In Your Corner

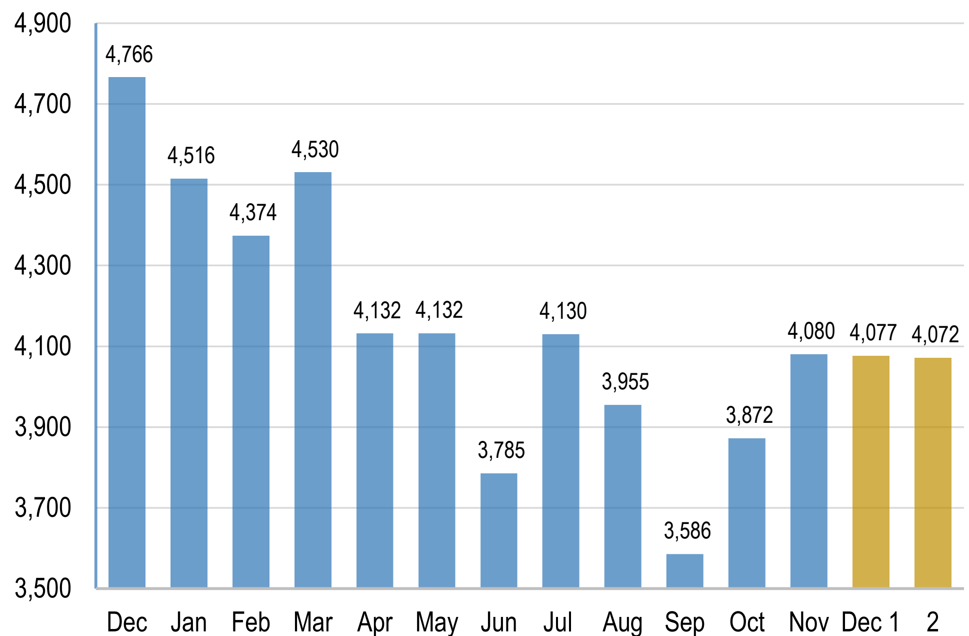
Weekender

December 3, 2022

Good morning and welcome to the *Weekender* for Saturday, December 3, 2022. It was another volatile week, reflecting expectations that the US Federal Reserve will soon moderate its aggressive interest rate posture. Not a new trade. In fact, it's the fourth time this narrative has taken over financial markets since summer. But this time is different. In the past, softer rate expectations have been fomented by wishful thinking. This time, Jerome Powell, the Chair of the Federal Reserve, gave wishful thinkers the idea. Markets took the good news, tossed everything else, and traded higher.

S&P 500 Month and Daily Levels

December 2021 - December 2, 2022



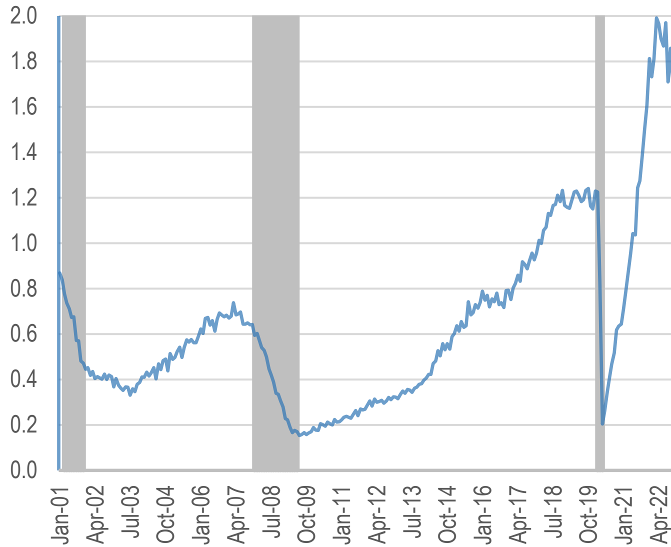
US equity markets, as measured by the S&P 500, were higher by 1.1% on the week. A battery of economic data was released suggesting labor markets continue to be tight. Job openings exceed the number of unemployed by almost 2 to 1. Wages are rising faster than the Fed's preferred inflation metric and economic contraction has moved from possibility to likelihood.

