FOMO Forever

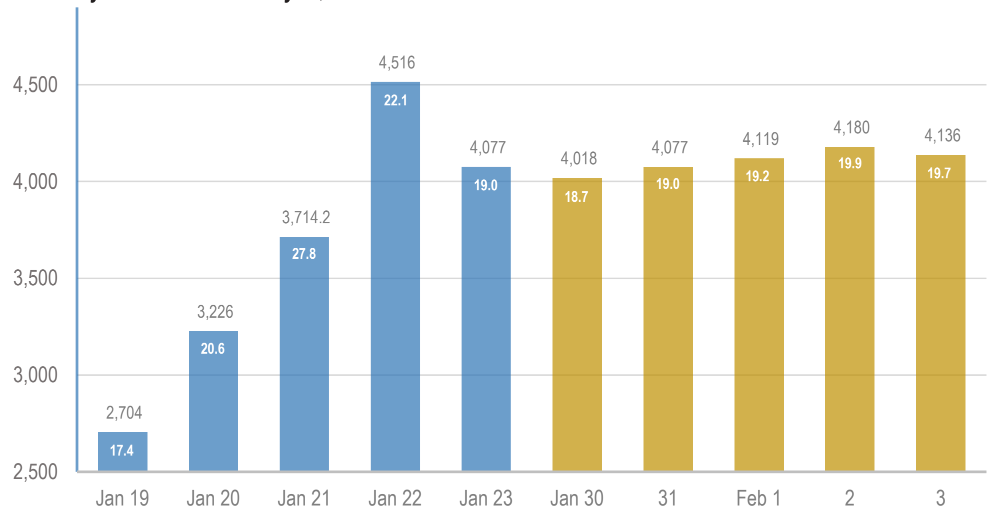
Weekender

February 4, 2023

Good morning and welcome to the *Weekender* for Saturday, February 4, 2023. Equity markets in the United States, as measured by the Standard and Poor's 500 index, were higher by 1.6%. In the accompanying graph, the January ending levels of the S&P 500 for the past five years are showed in blue bars linked to the left axis. Inside the bars, the price-to-earnings ratios on the same date are printed in white. Equity market valuation multiples rose going into the pandemic as excess liquidity washed over US consumers and investors. Stock price declines in 2022 pushed valuations back toward normal levels while equity market gains since January first are making markets expensive again, especially when earnings are expected to decline going into 2023.

S&P 500 Index Levels

January 2019 - February 3, 2023



Consider that the average S&P 500 PE ratio from the period beginning January 1, 2010, as the post-credit crisis market began mending, through January 1, 2020, before the COVID-19 pandemic burst on the world, was 16.2. The S&P 500 PE ratio currently trades at a 21.8% premium to this average.

Since the beginning of the 2023, markets have been trying to weave a narrative that the Federal Reserve is done raising rates, or at least close to

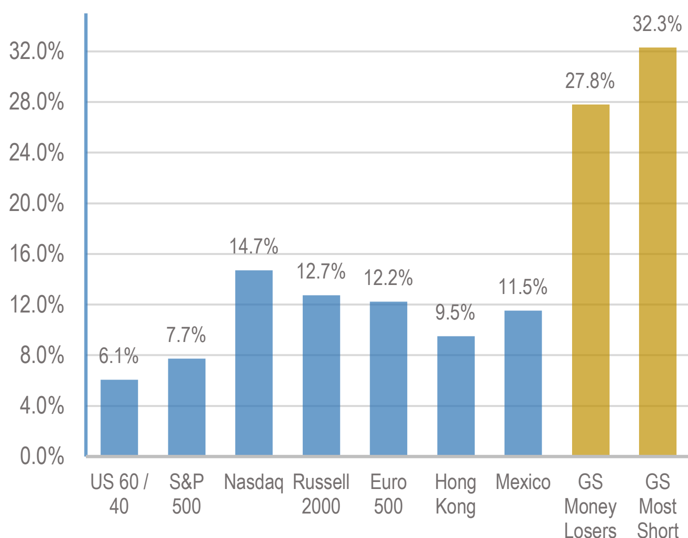
done. This same narrative was pushed and failed to hold three times in 2022. On Wednesday, the Federal Reserve target rate was increased by 0.25%, and in his prepared remarks Fed Chairman Jerome Powell confessed that he saw disinflation on the horizon. With that admission, financial markets had all they needed to party on, pushing the view that a rate pivot was now just around the corner. In totality, Powell's remarks were hawkish, suggesting rates would continue to go up, although at a slower pace, and would likely remain higher for longer. But traders would not be denied. They pulled from the Fed's comments whatever would perpetuate another run at the pivot trade.

