Watchword

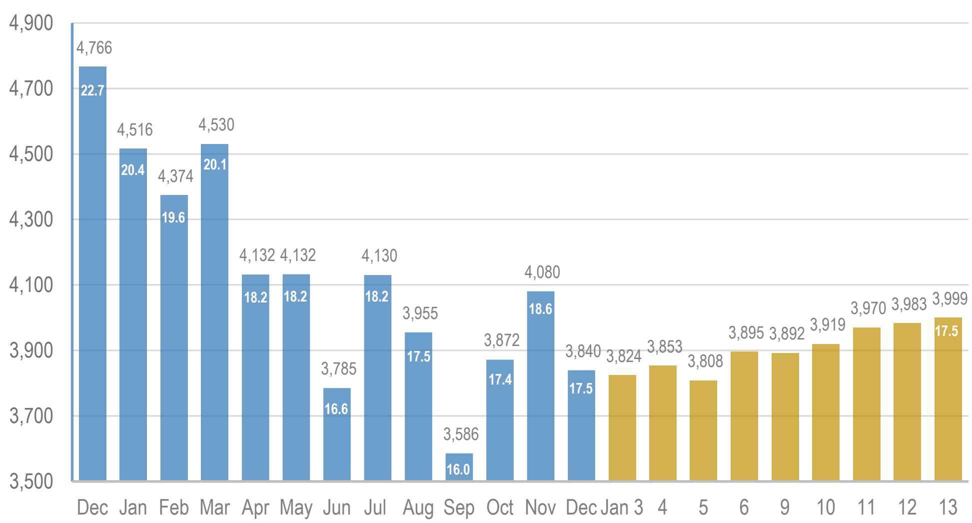
Weekender

January 14, 2023

Good morning and welcome to the Weekender for Saturday, January 14, 2023. Equity markets were higher by 2.7% last week. Inflation was the watchword. The consumer price index (CPI) for December 2022 printed right in line with expectations. However, it showed a continuation in the three-month decline from its peak which was enough to push many assets higher, especially equities.

S&P 500 Month-End Levels

December 2021 - January 13, 2023



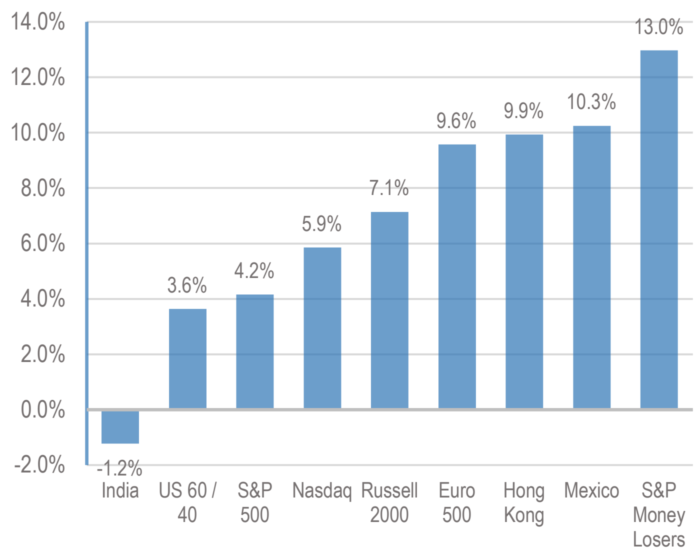
Equity valuations, using PE ratios as proxy, have come down steadily from pandemic bubble territory to 17.8 times forward 2023 earnings. Prior to the pandemic, the average PE ratio between the end of the credit crisis (2010) and beginning of the pandemic (2019) was 17.6. Although stocks are not broadly cheap, there are some remarkable deals among the detritus of 2022.

The S&P 500 closed at its highest level in a month on Friday and is within a whisker of 4,000. From a technical perspective, the S&P 500 crossed its 200-day moving average, a sign that market dynamics are leaning toward the upside in the medium-term despite being somewhat overbought at present.

As of Friday, the Nasdaq 100 climbed for the sixth straight day, something that has not happened since November of 2021. Since the beginning of 2023, prices of money-losing companies, in aggregate, have increased by 13.0% while the S&P 500 is higher by 4.2%.

Year-to-Date Returns

January 2 - 13, 2023



Bond traders continue to front run the Federal Reserve which is not new. During the second half of 2022, equity and debt traders got out over their skis by traded a Fed interest rate halt, or pivot, on three separate occasions, only to be rebuffed.