In the month of November, the US economy added 263,000 jobs, more than the 200,000 expected. The number of job openings remains above 10 million which exceeds the number of unemployed persons by 1.7x. While the ratio has moderated in the last few months, it remains well above its historical comparisons and nowhere near levels consistent with previous recessionary periods.

ARCHIMEDES
INSIGHTS & ANALYTICS

US Job Openings per Unemployed Person

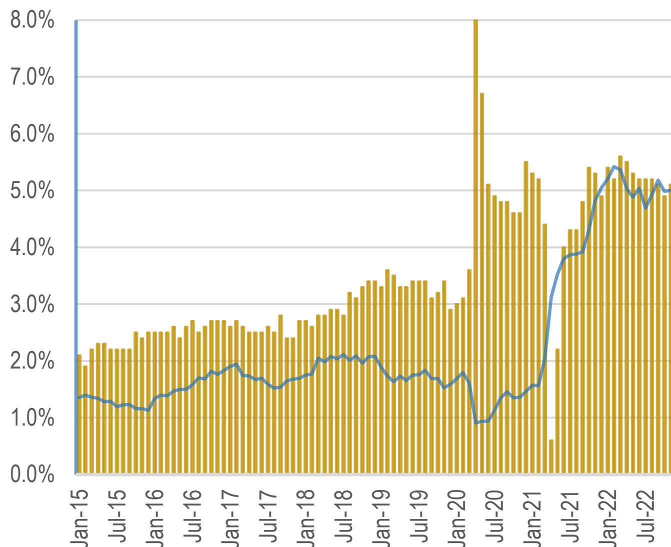
January 2001 - November 2022



While most economists use the consumer price index (CPI) to track inflation, the Federal Reserve focuses on the core personal consumption expenditure (PCE) index. For the month of November, the core PCE rose by 5.0%, the blue line, compared to average hourly wages, the gold bar, which was higher than last year by 5.1%. Not a remarkable difference. However, when wages are rising higher than costs, workers are no longer experiencing an inflation-induced reduction in purchasing power. Generally, this is positive news. But it makes the Federal Reserve's job harder. If they are to get inflation under control, they must now focus on the labor market by keeping rates higher for longer.

Core PCE (Blue) and Average Hourly Earnings Growth (AHE) (Gold)

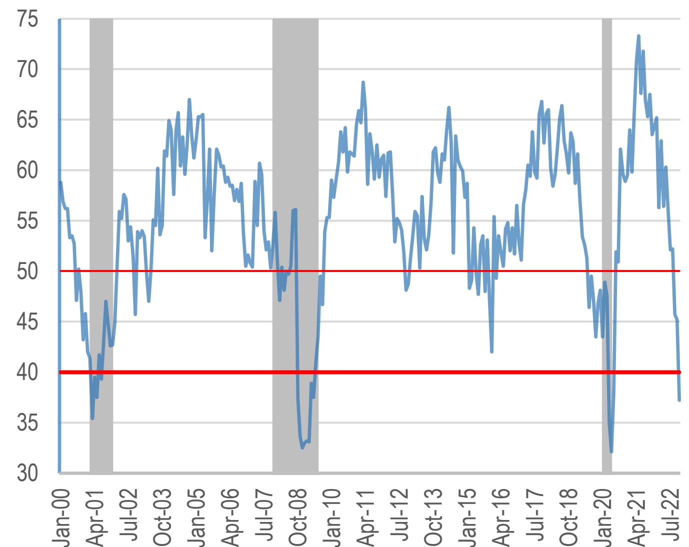
January 2015 - November 2022



In many past *Weekenders,* we have used the purchasing managers index (PMI) to gauge the immediate health of the US economy. Readings above 50 suggest expansion while those below 50 portend contraction. Below is a graph of the PMI for the Chicago economic area. In the past, when prints of 40 or below occur, recession has always been in the cards. Even so, Chicago is not the world or the United States.

