Ice Bath

Weekender

November 5, 2022

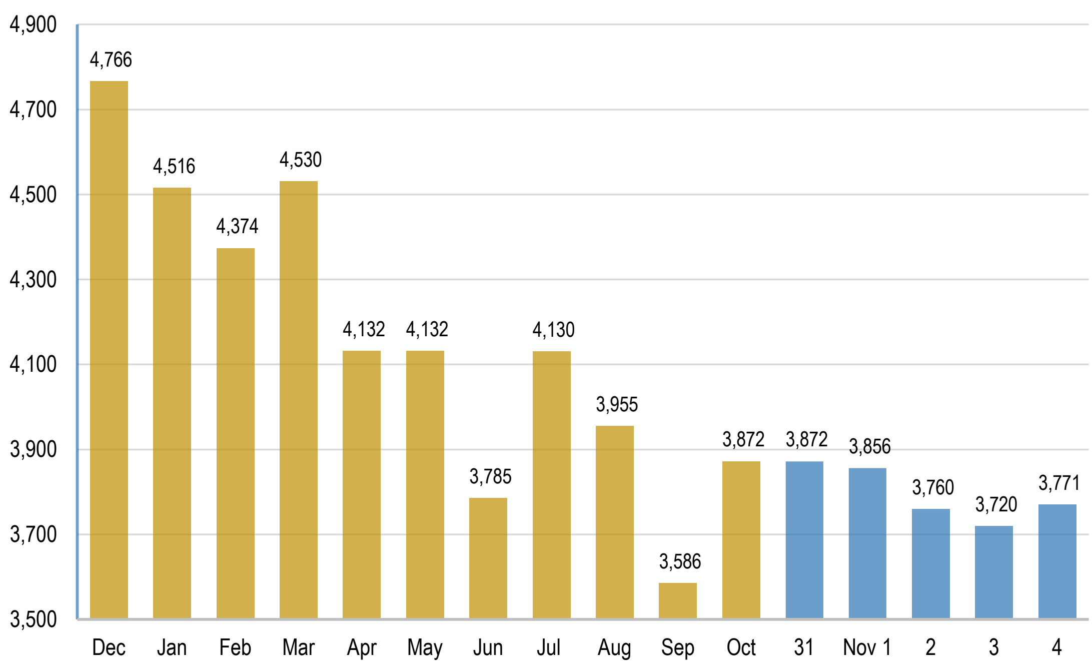
Good morning and welcome to the Weekender for Saturday, November 5, 2022. US equity markets shrunk last week after a strong performance the week before. This week's focus was the US Federal Reserve. Markets were trading on the third revival of a view that the Fed is on the edge of softening its hawkish position. However, on November 2, Fed Chair, Jerome Powell gave the markets an ice bath. In his presser, Powell renewed his hawkish narrative and suggested any pause or pivot in their staunch rate lifting was premature. Way premature. As he began to speak, US equity markets lost their composure and their hope in a proximate pause. An economic recession is all but certain.

Beyond interest rates, poor earnings performance held down shares of key market movers. Supportive product and service pricing power, driven by pandemic shortages, is beginning to wilt, which, combined with higher costs, is contracting profit margins. Now, softer consumer demand is pushing unit sales lower in many areas. The net result. An earnings recession is upon us.

In response, by the end of the week, US equity markets as measured by the S&P 500, were lower by -3.3%.

