Move On

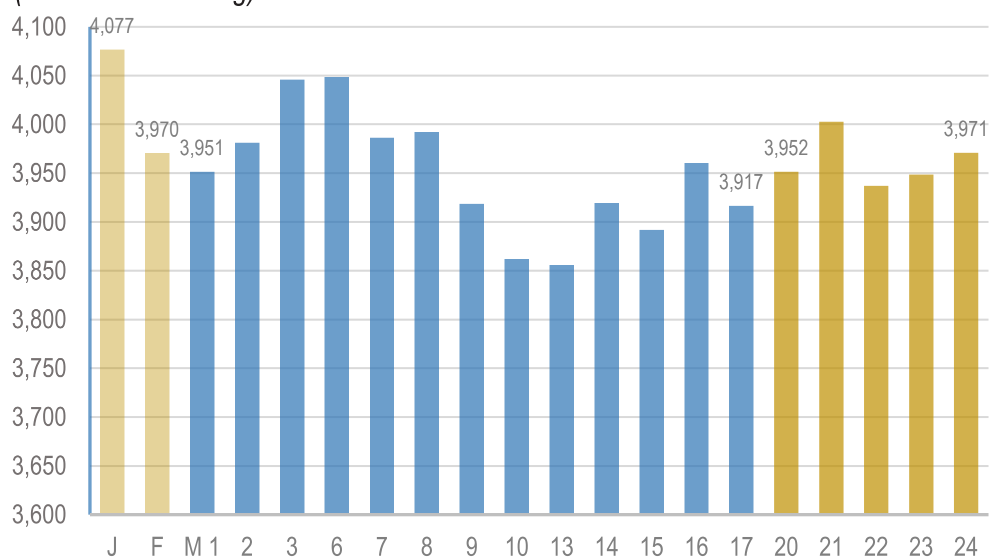
Weekender

March 25, 2023

Good morning and welcome to the *Weekender* for Saturday, March 25, 2023. US equity markets, as measured by the S&P 500, were higher by 1.4% this week, the second consecutive week of gains. Over the last fortnight, financial markets rose in the face of two narratives: bank failures and their potential systemic contagion and growing expectations of an economic recession. Despite difficulty digesting these potentially negative narratives, markets have, instead, decided to swallow them hard and move on. But "moving on" means focusing on fundamentals, like poor corporate earnings, deteriorating profit outlook and persistent inflation. Damned if you do. Damned if you don't.

S&P 500 Index Levels

(Source: Bloomberg)



Companies will begin reporting first quarter earnings in three weeks. Assuming bank-related issues have been put to rest by then, fundamentals will take center stage. As a recap from the last earnings season, sales for the fourth quarter of 2022 were higher by 4.41% while earnings were lower by -11.28%. Most of the drop in profits came from margin contraction resulting from higher costs. We expect margin contraction to endure into the next two quarters, at least. In addition, it's likely consumer debt and abiding inflation begins constraining consumer spending which will dampen revenue growth.

Together, these factors are likely to result in a negative adjustment to analyst estimates for the 2023 earnings and beyond.

Despite a meaningful degree of corporate profit deterioration, many broad macroeconomic datapoints remain stubbornly optimistic. The US labor market remains robust with new unemployment claims close to all-time lows and job openings close to record highs. Residential real estate seems to have bottomed, despite significantly higher mortgage rates. Forward looking data from the purchasing managers indices, released last week, suggest a manufacturing sector that is approaching expansion and a services sector that is growing at flank speed.

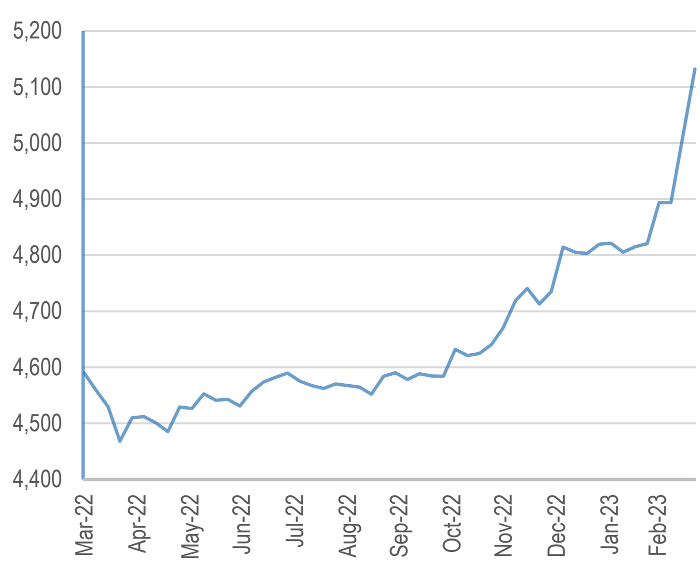
Even so, clouds are forming on the horizon suggesting storms ahead. A deeply inverted yield curve is the red sky in morning. But consumer credit is also at worrying levels and income gains are slowing fast, especially when the impact of inflation is included. Consumer sentiment for last month, before all the banking brouhaha, unexpectedly fell. Next week, a bevy of additional consumer-related data will be released. This will give us a better sense for the strength of the consumer, and will be the subject of our next *Weekender* and the primary emphasis of the second quarter *House View.*