Chicago Economic Area PMI

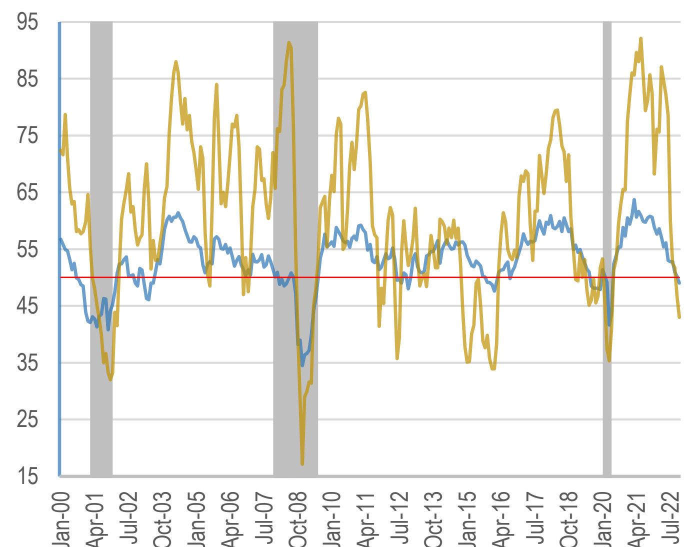
January 2000 - November 2022



A series of PMI data for the US economy's manufacturing sector was also released last week. All of them showed the US economy in the early stages of contraction. In this graph, the blue line is the manufacturing PMI for the United States, barely in contraction territory. The gold line is the prices paid component which shows a remarkable retreat of pandemic-related price pressures on manufactured goods.

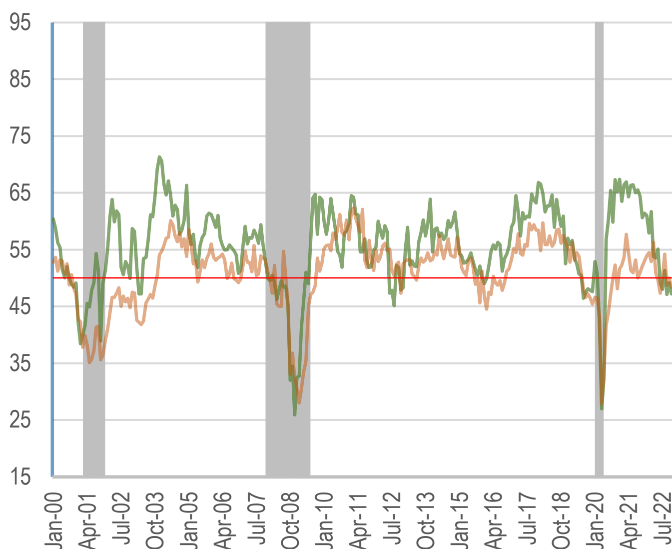
Manufacturing PMI (Blue) and Prices Paid (Gold)

January 2000 - November 2022



Additional PMI data measures manufacturing new orders, the green line, and manufacturing employment, the rust line. Manufacturing, which accounts for slightly less than twenty percent of US economic output, is already in contraction. PMI data for the services sector, which is the primary mover of the US economy will be released next week. However, October's data released a month ago had services in contraction. We expect this trend to continue.

New Orders (Green) and Employment (Rust)
January 2000 - November 2022



Market Narrative

Back to the Federal Reserve. In last week's comments, Jerome Powell suggested future rate increases will be less aggressive. Having pushed up interest rates by 0.75% at each of the last four meetings, it now seems likely that rates will move in milder jumps, probably 0.5% for a few months and then 0.25% as the Fed tries to negotiate a soft landing for the economy.

While it's common for market pundits to square off in the opposite corners of many market debates, this time is different. Many respected and experienced economists and investors are predicting a dire economic response to the Federal Reserve's aggressive tussle with inflation. Another gathering of respected experts predict a short and shallow recession, if we have one at all.