Standard and Poor's 500 Index

Monthly and Daily Levels



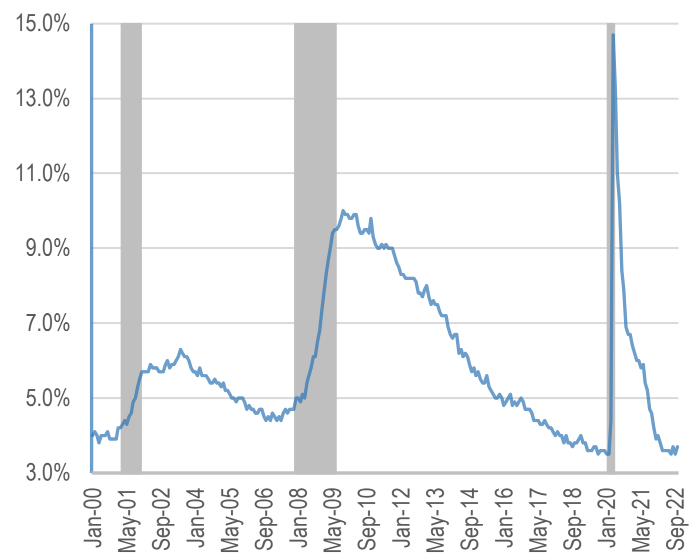
While rising inflation and interest rates have taken the majority of market mind share since the beginning of the year, the stage is necessarily broadening to include future economic and earnings growth.

Powell sent a clear message that the interest rates would continue to rise, although not necessarily at the same pace, for a while, and that the higher rates are likely to persist for a longer period of time than previously expected. Such a rate environment will ensure that real estate languishes in an increasingly comatose environment for the foreseeable future. Similar near-death experiences are likely in all areas where product and service demand are tied to the cost of money.

October's jobs report provided some data for both sides. Job gains in the United States came in at 233,000, higher than expected even though the unemployment rate ticked up slightly.

US Unemployment Rate (U3)

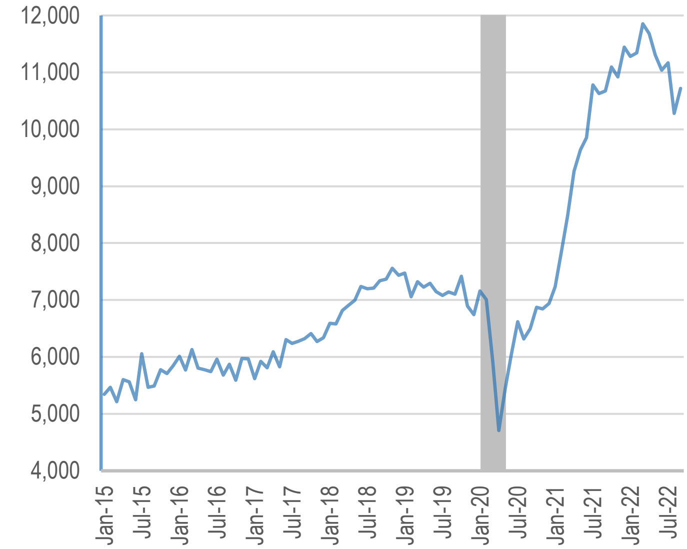
January 2000 - October 2022, Shaded Areas are Recessions



In a show of labor market support, Jolts data showed an increase in job openings in October, which were already at extremely high levels.

US Job Openings (Jolts)

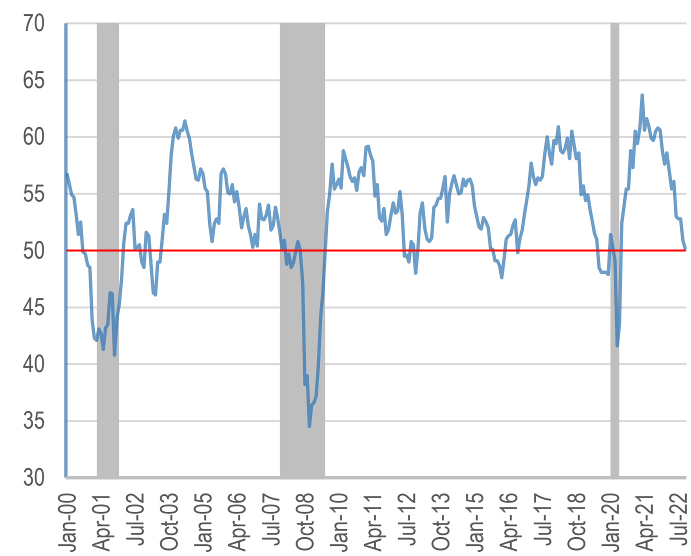
January 2015 - October 2022, Shaded Area is Recession



As mentioned in past Weekenders, the Institute of Supply Management releases robust data for major global economies on a monthly basis. The data cover a range of economic indicators. For each indicator, a reading above 50 suggests growth. Below 50 suggests contraction. After considerable pandemic growth, US manufacturing has been falling and is close to entering contraction.