Broadly speaking, equity markets have been undergoing a powerful rotation over the past two weeks. Investors are avoiding companies with high leverage and volatility. They are also ditching high dividend names and those that are actively buying back their shares. Instead, investors are looking for firms who opt for retained earnings; a clear expectation that the company will try to conserve cash in the months ahead. Meanwhile, demand for short-term bonds and money market instruments, where investors are paid to wait for the clouds to clear, is insatiable.

Money Market Assets (US$ Billions)

March 23. 2022 - March 24, 2023

(Source: Bloomberg)



Aggregate funds in money market accounts, by Friday, swelled to more than $5.1 trillion; an all-time record.

We continue to believe that our asset allocation models are well placed to take advantage of the present environment. An appropriate risk-adjusted combination of fixed income, core quality equities, and alpha generating stocks are likely to outperform in the months and years ahead. Equity positions should focus on companies with unit sales growth exceeding inflation, pricing power, and strong balance sheets. If you would like more information on our allocation models, please contact us.

In this *Weekender* we will discuss banks in a bit more detail as they relate to the US economy. We will also highlight commercial and industrial real estate and earnings.

Economic Update

The Federal Reserve increased their target interest rate to 5.0% on Wednesday. Inflation's persistence was the proximate reason for the move. Economists and strategists were split going into the Fed's meeting. Some thought recent bank failures would prompt the Fed to hold pat on rates and not risk pushing more banks to the brink. Others perceived recent bank challenges as isolated to particular institutions and unlikely to alter the Fed on its path - which is a view we share.

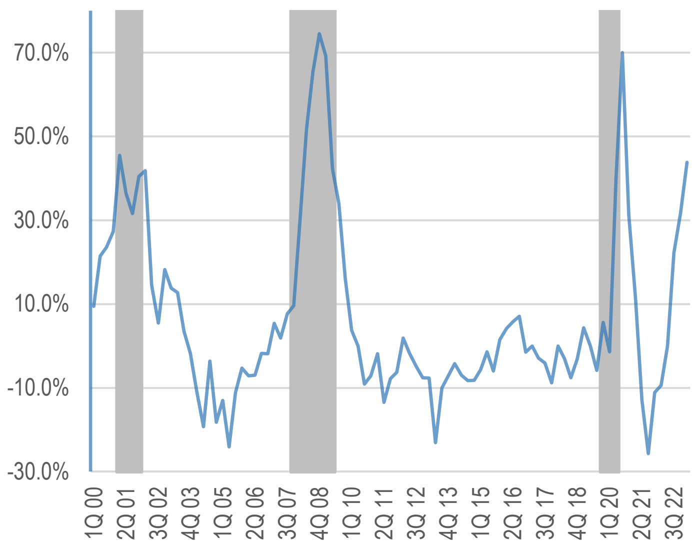
Even so, in their prepared statement following the rate increase, the Fed was more dovish than they have been in the past. Markets continue to discount an additional rate increase of .25% at the Fed's May meetings. From there, opinions diverge considerably. Most economists and strategists believe the Fed will begin cutting by July, a position Powell openly refuted in the question-and-answer session of his Wednesday press conference. For markets to be right, something seriously bad will need to happen to the economy.

Neel Kashkari, Federal Reserve Bank of Minneapolis President, said that recent bank turmoil has increased the chance of a recession. During the Fed's press conference on Wednesday, Jerome Powell said that the banking problems are mimicking a .50% increase in interest rates by effectively tightening credit standards.

