River of Fire

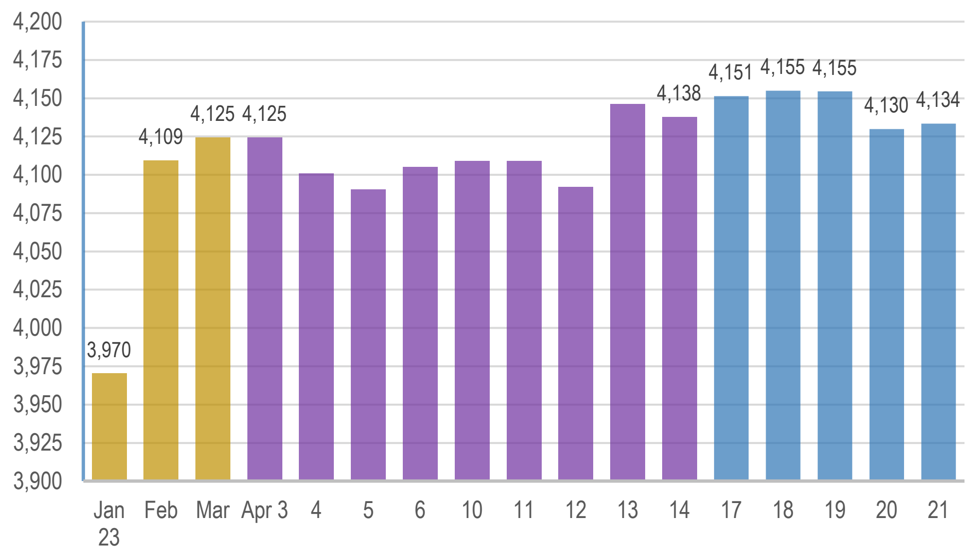
Weekender

April 21, 2023

Good morning and welcome to the *Weekender* for Saturday, April 22, 2023. As measured by the S&P 500, equity markets were lower by a rounding error last week. Over the past year, the Fed has been playing catch up, raising interest rates to combat persistent inflation that they now admit caught them off guard. As the Fed has been raising rates, financial markets have been eagerly anticipating, predicting, and trading when rates will peak and the Fed will pivot. As an investing narrative, markets have treated bad economic news as suitable for markets. Data that shows the economy is weakening has been good news instead of bad news since it portends a Fed pivot away from rate increases and assumes rates will be lower in the future. Such a future would be constructive for asset prices all around.

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

(Source: Bloomberg)



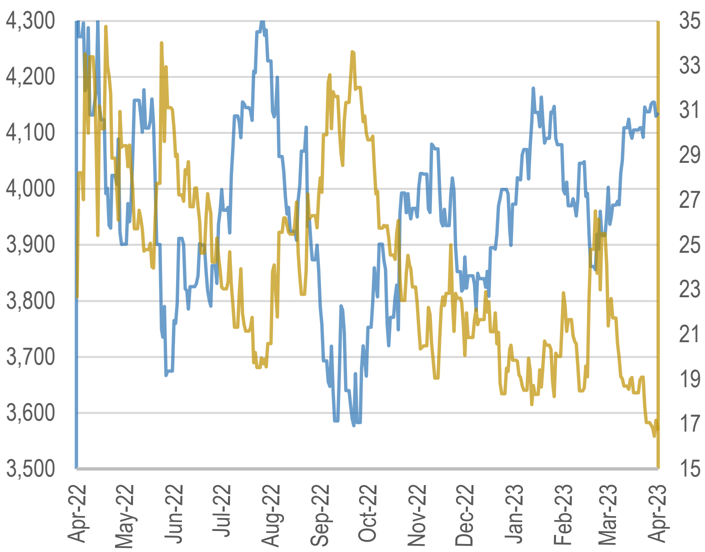
A new narrative, where bad news is bad news, is beginning to take hold. This-narrative changes nothing for a Fed that has been creating policy by putting its finger in the air to measure the daily gale. Their trilemma comprises price stability, a strong labor market, and financial stability and will continue regardless of the dominant narrative. The new narrative does, however, remove the Fed as the primary source of global financial market focus. Instead, fundamental factors like earnings, valuation, growth, and recessionary resistance will guide markets.

Equity market complacency is often a proverbial canary in the coal mine, suggesting an oncoming change in narrative. The VIX is a measure of volatility in equity markets. On Friday, it fell to its lowest level since 2021. When volatility is low, equity markets tend to rise, and vice versa. However, we believe equity markets are inaccurately discounting the probability of recession, at worst, and stagflation, at best. As evidence, investors and traders have been pouring capital into ETFs that employ derivatives, betting that the VIX will rise.

