Finding Never Land

Weekender

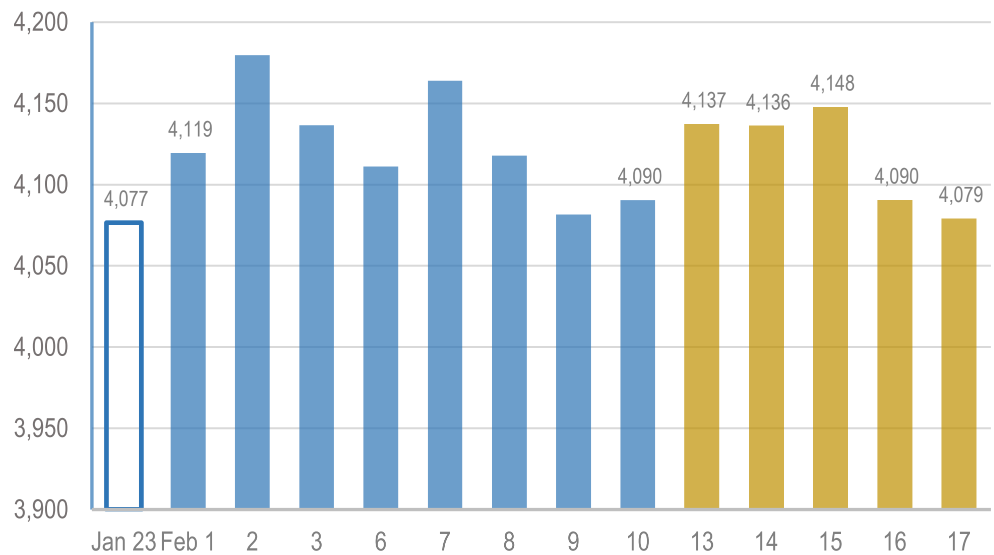
February 18, 2023

Good morning and welcome to the *Weekender* for Saturday, February 18, 2023. Equity markets, as measured by the S&P 500 index, were lower by -0.3% last week. Price action in most financial markets were driven by data showing persistent inflation at levels higher than expected. But the equity market response to the inflation data was muted, suggesting investors are less skittish than they were last year.

In fact, US equity markets throughout the month of February have been characterized by sideways moves with few dramatic ups and downs.

S&P 500 Index Levels

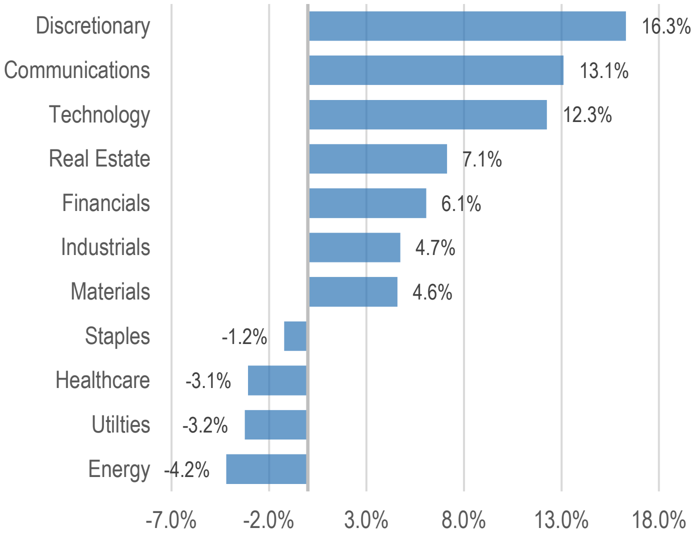
January 2023 - February 17, 2023, (Source: Bloomberg)



Equity market strength on a year-to-date basis has been boosted by unexpected consumer strength. Consumer discretionary companies in the S&P 500 have put up the best performance on a year-to-date basis, followed by communications, which includes the likes of Netflix, then technology companies. Next week, a host of retailers, from Home Depot to Walmart, will release year-end 2022 profits. Results are expected to be strong, but analysts are going to focus on statements providing guidance for the year ahead.

