ANDINA
ADVISORS

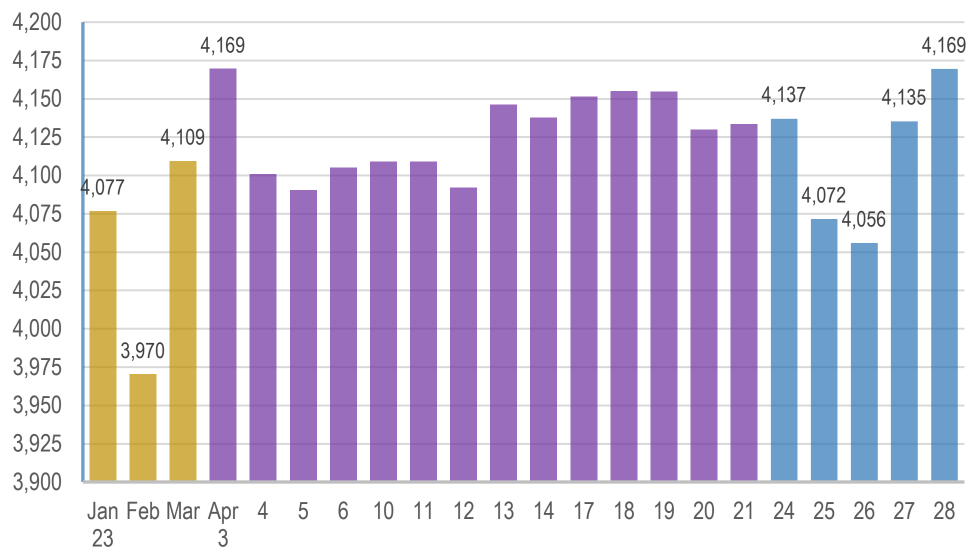
Canaries and Coal Mines

Weekender
April 29, 2023

It's better to debate a question without settling it
than to settle a question without debating it.
Joseph Joubert

Good morning and welcome to the *Weekender* for Saturday, April 29, 2023. The Standard and Poor's 500 index was higher by 0.9% last week amid a deluge of earnings and economic data. Earnings were more robust than expected, while the economic data was weak.

S&P 500 Index Levels
(Source: Bloomberg)



Strong earnings, especially from technology names, diluted the stagflation narrative that has been forming since the beginning of the year. However, economic data showing slower growth and higher inflation propped up the stagflation narrative, a bit. Credit standards remain tight while the slow drip, drip, drip of bank failures continues pushing deposits out of the banking system, magnifying the attention paid to regional banks and tightening lending standards accross the board. Economic data points increasingly support a stagflation narrative while corporate earnings suggest the consumer, which accounts for 70% of economic growth, remains potent.

ARCHIMEDES
INSIGHTS & ANALYTICS

Market risk is increasingly asymmetric. As the Fed has telegraphed, rates will be higher for longer, tracking the path of core inflation. Higher rates increase the probability of an economic downturn, leading to a drop in asset prices. All the inflation data released over the past week suggest inflation is entrenched.

Inside the market indices, a few observations are worthy of consideration. The past week was about stellar technology earnings. Markets responded to the positive results by pushing tech shares higher. So much so that the combined weightings of Apple and Microsoft in the S&P 500 are approaching 14% by total market value. If Alphabet, Amazon, Meta, and Nvidia are included, nearly one-fourth of the index's market value comes from six stocks.