We believe financial markets are already pricing in two twenty-five basis point interest rate increases over the next few months. At that point the Fed's target rate will be at 5.0%. Since 2000, whenever, the Federal Reserve pushed rates higher than 5.0%, a recession followed.

In this weekender we will discuss inflation in the United States. To do it justice, we will venture into the caverns of economic geekdom. Hopefully it will be worth the spelunking.

Market Narrative

Inflation comes from two forces—demand pull and cost push. Demand pull inflation occurs when too much money is pursuing too few goods. In short, when demand is outstripping supply. Demand pull inflation often peaks when economies are at the pinnacle of an economic cycle. A period where unemployment is low, credit is plentiful, wages are high, and the wealth effect, a function of rising residential real estate prices and stock market levels, is constructive. Add to these elements, government stimulus payments and you have the demand environment during the pandemic.

This is a graph of weekly wages, adjusted for inflation. Real weekly wages. Normally, real weekly wages are in a gentle upward trend. Pandemic stimulus payments and arrangements pushed up real wages to unsustainable levels creating an economic environment where demand exceeds supply. Demand pull inflation was the result. With the stimulus spent and inflation largely remaining, real weekly wages have fallen back to where they were before the pandemic.

US Real Weekly Wages

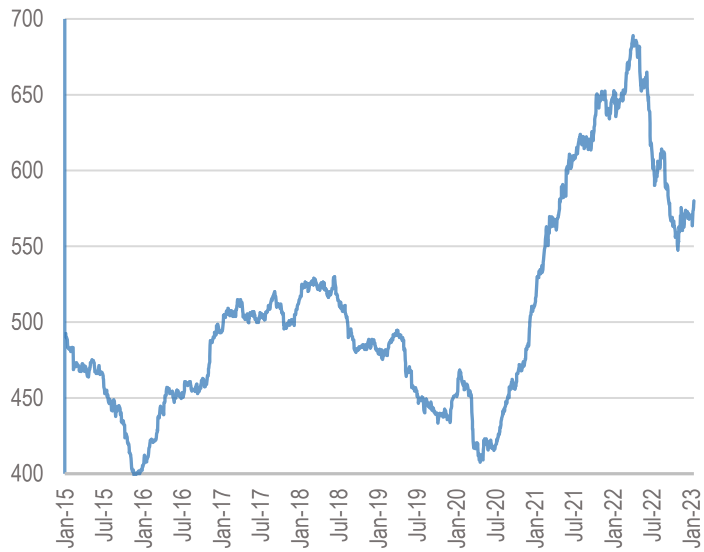
January 2015 - December 2022

Cost push inflation comes from a general increase in the price of raw materials, primary products, and components. During the pandemic, dislocations in labor, shipping, and trade created shortages in a vast array of goods and services, pushing cost push inflation higher. Each raw material has its own demand and supply dynamic. Lumber prices more than tripled before falling back to their pre-pandemic levels. Many other commodities took the same path. However, some remain stubbornly high.

This is a graph of an aggregate raw commodities index published by the Commodity Research Bureau. Prices for raw commodities ran from their pandemic bottom in May of 2020 to a peak in April 2022. They have since fallen dramatically although they remain well above their pre-pandemic level. It's likely that, as China reopens, some upward pressure on raw materials will persist. Labor rates, given the robust nature of the market, are likely to remain strong as well.