Year-to-Date Sector Returns

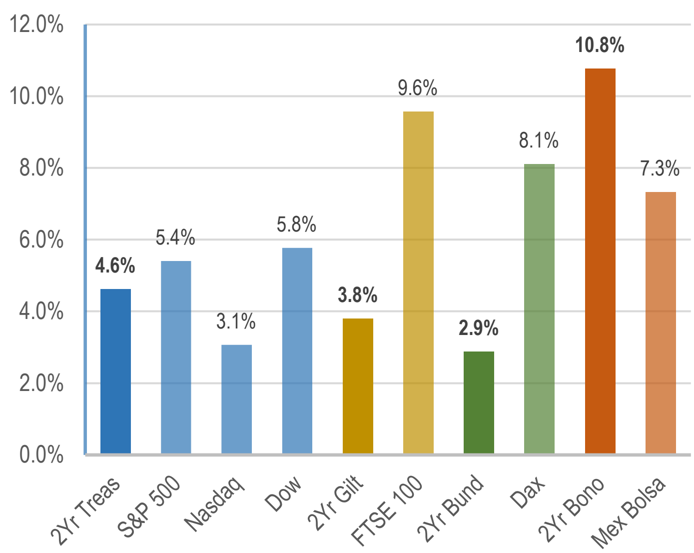
February 17, 2023 (Source: Bloomberg)



Below is a graph of the sovereign two-year government bond for the US (treasury in blue), the United Kingdom, (gilt in gold), Germany (bund in green) and Mexico (bono in rust). Of particular note is the yield of each sovereign bond compared with the earnings yield of the related stock market index. For the US, obvious interpretation calls out the tech-heavy Nasdaq as expensive compared to the US government treasury yield. In the United Kingdom and Germany however, equities present a formidable preference compared to debt. In contrast, for Mexico, debt is more attractive relative to the bolsa.

Sovereign Bond Yield and Index Earnings Yield

February 17, 2023 (Source: Bloomberg and AIA Research)



Major equity indices, like the S&P 500, used to be indicators of the industrial strength of an economy. Today, the S&P 500 is a consumer index, heavily weighted by technology, healthcare, and consumer discretionary and staples. Wall Street analysts predict that the retail sectors will show continued declines through the first quarter of 2023 and return to growth in the second quarter. A more hopeful outlook, coming from companies, push stocks higher. Retailers, in general, are grappling with bloated inventories from 2022 which is likely to constrain margins. Perhaps a more pressing concern is top-line revenue guidance. In the face of higher rates and persistent inflation, will consumers continue to spend? This will be the subject of next week's *Weekender.*

In this *Weekender,* we will focus on the Never Land economic scenario, provide an economic summary based upon data released last week, and summarize moves in countries, instruments, sectors, and themes. Our one more thing segment is about driving cattle.

Finding Never Land

The title of this *Weekender* is *Finding Never Land*. Neverland is a fictional place in the stories of Scottish author and playwright James Matthew Barrie. In his stories, a fictional character, Peter Pan, lives in Neverland where children never need to grow up. The concept of Neverland is a wonderful metaphor for our modern society and economy, where responsibilities are kicked down the road for another generation to burden. Past the play on words, though, this *Weekender's* title, is really about an emerging economic view that the US economy is strong enough to withstand higher interest rates and inflation without a meaningful correction or adjustment.

Economic and financial market pundits have been aflutter predicting their version of the economic future of the world, in general, and the United States, in particular. Some predict a hard landing, where the ravages of inflation and the consequences of the Fed's interest rate policies, push the economy into recession. Another potential outcome is a soft landing, where inflation is vanquished through the artifice of a savvy Fed with only minor damage to the economy. Never Land, like its fictional counterpart, is a fairy tale being told by the wishful. In this tale, inflation will come down and the economy will continue to grow unhindered by any consequences.

We believe that if inflation remains persistent, one of two mutually exclusive outcomes must materialize. The Fed's 2% inflation target must be abandoned, or the labor market will break resulting in economic recession. Abandonment of the 2% target means the economy and financial markets will need to recalibrate to a decidedly non-Goldilocks environment. Toleration of higher inflation, as a baseline, will push asset prices lower across the board and usher in an economy that experiences broad swings between periods of boom and bust. Remaining committed to a 2% target will required tighter monetary policy for more than a year breaking the labor market and pushing the economy into recession.

We believe the economy is slowing. Evidence continues to pile up to support this view, although the full impacts have yet to be felt.

From a portfolio perspective, we continue to hold the view that a combination of stocks and bonds, all focused on the most conservative edge of quality should compose the core of any investment portfolio. Alpha components should be added as pricing comes back to acceptable levels.