US Manufacturing PMI

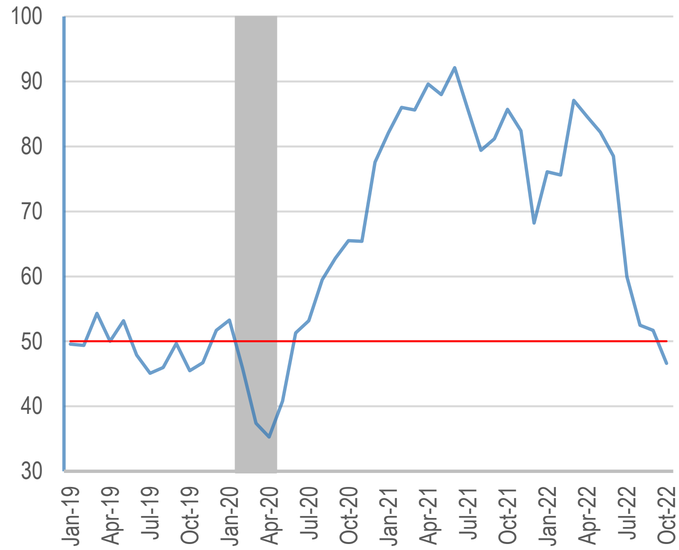
January 2000 - October 2022, Shaded Areas are Recessions



Product prices paid, which rose to the highest level in history during the pandemic, crossed into contraction territory last month, suggesting supply chains are beginning to mend and the weight of record inventory levels is leading to discounting in both the wholesale and retail product channels.

US Manufacturing PMI, Prices Paid

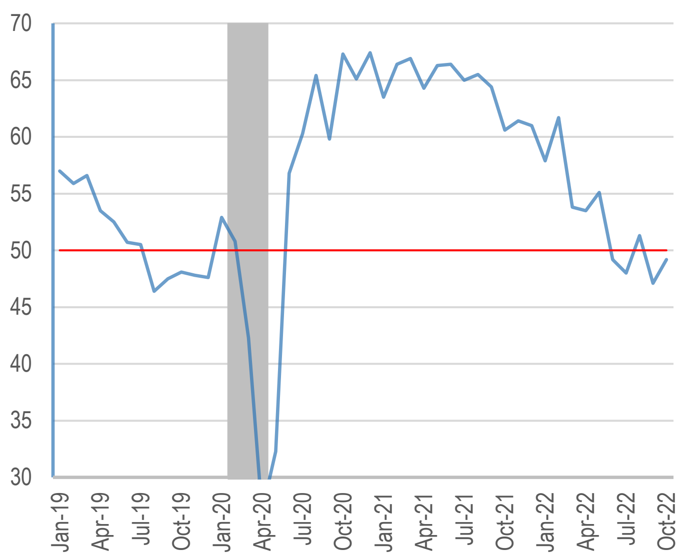
January 2019 - October 2022, Shaded Areas are Recessions



New product orders have been in contraction for some time. New orders are likely to remain soft in light of bloated inventory levels.