VIX (Gold) and S&P 500 (Blue)

April 21, 2022 - April 21, 2023

(Source: Bloomberg)

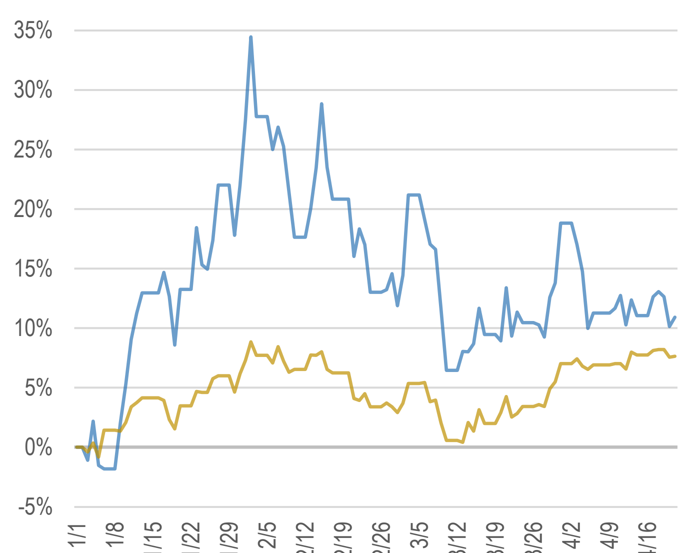


Year-to-date, the Dow is higher by 2.0%, the S&P 500 by 7.7%, and the tech-heavy Nasdaq by 15.3%. To some extent, the positive gains come from a relief rally following last year's losses. Animal spirits play a decisive role as

Unprofitable (Blue) and S&P 500 (Gold)

January 2 - April 21, 2023

(Source: Bloomberg)



well. Below is a graph of the cumulative stock price return of companies that don't make money within the S&P 500, the blue line, and the S&P 500, the gold line. Until mid-March, gains were disproportionately attributable to the riskiest companies. Since then, they have come more in line.

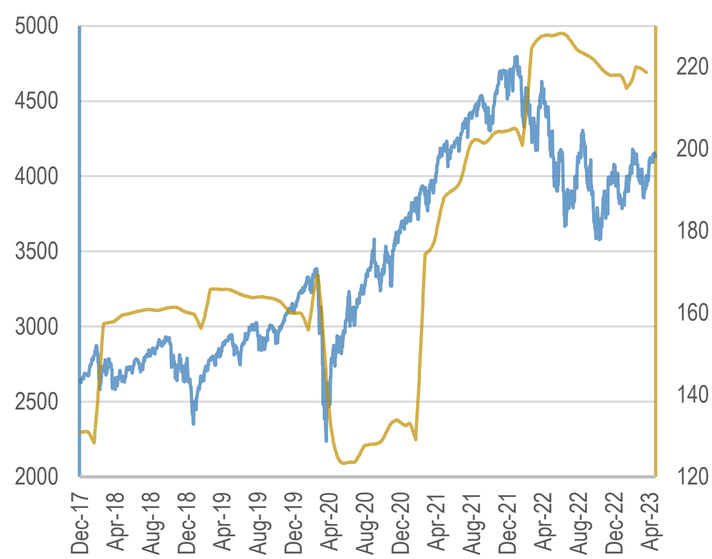
While the first-quarter earnings season has just begun, several interesting trends are emerging. Industrials, energy, consumer discretionary, financials, and real estate are doing well. Revenues and profits are growing. But in the other sectors, an earnings bloodbath is in the making. Some market strategists have assessed earnings reports from the season's first week and determined that the earnings recession may not be as bad as expected. We tend to disagree.

Industrials, like Caterpillar, benefit from long-term contracts struck in the "money for nothing" stage of the pandemic. These contracts will take a while to wear off. Energy benefits from continued high crude and natural gas commodity prices, which will likely continue. Services have been the earnings driver for consumer discretionary. Earnings reports for retail, wholesale, and other discretionary product companies have fallen more than -20% so far. Financial earnings gains are represented, almost exclusively, by large firms that benefitted from the mini-financial crisis following the failures of Silicon Valley Bank and Signature Bank. Real estate is higher on better pricing and constrained product availability.

New Business Formation

December 1, 2017 - April 21, 2023

(Source: Bloomberg)

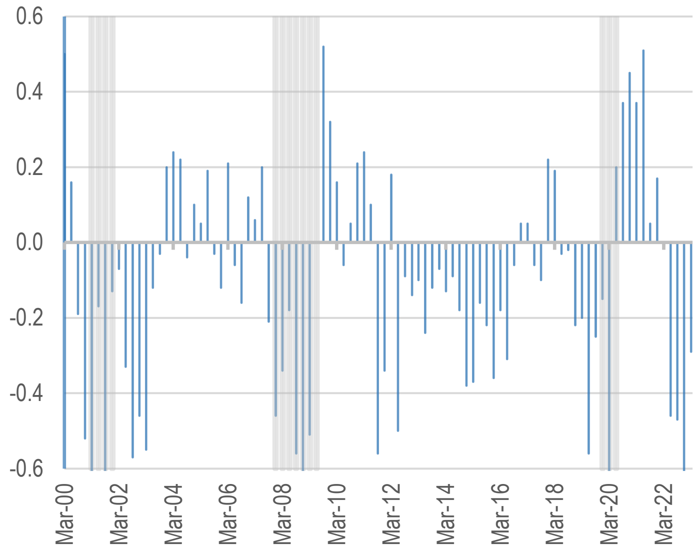


One enormous caveat on earnings. We are only a week into the reporting season, which lasts until May 15, 2023. After next week, we will get a better picture. However, earnings are coming in as we anticipated. As earnings continue to be released for the remainder of this and next quarter, we expect negative earnings revisions to continue mounting.