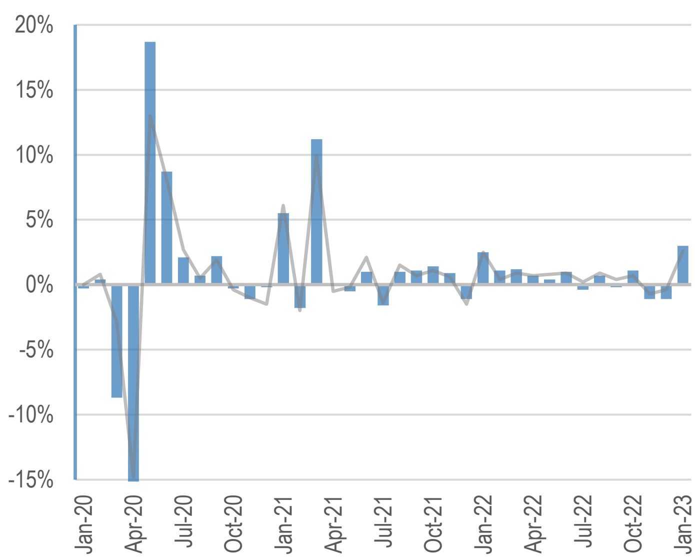
Economic Summary

Consumer prices, producer price, and retail sales data were all released last week. They told a story of robust demand in the face of higher inflation. Feeding off this narrative is an emerging view that the economy and its consumers are much more robust than expected and unlikely to be materially impacted by inflation, interest rates, or the aftermath of the Federal Reserve's compensatory actions. We believe this Never Land scenario is a flawed narrative.

A combination of higher borrowing costs, persistent inflation, and low consumer savings are certainly taking a toll on consumer finances, even though the consumer persists. Comparisons against similar periods in economic history are unable to provide a useful guide for the road ahead. Unprecedented government fiscal and monetary stimulus conjure enough fog to make the road itself hard to see. However, we believe cracks in the consumer are beginning to emerge.

US Retail Sales, Month-over-Month Increase

January 2020 - January 2023 (Source: Bloomberg)



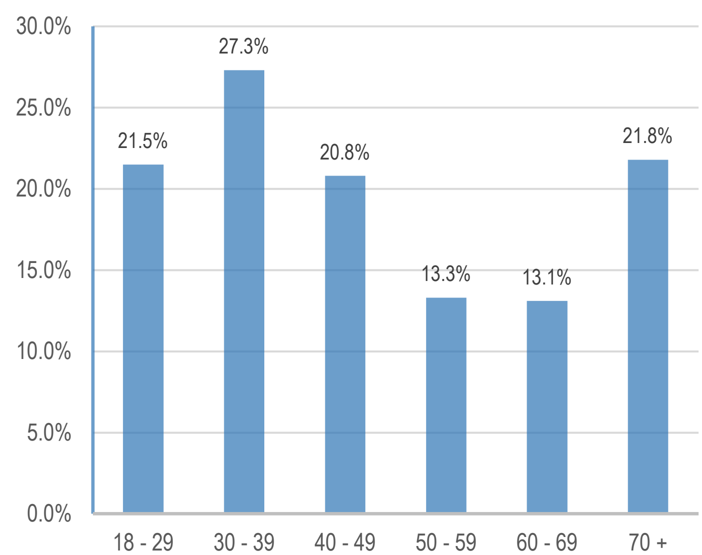
While consumer prices held tight and producer prices rose briskly, retail sales registered a powerful rebound, the likes of which we have not seen since the lockdowns ended and consumers began to spend their ill-gotten government booty. The US Retail Sales graph shows the month-over-month growth in retail sales. For the month of January retail sales rose by 3.0%, a very strong gain, despite the considerable fluctuations over the past two years during the pandemic.

Consumers are showing no sign of retrenchment which typically accompanies periods leading up to recession. US household debt is now $16.9 trillion, approximately $2.75 trillion higher than it was at the end of 2019, right before the pandemic. Meanwhile, savings as a percent of disposable income have fallen back to record low levels. Young borrowers admit they are having trouble keeping up with loan payments. In the Fed's latest debt report, which includes data through the end of 2022, a significant increase in delinquencies were noted in young borrowers from 18 – 59. Old farts, like me, kept paying.

This is a graph of debt increases in during the pandemic period, from the end of 2019 through the end of 2022, by age group. Notice that the younger cadres show the highest increase in endebtedness. The three-year increases are remarkable.