Small Banks Tightening Credit Standards

1Q 2000 - 4Q 2022

(Source: Bloomberg)



While concern about financial system fragility continues to weigh down many bank stocks, the sector, in the main, has been remarkably resilient. Weekend announcements by regulators that they stand willing to do whatever is necessary to ensure depositors don't lose their money and banks remain solvent will certainly help financial stocks find a floor in the coming weeks. We believe most banks are sound, at present.

Citizens Financial Group rose by 0.78% while Zions Bancorporation fell by another -5.64% last week. First Republic, on the other hand, continued to fall prey to gravity, extending this year's rout to 90%. Meanwhile, Credit Suisse was absorbed by Union Bank of Switzerland (UBS). By the end of the week, Deutsche Bank was fending off disruptive rumors.

Broad decreases in financial stocks over the past two weeks have been about profitability and solvency. Solvency risks can be ameliorated through the Federal Reserve's commitment to act as lender of last resort and the combined regulatory commitment to guarantee all deposits at all levels. However, we expect bank profitability to suffer in the coming years. If an economic recession begins to unfold over the next 12-18 months, banks will increase their loan loss reserves and charge-offs which will reduce earnings. Loan growth will also suffer as banks tighten their lending standards.

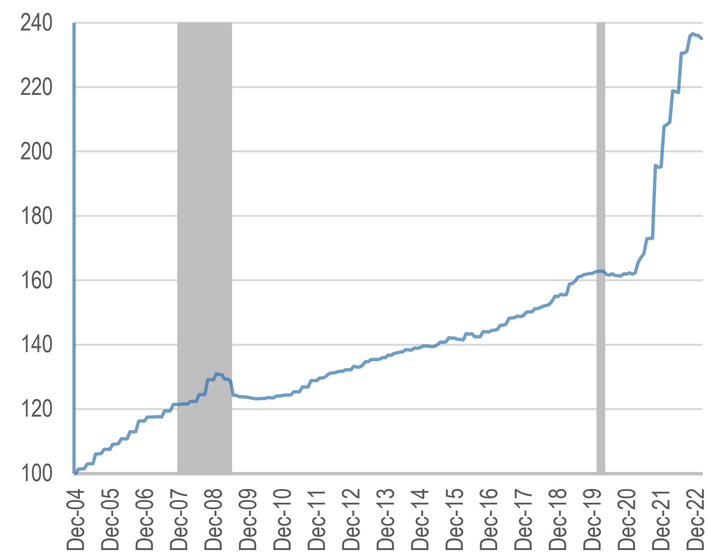
Office REIT's are lower by -54.30% over the last twelve months. A powerful decline that is due to higher interest rates. In the coming months, the industrial and office sectors will need to take on the added burdens of overbuilding and lease failures. While residential real estate continues to struggle with low inventory, commercial, industrial, and retail is sitting on a glut of space.

The cost of warehouse space has increased by 45.2% since the beginning of the pandemic as illustrated in this graph. We believe warehouse- and office-related real estate, and related lending, is going to enter a depression soon - not just a recession or a soft patch. We expect vacancy rates to accelerate as businesses work through their excess inventories in the coming months.

Producer Price Index (PPI) for Warehouse Space

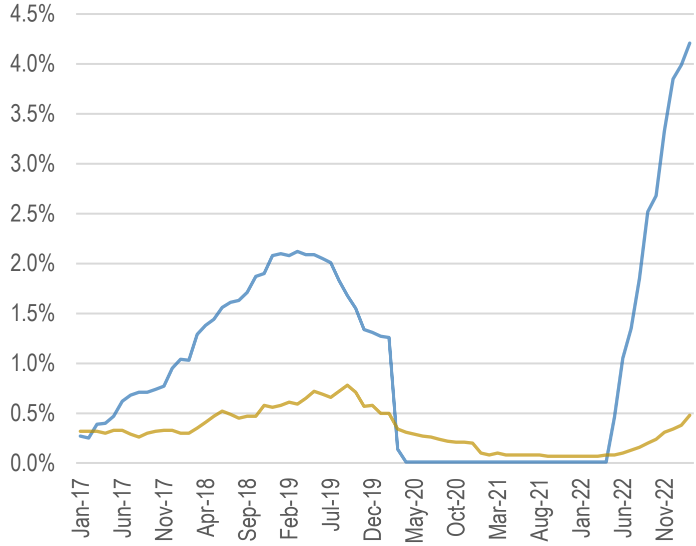
December 2004 - February 2023

(Source: Bloomberg)



Certainly, some of the deposit flight affecting small banks has shifted to larger financial institutions. But something more significant is happening. The average cost of deposits for banks in the US banking system remains low, the gold line, compared to the yield paid to investors in Fidelity's money market fund.