On a year-to-date basis, the S&P 500 is higher by 7.7%. By any comparison, 2023's as yet unfinished equity gains are remarkable. But the factors driving the gains are non-durable. Analyst's earnings estimates for 2023 continue to fall and economists continue to expect economic softness going into the second half of 2023, neither of which are supportive of higher equity prices, broadly.

Target interest rates are going to rise a bit more from where they are at 4.75% but financial markets are already ignoring the Fed's target rates and selling them lower in financial markets. Inflation is coming down. But its is not likely to settle near the Federal Reserve's 2.0% target for a while. It may be that the year-to-date equity gains are a reflection of markets getting a bit over their skis. Markets are being driven by an intense fear of missing out (FOMO).

Selected Year-to-Date Returns

January 2 - February 3, 2023



On the bottom left is a graph of the year-to-date gains in a few equity categories. Notice the extraordinary gains generated by the riskiest side of the market. A Goldman Sachs index incorporating stocks of money losing companies and a sister index of the most shorted stocks are the two best performers year-to-date by a considerable margin.

We do not believe year-to-date positive returns reflect an "all clear" for equity markets in general. We expect earnings adjustments to drive equity prices after a short period of animal spirit-induced euphoria abates. That said, we are actively building positions in names that have been beaten down more than we feel their fundamentals warrant.

In this *Weekender* we will review some timely economic and market data and provide a summary of the weekly moves in countries, instruments, sectors and themes. In our one more thing segment we will discuss the power of family stories. Please be sure to consult with a qualified financial advisor, prior to making financial decisions.

Market Narrative

Financial markets are in the process of shifting narratives. For most of January and the first week of February, they traded on the changing expectations of what the Federal Reserve would do with interest rates. Now that rates are peaking, a more mature long-term narrative will take shape that can explain the new normal in a post-pandemic world. We believe this narrative must discount a world where inflation will normalize higher than the Fed's target and corporate earnings will soften after the foam of pandemic spending is fully blown off and margins come back in line with historical averages.

An unreconciled hole in the emerging narrative is whether the Federal Reserve will need to or chose to hold interest rates at a restrictive level long enough to cause significant harm to the labor market. If they don't a soft landing is possible. Recent economic data suggest that the rate hikes of 2022 have been effective reducing demand for interest rate sensitive products like housing and automobiles but have had almost no effect on other services.

Last week, the Institute for Supply Management released their Purchasing Managers Index for both manufacturing and services. These data sets are very insightful because they are intended to provide a forward looking view of the economy. Most economic data is backward looking and has little predictive value. The red line in the graph is set at 50. Readings above 50 suggest expansion while results below 50 portend contraction.

For manufacturing, which accounts for 12% of the US economy, ISM data is below 50, the blue line, which predicts a contraction of manufacturing in the months ahead. Additional data points released this week support the ISM. Factory orders, when airplanes are removed, are in decline. Capital goods orders as well. Prices paid in manufacturing, the gold line, are still in contraction but is showing some resilience recently. This is consistent with the view that declines in product prices are starting to moderate. The gray line shows manufacturing employment which continues to hover around neutral. This reflects a general perception that the labor market continues to be tight, making manufacturing firms unwilling to shed workers until the last minute. Of particular concern is new orders, the green line, which is sinking deeper below the neutral watermark.