To some degree it's a difference that does not matter. History shows that remaining invested during economic cycles beats attempts at market timing. However, if a deep and broad recession is the result of aggressive interest rate tightening, allocating assets toward protective sectors and instruments will cushion a likely extended market correction. On the other hand, if a potential recession is shallow and short, now is the time to position asset exposure away from protection by overweighting sectors that perform better as interest rates fall, which may be likely by the end of next year.

In order to make sense of the battling narratives, it's valuable to consider the fact that inflation is generally caused by debt-fueled demand. As an economy expands, the number of employed rises as does consumer spending, first driven by higher aggregate wages and then by increases in consumer credit. More money chasing fewer goods leads to demand-driven inflation. At times, supply factors may also stoke inflation.

During the pandemic, trillions of dollars of government cash were pumped into the economy at every level. State and local governments that were on the edge of insolvency prior to the pandemic found themselves flush with cash. Corporations were paid to keep their doors open and consumers were sent checks for thousands of dollars, often unaware of why they were arriving. The Federal Reserve increased the table stakes by lowering interest rates and flooding money markets with unprecedented liquidity. Hardly unpredictable, a spending frenzy began.

Like adding gasoline to the fire of demand inflation, 'found' money spending combined with fewer goods and services available. Pandemic-related supply chain challenges and lockdowns created shortages in many goods and services giving corporations license to raise prices.

For the first time in generations, US inflation is being driven by both demand and supply factors. Higher interest rates are softening excess demand for products that are acquired using credit, particularly real estate, automobiles, recreational vehicles, boats, and durable goods (i.e., dishwashers, televisions, etc.). Meanwhile, supply chain-induced inflation, for which the Fed has no remedy, seems to be slowly mending itself.

To provide a sense for what higher rates are beginning to do to the US economy, consider this. As interest rates have increased under the hands of the Federal Reserve, mortgage rates have increased in a sympathetic manner. In response, weekly mortgage applications have fallen to levels unseen since the early 1980s. Fewer mortgages mean a percentage drop in pending home sales lower than during the pandemic and the Credit Crisis.

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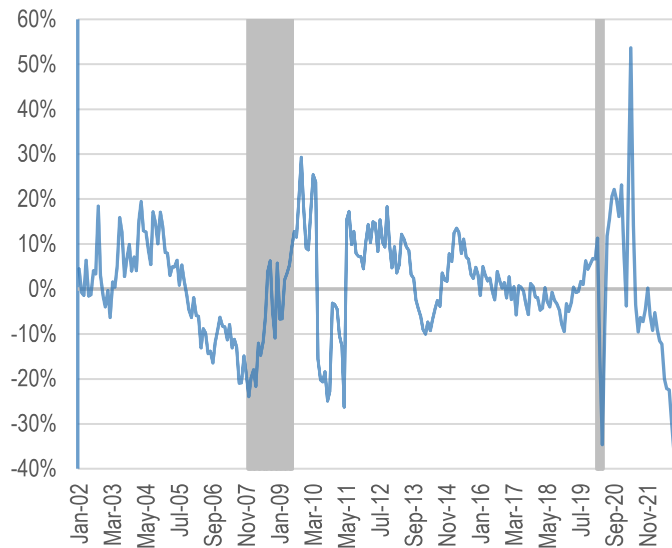
US Pending Home Sales, Percent Change
January 2002 - November 2022



