Second Quarter House View

Weekender

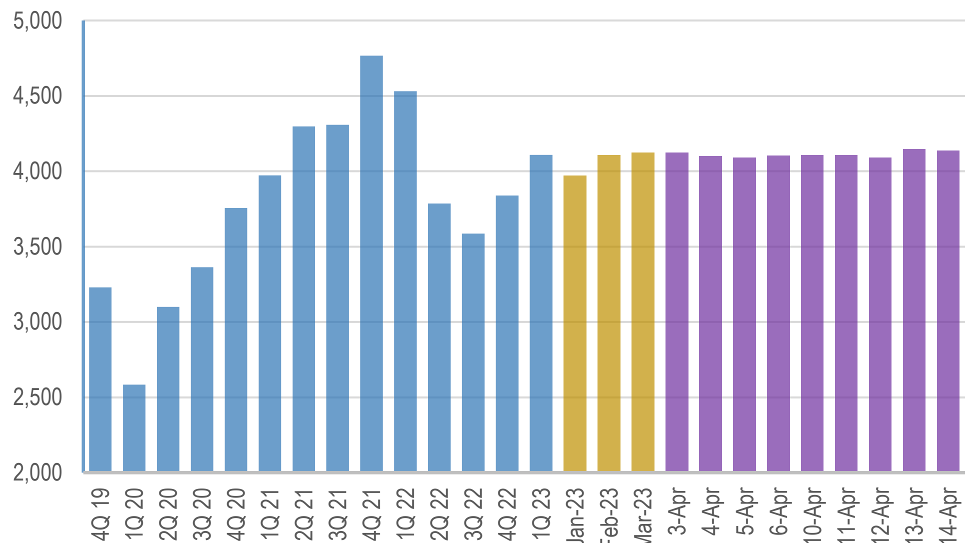
April 14, 2023

Good morning and welcome to the *Weekender* for Saturday, April 14, 2023. This *Weekender* provides a summary of our second quarter 2023 *House View*. The *House View* is a comprehensive analysis of investment markets looking through the rest of this year and into 2024.

Equity markets, as measured by the S&P 500, were higher by 0.79% last week. On the year, equities are higher by 7.8% since the beginning of the year. But valuations are very expensive compared to historical averages at 21.2 times earnings.

S&P 500 Index Levels and Price-to-Earnings Ratios

(Source: Bloomberg)



After strong gains in January and February, equity markets have been treading water, waiting for the Fed to introduce its last rate hike of the current cycle, which will probably take place at its scheduled meeting in May. Being closer to the end than the beginning is a temporal positive for all financial markets and the economy. Financial markets believe the Fed will be compelled to begin lowering rates by July. However, we do not see any data that suggest such a move will happen.

ARCHIMEDES
INSIGHTS & ANALYTICS

As rates peak in summer, we expect financial markets to begin to shift their focus from interst rates rates to lower corporate earnings and potential economic recession. Earnings softness and recessions are typically accompanied by declining equity values and a general portfolio reallocation away from equity and toward the safety and security of fixed income alternatives.

We continue to believe that the most appropriate investment allocation for the coming year is a diversified portfolio of core equity, equity income, fixed income, and alpha-generating equity. Core equity positions should be cheap relative to the broader market, are expected to expand unit sales growth, have pricing power, and are protected by a strong balance sheet. Equity income names are most useful when they are cheaper than the market, possess strong balance sheets, and have a history of expanding their dividend payout. Fixed income positions should lean toward shorter duration and higher quality. Choosing a portfolio of alpha generating equity must include those that benefit from the early cycles of economic expansion.

This *Second Quarter House View* looks focuses on the labor market, interest rates, inflation, the consumer, corporate earnings, and recession. This *Weekender* provides a summary treatment of the same areas.

Please be sure to consult a qualified financial advisor prior to making investment decisions.