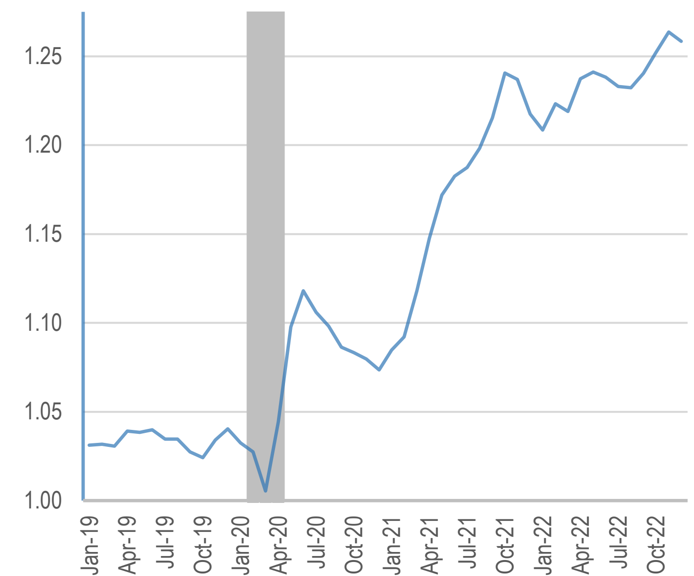
Manufacturing PMIs

January 2019 - January 2023

Manufacturing is also shackled by excess inventory built up over the pandemic. Excess inventory is sitting in the wholesale side of the supply chain because retailers are out of space to hold product. Some retailers are forcing suppliers to hold onto inventory by expanding the size of their warehouses or renting a fleet of shipping containers. This is a graph of the ratio of wholesale inventory to retail inventory, which is significantly above pre-pandemic levels. Wholesalers are stuffed. Only continued discounting will clear the excess, which will constrain profit margins for the next few quarters.

Wholesale / Retail Inventory

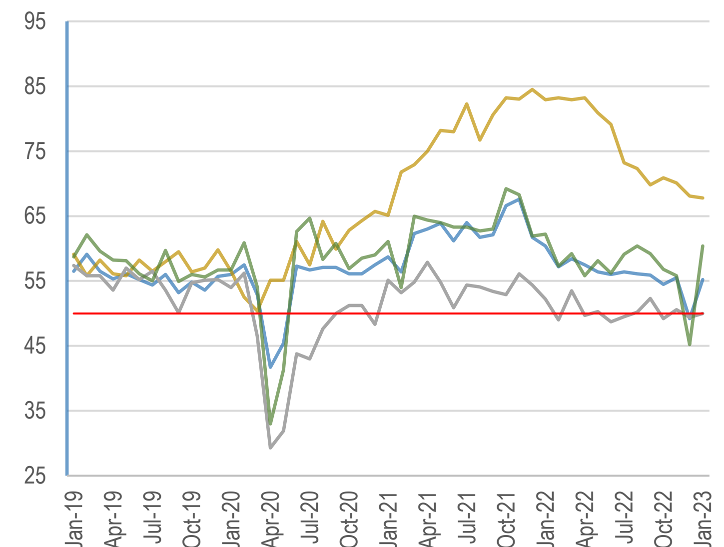
January 2015 - December 2023



On to services, which accounts for approximately 60% of the US economy and is growing every year. Services, in general, have popped out of pandemic contraction and are now expanding again, as indicated by the blue line moving above 50. Similarly, new or-

Service PMIs

January 2019 - January 2023

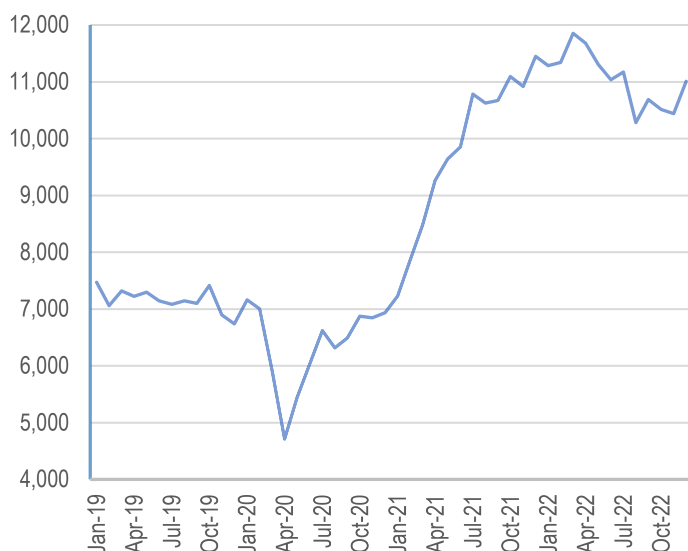


ders, the green line are growing again and price levels, the gold line, remain firmly in expansion territory. Employment in the service sector hovers around the neutral barrier, the grey line. A strong service sector will compel the Fed to keep interest rates restrictive for longer.

