The Fat Pitch

Weekender

May 20, 2023

Peace is when time doesn't matter as it passes by.

Maria Margarethe Anna Schell

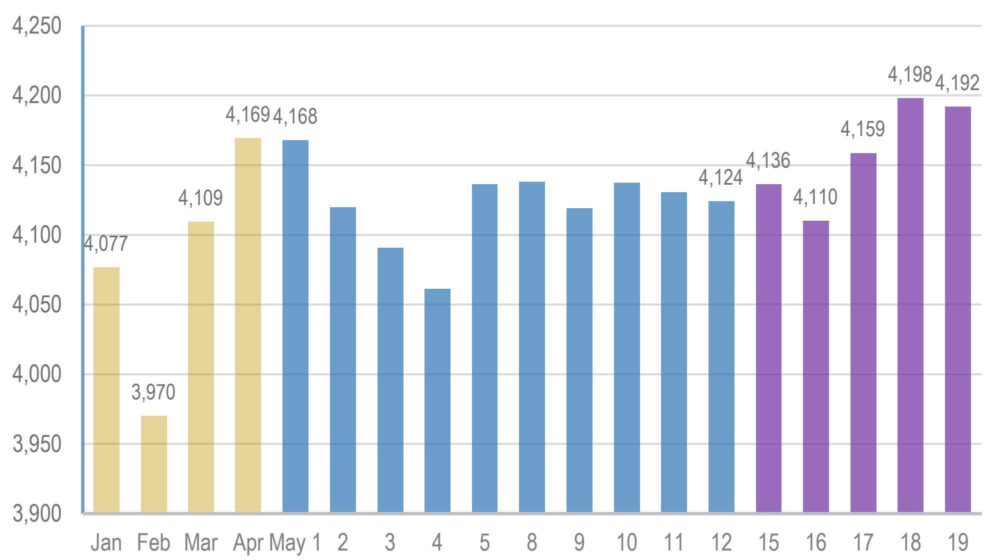
Good morning and welcome to the *Weekender* for Saturday, May 20, 2023. As measured by the S&P 500, equity markets were higher on the week. Going into Friday, it looked like the index would post a new year-to-date high, but concerns about a breakdown in debt ceiling negotiations evaporated some of the week's "would-be" gains.

Interest rates rose on the week, creating a narrative that now includes a potential US government debt default. Stocks responded to the fixed-income pessimism by rallying. Wait, what?

For the week, the S&P 500 was higher by 1.6%.

S&P 500 Index Levels

(Source: Bloomberg)



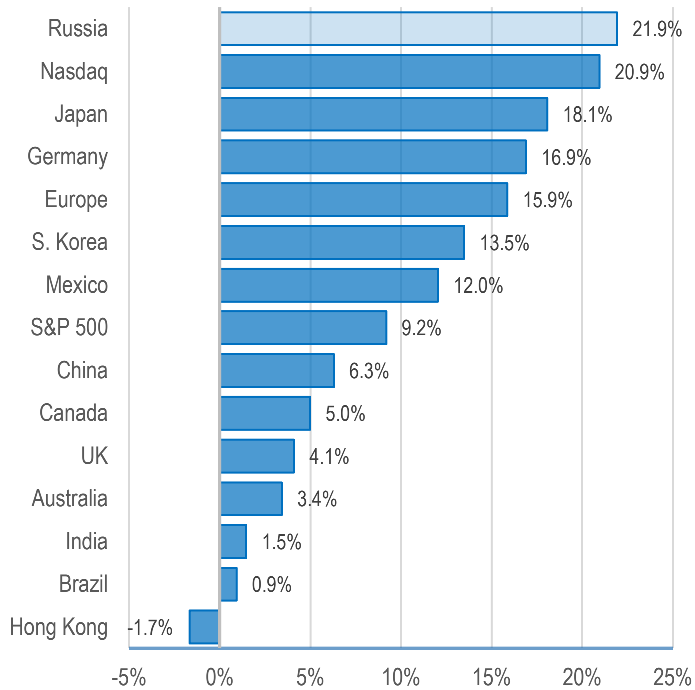
Financial market drivers for the week include angst about our petulant political system and its inability to resolve the debt ceiling debate, soft corporate earnings, a Fed finally ready to pause, and the unfathomable market upside possibilities emanating from artificial intelligence juju.

For the year, the S&P 500 index is higher by a very respectable 9.2%. The tech-heavy Nasdaq is higher by 20.1%, a stunning rebound from last year. Most global equity markets have also had a strong year.

Year-to-Date Returns (Local Currency)

January 2 - May 19, 2023

(Source: Bloomberg)



On Friday, Fed Chair Jerome Powell signaled that he was inclined to pause interest-rate increases at their June meetings. While the choice isn't solely his, the central bank tea leaves lean in that direction. Lending conditions have been tightening since the mini-banking crisis in March, giving the Fed the gift of time on interest rates. But the banking sector carnage is far from over. In the increasingly low-margin world of global finance, size matters. We expect thousands of mergers among small- and medium-sized US banks over the coming years.