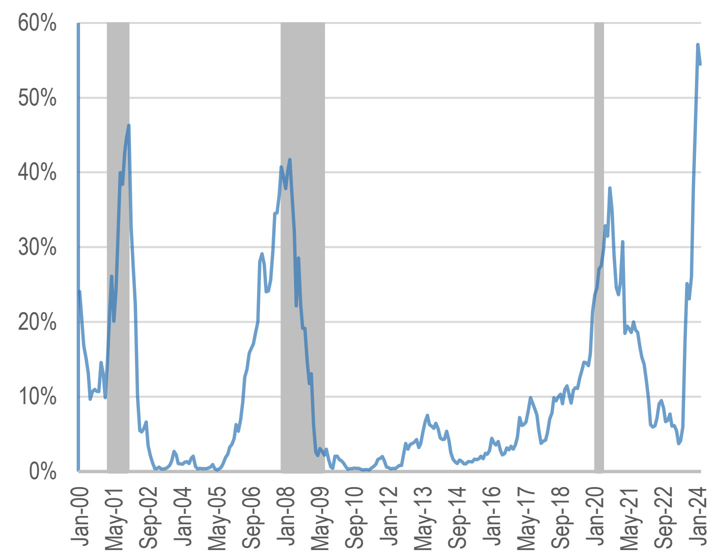
Money Market (Blue) and Deposit (Gold) Yields
January 2017 - February 2023
(Source: Bloomberg)



This discrepancy in yields has the impact of draining liquidity from the banking system, generally, as it flows into the capital market-based alternatives.

Most of the recent moves in bank stocks have been driven by fears highlighted by Silicon Valley Bank. While we do not believe SVB's problems are remotely generalizable, bank runs are often based upon herd mentality instead of fundamental weakness. Where they come from doesn't matter a lot since the outcome

Probability of Recession
January 2000 - February 2024
(Source: Bloomberg)



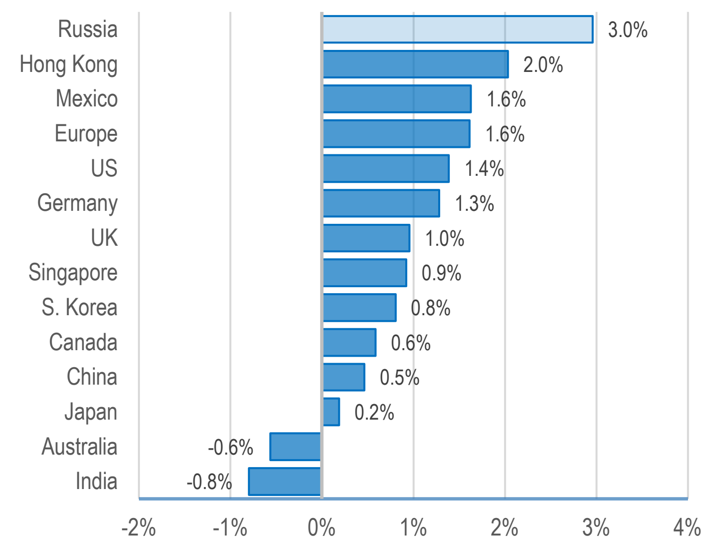
is the same. A fundamental take home of the Jerome Powell Fed is one of questionable competence.

We believe credit and equity markets are too greedy and unrealistically hopeful for rate cuts and not fearful enough of a coming recession. Lower rates may benefit stocks and bonds, all else being equal, but since inflation remains persistently high, the only real justification for the Fed to begin dropping rates is the approach of economic recession. We continue to expect a relatively soft landing, not because of the Fed's ability to pull a camel through the eye of a needle but because structural demographics keeping the labor market taut.

Countries

Russia was the best performer on the week, but we consider the country to be uninvestable. As the war in Ukraine drags on, Russia looks less and less attractive. An arrest warrant has been issued for Russian President Vladimir Putin by the International Criminal Court (ICC). Beyond the tragedy of what Russia has done to Ukraine, they have legitimately earned the title of a pariah state which they are unlikely to shake for generations.