Earnings Revision Index

1Q 2000 - 1Q 2023

(Source: Bloomberg)



We assess recently released economic data in this *Weekender* as they confirm or confuse a prospective alternate narrative. Country, instrument, sector, and theme returns will also be summarized. Out one more thing segment is about sex. Next week's *Weekender* will introduce an oft-forgotten economic conundrum called stagflation.

Please review any financial or investment ideas with a qualified financial advisor.

Economic Narrative

Digesting the components that make up a new narrative, and letting the outdated aspects of an old narrative evaporate and be replaced, takes time. In the transition phase, where a new narrative is being formed, economic and financial data are rarely unanimous in support of the new narrative. Some data support it, while others conflict. Last week's economic data was a lesson in contrasts.

Let's assume we are at least moving into a narrative where good news is good news, and vice versa. In this new narrative, housing is finding a bottom at or near its pre-pandemic bottom. Automobile sales remain strong, with most cars arriving on dealer lots already pre-sold. Consumer spending continues to be strong, although increasingly financed via high-interest-rate credit cards. Sentiment is beating expectations even though consumers expect inflation to be approximately 4.6% over the coming year, only slightly lower than its current 5.0%. Dramatic increases in debt, housing, and transportation costs increasingly constrain consumer balance sheets. In short, the economy, consumers, and corporations are all adapting to a higher interest rate and inflation environment.

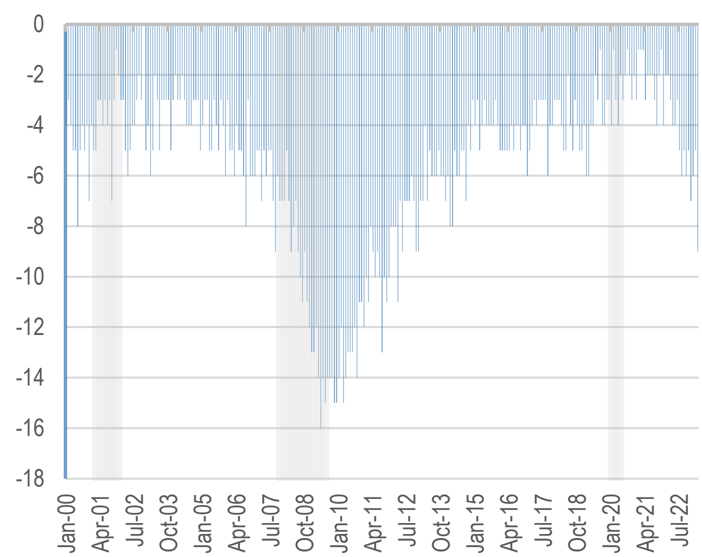
Meanwhile, the work-from-home love affair is on the rocks. Employers have been tracking their remote workers and found that the once strident workaholics from the early days of the work-at-home pandemic have transformed into binge-watching followers of *Stranger Things* and the *British Baking Show.* So far, it's a tug-of-war between employers and their remote employees. Neither seems to have a clear advantage.

Concerns that a full-on banking crisis would cloud the financial system have mostly burned off. But tighter credit standards coming out of the few but notable failures of Silicon Valley Bank and Signature Bank have dried up credit in pockets of the economy. Treasury Secretary Janet Yellen recently said she hadn't seen any contraction in lending. But pardon us if we are skeptical about her vision after the "inflation is transitory" oversight.

Small Business Lending Conditions Index

January 2000 - March 2023

(Source: Bloomberg)

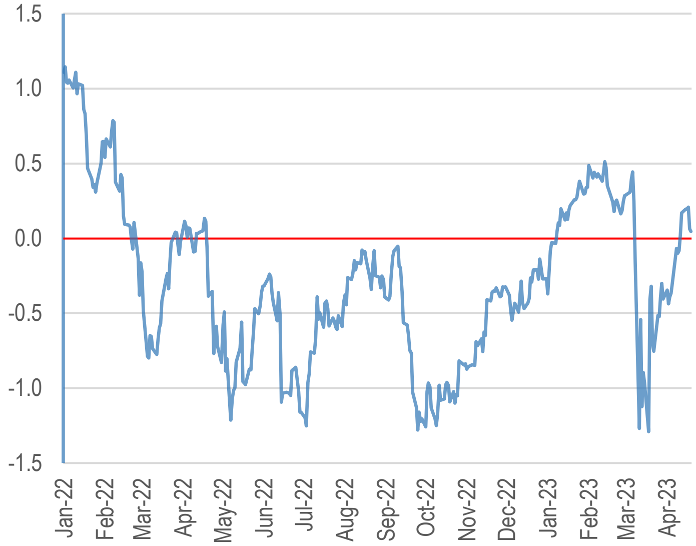


Here is one graph showing that Yellen could use a new prescription. At the small business level, lending conditions are tightening. While lending conditions and the factors leading to them have almost no resemblance to the Credit Crisis, they are having a real impact on how small businesses, which employ half of the total US labor force, see and plan for the future.