Earnings reports for the first quarter are mostly published, with 91.9% of US companies having reported. The results are as we have telegraphed in previous Weekenders. Revenues are higher by 4.9%, roughly in-line with inflation, and earnings are lower by -5.3%. Retailers dominated this week's earnings reports. It was a somewhat mixed bag.

Foot Locker, a company already struggling, suggested that it expected revenue to decline by approximately -8.0% this year, a much more significant drop than expected earlier. CEO Mary Dillon said on their earnings call, "Our earnings trends have slowed significantly. The recent softness has resulted in us taking a more aggressive promotional stance to drive demand and to manage our inventory effectively."

Profit reports from Walmart, Target, and Home Depot illuminated a general trend amidst each firm's unique operating characteristics. Large ticket purchases are being procrastinated. Shoppers are spending less on discretionary items and more on must-haves like groceries. Consumers are also tuning their spending lower following the March mini-banking crisis, suggesting a niggling concern that rough times may be ahead. Tapestry, the parent company of Coach and Kate Spade, reported that their sales softened considerably as the first quarter progressed.

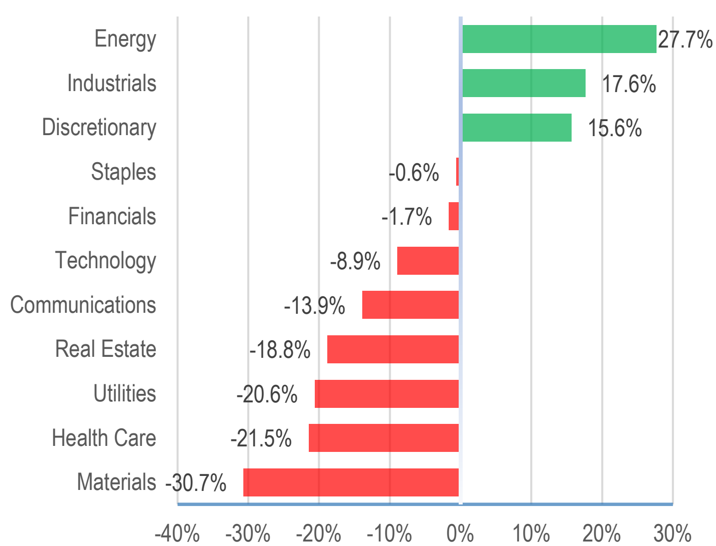
Across the board, heavy promotions and discounts are required to move bloated inventories and support revenue expectations. Foot Locker expects to continue dropping prices through the end of the year. Home Depot's results showed a sense of resilience. But that may be because, after a long winter, the renewal of "honey do" lists has do-it-yourselfers reenergized. With lumber back below pre-pandemic levels, pandemic-postponed projects are back on the list.

Next week the big-box and budget retailers (Best Buy, Costco, and Dollar Tree) will report. We expect them to echo the cautionary tales, although to

First Quarter Earnings by Sector

Year-over-Year Comparison

(Source: Bloomberg)



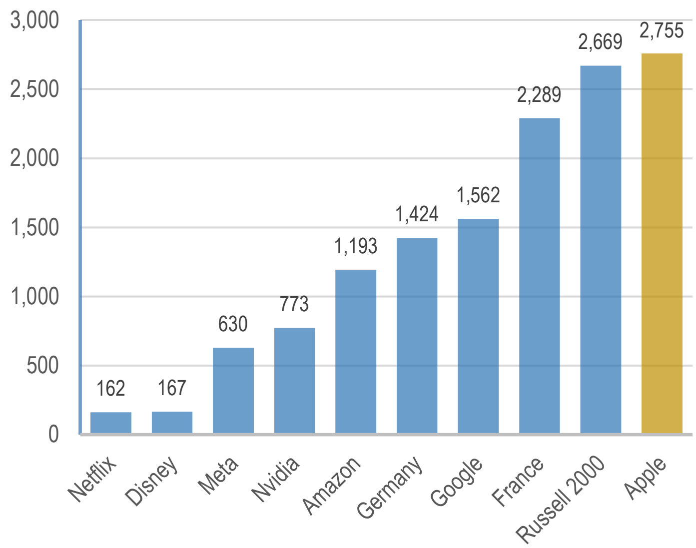
a lesser degree than the retailers have already said. US corporate earnings show contraction, as we have telegraphed in many previous *Weekenders.* As the graph below illustrates, the sectors showing continued margin expansion are those in which higher prices can still be passed on to the end customer. For all the others, earnings for the first quarter, compared to last year's period, are lower.