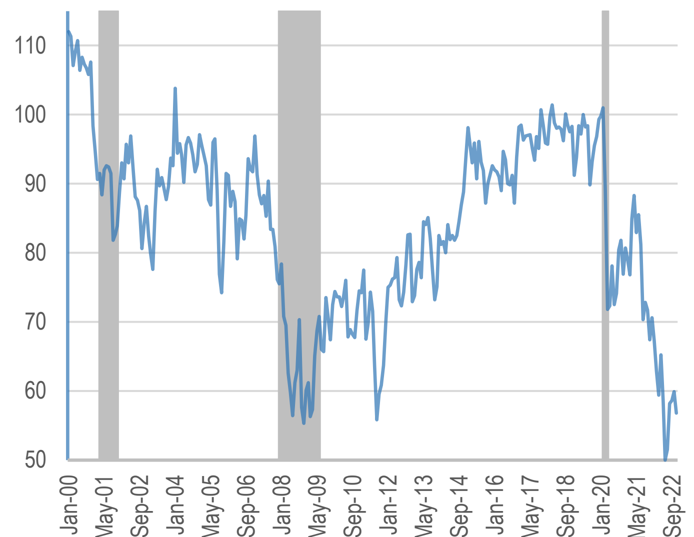
Higher interest and mortgage rates have conspired with high prices to make home ownership unaffordable. Pandemic-era single family home price levitation has reversed in a violent manner recently, although they are still much too high.

US 20 City Housing Price Index, Percent Change
February 2000 - November 2022

We believe that if the labor market can remain robust for another six months, product and service inflation will come back in line with pre-pandemic trends and higher wages will soften the sting of higher prices. However, we do NOT expect a return to the pre-pandemic Goldilocks environment for the forseeable future.

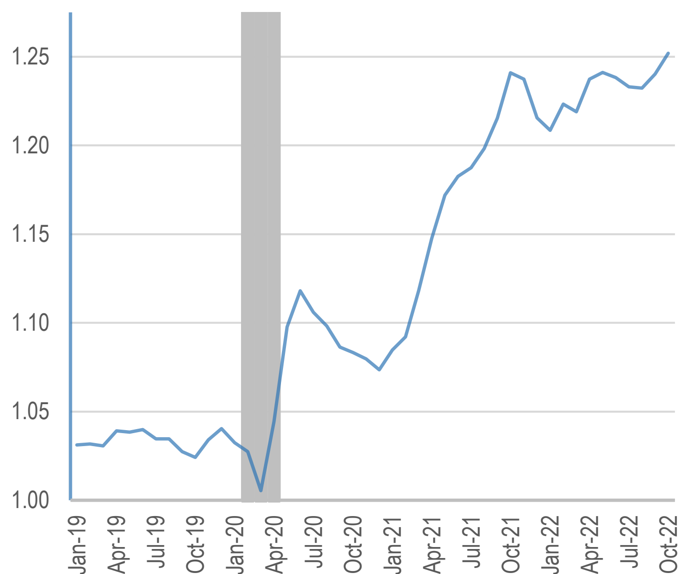
As long as higher rates do not break the labor market, an economic slowdown is likely to be soft and silent. Consumer sentiment, which remains at recessionary levels, is being held down by the negative effects of inflation. If inflation eases, sentiment is likely to continue to rise as long as the labor market remains robust.

Consumer Sentiment
January 2000 - November 2022



Wholesale and retail inventory data continue to suggest a large backlog of products will continue to force discounts in order to clear the retail channel. Excess inventories are likely to force corporate profit margins from their peak levels over the next few quarters.

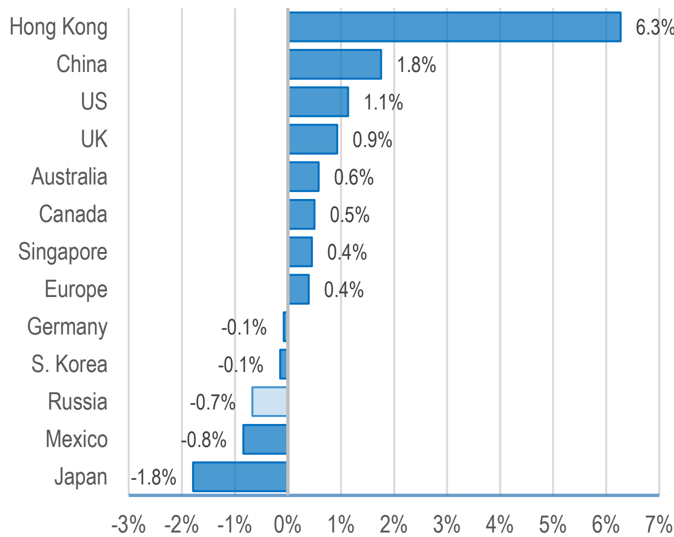
Wholesale-to-Retail Inventories
January 2019 - November 2022