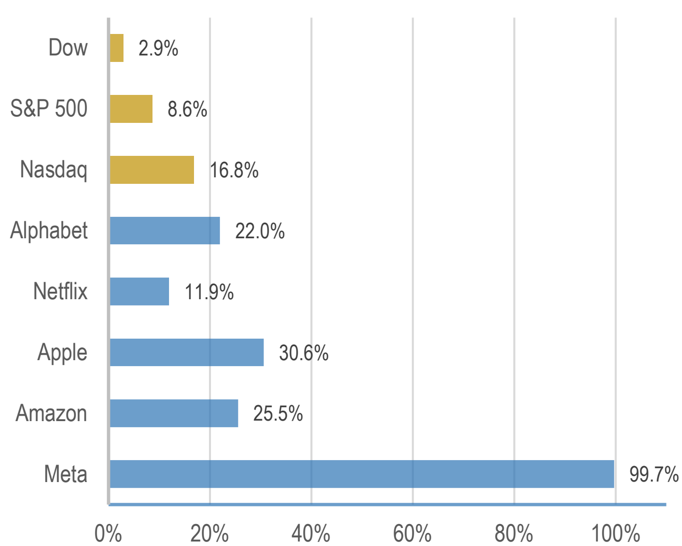
Apple and Microsoft, together, have increased their market value by more than $1 trillion since the beginning of the year, a gain that accounts for half of the total year-to-date return of the S&P 500. The point? As an index becomes increasingly top-heavy, the risk of investing in it passively rises.

The NASDAQ 100 is a large capitalization technology index full of the usual suspects. It trades at 29.5x earnings compared to an average of 21.4x between the end of the Credit Crisis and the pandemic's beginning.

We have been discussing and predicting a softer earnings environment over the next eighteen months.

Year-to-Date Returns

January 2 - April 28, 2023
(Source: Bloomberg)



In past *Weekenders,* we suggested that earnings in the first quarter would be substantial relative to expectations but essentially flat relative to last year. Our thesis is playing out with approximately 28% of US publicly listed companies having reported their first-quarter earnings. Earnings are 6.8% higher than expectations but -0.82% lower than last year.

Enter the FAANG. Strong earnings from Meta (AKA Facebook), Alphabet (think Google), and Amazon contradict our sanguine earnings predictions. Incredible price gains in FAANG names have been the primary catalyst moving markets higher by 1.5% for April.

Large tech companies deserve another round of applause. They have done an excellent job managing their business. Earnings reports highlight how large technology companies may be able to weather a coming economic storm. As growth slows, these firms are working on the inside of their income statement by cutting costs.

Looking forward into the rest of 2023 and through most of 2024, we continue to believe increased cost pressures and a weaker consumer have been and will continue to be the proximate cause of margin compression and lower earnings through 2023.

Economic and Market Summary

Any rational economic analysis must incorporate hundreds of data points that often conflict. Market soothsayers try to read the data cards and tea leaves for guidance. Historical comparisons are also employed to predict endpoints to the present from historical precedent. While past economic cycles teach valuable principles, their general application to the current environment conjures few helpful conclusions. Each economic cycle is different. Recent analyses have suggested that our current economic environment resembles that of 1966. That's hogwash. Obscure similarities provide only remote usefulness.

Three questions must be answered to understand where the economy and markets will find themselves over the next eighteen months. First, what does the Fed do with interest rates? Second, what is the impact on the economy? Third, what is the compound effect on corporate earnings and the financial markets?

Interest Rates. The Federal Reserve has been uncharacteristically resolute in its declaration that its target rate would get to 5.25%, where the Fed will pause and see what damage has been wrought and make further decisions from there. We expect a 0.25% bump to seal the deal at their next meeting. Fed officials have shown that the bar for lowering rates is very high and isn't likely to be met this year. Recent inflation data, the inflation data set preferred by the Fed, show that core inflation is not softening but firming instead.

Markets have been hesitant to pay heed to the Fed's insistence. Instead, markets are continually trading an imminent Fed pivot. Getting a pivot this year or early next year will require a degree of economic distress no one should hope for. Such an environment doesn't appear likely from the data either. Without significant dislocation in the labor market and a clear sense that inflation is in full retreat, a pivot like that being telegraphed by markets is extremely unlikely.