Despite tightening in small business lending, financial conditions, writ large, have been recovering since the mini-financial crisis.

Financial Conditions Index

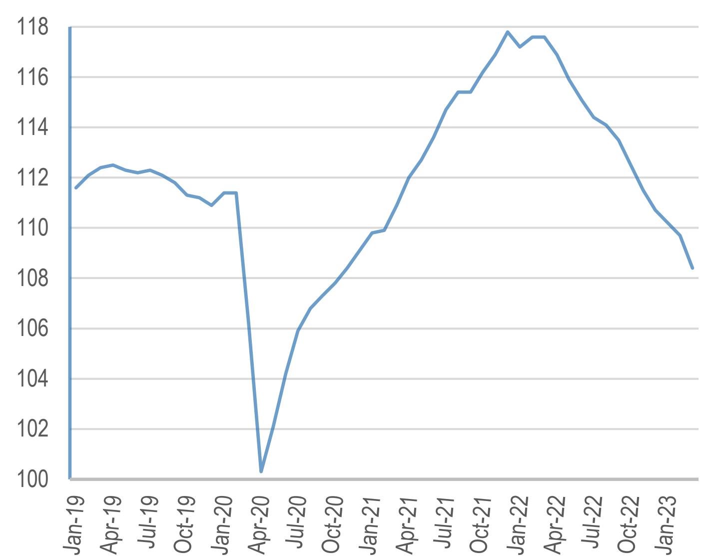
January 3, 2022 - April 21, 2023
(Source: Bloomberg)



Most economic data is backward looking. By the time it's collected and reported, it provides little more than a rearview mirror perspective of where the economy has been. A set of forward-looking economic measures called leading economic indicators provides a composite look at the US economy looking ahead. These leading economic indicators show an economy that is weakening.

Leading Economic Indicators

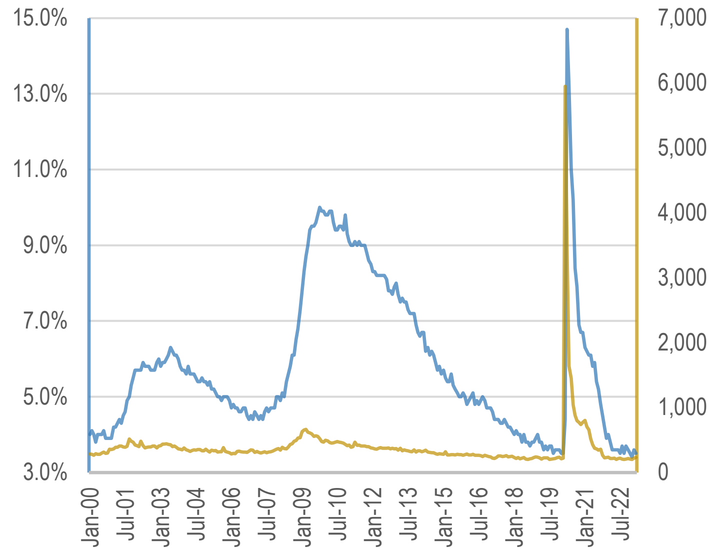
January 2019 - March 2023
(Source: Bloomberg)



Last week's *House View* summary stressed the importance of getting the labor market right. At first blush, the labor market seems remarkably resilient. Unemployment at 3.5% is close to its historical nadir of 3.4%. Job openings exceed unemployed persons by a two to-one-margin. If the labor market does not tip over, we expect any potential recession or economic softening to be mild.

US Unemployment Rate (Blue) and Claims (Gold)

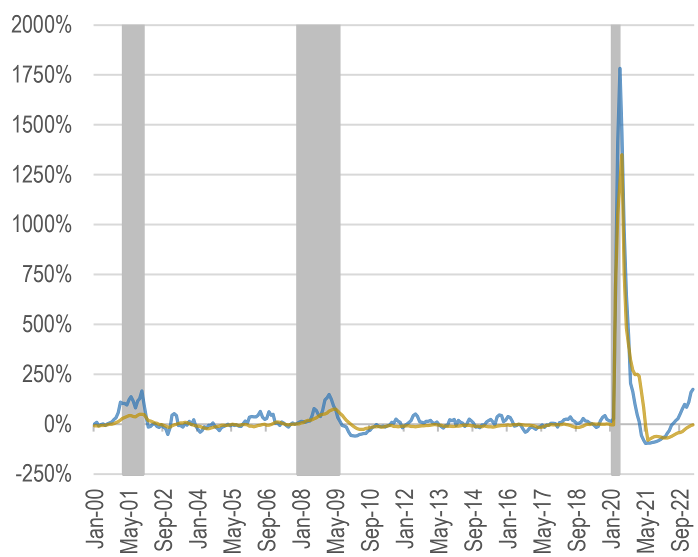
January 2000 - March 2023
(Source: Bloomberg)



However, looking side-eye at some less common indicators reveals a labor market that is beginning to buckle. In a sign that the labor market may be turning, initial jobless claims, when looked at on a percent change, year-over-year basis, are starting to rise, the blue line in the graph below. A WARN notice is filed by a company 60-90 days before the firms plan to close a plant or initiate mass layoffs. WARN notices have risen for a year, and the curve's slope and comparisons to other recessionary periods look ominous.

