Cap (Gold) and Equal Weight (Green) Price-to-Earnings Ratio**

*January 2, 2015 - October 14, 2022*

While PE ratios are generally useful, if a company does not have earnings it falls out of the calculation. To illustrate this point we compared the same indices using price-to-sales ratios. Using this ratio, the differences between market capitalization weighting and equal weighting was pronounced. Only the equal-weighted index trades below its pre-pandemic average. Many large companies continue to trade at premiums to their pre-pandemic levels.

**S&P 500 Market Cap (Gold) and Equial Weight (Green) Price-to-Sales Ratio**

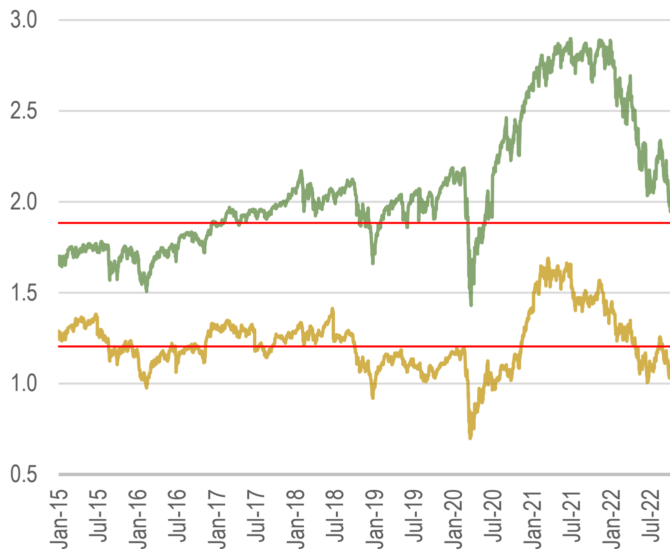
*January 2, 2015 - October 14, 2022*




Looking at markets more broadly, the Russell 3000, in green, continues to trade above its pre-pandemic average while the Russell 2000 small cap index, in gold, trades below its pre-pandemic average.

### Russell Small (Gold) and Full (Green) Price-to-Sales Ratio

*January 2, 2015 - October 14, 2022*




We continue to believe small and medium-sized companies offer incredible opportunities at their current levels.

So much of the pandemic's bubble story can be told in this graph. Growth stocks rose in price and valuation to unrealistic levels as the pandemic bubble was built, the gold line. Now the hot air is escaping as markets recalibrate. Valuations of growth still have some considerable distance to fall. But value (or price) is another story. Price-to-sales ratios for the Russell 3000 value index have corrected below their pre-pandemic levels.

### Russell 3000 Value (Green) and Growth (Gold) Price-to-Sales Ratio

*January 2, 2015 - October 14, 2022*

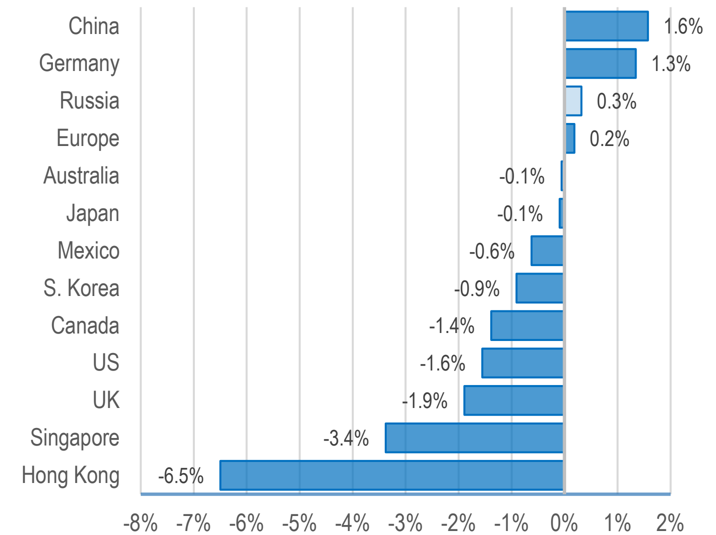
We continue to believe equity investors should focus on companies with strong organic unit sales growth, pricing power, and strong balance sheets.

## Countries

Hong Kong was the poorest performer, which is odd given that China took the top spot. Technical factors played a critical role in all weekly returns.

### Country Returns

*October 10 - 14, 2022*

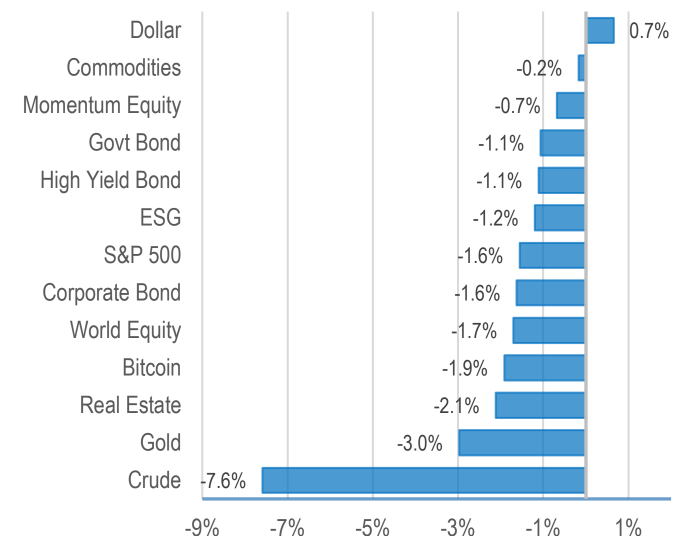



## Instruments

The US dollar was the only primary investment instrument to register a positive gain for the week. The dollar's unprecedented strength is beginning to pose more than an annoyance to the global economy and related financial markets. Dollar strength is prompting central banks and treasuries to intervene to protect their currencies. On Friday, the US treasury floated the possibility that they may purchase longer-dated bonds in an attempt to increase market liquidity.