After almost four decades of falling inflation and a Fed that seemed trigger-happy at the earliest sign of economic and financial market risk, financial markets have been conditioned to expect an interest rate pivot. They also predicted and traded a pivot in the early 1980s. But Paul Volker, the Fed chair then, kept steaming ahead.

We believe the Fed will keep rates higher for longer. Almost all interest rate-sensitive parts of the economy are probing a new normal. Residential real estate has moderated and now has found its level. Low inventory helped it bottom quickly—automobiles and in the same camp. Commercial and industrial real estate will not be lucky enough to dodge the same bullet.

Economy. Economic output for the first quarter of 2023 came in at 1.1%. If it feels soft and squishy, it is. But not for the commonly expected reasons. US consumers are spending, and the labor market continues to be robust. Business spending and inventories were the main reason for soft economic performance.

Shipping, freight, and transportation act as a canary in the coal mine of economic performance. In recent economic releases, ground and air freight experienced a significant drop in pricing and demand. JB Hunt, Old Dominion, FedEx, and UPS have all seen volume deterioration. Meanwhile, rail traffic volumes are higher. Rail traffic tends to reflect raw material demand, while ground and air shipment volumes reflect end-product demand.

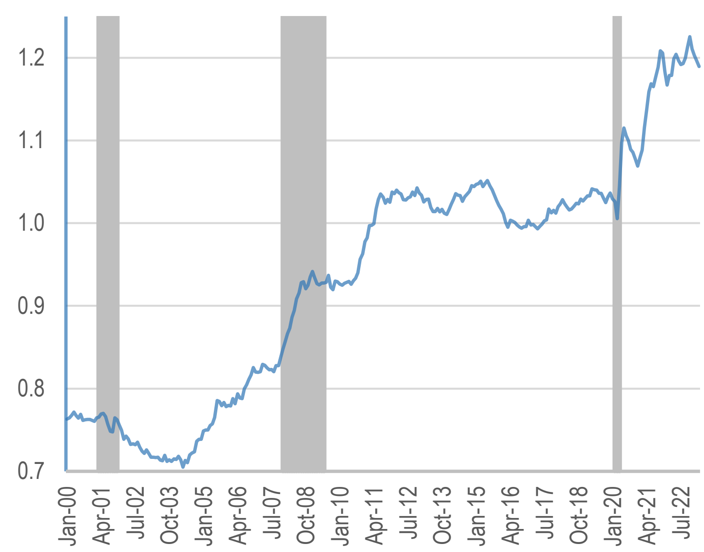
In October of 2021, the west coast ports of Los Angeles and Long Beach were stuffed. More than 100 container ships were waiting offshore to unload. Pandemic constraints shuttered the service sector as people lived, worked, and schooled in their homes. Flush with cash, new denizens of online commerce shopped 'til they dropped. Determined to avoid stock-outs, retailers over-ordered, and in the Fall of 2021, all that "stuff" was creating congested chaos at the two ports where, before the pandemic, 40% of containerized products were unloaded. West Coast ports are now operating at approximately half of their pre-pandemic levels. Some container ships have been redirected to other ports to avoid congestion. But in general, we believe a material slowdown in product movement is beginning and has not yet been extrapolated into the broader economy.

Inventories around the world are hitting the rafters. Consumer spending is robust, but it is targeted toward services. Not products. The retail-to-wholesale inventory ratio continues to be well above pre-pandemic levels. Clearing inventory will require deep discounts leading to compressed profit margins. In the meantime, new orders will continue to slow, putting a lid on economic growth.

Retail-to-Wholesale Inventory Ratio

January 2000 - March 2023

(Source: Bloomberg)



Earnings. Equity market returns of the next eighteen months will be based on the resilience of US consumers. Will they continue to spend as inflation becomes more entrenched, their post-pandemic wunderlust satisfied, and a new normal settles in?

Companies with pricing power will continue to benefit the most from a robust labor market and a willing consumer. Last quarter's earnings also show a remarkable willingness in company management teams to pivot—away from a focus on growth and toward efficiency.