WARN (Blue) and Claims (Gold), Year-Over-Year Change

January 2000 - March 2023
(Source: Bloomberg)

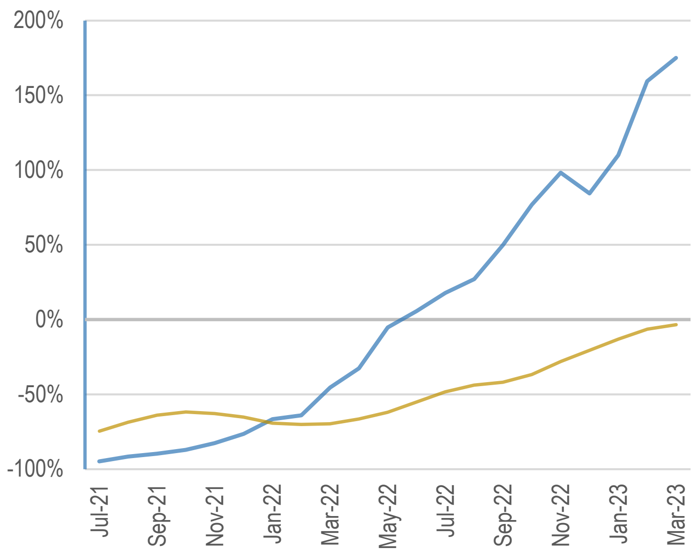


Forgetting about the pandemic irregularities by shortening the time frame in the graph shows the year-over-year percent change in both unemployment claims and WARN notices rising fast.

WARN (Blue) and Claims (Gold), Year-Over-Year Change

July 2021 - March 2023

(Source: Bloomberg)



Unemployment claims are rising state by state, suggesting a degree of labor market weakness that is beginning to spread across the country. A quarter of states are experiencing more than a 30% increase in unemployment claims. This condition is always a precursor to recession.

However, if a recession is averted through dumb luck or the mysteries of central bank Krav Maga, the potential economic outcome is not relief and renewal but stagflation. Most assets are not priced for this potentiality. Stagflation is the topic of next week's *Weekender.*

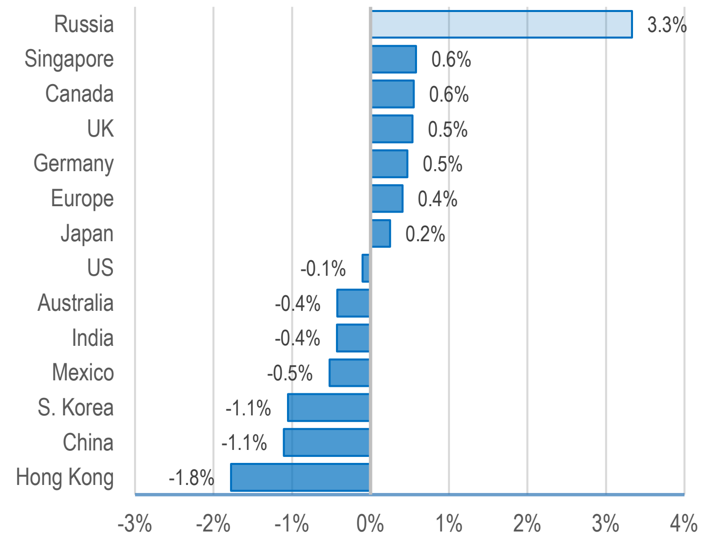
Countries

Russia's uninvestable equity markets were the best performing last week. We believe non-US equity markets are involved in a narrative adjustment similar to that in the United States. Most global central banks are close to peak rates, and inflation in most developed markets is beginning to turn.