Consumer Debt Growth, by Age

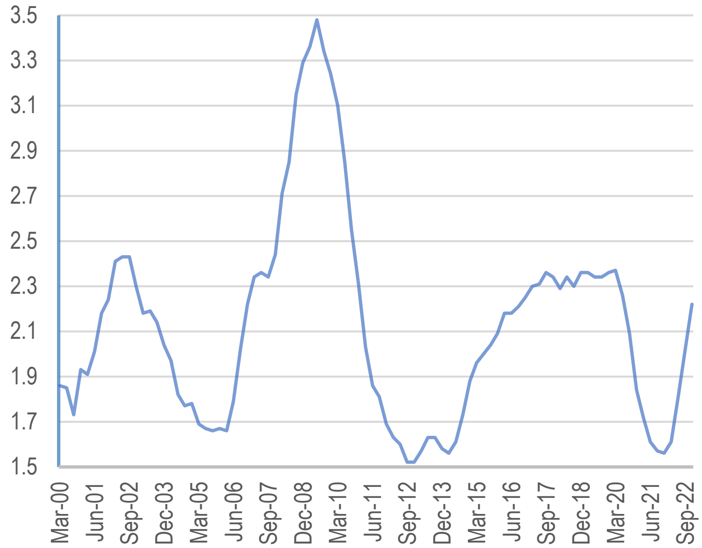
Calendar Year 2019 - 2022, (Source: US Federal Reserve)



But things are beginning ot change. Consider automobiles. Used car prices had been falling since the fourth quarter of last year. They are now rising again, driven to some degree by limited new car inventories. New car prices are also rising. The average price for a new car is now more than $50,000 and it's more than inflation driving prices higher. Car buyers are buying fewer cheap sedans, sorry

Auto Loan 90+ Days Delinquent

1Q 2000 - 4Q 2023, (Source: US Federal Reserve)



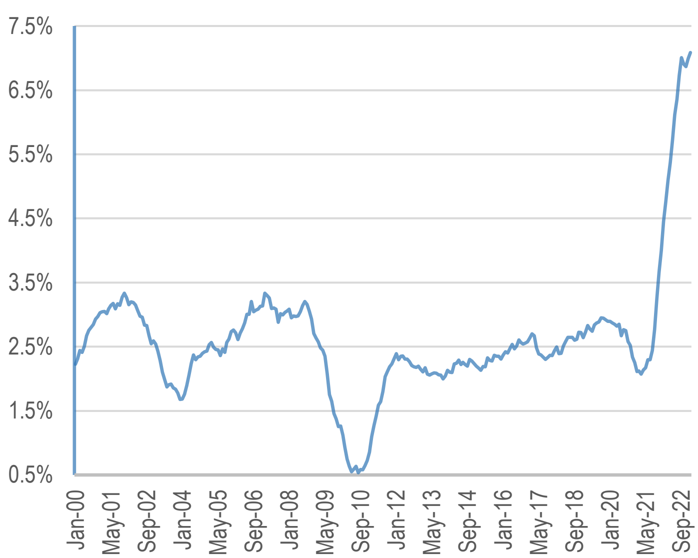
Prius, instead opting for luxury SUVs. All on credit. Car loan delinquencies are now rising.

Inflation at both the consumer and producer levels came in hotter than expected. Consumer inflation softened on both year-over-year and month-to-month comparisons, just not as much as economists had expected. Producer price inflation showed a smaller drop than expected compared to last year. But when compared to last month, producer inflation actually accelerated. Instead of presenting a graph of the consumer price index (CPI) or the producer price index (PPI), which we have done many times in the past, consider an alternative measure of consumer inflation.

Below is a graph that measures median inflation. It is produced by the Cleveland Fed. By construction, it eliminates the most volatile elements. Those that went up the most and fell the farthest during a given period. This graph illustrates extreme inflationary moves during this cycle. It also suggests that, contrary to alternative measures, prices are not cooling.

Median CPI

January 2000 - January 2023, (Source: Cleveland Fed)



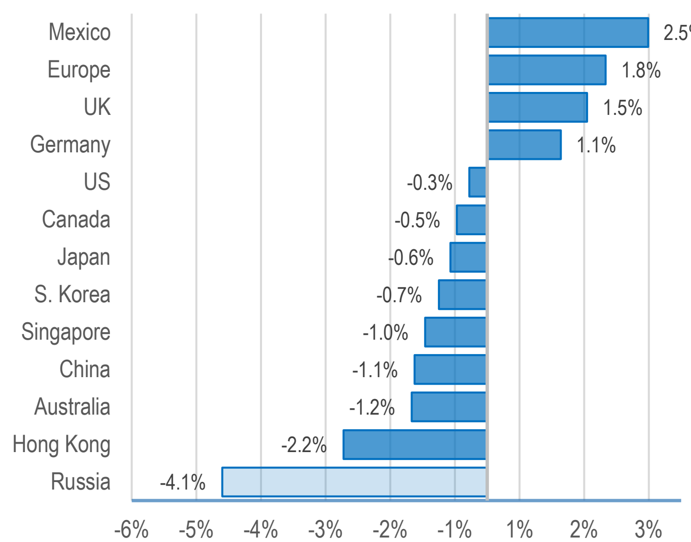
The economy will land. The longer it stays at altitude without slowly descending, the more likely it will crash when stores of fuel are exhausted. Federal Reserve actions are designed to bring the economy close to the ground before the fuel runs out. We believe the economy is slowing. Slowly. We also believe that this time really is different. Comparisons to previous economic periods provide little transparency to our current situation.