CRB Raw Commodity Index

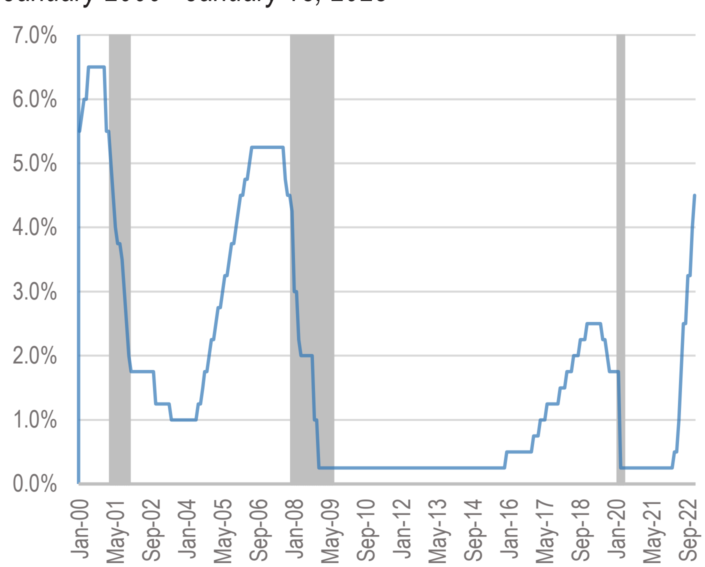
January 2, 2015 - January 13, 2023



Thursday's inflation data hit right on expectations and showed a concerted softening in inflationary pressures in most areas, except services. More on that in a minute. Inflation data rekindled expectations that the Federal Reserve may reduce the scale of its rate hikes to twenty-five basis points at each of its next two meetings. Down from previously expected fifty basis points.

Fed Target Rate Upper Bound

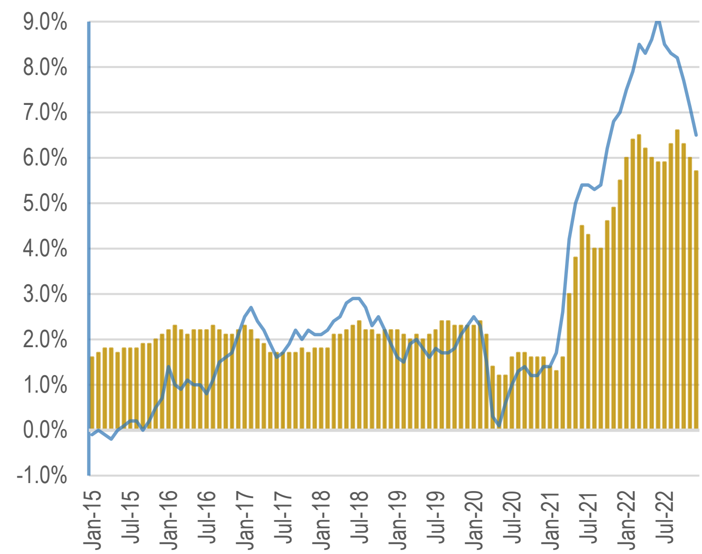
January 2000 - January 13, 2023



Headline inflation, as measured by the consumer price index (CPI), for the month of December was 6.5%, right in line with expectations. Core inflation, which backs out food and energy was 6.3%. On the back of current data, we expect annual headline inflation, as measured by the consumer price index (CPI) to fall to approximately 3.6% by the end of 2023.

CPI Headline (Blue) and Core (Gold)

January 2015 - December 2023



Owner's equivalent rent inflation accelerated. For most of us, this doesn't make sense when residential real estate prices are falling rapidly. Shelter inflation, in the Bureau of Labor Statistics (BLS) calculations, has a lag of approximately six months. Meaning, one stubbornly sticky area of inflation will soon be falling with a vengeance.

In the months ahead we expect shelter-related inflation to tumble, coming in line with the softening private sector-related measures. Used car prices, although falling, are in for a precipitous drop as more new car inventory hits dealer lots and traditional price incentives make the trade between new and used a no-brainer in a new car's favor. Medical care costs are a lost cause.

Meanwhile, bulging product inventories will consummate the power shift from sellers to buyers in the face of continued rabid discounting. A somewhat sloppy mending of raw material and finished product shortages will march forward in a spasmodic manner.

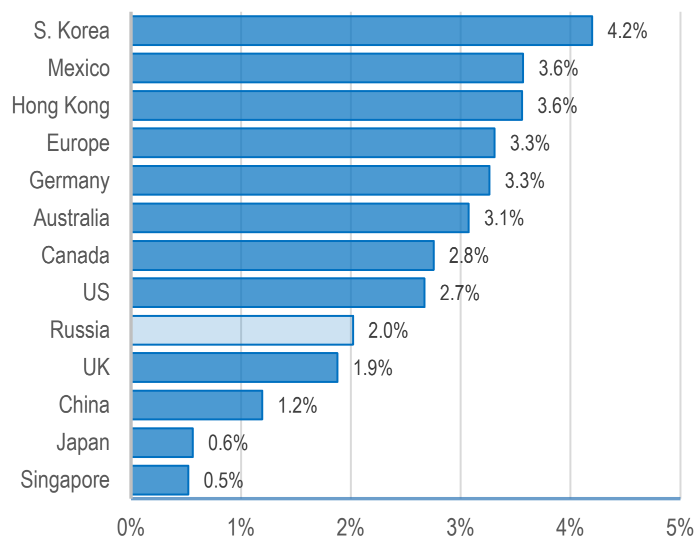
The point. Inflation is going to come down even faster than most professionals expect. Even and especially the sticky bits. This will give the Fed a lot of room to maneuver on rates. Low inflation may come after the damage is done. We will have to see.