Countries

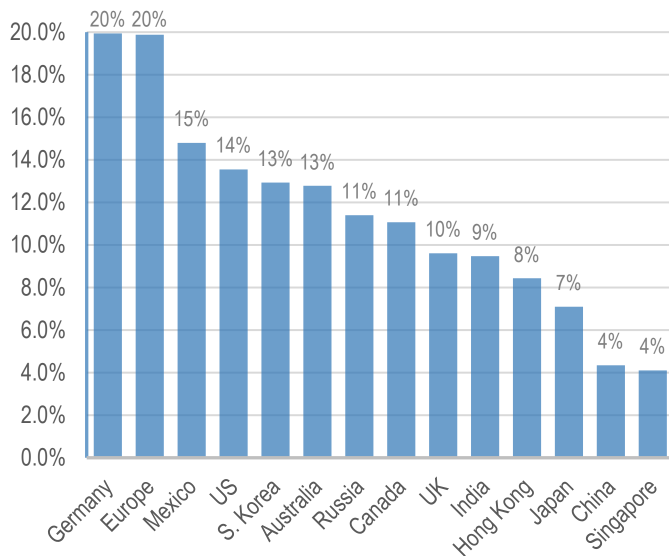
Hong Kong, a market proxy for China, was the best performing equity market by a large margin. China itself was second.

Country Returns
November 28 - December 2, 2022



Since the beginning of the third quarter, all equity markets have had a fairly remarkable recovery with Europe, generally, and Germany, in particular, leading the pack.

Quarter-to-Date Returns
October 1 - December 2, 2022



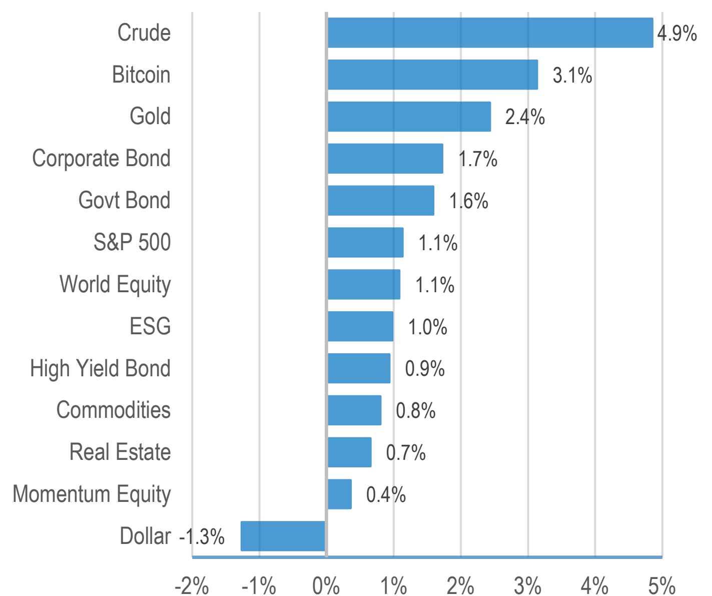
We tend to focus on the impact of higher interest rates on the US economy. This is because we are, in the main, US dollar investors. Looking outside the US, especially in Europe, the impact of higher inflation and interest rates is having a much more profound impact. Prior to the pandemic, a majority of European countries lived under a negative interest rate backdrop which is remarkably stimulative. European inflation has overshadowed the stimulative power of negative interest rates while the amount of negative interest rate debt has fallen dramatically.

Negative Debt Outstanding
January 2020 - November 2022

Instruments

Some beaten down investment instruments forced a recovery last week. Crude oil was higher by almost 5.0%, lifting back to $80 per barrel. Bitcoin staged a modest recovery after a disastrous November. Bonds played well with a general expectation that the cadence of Federal Reserve rate increases will slow in the foreseeable future.