Weekly Country Returns

April 17 - 21, 2023

(Source: Bloomberg)

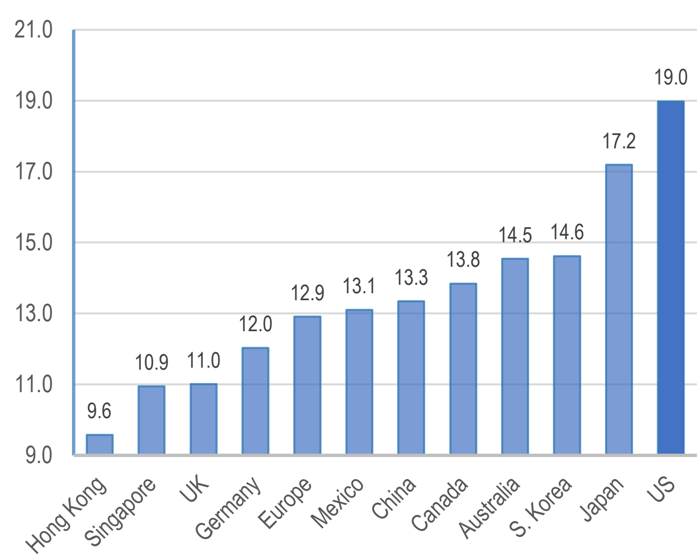


Regardless of one's expectation of future global economic performance, country equity markets are disparately valued. The US S&P 500 remains the most expensive developed market. Consequently, diversifying equity allocations in other markets may be appropriate.

Country PE Ratios

April 21, 2023

(Source: Bloomberg)

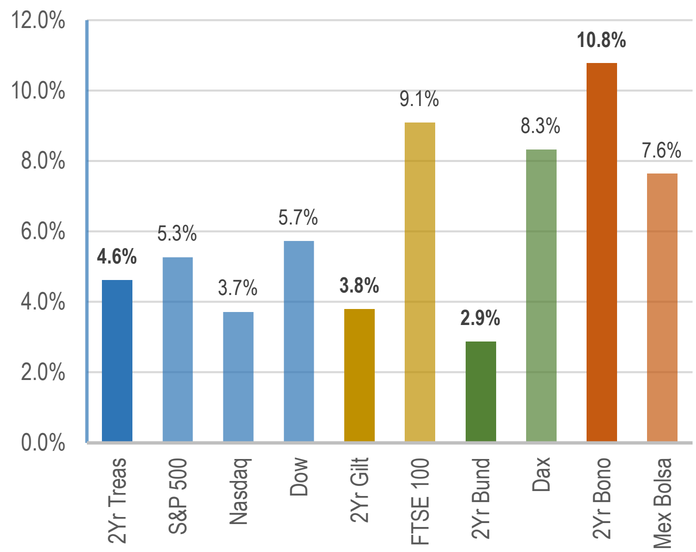


Below is a graph of the sovereign two-year government bond for the US (treasury in blue), the United Kingdom (gilt in gold), Germany (bund in green), and Mexico (bono in rust). Of particular note is the yield of each sovereign bond compared with the earnings yield of the related stock market index. For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

Sovereign Rates and Earnings Yield

April 21, 2023

(Source: Bloomberg)



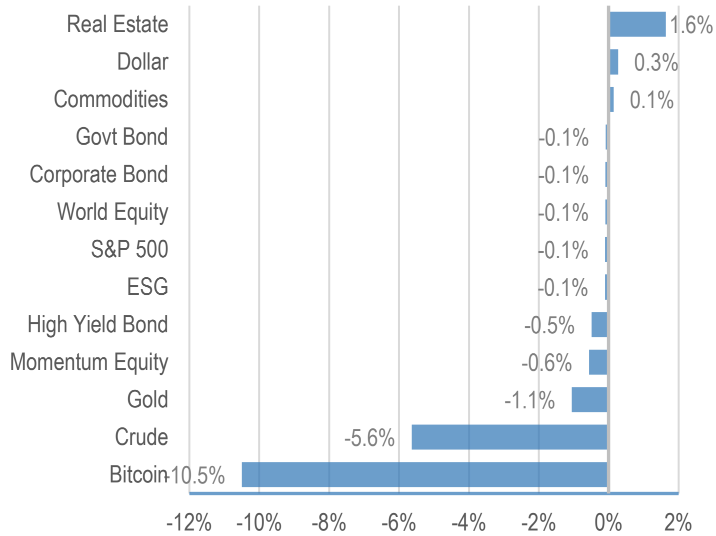
Instruments

Among investable instruments, most were flat on the week. Bitcoin was the worst performer. Fears about approaching regulation continue to heighten uncertainty in crypto land. Economic data suggest inflation will remain persistent and interest rates higher than expected. These also put pressure on Bitcoin, which is now below $30,000.

Weekly Instrument Returns

April 17 - 21, 2023

(Source: Bloomberg)

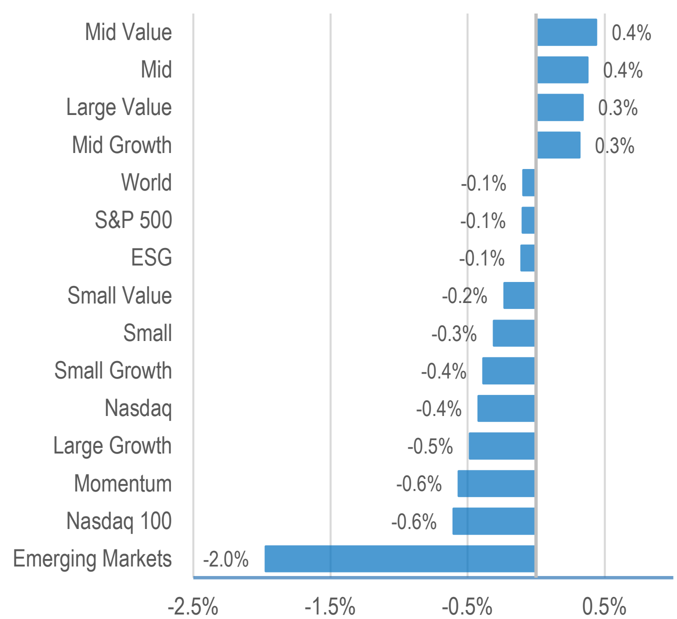


Emerging markets were the poorest performer as inflation and interest rates pushed hard. Among Equities, value continued outperforming relative to growth—a typical response to higher interest rates.