Since the beginning of the year, a handful of companies have dominated the S&P 500 equity index. We have highlighted this in previous Weekenders. Apple, the most valuable company, is worth $2.8 trillion more than the Russell 2000 index of small-cap companies. Narrow markets require savvy stock picking. Passive investors will underperform.

Market Capitalization in US Dollars

May 19, 2023

(Source: Bloomberg)



In this *Weekender,* we will look at general economic data and the US residential housing market and highlight last week's moves in countries, instruments, sectors, and themes. Our one more thing segment is on The Walt Disney Company. Please be sure to consult a financial advisor before making financial decisions.

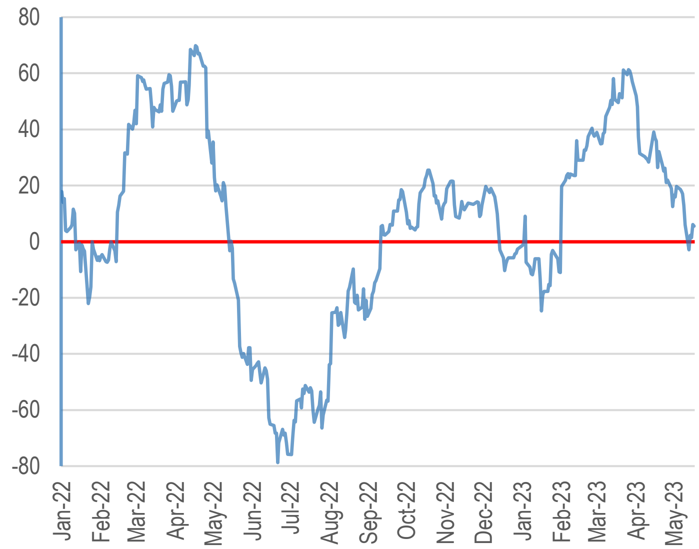
Economic Commentary

The Citi Economic Surprise Index tracks the tenor of economic data as it deviates from what was expected. A negative reading suggests data is coming in worse than expected, and vice versa. This week the gauge dipped below zero and rebounded a bit. The point? Macroeconomic data in the United States has been surprising on the downside since the end of March 2023.

US Citi Surprise Index

January 1, 2022 - May 19, 2023

(Source: Bloomberg)

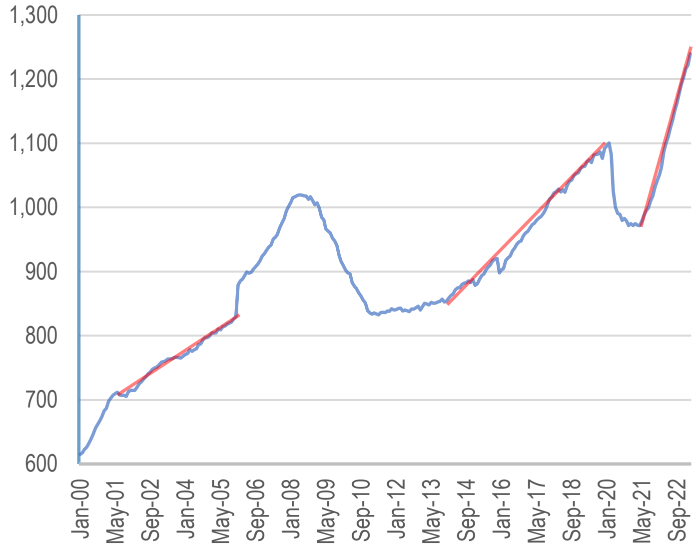


While data portend oncoming economic softening, the US consumer seems to be on a long bender. Retail sales remain strong, and the labor market defies expectations on the upside. Our view continues that a full-on recession is only possible with significant dislocations in the labor market. However, in the "be careful what you wish for" camp, a softer consumer and tenuous labor market may be around the corner.

Following the onset of economic recession, it is common for monetary and fiscal policy to shift toward accommodation. This usually precipitates a bottoming of the economic cycle. The consumer remains sturdy, and the labor market is robust because the monetary and fiscal accommodation was applied before the recession. Consider the firehose of stimulus flooding the US economy in and out of the pandemic. A large part of this stimulus continues to work through the system, keeping employment, spending, and investment artificially high.