Two employment data points were released last week that confirm the sticky wicket of the Fed. Jolts data show how many job openings there are in the country. More than eleven million, well above the pre-pandemic level and close to an all-time record. In the United States there are almost two job openings for every unemployed person.

JOLTS Job Openings

January 2019 - January 2023

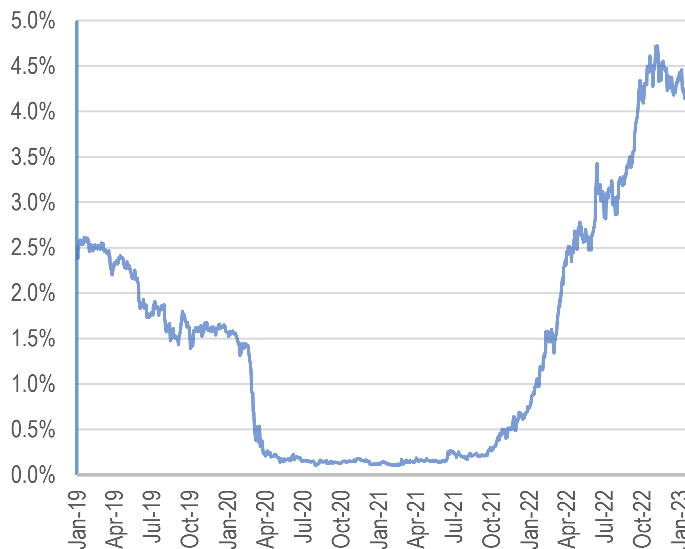


Also released last week was the government calculation of how many jobs were added to the US labor force in December. Economists expected a softening from the previous month when the economy added 188,000 jobs. 517,000. Well above expectations. Data wonks were quick to pull the "ya but" card due to a number of seasonal factors that play into the number. Certainly seasonal factors would have made a difference on the margin. But in total, it was a stunning number making a glaring pronouncement that the labor market is remarkably robust and seems largely unaffected by higher interest rates, at present at least.

Continued rate increases by the Fed are pushing up against and obstinate barrier. Financial markets are increasingly certain the Fed will pivot soon and begin lowering rates to avoid a policy error, embarrassment, and / or economic disaster. Two-year government bond yields have been trading a pivot since the beginning of November 2022. Falling inflation is giving fixed income markets confidence that their trade will pay off. Lower market rates in the face of higher Fed target rates make the Fed's further actions impotent.

US Two-Year Government Security

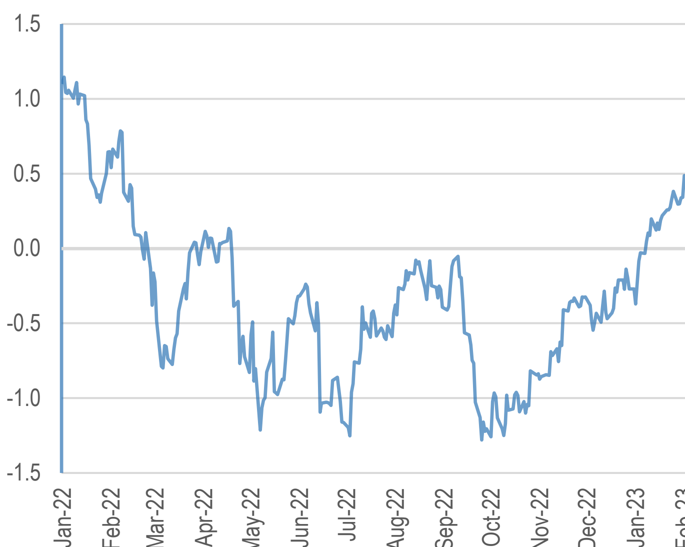
January 2, 2019 - February 3, 2023



Looking at higher rates, Chair Powell suggested in his Wednesday press release that rate increases have helped tighten financial conditions significantly. While headline rate increases support his view, what is happening in financial markets is very different. Declining bond yields and higher equity prices are slashing the cost of capital in the face rising target rates. In fact,

US Financial Conditions

January 3, 2022 - February 3, 2023



financial conditions were at their most restrictive in September 2022. Peak hawkishness. Since then, markets began discounting an imminent peak in target rates by pushing down market rates. The result is that financial conditions are about as loose as they were at the beginning of 2022.