Countries

International, non-Asia equity markets were the best performing last week, which is not a surprise if you are a regular Weekender-er. Asian equity markets were the worst performing.

Country Returns

February 13 - 17, 2023, (Source: Bloomberg)

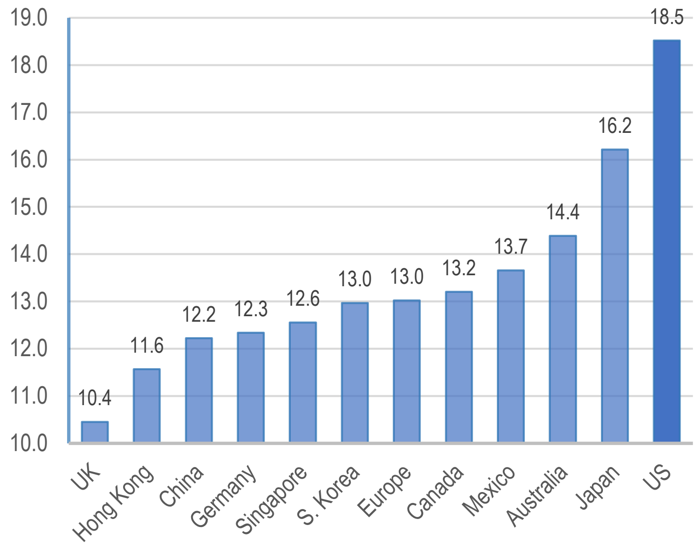


We believe undervaluation is the primary reason for international outperformance of late. As a precautionary stance, most managers that had to, or chose to, remained invested last year, crowding into US markets for protection, leaving international allocations thin. After a stout run in the first forty-five days of trading this year, US equity markets are looking overvalued, especially compared to their international peers. It makes sense that investors are now rotating to increase their international, especially European, exposure.

A host of factors, events, and altered states convince us that the post-cold war kumbaya is not just on pause or hiatus but over. A new world order is forming. Such an

Country Price-to-Earnings Ratios

February 17, 2023, (Souce: Bloomberg)



exhaustive topic warrants more thorough treatment, which we will do in a few weeks. However, it's clear to us, that the post-Cold war era ended February 24, 2022 as mortars began to rain down on Ukraine.

Shortly after Russia invaded Ukraine, Poland passed a new law designed to double its military. While Poland may not be a primary player in geopolitical affairs, its move is consistent with a general trend taking place, almost everywhere. Defense spending is increasing and home-grown production of ammunition, armaments, tanks, artillery, and air defense solutions are all likely to increase in tandem. The Royal United Services Institute of the United Kingdom published a preliminary study of lessons learned in Ukraine. Key takeaways include the need for more weapons and ammunition, the power of drones, and the need for real time intelligence and communication.

Governments around the world are reassessing their military strength, weapons, and stockpiles. Both Russia and Ukraine are close to running out of armaments. Most of Ukraine's weapons come from other countries and those countries are also running out. NATO defense ministers met last week. They agreed to ramp up military support for Ukraine. Part of the meeting included a comprehensive agreement to invest more in air defenses and deep strike capabilities.

A generational trend is afoot. After decades of passive lip service given to defense spending targets required of NATO members, the consequence of underspending is now readily apparent. For example, in the 1980s Germany had thousands of tanks. Only 321 remain in inventory. In another comparison, the UK's entire stock of 155mm artillery shells would be depleted in only two days at the rate Russia was firing them in the Donbas last summer. Without help from beyond its borders, Ukraine's forces would have run out in a week. Defense-leaning corporations are expectantly calculating the amount of ordinance exploding around the world in anxious anticipation of future orders.

Armies around the world are learning from the war in Ukraine. In the eight years between Russia's two attempts to subjugate Ukraine, Kyiv has learned a lot, resulting in ardent training of its military, in most cases conducted with its allies. Some of the lessons learned are expected to be applied in conflict zones that are already heating up in places like Taiwan.