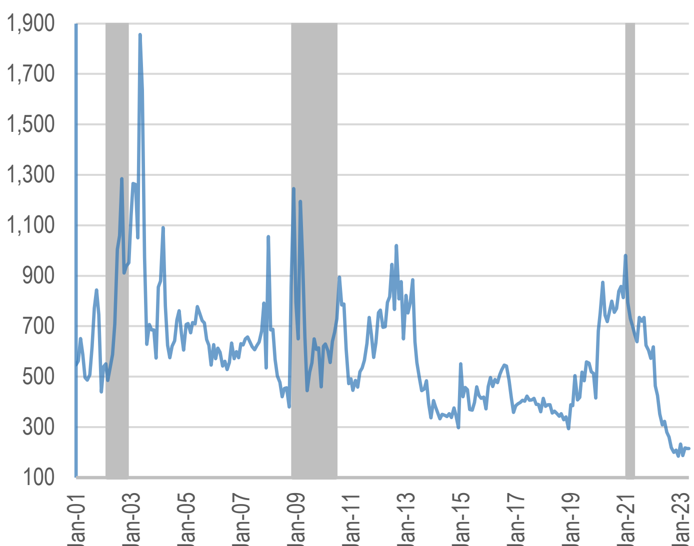
As the kindness of strangers wears off, consumers will need to rely on their resources. In September, student loan payments will come due. Feeling flush with cash in the meantime, consumers have been spending well beyond their means. This is a graph of revolving consumer credit (credit cards). Red trend lines have been added to highlight the slope of change during the last three periods of consumer excess. The grey-shaded areas are temporal indications of recession in the United States.

Revolving (Credit Card) Credit
January 2000 - March 2023
(Source: Bloomberg)



A significant contraction has led to every past recession in the interest rate-sensitive areas of automobiles and residential real estate. This time is different. At present, automobile companies are selling, and in many cases preselling, every vehicle that comes out of the factories in many cases above MSRP. The tight car market comes from shortages during the pandemic that remains unsatiated. Residential real estate is in a similar situation.

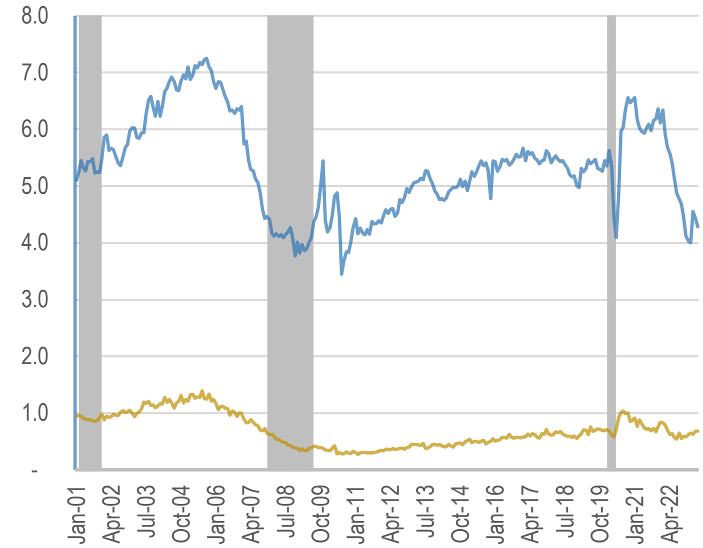
Mortgage Applications Index
January 2001 - May 17, 2023
(Source: Bloomberg)



Mortgage applications have fallen back to levels lower than before the pandemic. They are lower than at any point since the data has been collected. Higher interest rates have shut down the refinancing market and have locked out all but the most-worthy homebuyers.

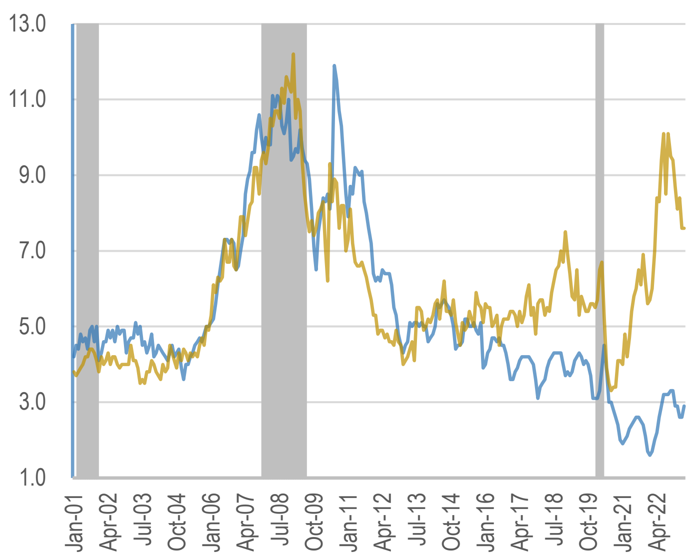
New home sales remain strong (the gold line), while existing homes, which account for most of the total sales, have fallen back to recession levels.