We see a narrative beginning to coalesce around existing economic data. Falling inflation is driven by product markets and not services. The recent turn in inflation, which is positive for consumers, corporate profits, and financial markets generally, has been delivered on the back of lower product prices, owed primarily to fewer material, component, and product shortages. Mended supply chains are not a function of Federal Reserve policies or actions.

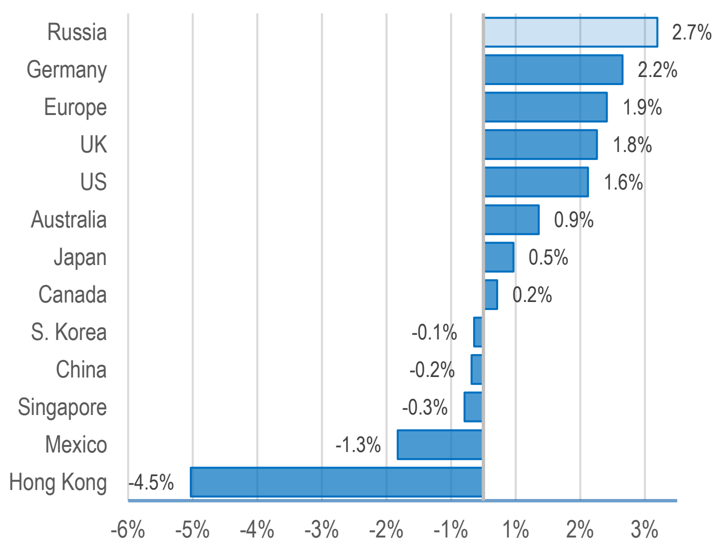
Persistent service inflation will keep sustained inflation well above the Fed's target. Since there is a long lag between interest rate actions and their results, its likely the Fed lifts rates one or two more times and then sits back to survey the results of their handiwork. A strong labor market, mending supply chains, and an interest rate market that is already pricing in softer rates ahead give them the luxury of time. Earnings are falling and will continue to do so, at least through the second quarter.

Countries

Russia was the best performer on the week. But for moral, practical, and obvious reasons we do not feel the country is investable. Behind them, Europe

Country Returns

January 30 - February 3, 2023



continues to outperform. European equity markets are considerably cheaper most other developed nations which attracts value investors who eschew US markets on the basis of valuation. Asia, broadly speaking, underperformed.

Investment value seems to be bunched outside of the United States. At present, the UK and Hong Kong are jostling to be the cheapest markets in the world. The UK trades at 10.0 times earnings and has an average 3.6% dividend yield. Most European markets trade below 13.2 times earnings.

A "weather" balloon driven off course by high altitude winds was shot down by the US military just as it was about to leave US territory over the Carolinas. China protested, but me thinks she doth protest too much. Before Balloongate relations between the US and China were slowly beginning to thaw, but with China lobbing spy balloons over North America that may change. Although minor in relative terms, the weather balloon spat is emblematic of the increasing impossibility of getting the two nations back on their pre-pandemic glide path. Looking beyond the two countries, an emerging rewrite of globalization is beginning to lot different than before the pandemic. Nationalistic and bilateral agreements and understandings are likely to be the norm. The kumbaya music of the "new world order" that harmonized most global interactions beginning with the fall of the Berlin wall in 1989, has been shredded.

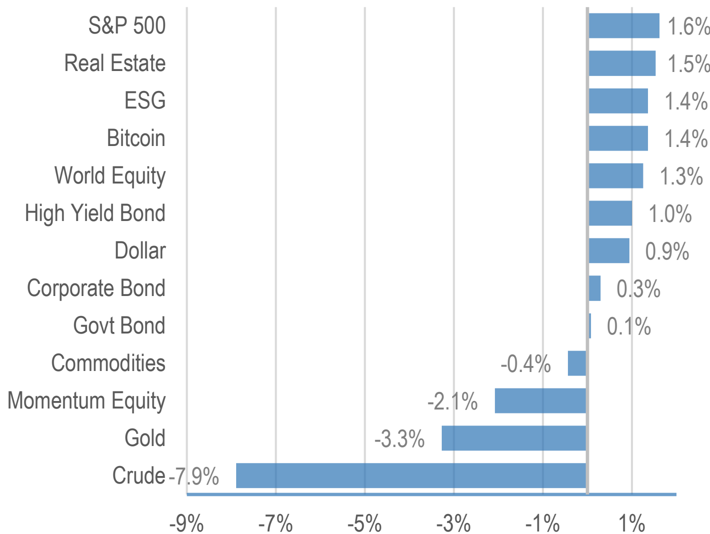
Investors should prepare for a return to near-shoring and a focus on nurturing traditional treaty relationships at the expense of developing friendships in unpredictable locales. Global supply chains will suffer. Prices of raw materials, components, and final goods, which have been falling for generations, will rise.