US Manufacturing PMI, New Orders

January 2019 - October 2022, Shaded Areas are Recessions



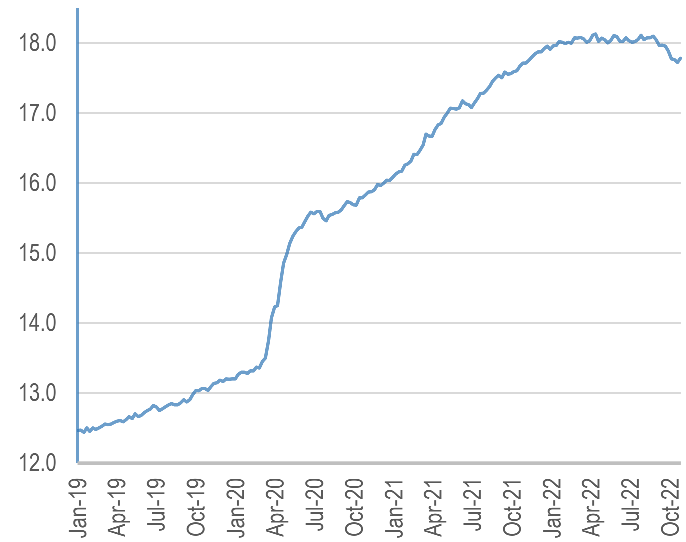
On the services side, a general sense of expansion continues, but the party is close to midnight. Services PMI data is approaching the flatline of 50 and is likely to arrive by the second half of next year. Meanwhile, travel and tourism are still able to fill every seat and room. We believe that as the consumer continues to ratchet debt levels, higher premium travel will give way to staying at home.

A few more economic data points are worth mentioning. Milton Friedman famously said, "inflation is always and everywhere a monetary phenomenon."

Monetary supply, for which a reasonable proxy is total deposits in the bank lending channel, rose at a phenomenal pace going into the pandemic. The same metric peaked and has begun falling, suggesting a gradual draining of liquidity from the global financial system which also suggests a softening of inflation pressure from money supply.

US Bank Deposits

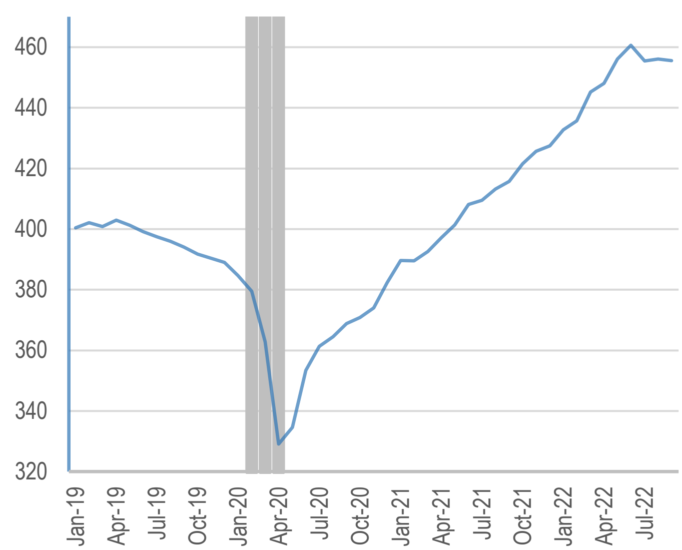
January 2, 2019 - November 5, 2022



Factory orders, with transportation removed, show a flattening over the past few months.

US Factory Orders without Transportation

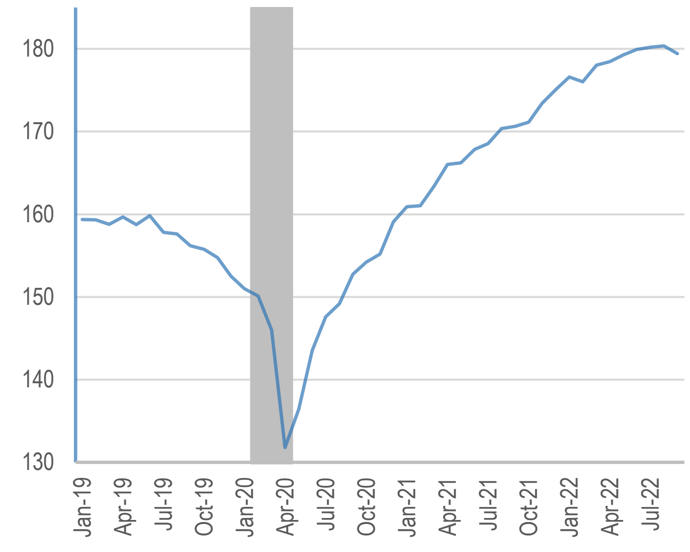
January 2019 - October 2022, Shaded Areas are Recessions



A similar story is being told by durable goods orders, with transportation removed.