Existing (Blue) and New (Gold) Home Sales (Millions)
January 2001 - April, 2023
(Source: Bloomberg)



Inventory, as measured by the month's worth of homes available for sale, remains attractive for new

Existing (Blue) and New (Gold) Months Supply
January 2001 - April, 2023
(Source: Bloomberg)



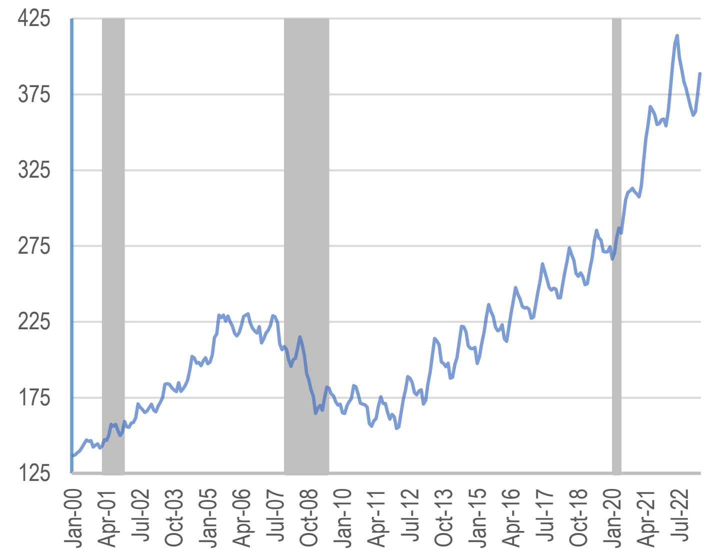
homes (the gold line) and scarce for existing homes (the blue line). It's challenging for homeowners to list their homes in the current environment. Selling an existing home with a 3.0% mortgage payment in exchange for something else at double the interest rate and a higher price doesn't make sense.

Tight supply has been the prevailing dynamic, keeping home prices firm. Nothing like the environment of the 2008-09 credit crisis.

Median Home Price

January 2000 - April, 2023

(Source: Bloomberg)



Looking at home prices broadly often camouflages regional trends. This chart shows regional month-over-month home price changes by area in January 2023 published by Black Knight.

Black Knight Home Price Index

January 2023

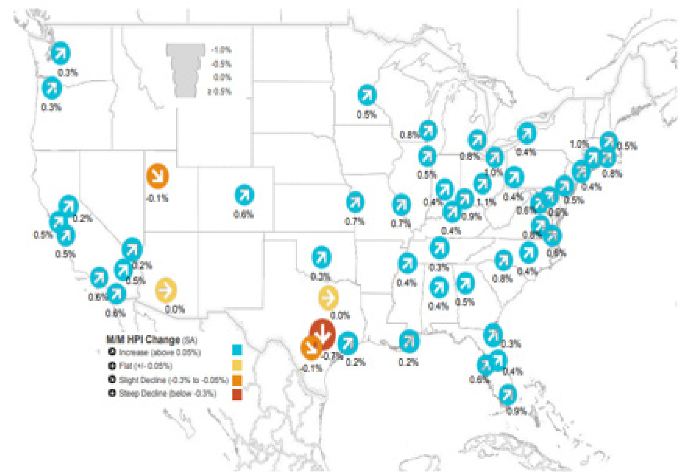
(Source: Bloomberg)

This is the same chart for March 2023.

Black Knight Home Price Index

March 2023

(Source: Bloomberg)



Consumers are beginning to accept a new, higher for longer interest rate environment as a given. Automobile and residential real estate markets have already bottomed and, short of a significant dislocation in the labor market, do not pose a systemic threat to the economy or the consumer.

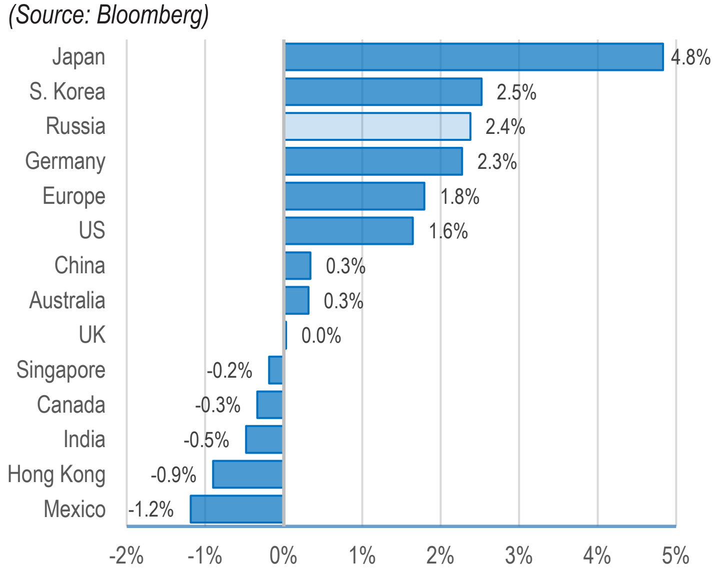
Countries

Japan was the best-performing country last week. This is unusual because Japan has been muddling through its demographically inspired decline since 1989. A group of seven industrialized country leaders met in Japan this week, which drew much attention

Weekly Country Returns

May 15 - 19, 2023

(Source: Bloomberg)



Money

March

(Source

to the island nation. A batch of economic data was released last week suggesting China's reemergence from the pandemic was less potent than hoped.