Labor Market

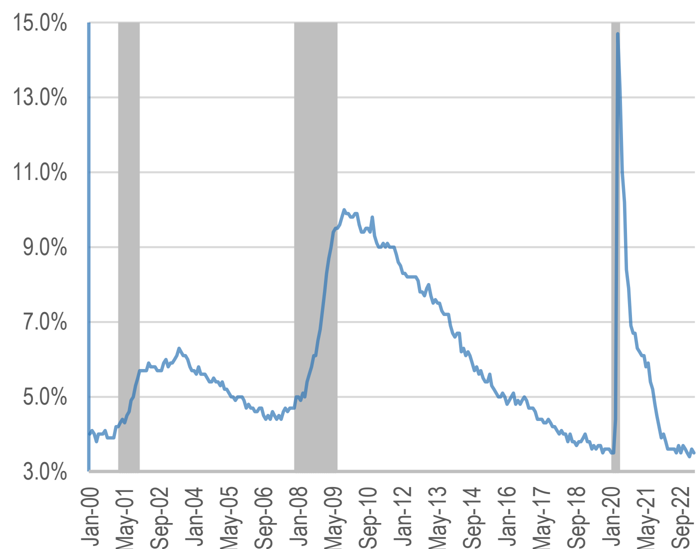
The four most dangerous words for any investor are "this time is different". Financial markets are mean reverting and the bodies of those certain of a new reign of uncorrelated fundamentals line the trenches of the craft. Even so, there is something different in the labor market this time.

During inflationary periods, the Federal Reserve hikes interest rates to cool the economy which typically leads to workers getting fired and the unemployment rate rising. Deep recessions come from a large dislocation in the labor market. If the labor market remains robust in the months ahead, the chance of recession is marginalized. Consequently, nothing matters to the economy and financial markets more than the labor market. In this section we will look at the characteristics of labor demand and supply.

Demand. Pandemic labor market strength was fueled by demand for products needed for the transiton to work and school from home. Then the federal government began cutting checks to consumers hoping the payments would keep consumer spending. In the face of incredible, some would say artificial deman, product shortages becam common which pushed prices higher. As a partial remedy, product companies put in larger orders as a means to stave off future shortages. Satisfying this unsual and unprecedented demand has been key to the strong labor market.

US employment data for the month of March shows that the labor force grew by 236,000. The number was slightly above what economists had expected. A weak number would have given the pivot crowd a little grist for their mill. Instead, it looks like the mill will be grist-free. Based partly on the strong data, the unemployment rate fell to 3.5% only 0.1% higher than its low of 3.4%.

U3 Unemployment Rate
January 2000 - March 2023
(Source: Bloomberg)

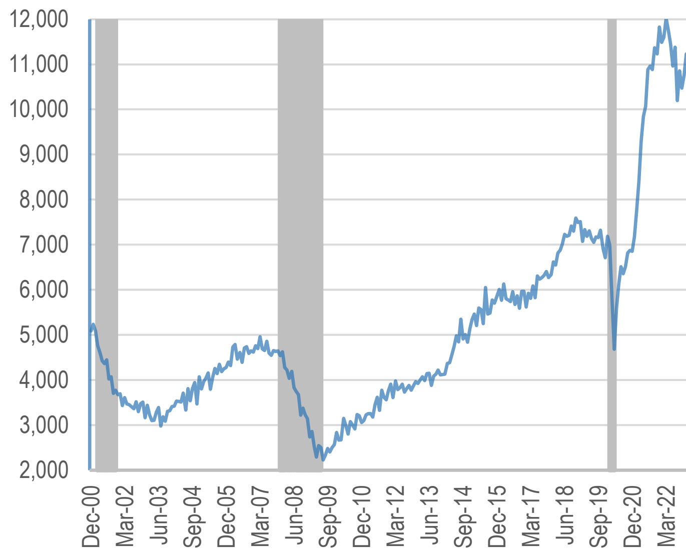


JOLTs data, which measures the number of job openings, showed signs of some cooling. Job openings fell by 632,000, although the number of job openings outstanding remains well above their pre-pandemic levels. Smaller firms with less than 250 employees continue to add to their labor roles while large companies with more than than 5,000 employees have been cutting jobs.