US Durable Goods without Transportation

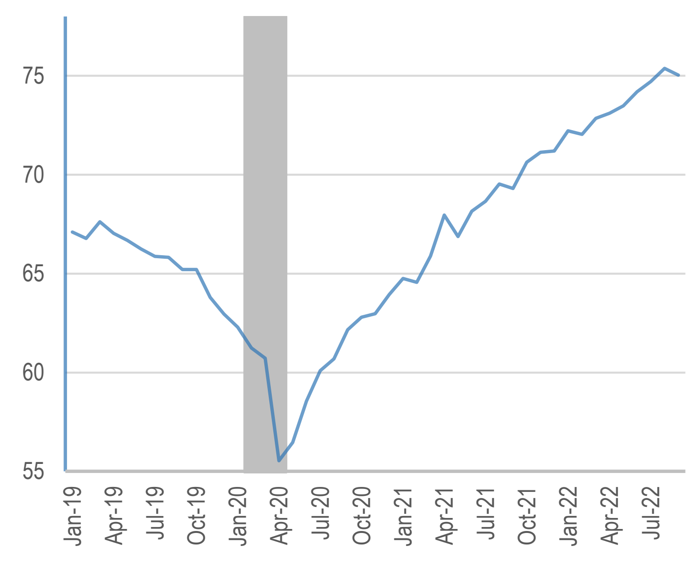
January 2019 - October 2022, Shaded Area is Recession



Finally, as a strike out for the product side of the economy, data shows capital goods beginning to come off its post-pandemic high.

US Capital Goods without Transportation

January 2019 - October 2022, Shaded Area is Recession

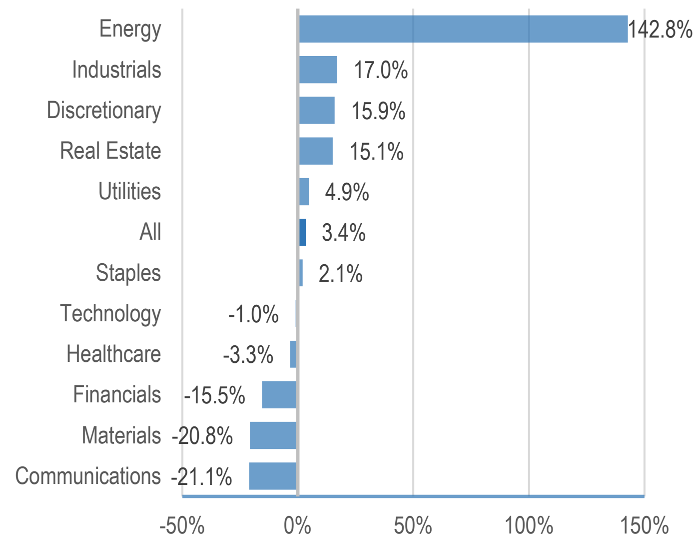


The point. The product side of the US economy has overbuilt its capacity and inventory in response to pandemic-driven shortages and is now beginning to fall in search of a more normal post-pandemic run-rate. Economic recession in the product side of the US economy is near certain. However, without a liquidity-induced financial crisis, it's likely such a recession will be mild since the labor market continues to be robust.

A quick note on earnings. As of Friday's close, sixty percent of all publicly listed US companies have released third-quarter earnings. Looking at the numbers generally, earnings grew by 3.9%, compared to the same period last year. However, this result is completely warped by profits from the energy sector. Below is a graph of 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%.

Sector Earnings Growth of US Public Companies

Third-Quarter 2022 Compared to Third-Quarter 2021



Next week's *Weekender* will be a summary of our *House View* for the month of November. We had previously planned to publish it this weekend but opted to wait a week in anticipation of the inflation data for October.