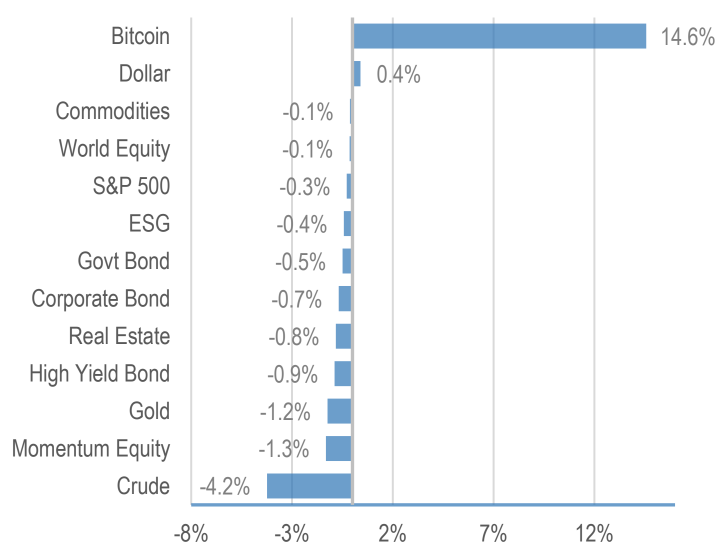
One year ago, when the attacks in Ukraine began, China's president Xi Jinping declared that the middle kingdom had a "no-limits friendship" with Russia. But friendships come at a cost and China has yet to get the bill for this one. Aligning itself with what most believe to be a pariah state like Russia will have consequences. To the extent that China moves past the red line and openly provides arms to Russia, the consequences will be severe.

Instruments

Among investment instruments, bitcoin was the best performer by a large margin. On the backside, crude oil was the poorest performer. Most other primary investment instruments were lower on the week.

Instrument Returns

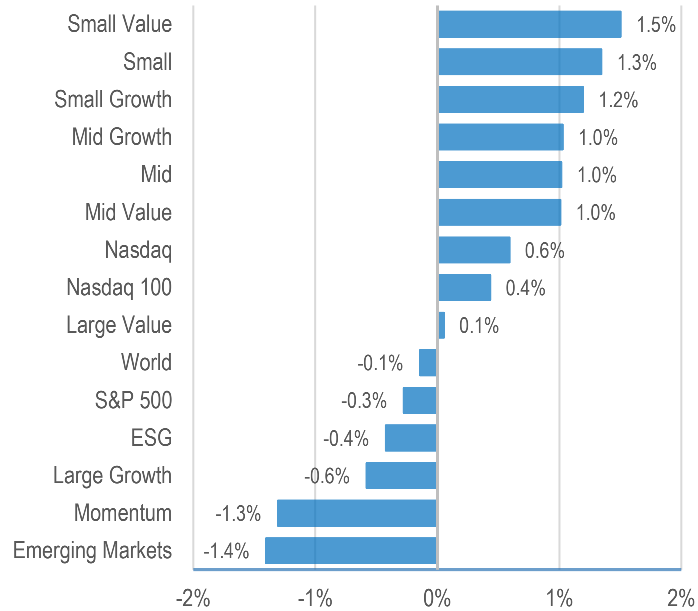
February 13 - 17, 2023, (Source: Bloomberg)



Small and mid-sized companies outperformed other primary equity market players which has been a trend for more than a year now. Emerging markets, generally, were lower as the dollar strengthened a bit over the past week.

Equity Instrument Returns

February 13 - 17, 2023, (Source: Bloomberg)

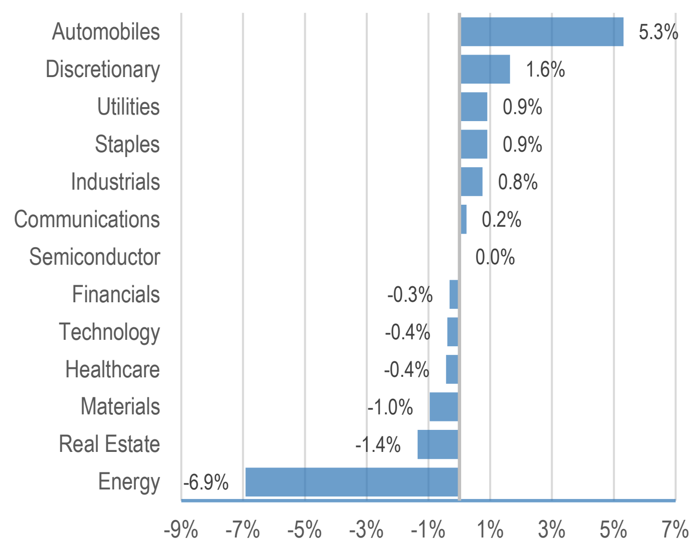


Sectors

Automobiles were the best performing sector while energy, on the back of a fall in crude oil, was the poorest performer. Discretionary stocks continued their relative outperformance compared to the rest of the market. As mentioned earlier, discretionary outperformance is being bolstered by a resilient consumer.