Country Returns
March 20 - 24, 2023
(Source: Bloomberg)



In a sign of significant escalation, Putin announced Russia is preparing to place tactical nuclear weapons in Belarus which shares a border with Ukraine. Ten aircraft with nuclear warhead carrying capability are already in Belarus waiting the completion of a storage facility for the weapons. Short-range nuclear missiles, capable of carrying nuclear warheads, have also been sent to Belarus.

No one knows how much of Russia's escalation is saber rattling, designed to keep the West at bay. Chinese leaders spent the last two weeks stroking Putin's ego and announcing a long-term friendship that is so remarkably one-sided as to make clear the likelihood that, in the long-term, Russia becomes the Middle Kingdom's resource colony. No one knows where all this ends. What is clear is that the soft and gentle post-Cold War days have ended.

In other news, France is falling apart. France is France, which says a lot. However, the country is also a mirror of many socialist countries that have promised and provided a gilded set of benefits for decades funded by debt burdens heaped upon the backs of future generations. Anyone who spends any time in France is accustomed to the rotating labor strikes that seem to arrive inline with seasonal weather patterns. But this time is different.

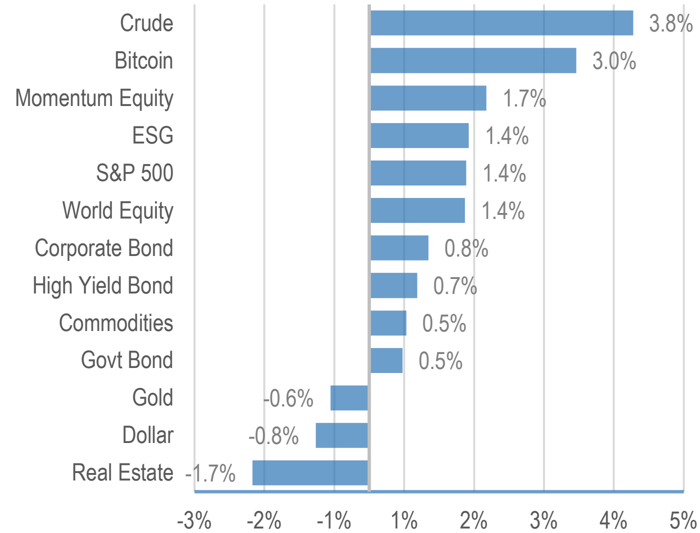
President Macron is trying to raise the minimum retirement age from 62 to 64, bringing the country closer to its European peers. Changes are necessary in order to stave off a complete collapse in the country's cradle-to-grave government protections. France's problem is emblematic of a movie coming to every European theater in the near future. Citizens were promised a degree of ease and comfort, provided by government, that was always unsustainable. It is even more unsustainable when the cost must be borne by a future population that is shrinking.

France's inability to make hard choices, buckle down, and alter their expectations, is only the beginning of the structural long-term decline of Europe.

Instruments

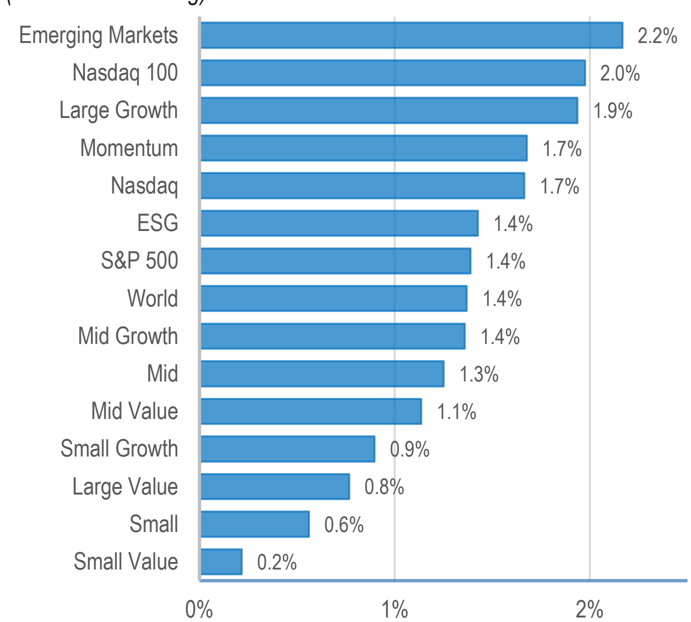
Among broad investment instruments, crude oil was the best performer, followed by bitcoin. Real estate fell the most as news of mounting defaults in residential, commercial, and industrial loans begin to rise and credit standards tighten. The dollar also fell, relative to other primary currencies, as traders bet that rates are at or close to their peak.