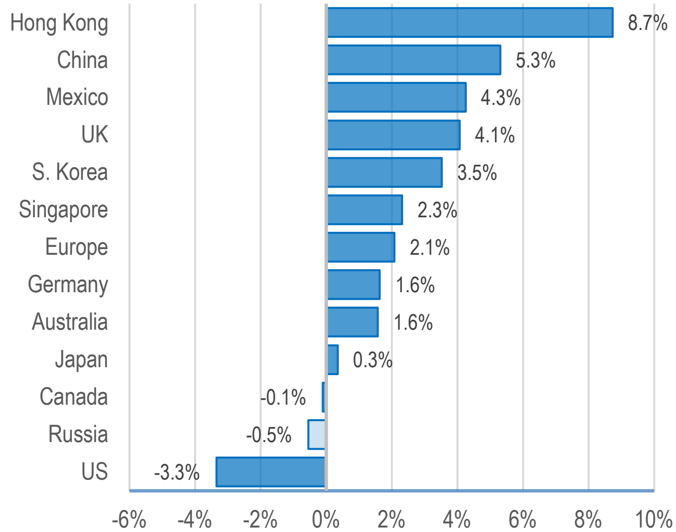
Countries

As we discussed last week, China and Hong Kong's equity markets have been approaching record lows in valuations and recent lows in market value. The prospect of some rational approach to COVID lockdowns emerged this week and helped resurrect what, by some, were deemed dead markets. However, China has not stepped back from their COVID strategy. Over the weekend, Apple announced availability of their new iPhone 14 would be constrained by factory COVID closures.

US equity markets typically provide a draft for global equity markets, generally. Not this week. The US was the worst performing market, compared to other major equity markets.

Country Returns

October 31 - November 4, 2022

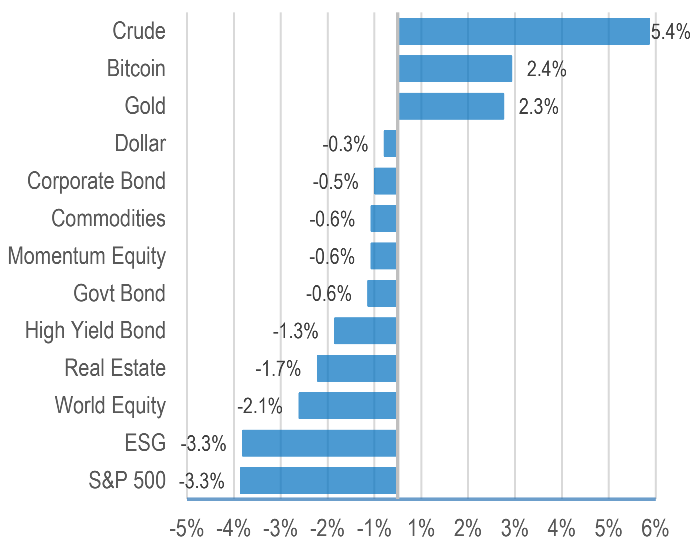


Instruments

Most asset classes were lower, with crude oil, bitcoin, and gold being notable exceptions. With crude now back above $90 per barrel, the consumer relief experienced, for a couple of months, from lower fuel prices will certainly dissipate. Jerome Powell's conviction that rates in the US will likely be higher for longer pushed bonds, stocks, and real estate lower.

Instrument Returns

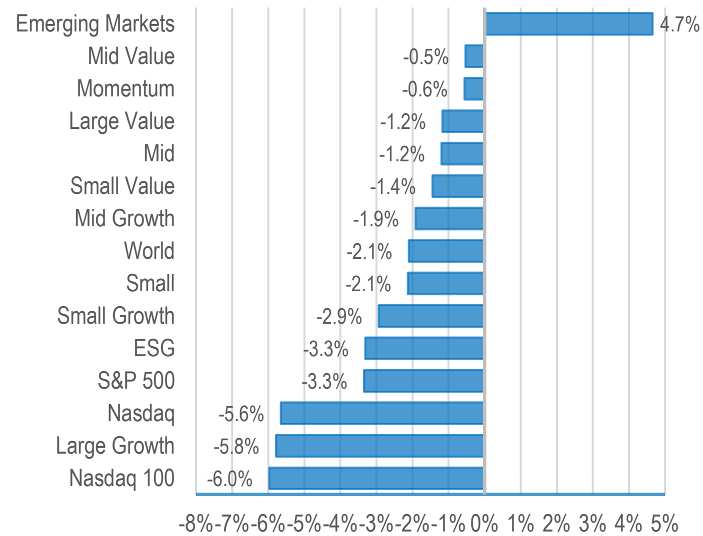
October 31 - November 4, 2022



While crude, as a commodity, was particularly strong, commodities, broadly, remained firm on a relative basis, following the dollar. Emerging markets, higher by 4.7%, responded to a slight fall in the dollar. Instrument internals reveal the general trend we discussed, with value holding up better than growth. Not an unusual response since growth suffers from higher interest rates in two ways: lower valuations and slower growth. However, in a rising interest rate environment, value stocks are impacted by the principal of valuation, which is the dominant factor impacted in a higher interest rate environment.