JOLTS Job Openings (000)

January 2000 - March 2023

(Source: Bloomberg)



When many workers were forced to work from home during the pandemic, away from the adoring gaze of bosses and uber-mangers, they recovered hours of daily commuting time which, in some cases, was redirected to side-gigs. Low barriers to starting companies and rampant availability of online selling tools created a seismic shift in the number of new businesses formed. Many newly formed businesses found quick success and began hiring.

New Business Formation

June 2005 - February 2023

(Source: Bloomberg)

KPMG research suggests that half of all job openings are coming from newly formed companies. In fact, the correction between business formation and job openings is the tightest it has been for a very long time. Approximately half of all new startups come from: 1. online retail; 2. trucking and warehousing; 3. professional, scientific, and technology services; 4. administrative support; and, 5. personal services.

It is unknown, however, how sensitive these new enterprises will be to an economic downturn. The reaction function of small companies to higher interest rates tends to be much more levered than larger companies.

Labor Force Supply. Post-pandemic demand for labor has been met with a counter-balance in the reduction of the labor force itself. Over the last three years, the labor force grew by only 1.8%, or 1.4 million workers. The Bureau of Labor Statistics (BLS) expects labor force growth to continue to slow over the next decade, underscoring the structural, instead of just cyclical, nature of the changes. The BLS estimates that there is currently a 3.6 million shortfall of labor supply versus demand.

Labor supply is being impacted by a number of factors. Previously mentioned, business formations are pulling some of the best and brightest into the ranks of the entrepreneur. Rapidly aging populations are pushing older workers into the ranks of retirement. A more morose data point comes from approximately 270,000 working age people who died from COVID. Partially driven by COVID. Legal immigration, which usually increases the ranks of well-paid knowledge workers, has slowed significantly.

Labor force participation is another key to the smaller labor force. Among prime age workers (25 – 54), women are engaged in the labor force at a similar rate as before the pandemic in February 2020. Not men. Male workforce participation peaked in 1954 and has fallen after every subsequent recession since then. While the drop in male participation is a global phenomena, it is worse in the United States. In fact, the US ranks last among the twenty most industrialized nations in the much-watched labor force participation rate among prime age workers, among both men and women.

We expect the labor market to remain much more robust than in previous economic slowdowns which will cushion the impact of the Federal Reserve's actions.

Interest Rates

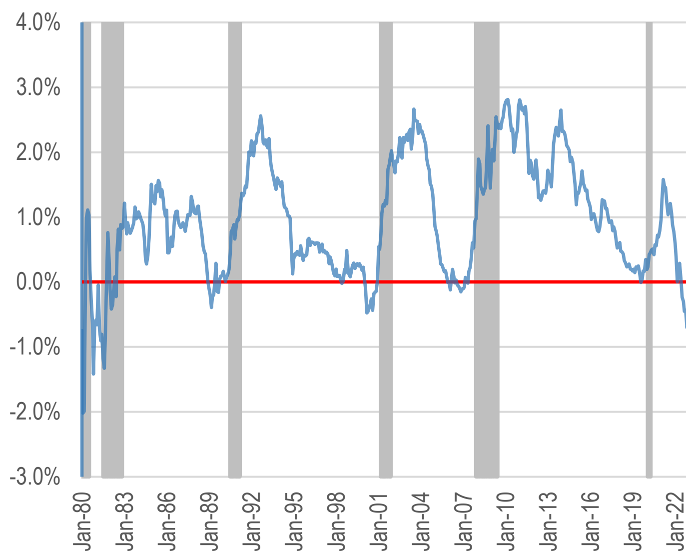
The Fed is unique among its central bank peers inasmuch as it has a dual mandate. Control inflation and don't break the labor market. It's a worthy mandate, in principle, but a tight rope act, in practice. Fed policy tools are blunt instruments when surgical precision is desired. Their effectiveness can only be perceived long after they have been implemented due to a dramatic time lag from when tools are implemented to when their effect is felt and manifested.

Because the success of monetary policy tools can only be seen from the rear-view mirror, financial markets embark in constant attempts to predict pending economic outcomes. An inverted yield curve is a primary, and generally reliable, indicator of a coming recession. Yield curves are considered inverted when long-term government bond yields are lower than short-term yields, a situation that would only be likely if the Federal Reserve is expected to lower rates in the near future to combat economic recession.