Instrument Returns
March 20 - 24, 2023
(Source: Bloomberg)



All equity instruments were higher. Emerging markets led the pack after the dollar fell. Large technology and momentum names were also winners on the week in a general move toward the expected protection of larger companies in the face of a potential economic recession.

Equity Instrument Returns
March 20 - 24, 2023
(Source: Bloomberg)



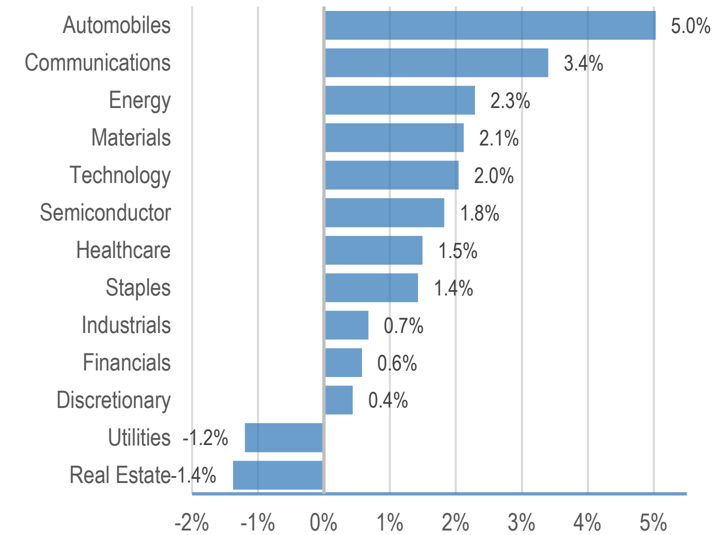
Sectors

Among primary sectors, automobiles rose the most. Tesla was higher by 5.7% on the week. The other autos were only marginally higher. Real estate was the worst performer as banks faltered a bit and lending standards rose. Financials rose slightly as strong banks recovered from a reflexive battering last week.

Sector Instrument Returns

March 20 - 24, 2023

(Source: Bloomberg)



Deep within sector moves is evidence of a nascent rotation out of cyclical sectors. Communications, technology, and semiconductors rose after taking a beating earlier in the year. Energy rose with crude oil.

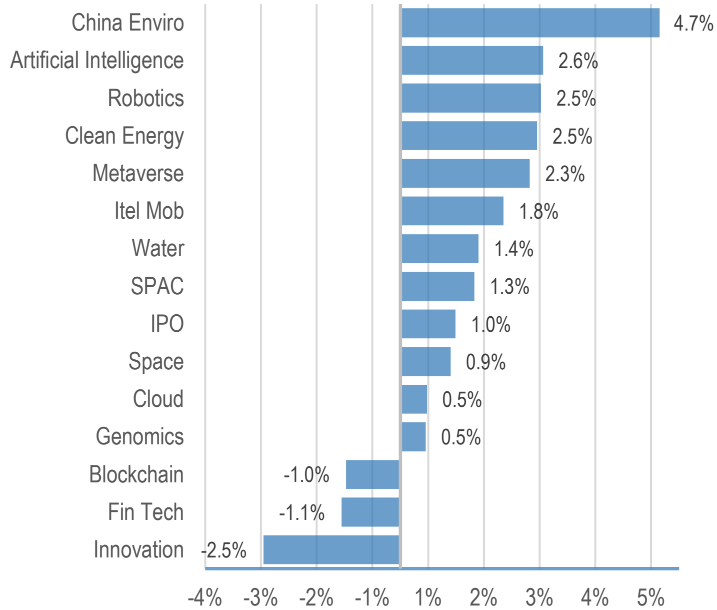
Themes

In an odd reaction, most themes were higher. Artificial intelligence has been above the fold in press articles for a while which has investors all aflutter about potential future applications. Personally, we are all a bit terrified.

Theme Instrument Returns

March 20 - 24, 2023

(Source: Bloomberg)



Conclusion

That's it for this *Weekender*. Next week we will not have a Weekender as we prepare for our second quarter *House View* to be published on April 8, 2023.

Disclosure Statement

Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Indexes are unmanaged and investors cannot invest directly in an index. Past performance does not guarantee future results. Investing involves risk, including loss of principal.

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