Sector Returns

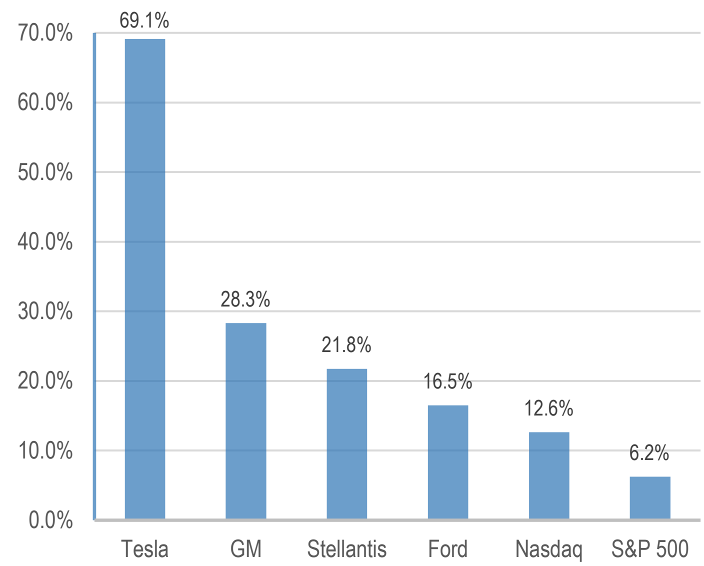
February 13 - 17, 2023, (Source: Bloomberg)



Automobile outperformance is almost exclusively attributed to Tesla. This is a graph of the year-to-date performance of each primary automobile company in the United States, compared to the S&P 500 and the tech-heavy Nasdaq. Being overweight, automobiles have been a powerful allocation.

Year-to-Date Auto Stock Performance

February 13 - 17, 2023, (Source: Bloomberg)

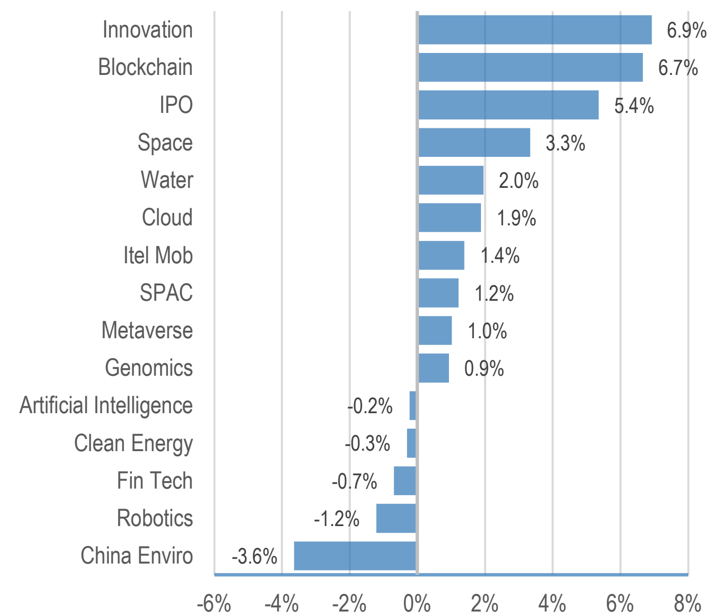


Themes

Despite a modest fall in equity markets last week, most themes had a great week suggesting that animal spirits remain alive. Themes related to Asia were softer than the others.

Theme Returns

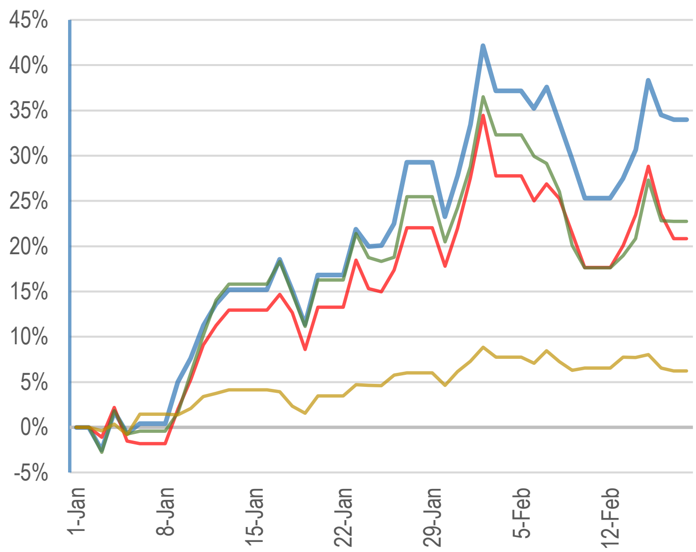
February 13 - 17, 2023, (Source: Bloomberg)