Yield Curve Inversion

January 2, 1980 - April 14, 2023

(Source: Bloomberg)



As can be seen from the graph above, the yield curve is currently significantly more inverted than it has been at any time since the early 1980s.

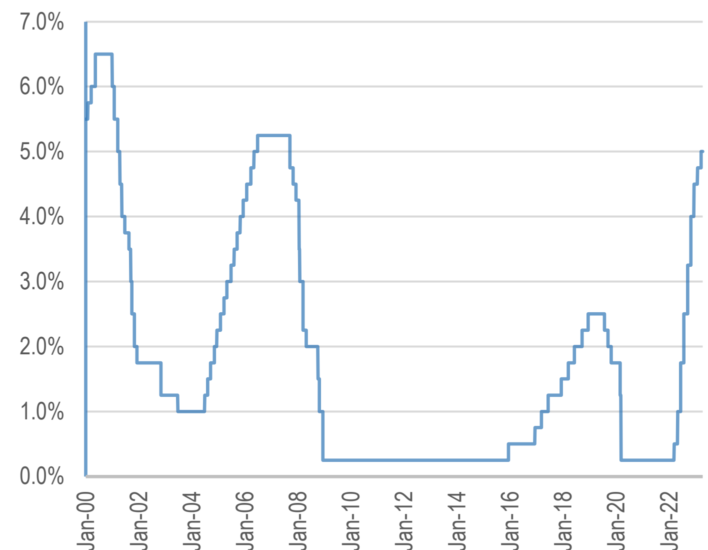
Without equivocation, the Federal Reserve is in the final innings of the current monetary tightening cycle. Interest rates have been pushed from the zero boundary to 5.0% at the fastest rate in history. Higher rates have blown the free-money froth from the pandemic real estate market in addition to every other interest-rate sensitive segment, except automobiles, which are still somewhat constrained by supply chain problems.

At the beginning of April 2022, the Fed's target interest rate was 0.5%. Rates are now 5.0%. The fastest rise ever. The result? Inflation is slowing slowly. The Federal Reserve's preferred gauge of inflation, core personal consumption expenditure, or PCE, has fallen from a high of 5.4% at the end of February 2022 to 4.6% as of the end February 2023. Their view that inflation was merely transitory is no longer held.

Federal Reserve Target Rate (Upper Bound)

January 3, 2000 - April 14, 2023

(Source: Bloomberg)



Before the recent bank failures, the Federal Reserve was the dominant financial market influencer. Because of persistent inflation, a robust labor market, and a relatively unfazed consumer, they were the only game in town - at least in the interest rate picture. Recent bank failures forced another player into the monetary picture. As banks failed, lending standards accross most lending institutions tightened with a similar impact of a rate increase. In short, recent bank failures acted as a synthetic interest rate increase.

US bank lending has already bottomed from the mini bank crisis that began in March. We believe bank-related sensitivities should not be translated as a broad phenomena affecting large swaths of the financial system.

We believe interest rates are very close to topping. At the summit, markets are likely to survey the landscape and shift their focus to non-rate fundamental factors like profits, credit risk, dividends, growth, and valuation.

However, we also believe that the economy continue to grow with rates that are higher than previously deemed acceptable following the Credit Crisis. We expect that a new economic reality and equilibrium can be formed with long-term interest rates and inflation higher than the Fed's wishful target of 2.0%.

Inflation

One year ago, the consumer price index was rising without friction. Jerome Powell of the Federal Reserve and Janet Yellen at the Treasury had humble pie and acknowledged that they were wrong. Inflation wasn't transitory after all. In response, they embarked on an unprecedented path of monetary tightening.

The current inflation landscape was driven by a cascade of foolish fiscal and monetary responses to pandemic-related economic shutdowns and uncertainties. In hindsight, policy makers did not understand the economy well enough to provide a surgical response to pandemic-related economic phenomena. Instead of a scalpel, bureaucrats used a bevy of blunt macro instruments that brought with them unintended, yet foreseeable, consequences. We are now left with an economy searching for a new equilibrium.