Instruments

Among investment instruments, the worst performer was crude oil which was down -7.9% on the week resting at $73.39 per barrel. Oil companies released peak earnings over the past two weeks and announced significant share buybacks. We believe many oil companies continue to be worth holding given their deeply discounted valuations and strong dividends. We also expect oil to trend higher over the coming decade.

Instrument Returns

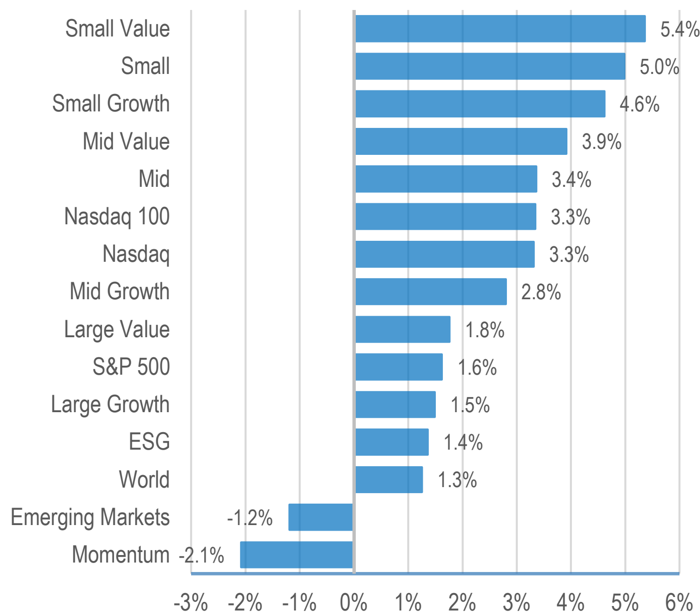
January 30 - February 3, 2023



Looking at equities, value continues to outperform growth. We expect this trend to continue.

Equity Instrument Returns

January 30 - February 3, 2023



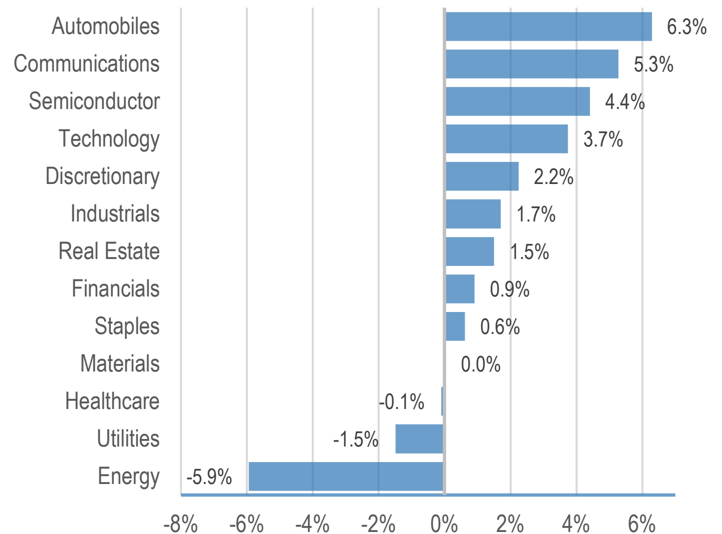
Sectors

Automobiles were the best performing sector thanks to Tesla and General Motors. GM reported strong earnings. Ford earnings were a disaster due almost exclusively to continued supply chain troubles.

The Philadelphia Semiconductor index clocked its best January performance in twenty years. On a year-to-date basis, it is higher by 23.2%, mostly driven by Nvidia and the new soup de jour, artificial intelligence. Investors and traders have been pushing Nvidia higher on the back of AI-related news from OpenAI and ChatGPT. Nvidia is a unique semiconductor company. They do not produce commodity chips but focus their proprietary technology on high-growth specialty areas like artificial intelligence, automated driving, data science, and digital mining.