Equity Instrument Returns

October 31 - November 4, 2022

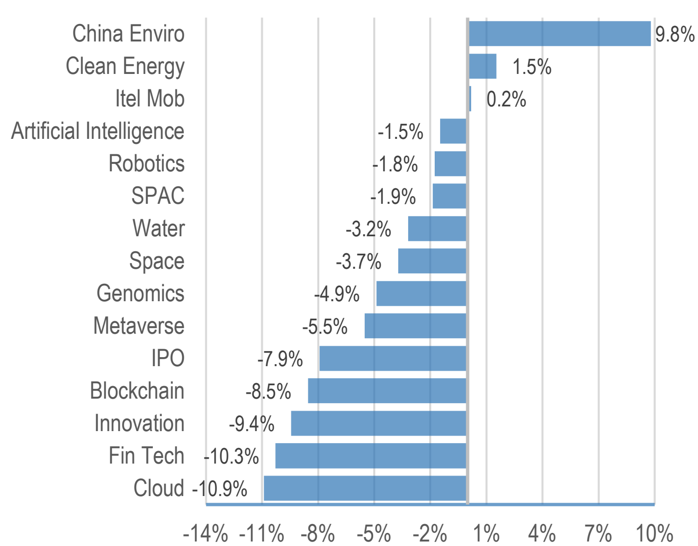


Sectors

Higher crude prices kept energy stocks on the top spot of the leader board. However, other commodity sectors, like materials and industrials, also performed relatively well. Part of the reason for a commodity sector equity outperformance comes from a lower dollar.

Sector Returns

October 31 - November 4, 2022



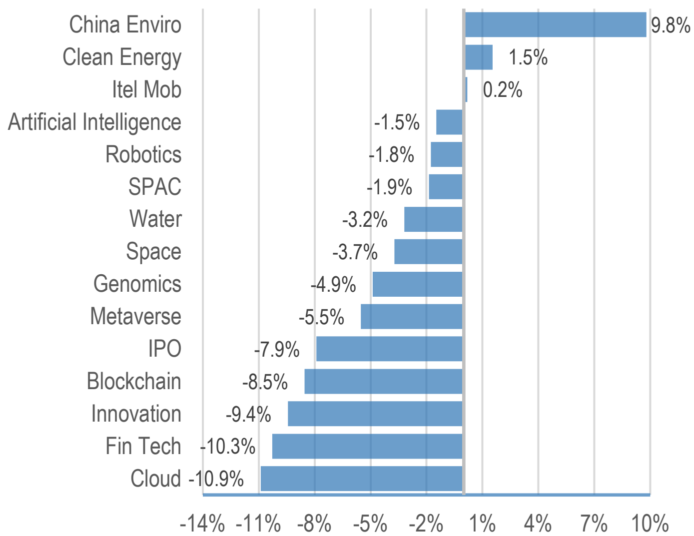
Automobile sector underperformance continues with unique stock-specific stories weighing on particular names. Supply-chain weaknesses continue to impact every auto company, although in a unique way for each. Tesla bears an unusual burden with its ties to Twitter.

Themes

Inline with the material outperformance of Sino markets, China's environmental theme was the best performer. Similar outperformance also lifted clean energy and intelligent mobility on a relative basis. All the other themes were lower.

Theme Returns

October 31 - November 4, 2022



Conclusion

That's it for this *Weekender*. Next week we will publish a summary of the *House View*. We will also return to a bifurcated production platform. We will provide all future *Weekenders* in video and PDF formats. Have a great week.