Weekly Equity Instrument Returns

April 17 - 21, 2023

(Source: Bloomberg)



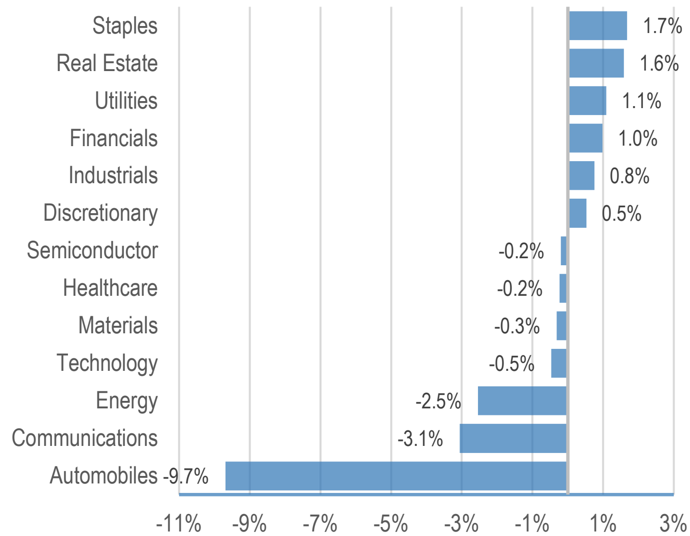
Sectors

There was an air of protection in the sector returns last week. Staples, real estate, utilities, and financials were the best performers. Automobiles, heavily weighted by Tesla, were the worst performers.

Weekly Sector Returns

April 17 - 21, 2023

(Source: Bloomberg)

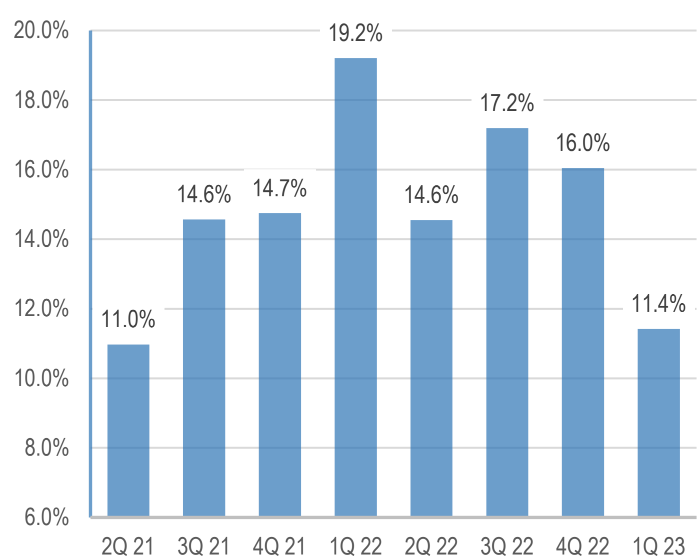


Tesla signaled it would keep cutting prices to buttress demand for its electric vehicles. The company's operating margin has fallen to 11.4% in the first quarter, a two-year low. Price cuts in January and higher component and operating costs pushed operating margins to their lowest level in two years. Even so, Elon Musk indicated that Tesla would continue to cut prices to stoke demand.

Tesla Operating Margins

2Q 21 - 3Q 23

(Source: Bloomberg)



When Tesla launched its first electric car, the Model S, its target market was high-end customers who considered themselves BMW or Mercedes buyers. The Model S kept the company afloat while it refined its manufacturing process, established a broader market presence, and expanded its product offerings. Over the last year, Tesla has opened two new factories that will significantly expand output. At the same time, legacy auto manufacturers have introduced many competing electric offerings.

Tesla Pricing by Model

Model	Current	Initial	Change
Model 3	33,990	46,990	-15%
Model Y	46,990	65,990	-29%
Model S	87,490	104,990	-17%
Model X	97,490	120,990	-19%

In slightly more than three months, Tesla dropped the price of its Model Y by -29%, igniting a price war among legacy automobile companies trying to break into the EV segment. While Tesla shares are lower by -12.6% on the week, that pales in relation to the 31.2% gain they have clocked since the beginning of the year.