Sector Returns

January 30 - February 3, 2023

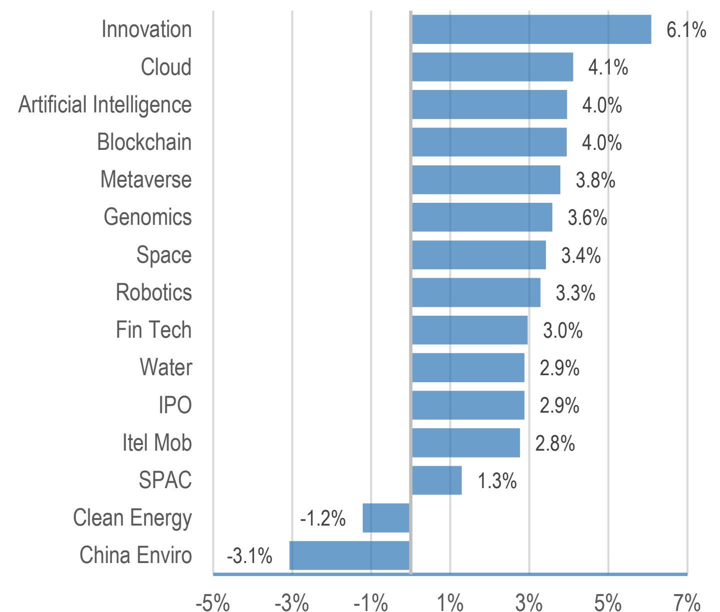


Themes

Theme performance is tightly related to the degree to which investors manifest their animal spirits,

Theme Returns

January 30 - February 3, 2023



which this week was bare naked. All themes, except those tied to China were higher.

One More Thing

Grandchildren are what life is about for Jeanne and me. We currently have six with one pending. On occasion, a couple of them spend the night with us. As part of our bedtime routine, my wife reads them a story and kneels with them in prayer. After the prayer the kids launch a barrage of attempts to postpone falling asleep. One of them involves the question, "can you tell me a story about when you were my age?"

My childhood was wholly unremarkable. Every year, since I was very young, our family would load the care on the last day of school and drive almost thirteen hours from Solvang, California to Scipio, Utah, a small farming and ranching community where my father, grandfather, and great-grandfather were born and raised and where my older brother Chris and I would spend our summers. We spent the summer under Gramp's instruction, learning how to farm and help Gram run a small general merchandise store called Lloyd's Market.

Lloyd's Market was the town's proverbial watering hole. Grandma stood behind the worn Formica countertop and verbally sparred with a seemingly endless march of townsfolk who would come in, sit on an old grey round back wooden chair, and talk. For hours. On our lunch breaks we would often go in the store and warm up a Stewart's sandwich and listen to the stories.

Over time a family narrative was formed from the overheard stories. Almost everything I know about my father an uncle come from these stories. My grandfather was a guileless soul who left home at fourteen years old to support his family. Riding the rails and finding work wherever he could. My great grandfather could pick up any instrument and, after figuring out how it worked, could play it with fluency. Sadly, music was not a skill passed down within the family's male genome. While each story was unique, the tone was the same. Adversity, some temporary and some poignant, was to be expected as the common lot of human existence and thwarted by persistence.

Last year, I celebrated, or at least marked, my sixtieth birthday. Since then, I have been almost overcome by a sense of nostalgia. Childhood memories seem to be flooding my awareness with remarkable clarity. Now, as grandchildren ask me to tell them what it was like when I was their age, memories flood my mind and the stories flow.

A study was conducted in 2001 about the determinants of childhood emotional resilience. The results were remarkable and unexpected prescribing a healing balm for the damage constantly done by an increasingly invasive social media complex. The study found that the more children knew about their family's history, the stronger the sense of control they felt over their lives and the more solid their self-esteem. The power of family stories beat out every other determinant by a large margin. Knowledge of common family stories gave children a sense of belonging and value. They were much more powerful than the voices and messages foisted upon them from outside sources.

Family narratives generally come in three genres: success, failure, and / or persistence. The story's genre was not as important as the sense of belonging created by being an heir to a family narrative. Research shows that if you want a happier more resilient family, create, refine, and tell, over and over again, the stories of your family.

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