Countries

Most country equity indices have shown considerable resiliency since the beginning of the year. By comparison, on the week, emerging markets with strong trading ties to the United States were the best performers.

Country Returns

January 9 - 13, 2023



Strong emerging market equity performance can be partially attributed to a US dollar that appears to be in free-fall. As the Federal Reserve begins to chart a more modest interest rate path into the future, the dollar will continue to be under pressure. A lower dollar will provide a tail wind for corporate profits earned abroad.

China continues to be a wild card. Pragmatic admission that their Zero-Covid policy was an abject failure has given way to a near-total opening and a commensurate increase in infections, sickness, and death. As the opening progresses, consumers are opening their wallets and spending, putting upward pressure on prices.

US Dollar Spot

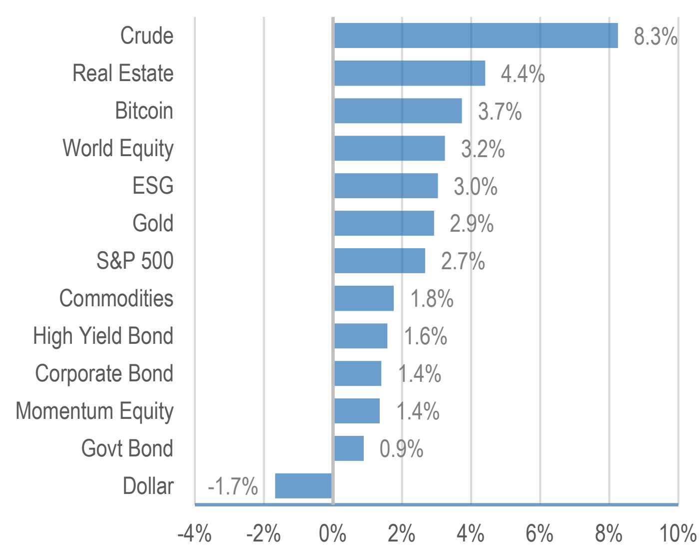
January 2, 2020 - January 13, 2023

Instruments

Among a broad category of investment instruments, crude oil was the best performer. Real estate was higher on expectations that mortgage rates would now come down from their peak following inflation's downward trek. Interestingly, weekly mortgage applications rose by 1.2% last week as mortgage rates softened. Bitcoin stages an unexpected rally and continues to rise over the weekend. A predictable trade continues. Lower inflation leads to lower interest rates. Lower interest rates lift the value of almost all assets.

Instrument Returns

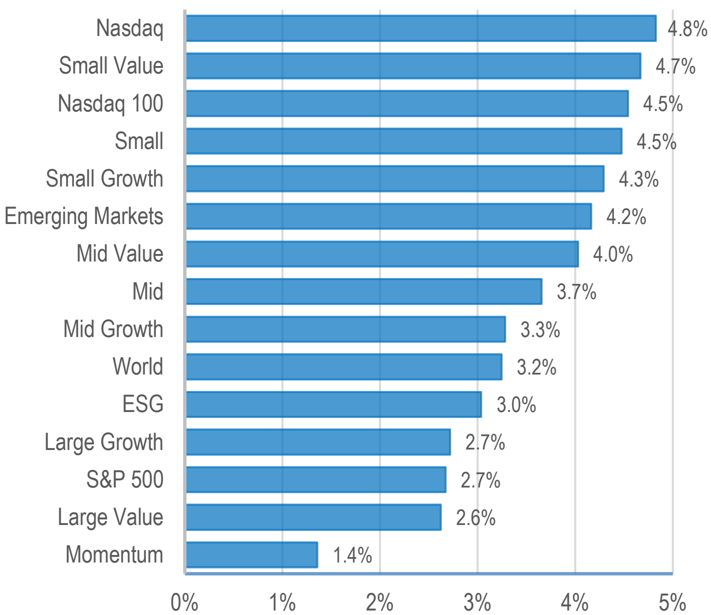
January 9 - 13, 2023



Among equity instruments, the trend in value-over-growth continues. In addition, from the beginning of the year equity investors have leaned in on shares of the most beaten down names like those in the Nasdaq and Nasdaq 100. Momentum was the poorest performer. However, momentum isn't what it once was. Components of momentum shift regularly. A year ago, momentum stocks were the technology darlings from 2021. Halfway through 2022 momentum funds were heavily weighted to financial firms. Now they are deep into energy.