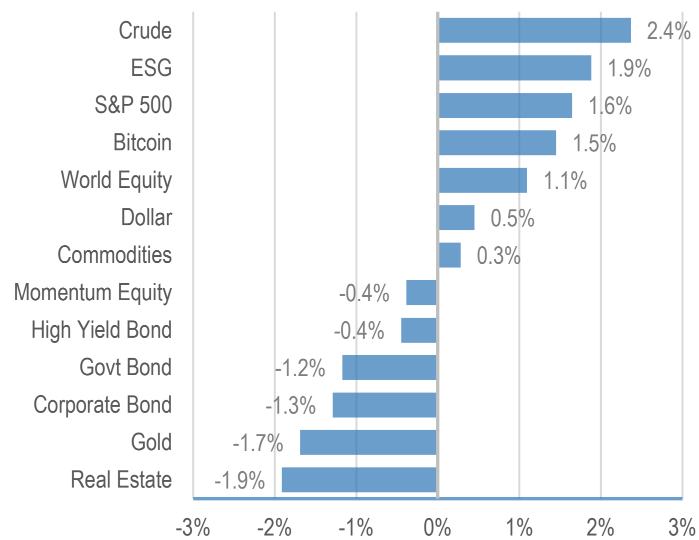
Instruments

Crude oil was the best-performing among many potential investment instruments. The interest-rate-sensitive tools declined as interest rates rose, especially at the short end of the curve.

Weekly Instrument Returns

May 15 - 19, 2023

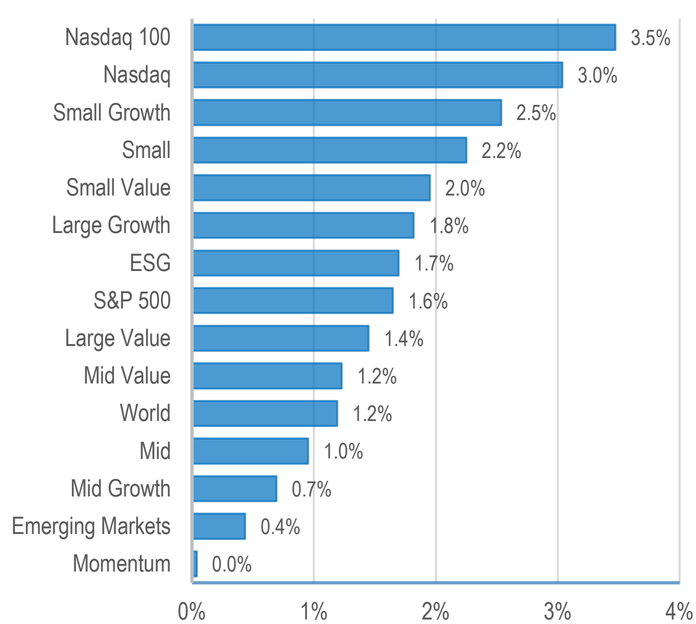
(Source: Bloomberg)



Weekly Equity Instrument Returns

May 15 - 19, 2023

(Source: Bloomberg)



Artificial intelligence continued to be the clarion call this week. Large capitalization tech companies are the initial beneficiaries, so they continue to lead the equity markets.

While small-cap stocks performed relatively well on the week, their underperformance in the face of a potential recession and general artificial intelligence foam-building among the large-cap technology shares has been remarkable since the beginning of the year. Small capitalization companies have fallen more than 10% from their February peak, while large ones have been on a tear. Once the pinnacle of post-pandemic optimism, smaller punters are now treated as a canary in the coal mine for equity markets. They are behaving as if recession is a foregone conclusion.

Russell 2000 / S&P 500

January 2, 2019 - May 19, 2023

(Source: Bloomberg)

A sell-off in small and regional banks has disproportionately negatively impacted small-cap indices due to their heavy weighting. The small-cap Russell 2000, compared to the S&P 500, is plumbing depths not seen since the bottom of the pandemic. When valuations pop in the large-tech names, we expect this to reverse.

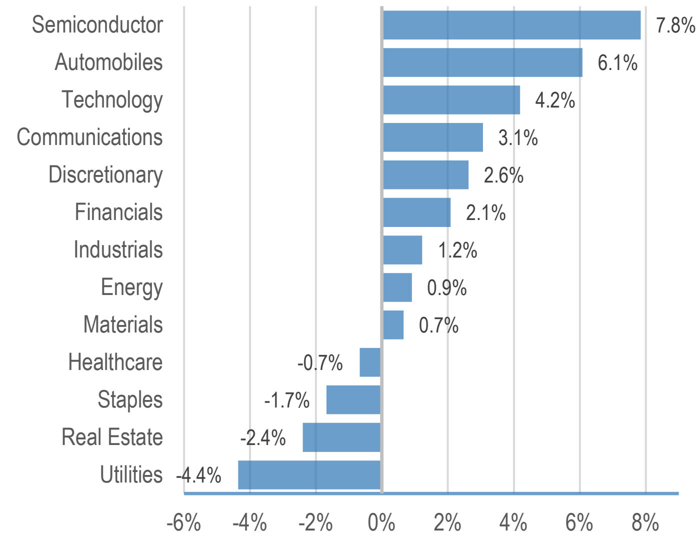
Sectors

Sector returns favored artificial intelligence, while interest rate-sensitive real estate and utilities pulled in last.