Tesla Stock Price

January 2, 2022 - April 21, 2023

(Source: Bloomberg)

Anyone with a YouTube account or Twitter handle knows that Elon Musk marches to the drummer inside his head. Even so, engaging in a price war when you are the undisputed market leader in electric cars, with no means to subsidize the war, seems either paranoid or realistic. The difference between the two may be paper thin.

We believe Tesla's price movements are a pre-emptive attempt to secure its leadership position in electric vehicles as other manufacturers ramp up production. They reflect an exciting take on the short history of electric cars. Henry Ford lowered the cost of automobile production by developing the moving assembly line, resulting in a price war that trimmed the car maker ranks.

However, Tesla's price moves are not occurring in a vacuum. Ford CEO Jim Farley said, "Price wars are breaking out everywhere." Tesla is walking a tightrope. Ford can compete on price with Tesla because most of its revenue and cash flow come from selling internal combustion autos. It can use these financial resources to subsidize an EV price war. For Tesla, every price drop cuts its profit margins, earnings per share, and stock price.

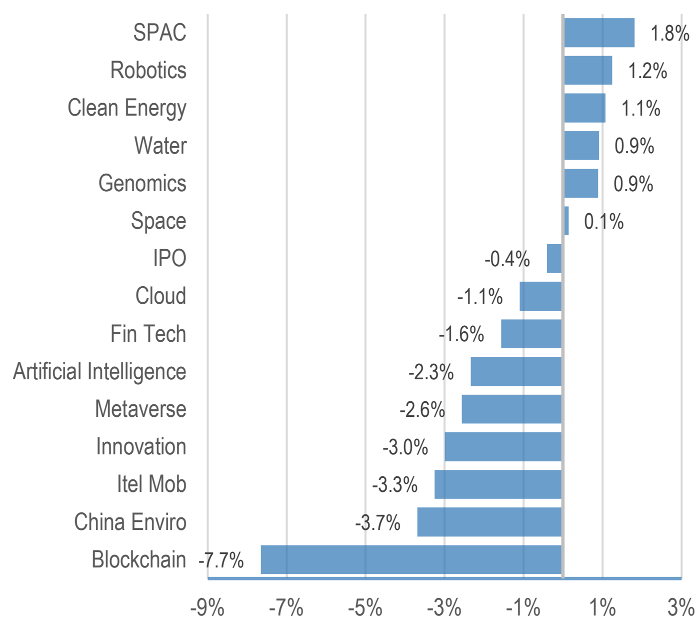
Themes

The themes were split. Following Bitcoin's fall under instruments, the Blockchain theme was the worst performer last week.

Weekly Theme Returns

April 17 - 21, 2023

(Source: Bloomberg)



One More Thing

Over the past month, I have been listening to Peter Zeihan's book *The End of the World is Just the Beginning: Mapping the Collapse of Globalization* on my one-hour driving commute. Personality and experience have disinclined me to be an easy conspiracy theorist or a member of any of their cults. But Zeihan's book has changed me. It is data-driven, lucid, and prescriptive. I recommend it without reservation. Many of the ideas in the book will be coming, in expanded form, to a *Weekender* on a regular basis. One of his observations is that preoccupation with sex is almost always a precursor to the collapse of civilization.

Long before Zeihan, JD Unwin (*Sex and Culture*, 1934) suggested a correlation between cultural achievement and sexual restraint. His book concludes with his theory that as societies develop, they become more sexually liberal, diminishing their creative and expansive energy. A total of 86 world cultures formed the basis of his analysis.

Edward Gibbon (*The Decline and Fall of the Roman Empire*, 1788) suggested five marks of decay in the Roman Empire. They included: 1. Art that was freakish and sensationalistic; 2. An increasing disparity between rich and poor; 3. Demands to live off the state; 4. Display of affluence instead of building wealth; and 5. Obsession with sex and perversion of sex.

Will and Ariel Durant wrote *The Story of Civilization,* a phenomenal eleven-volume summary of the human experience. A small volume, written and published after they were asked what lessons can be learned from their exhaustive work, *The Lessons of History*, is a goldmine. One of the lessons is that civilizations that lose their way and fall into unredeemable decline turn to an almost pathologic focus on sex. The Durants conclude that "sex is a river of fire that must be banked and cooled by a hundred restraints if it is not to consume in chaos both the individual and the group."

Our society seems to be obsessed with sex. I am not talking about gender or the rights that are illuminated in the *Declaration of Independence* and enshrined in the *US Consitution.* I am referring to the absolute preoccupation and debasement, at almost every level of our society, with something that is supposed to be private, intimate, sensitive, and special.

Something to think about.

That's it for this Weekender, have a wonderful week.

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.

The statements provided herein are based solely on the opinions of the author(s) and are being provided for general information purposes only. The information provided or any opinion expressed do not constitute an offer or a solicitation to buy or sell any securities or other financial instruments. Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful. The foregoing information has been obtained from sources considered to be reliable, but we do not guarantee it is accurate or complete. Consult your financial professional before making any investment decision.

The stock indexes mentioned are unmanaged groups of securities considered to be representative of the stock markets in general. You cannot invest directly in these indices.