Supply-driven shortages create a floor on prices for many goods. Unable to solve the supply-related shortages due to global supply chain problems, policy makers are working to slow demand by raising interest rates. Government stimulus payments, which were a primary cause of the inflationary problems, have dried up. So, all we need to do is allow the economy to recalibrate and find its center. A different center than before the pandemic.

As a salve for future inflation, commodity prices are falling. But they are still higher than where they were a year ago, which will keep inflation at front of mind for a year or so. However, a year from now, year-to-date inflation comparisons are more likely to be negative than positive. Wholesale inventories continue to build to unprecedented levels, suggesting shortage will shortly turn to surplus. A sellers-market will yield to a buyer's advantage. The Fed is keenly aware of this but is trapped by the magnitude of their error at being far too late to take up the cause of inflation. The net effect will likely be a couple more rate hikes, followed by a period of data gathering and reflection. In the first quarter of next year rates will begin to fall.

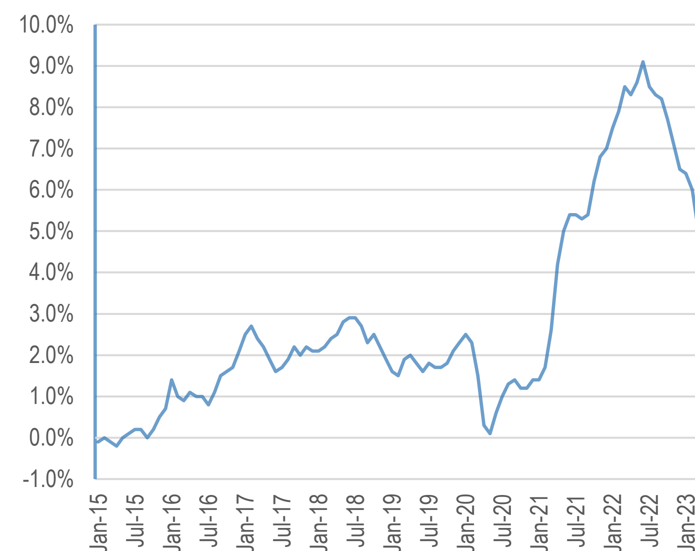
A number of inflationary heavyweights have yet to report in. Housing costs are falling although the data has not yet been fully reflected in inflation data. Energy prices continue to whipsaw the numbers, both up and down.

Although the consumer price index' current level suggests considerable progress toward normalization, the annual rate in price increase is still well above the Fed's target of 2.0%. We believe inflation will continue to come down, but at a more modest clip. The net result is that inflation will remain persistently high for a longer period than previously anticipated. The economy seems robust enough to manage higher inflation and interest rates. If this environment holds, solid dividend yielding equities and short-term fixed income will buttress portfolios. Expensive growth names are likely to be punished.

Consumer Price Index

January 2015 - March 2023

(Source: Bloomberg)



Consumer

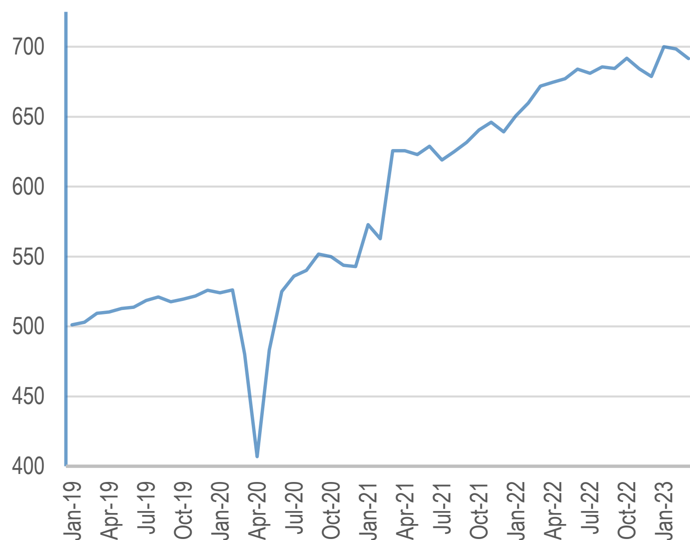
A combination of higher borrowing costs, persistent inflation, and low consumer savings are certainly taking a toll on consumer finances, even though the

consumer persists. Comparisons against similar periods in economic history are unable to provide a useful guide of 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. While consumer prices held tight and producer costs 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.