Weekly Sector Returns

May 15 - 19, 2023

(Source: Bloomberg)



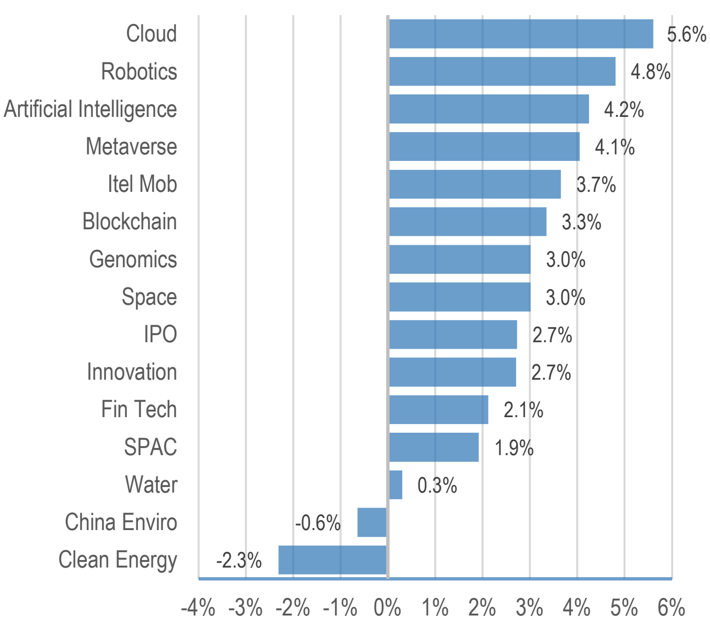
Themes

The themes played a rerun from last week. Themes related to artificial intelligence all outperformed the more mundane but virtuous environmental stories.

Weekly Theme Returns

May 15 - 19, 2023

(Source: Bloomberg)



One More Thing

One more thing. If Forrest Gump is correct and "stupid is as stupid does," then Ron DeSantis and Robert Iger are idiots. DeSantis will likely win on the merits and other companies will wonder if they are next. Iger has already lost, and Disney is paying the price.

As mentioned in previous Weekenders, my pre-college summers were spent working on a family farm in Scipio, Utah. It was a twelve-hour drive from our home in Solvang, California, and we occasionally broke the drip by stopping at Disneyland. On one occasion, I snuck out of the Disneyland Hotel unawares early in the morning and found myself rummaging, mesmerized, through the amusement park before it opened. I remember little about my adventure other than the feeling. As I walked around, the sprinklers were on, and the early morning dew magnified the genuine sense that I was in Neverland.

I found a book by Bob Thomas, *Walter Disney: An American Original,* and devoured it, determined that if I was to be like Walt Disney, creating my own amusement park was essential. Wasdenworld was born, at least in my head. Not a particularly unique name, but I was nine. Working on Wasdenworld was a salve on a childhood of bullying and sadness.

After long, dusty days on the farm, I would hunker down in my grandparent's basement and work on my amusement park designs. Crude models were crafted from discarded materials common to a working farm. For Christmas, I asked my parents for a drafting table so I could refine my designs. As the years rolled on, my commitment only intensified. My parents never criticized my interest and provided an uncommon degree of support.

When I was twelve, I resurrected my mother's college typewriter from underneath her sewing supplies and typed a letter to the chief executive of AT&T. My letter outlined my plans and asked if he would consider sponsoring a ride. Special care was taken to ensure there were no errors. My commitment was such that I was utterly unsurprised when a response was received from his office asking for more information.

Walt Disney has been an inspiration for me all of my life. He was a man who continually failed, rose, and persisted until success was his duty and just reward. My wife and I are Disneyland annual pass holders. We used to go every month, spending most of our time sitting on one of the Main Street park benches, eating popcorn, and watching the parade of fellow enthusiasts coming through the turnstiles.

Most adults viewThe Walt Disney Company with some ephemeral connection to its founder's creativity, genius, and persistence. Children feel a similar relationship to the characters created by Walt Disney and his company. However, the company seems increasingly lost and unsure about raison d'être. When Walt Disney opened Disneyland on Sunday, July 17, 1955, he said, "Disneyland is dedicated to the ideals, the dreams, and the hard facts that have created America with the hope that it will be a source of joy and inspiration to all the world."