Equity Instrument Returns

January 9 - 13, 2023



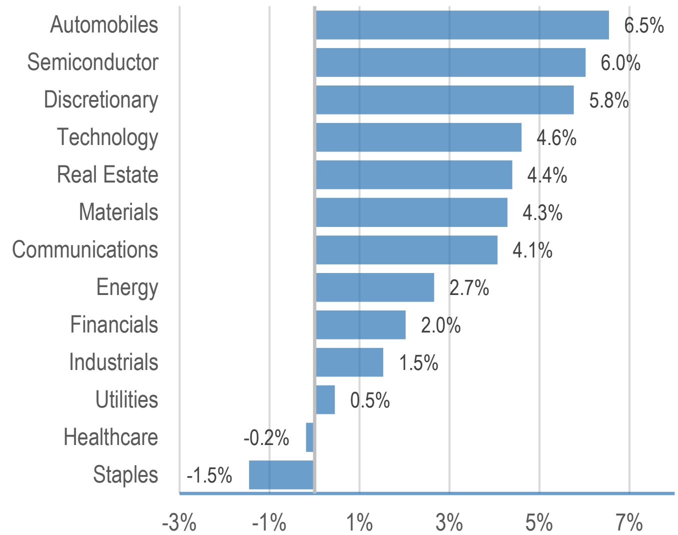
Sectors

Automobiles were the best performing sector last week. Followed by semiconductors and discretionary. Sector performance is another area showing that groups pummeled in 2022 are recovering in 2023. Staples, which generally provide market protection, didn't provide any last week. They were the poorest performing sector.

Next week earnings results for the fourth quarter pick up pace. While we expect earnings to be relatively strong on the whole, we will be listening carefully to each earnings call for clues on corporate expectations of the year ahead. Last week a number of financial firms reported earnings for the fourth quarter. In general, consumers were taking on more debt which helped banks make more money. Banks with strong mortgage origination businesses struggled. Some, like Wells Fargo, announced they would be reducing their commitment to the area.

Sector Returns

January 9 - 13, 2023

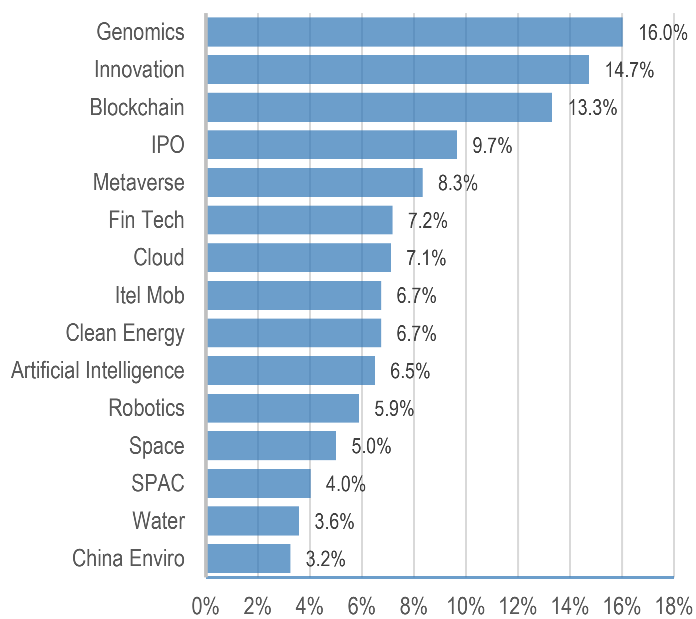


Themes

All the themes were higher. After a disastrous 2022, investors piled back in over the last fortnight. The prospect of lower interest rates in the future will continue to bode well for themes. However, any brush with the reality of business, like making mon-

Theme Returns

January 9 - 13, 2023



ey, will cause a reality check similar to the one experienced by Tesla, a car company, not a technology company. Just saying.

Conclusion

That's it for this weekender. We will not publish a weekender next week due to personal reasons. On the 31st, we will publish our first quarterly financial magazine, the Bucket List. Have a wonderful fortnight.