Instrument Returns
November 28 - December 2, 2022



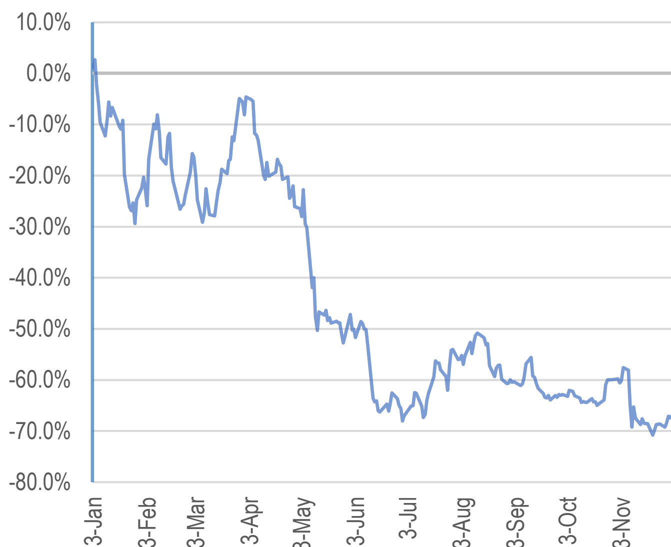
In the wake of the FTX and Alameda crypto implosions, a clarion call from know-it-all's have echoed through financial markets. Our view on cryptos has been plainly stated for the last three years. Larry Fink, the head of Blackrock, announced last week that he expects most crypto companies to fold.

Cryptocurrency firms like Coinbase, MicroStrategy, and Galaxy Digital all fell in value by more than 25% last month. These players were up on the week but on a year-to-date basis performance has been pretty dismal. Schwab's crypto index is lower by 63% this year. Aside from market leaders, most other crypto players have been likewise affected. Banks involved in crypto, like Silvergate Capital and Signature Bank, along with crypto miners like Marathon Digital and Hut 8 have significantly fallen in value since the beginning of the year.

The graph below is the cumulative year-to-date return of the Bloomberg crypto index. It's been a bloodbath.

Bloomberg Crypto Index

January 3 - December 2, 2022

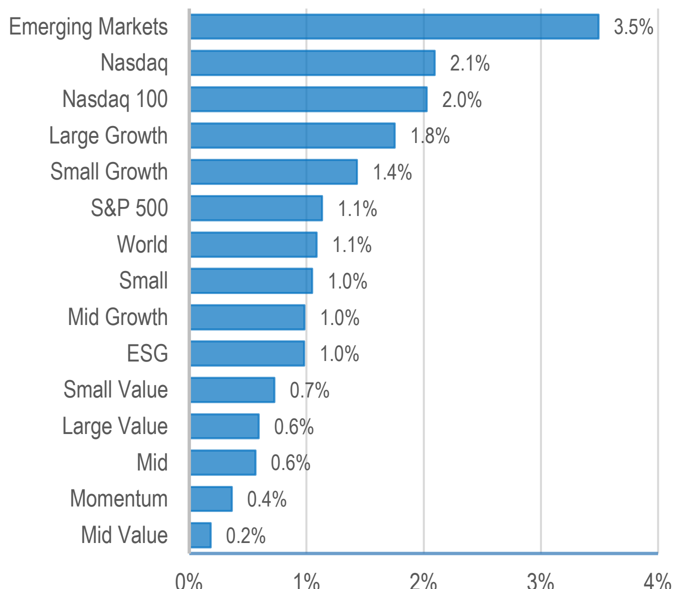


Core Scientific has seen its share price fall by 98.7% this year with markets assuming the company is teetering on the edge of bankruptcy. However, lower crypto values have some true believers piling in. Cathie Wood's Ark Investment Management has been buying shares of Coinbase, Silvergate, and Grayscale Bitcoin Trust. She continues to stand by her view that Bitcoin, which traded below $17,000 on Friday, will hit $1 million per token by 2030.