US Retail Sales

January 2019 - March 2023

(Source: Bloomberg)



We believe the consumer, so long as they are employed, will continue to spend. However, real wages are now negative suggesting inflation is crimping purchasing power. Most consumer balance sheets are now full of credit card debt for spending like drunken sailors after the pandemic.

Earnings

For the past year, financial markets have been completely entranced by the machinations that move interest rates. Equity and fixed income markets have gone up and down on bets and predictions concerning the next move of the Federal Reserve. As the Fed inches toward its interest rate peak, we expect markets to begin focusing on more practical fundamentals. Earnings and economic performance.

Graph 11—Earnings

Earnings for the S&P 500

February 14 - March 14, 2023

(Source: Bloomberg)

Meanwhile, large banks have reported first quarter earnings which were solid. Over the next month, the vast majority of equity players will report first quarter earnings. We expect a slow deterioration in earnings expectations and a fairly solid reduction in expectations for the rest of 2023.

As second quarter earnings are released in three months, we anticipate that many corporations will express a much more pessimistic view of the future.

Recession

The Institute for Supply Management's Purchasing Managers Index for both manufacturing and services show and economy in contraction. The red line in the graph is set at 50. Readings above 50 suggest expansion while results below 50 portend contraction.

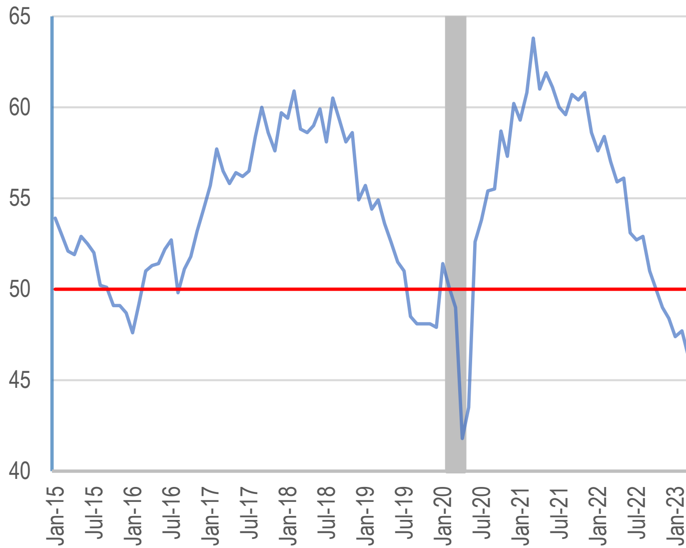
Manufacturing accounts for 12% of the US economy. ISM data is below 50, the blue line, which predicts a contraction of manufacturing in the months ahead. Additional data points, released this week, support the ISM. Factory orders, when airplanes are removed, are in decline. Capital goods orders as well. Prices paid in manufacturing, the gold line, are still in contraction but are 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 percep-

tion 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 PMI

January 2015 - March 2023

(Source: Bloomberg)