Disney, the company, has strayed from its identity many times. But it has always found its way back, usually through the unwelcome meddling of Disney family members concerned about the legacy and vision of its founder. Any course correction needed today will be more complex than before, given the evangelical pressure from social groups who want to use the company to advance their agendas. In the past, when the company found itself again, the spirit of Walt Disney was the force from which it drew its inspiration.

In May 2022, Florida Governor Ron DeSantis signed a bill banning classroom instruction about sexual orientation for young children. Activists and media have called it the "Don't Say Gay" law. The law says, "Classroom instruction by school personnel or third parties on sexual orientation or gender identity may not occur in kindergarten through grade 3 or in a manner that is not age-appropriate for students in accordance with state standards."

The bill's passage and signing caused a firestorm. At the time, the feckless short-term CEO of Disney, Bob Chapek, waffled on his support of the bill when pushed by Disney's LGBTQ+ employees. Bob Iger, the previous CEO of Disney, responded with disdain for the safety of the cheap seats. By November 2022, Bob Chapek's disastrous two-year stint at the helm of Disney was over, and Bob Iger, "man of the people," was back in the corner office. Iger immediately went after the bill and the governor. Peacocking for a national presidential run, DeSantis used Iger and Disney to fight Wokeism and favoritism. Reedy Creek was his foil.

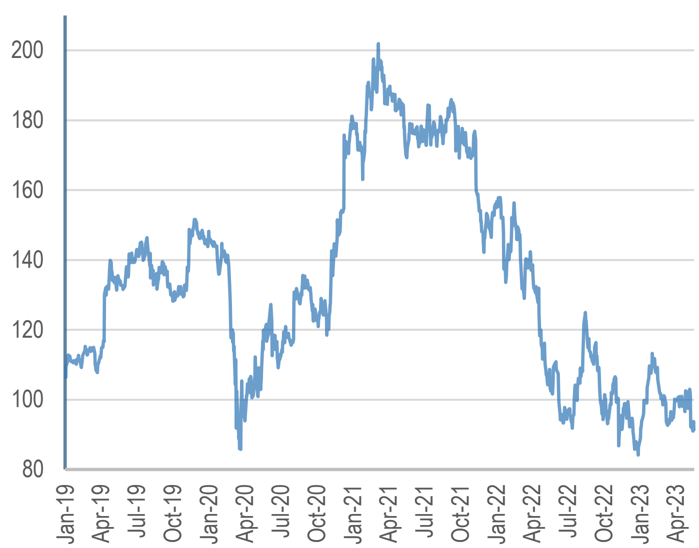
In 1967 the Florida State legislature created a special taxing district called the Reedy Creek Improvement District. Reedy Creek was given the same authority and responsibility as a county government. In short, The Walt Disney Company was granted the power to act as its county government over land it primarily owned. At the time, it didn't seem like a huge giveaway. Most of the land within the district was mosquito-infested swamp land with few redeeming qualities. Today the same land is precious. The Reedy Creek entitlements are far-reaching and enable Disney to curate an idyllic environment for its parks. No other company in the United States has such an endowment. For Disney to lose it based on hubris is idiotic.

Last week Disney announced they would close a new $1,200 per night Star Wars-themed hotel and cancel a planned move of Disney Imagineering staff from California to Florida. Media outlets tried to portray the moves as a "that's what you get" response from Iger to DeSantis. Building the Star Wars hotel and requiring customers to seek long-term financing was a dumb idea. But it was Iger's dumb idea when he was leading Disney. Moving the Imagineers from California to Florida faced incredible pushback from inside the company and had been postponed numerous times. Indeed, Iger and the press made hay in the current dustup by pretending these actions were retaliation for DeSantis' moves against Reedy Creek. But they weren't.

Disney Stock Price

January 2, 2019 - May 19, 2023

(Source: Bloomberg)



When he returned for a two-year encore, Disney's board gave Iger some strong counsel. Find your replacement. The spectacle being played out must make the board bristle. Engaging in a pissing match with DeSantis serves no productive purpose for the company.

Disney stock fell 54.8% from its pandemic high on March 8, 2021. The stock trades at 23.5x 2023 earnings estimates, a 32% premium to its pre-pandemic multiple.

While price increases keep the company's revenues growing, operating margins had fallen from 26% before 2019, when its performance led the entertainment industry to 9.1% today, less than half the industry average. Disney is a content company. Its content is distributed through movies, cable, direct-to-consumer (Disney+), theme parks, travel experiences, and consumer products. Any casual observer can see that Disney's primary content and stories are increasingly disassociated from its core customers. Disney content has been successful over the years because it has served as a fat pitch over the home base of America. However, it is increasingly far outside the strike zone. Unless changes are made, it won't end well.

A valuable lesson for all of us could be extrapolated from the DeSantis Iger tiff. Stop fighting battles on social media. Pick up the phone. Reach out and touch someone. Listen to understand.

Conclusion

That's it for this *Weekender*. Have a wonderfulweek.