### Instrument Returns

*October 10 - 14, 2022*



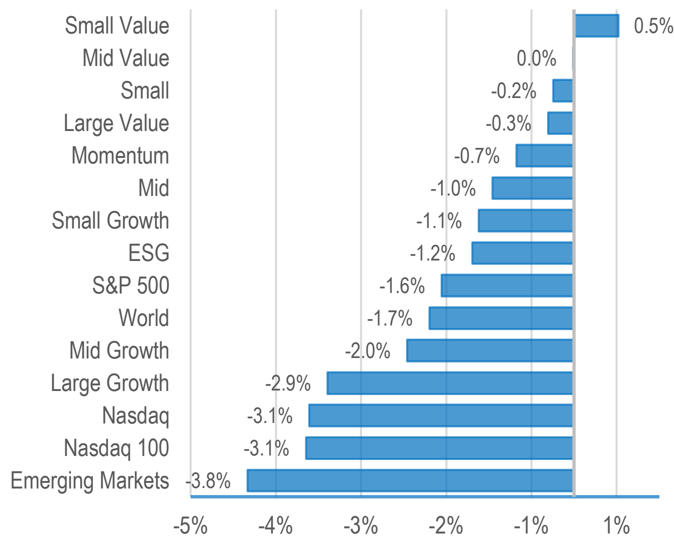
The point. All financial crises are, at their core, caused by liquidity problems. Post-credit crisis monetary experiments have all entailed a dramatic increase in market liquidity provided by government actors. Increased liquidity provides artificial support for asset prices. As liquidity is extracted, markets suffer from a bad case of dry mouth. If the lack of liquidity leads to a freeze up, a very real liquidity crisis may result.

Supposed inflation hedges did not outperform in a week where inflation was proven to be higher and more persistent than expected. Crude oil fell a week after it rose on the back of OPEC+ production cuts. Expected recessionary declines in crude and refined product demand, as recession moves from an idea to a reality, were the primary reason.

Looking at equity instruments in particular, value continues to outperform growth. We have discussed this trend since late last year. It has been a successful strategy from the beginning of 2022. Given the prospect of higher inflation, emerging markets underperformed which will likely keep the dollar strong and put pressure on developing country currencies.

**Equity Instrument Returns**

*October 10 - 14, 2022*

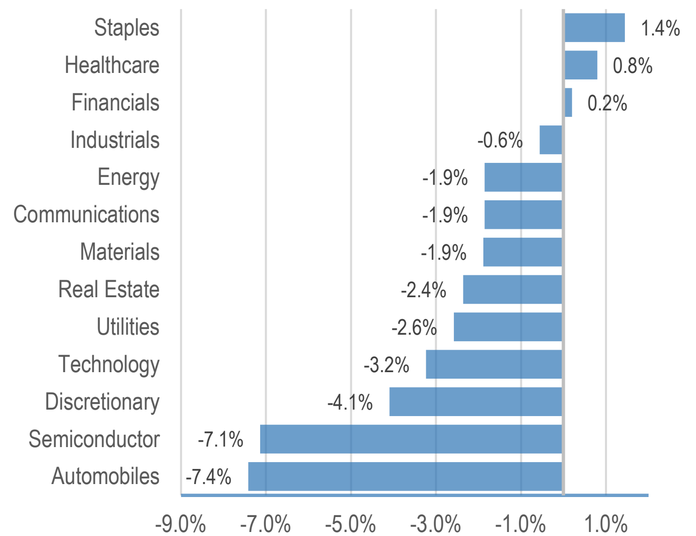



## Sectors

Protective sectors performed better on the week. Consumer staples and healthcare generally hold up well during periods of economic softness. Financials not so much. But third-quarter earnings reports from financial firms were better than expected. Net interest margins came in better than expected suggesting, despite lower trading and investment banking revenues, their regular-way business of lending may underpin relatively strong results going forward. In addition, bank valuations are so low, they are a relative bargain.

**Sector Returns**

*October 10 - 14, 2022*



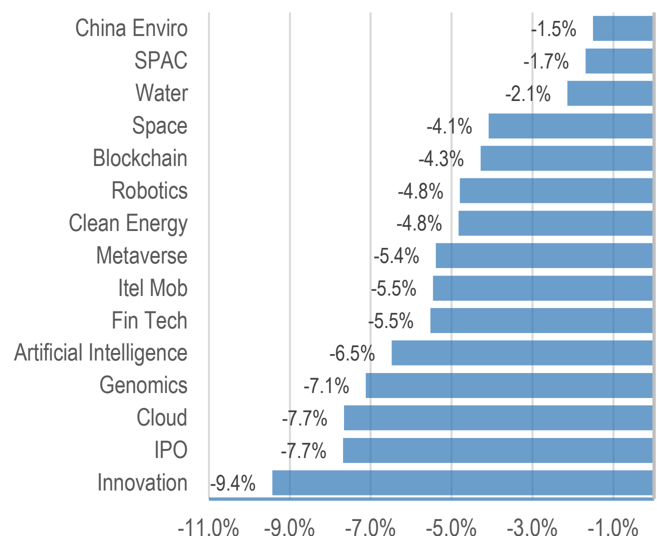

Economically sensitive sectors were all lower. Automobiles fared the worst.

## Themes

All themes were lower. Most of their constituents do not generate profits. Themes are likely to remain out-of-favor until rates peak in December.

**Theme Returns**

*October 10 - 14, 2022*




## Conclusion

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