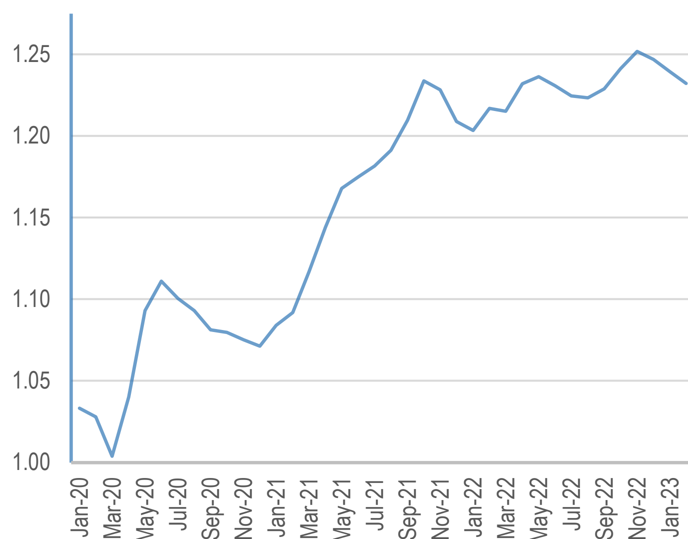


Manufacturing is also shackled by excess inventory built up over the pandemic. Excess inventory is sitting in the wholesale side of the supply chain because retailers are out of space to hold product. Some retailers are forcing suppliers to hold onto inventory by expanding the size of their warehouses or renting a fleet of shipping containers. This is a graph of the ratio of wholesale inventory to retail inventory, which is

Wholesale / Retail Inventories

January 2020 - March 2023

(Source: Bloomberg)



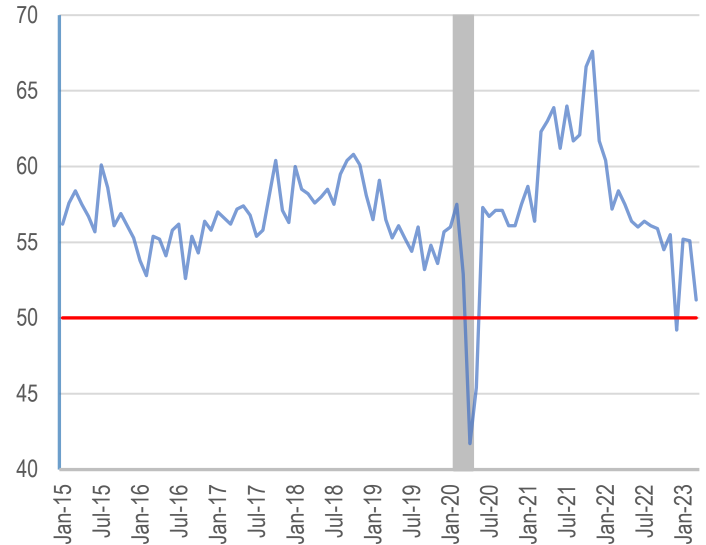
significantly above pre-pandemic levels. Wholesalers are stuffed. Only continued discounting will clear the excess, which will constrain profit margins for the next few quarters.

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 continuing to expand although the expansion is softening.

Services PMI

January 2015 - March 2023

(Source: Bloomberg)

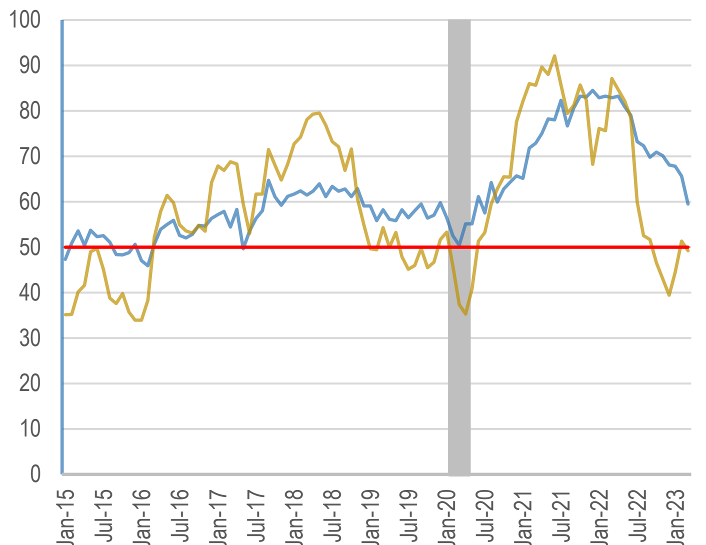


From an inflationary perspective, the PMI data showed that prices in the service sector continue to

Manufacturing (Gold) and Services (Blue) Prices Paid

January 2015 - March 2023

(Source: Bloomberg)