Looking at equity investment instruments specifically, the week belonged to growth versus value. However, the best performer in the equity camp came from emerging markets.

Equity Instrument Returns

November 28 - December 2, 2022



Emerging markets have been strong performers since the dollar peaked.

Dollar Spot Index

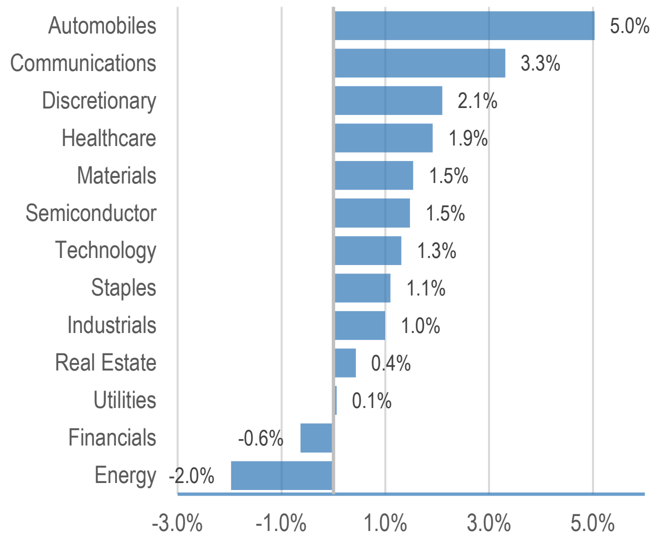
January 3 - December 2, 2022

Sectors

Among sectors, automobiles were the best performing. Energy was the worst, consistent with a fall in crude oil.

Sector Returns

November 28 - December 2, 2022

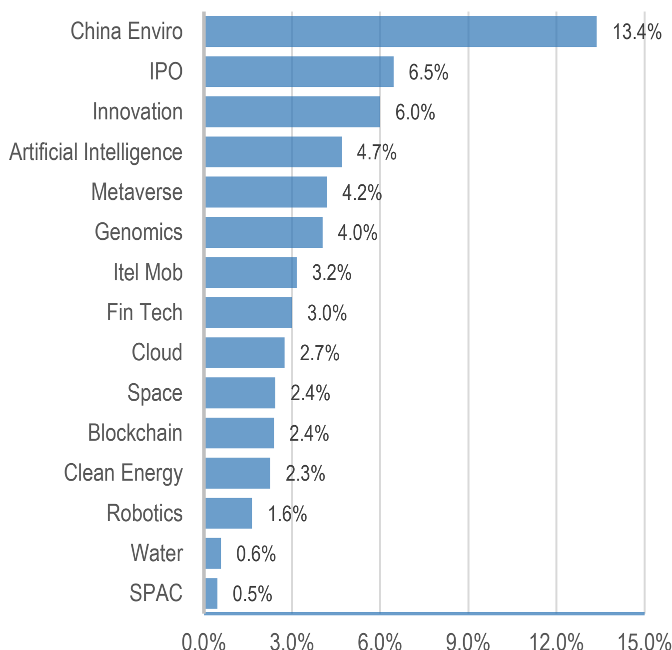


Themes

Themes are mostly composed of speculative companies, many of which do not make money and are unlikely to do so for the foreseeable future. Consequently, they tend to rise and fall based upon the general risk-on or risk-off mood of markets at the time. While broad equity markets rose modestly during the week, themes experienced a fairly dramatic move higher, especially the China environmental theme. We believe this move suggest a general and nascent investor trend of looking to future opportunities as opposed to focusing on the pressing negative environment.

Theme Returns

November 28 - December 2, 2022



Conclusion

That's it for this *Weekender*. Next week we will engage in a synthetic dialog about the Federal Reserve and what it sees and is likely to do in the year ahead. As a look ahead, we will not publish a *Weekender* on December 17th or 24th. On December 31, we will publish our investment outlook for 2023. We will also publish our first investment magazine called *The Bucket List*.