This is a graph of the innovation theme, using Cathie Wood's Ark Innovation Fund as a proxy (blue line), the S&P 500 (gold line), a graph of the most shorted stocks (green line), and stocks of companies that lose money (red line). Markets where the riskiest elements lead the safe and secure by such a large margin are those where fundamental valuation factors are not playing an important role. This is an ongoing concern.

Cumulative Year-to-Date Performance

February 13 - 17, 2023, (Source: Bloomberg)



One More Thing

As I have said before, I spent each summer as a youth, except one, with my grandparents, working on a farm in Scipio, Utah. My grandfather, Gramp, was a guileless soul who, by his own admission, didn't understand me. I have layers.

Each summer we drove a herd of cattle from spring pasture to our property at Scipio Lake. Spring and summer irrigation demands forced the lake's water levels lower, revealing a blanket of lush green pasture where the water once stood. It was an ideal place to fatten up the cows prior to the winter.

A cattle drive is an odd thing. The popular Peacock show, Yellowstone, romanticizes the cattle drive to a degree that makes it unrecognizable. Our cattle drives bore only one similarity to those depicted in the popular show. A horse. Cattle move slowly and the path of our drive was along highway 50 for approximately 9.5 miles. My grandfather rode Tek, a large horse reaching almost sixteen hands. Nathan was perched atop a beat up blue BMX bicycle. I started astride a Honda Trail 90.

We had three jobs. First, keep the cattle moving. Second, keep them off the highway and away from oncoming traffic. Third, as much as possible, make sure all the farmer's gates were closed along the route, otherwise the herd will follow the path of least resistance and spread out in open fields. Getting them back on the path would take a while. Sounds like humans.

Gramp asked me and Nathan to switch off between the Honda and the bike a few times on the way to the lake. A form of small farm equality, which at the beginning of the drive made perfect sense to all of us. By late afternoon we veered off the highway and onto a gravel country lane, signaling the final approach to the pasture destination. At the end of six hours and almost ten miles, I was still on the Honda. Nathan stayed on the bike all the way to the lake.

As we pushed the last cow through the gate, Gramp rode over and, loud enough for all the cows to hear, criticized me for my laziness. How could I remain on the Trail 90 for the whole drive and not give Nathan a break. Laziness was indeed a skillset I honed to perfection as a child, but it was not the proximate motivation for staying on the motorcycle. Equally indignant, I stood tall and responded with energy that his criticism was unfair. I had, indeed, asked Nathan many times along the drive if he wanted to switch, but he declined.

Gramp didn't know that. He did now. I was not inclined, nor was I ever permitted, to talk back. But this was different. I was worn out and not willing to absorb the unbased criticism without a response. I was also no longer a child. In fact, at six feet and fairly robust, I towered over my grandfather's five-foot-nine-inch, rail-built frame.

After we put the cows in the pasture and took the saddle off Tek, grandma picked us up and brought us home. I sat with Nathan in the back of the truck, which was a thing back then. Nothing was said between Nathan and myself. It seemed that my vocal, and dare I say, indignant response had broken chapter of the family code. After a quiet dinner, I sat on the outside porch licking my wounds when I heard the old wooden screen door on the store swing closed.

Gramp came over to me and handed me a jump rope he had fashioned from the store's meager inventory. I was training all summer for what I hoped would be a successful senior year and a jump rope was something I lacked. Nothing else was said, but I felt the rope was something of an apology. Nothing else was ever said about our harsh words to each other. I did tell this story at gramp's funeral because it had such a powerful impact on me.

On the morning of the next day, as we drove to the field, Gramp said to me, "when someone criticizes you, whoever it is, think about it honestly. If the criticism is just and true, adjust your behavior. If it's not, ignore it and move on." I assumed this gem was in response to our dust up the day before, but I was not entirely sure. Regardless, his counsel has been powerful advice and a balm applied to many wounds over the course of my life. I have also passed this advice to my children at opportune times over the years.

Small town wisdom is often simple, to the point, and requires personal responsibility. How valuable his advice would be in our modern, social media ridden, inflexible society today.

That's it for this Weekender. Have a wonderful holiday week.

Disclosure Statement

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