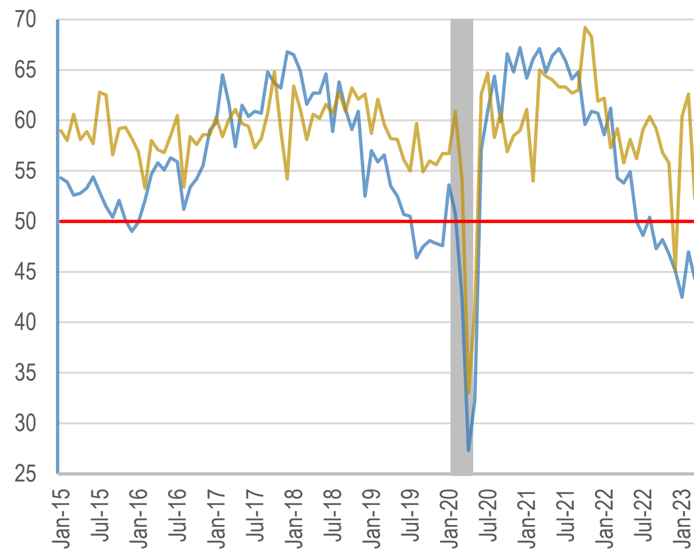
be high and those in the manufacturing space, after contracting for a couple months, have rebounded. While pricing strength in services is not a surprise, the turnaround in manufacturing is. We had expected robust inventories to lead to a consistent period of lower prices in manufacturing.

On the new order front a similar story emerges. For services, new orders are slowing. Manufacturing is still in contraction.

Manufacturing (Blue) and Services (Gold) New Orders

January 2015 - March 2023

(Source: Bloomberg)



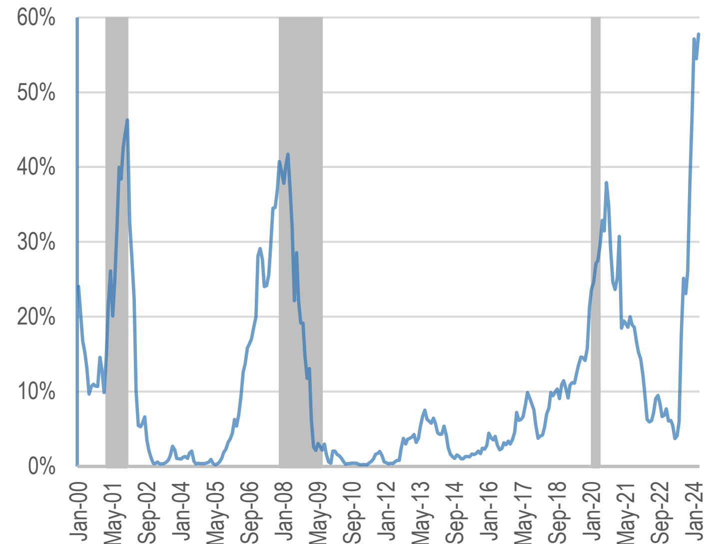
We believe the PMI data, in general, show an economy on the verge of recession. However, consumer spending on both products and services is being driven by debt. That can only go on for so long. More on that next week. We continue to expect economic softness in the months ahead. An earnings recession is already upon us.

Meanwhile, market participants are already betting on recession. The probability of recession has never been this high since the beginning of the century.

Recession Probability

January 2015 - March 2023

(Source: Bloomberg)



Conclusion

The path forward from seems murky. A few insights may shed light on where we think the economy and financial markets are headed. First, and most important, the labor market is strong. Without significant weakening in the labor market, a deep recession is unlikely. Second, while supply and demand for some products remains out of balance, a slow mending is occurring in global supply chains. Inventories are likely to be back to normal following the next holiday season. Sales and profit margins are likely to suffer in the mean time. Third, over the near term, corporate profits will fall, creating great opportunities to buy quality companies at a discount. Be ready. Fourth, the post-pandemic consumption patterns will change. We will not go back to the 2019 patterns. Online purchases will continue. Workers will go back to the office. Household formation will accelerate. Retrenchment and thrift will be en vogue. Fifth, inflation will come in-line and interest rates will fall. But they won't come back to where they were before the pandemic. The Goldilocks era is over.

Disclosure Statement

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