As mentioned, the US economy descended from perky growth of 2.6% in the last quarter of 2022 to only 1.1% in the first quarter. But personal consumption was relatively hot in the first quarter showing growth of 3.7% following a tepid comparison of 1.0% in the last quarter of 2022. Consumers will likely continue to spend through the current quarter as they become increasingly accustomed to higher inflation and interest rates. However, healthy consumer spending is coming by way of credit cards. As soon as student loan payments resume, 60 days after the Supreme Court decides or no later than September 1, 2023, consumption will be deeply impacted.

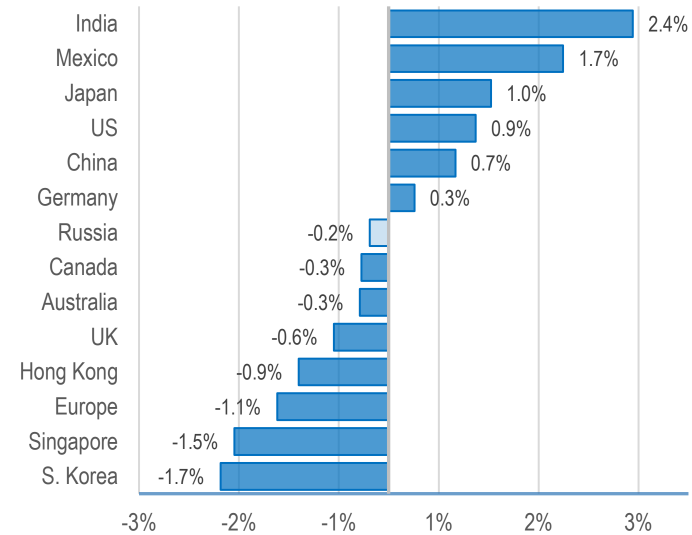
We continue to believe that as long as the labor market remains resilient, the economy will stay afloat. But it will slow. If the labor market breaks, all bets are off. As an investor, positioning in quality names and investment instruments continues to be the most appropriate action.

Countries

King to India this past week. The country continues attracting corporate and investor interest, pushing markets higher. We are very constructive on India over the medium- and longer term. India's Sensex equity index trades at approximately 21.4x earnings, which seems prohibitive.

Weekly Country Returns

April 24 - 28, 2023
(Source: Bloomberg)



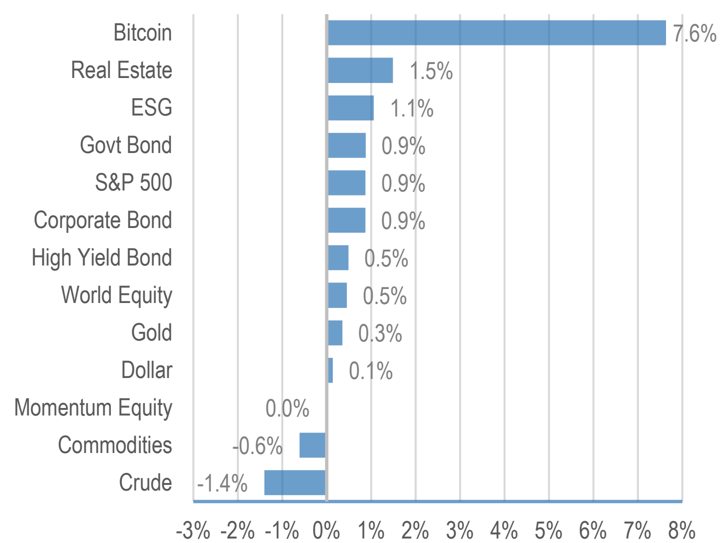
Countries around the world are releasing economic data for the first quarter. US growth, although tepid, puts it in the pole position compared to its group of seven peers. Compared to its rivals, US growth could be better. China posted growth of 4.5%, driven by a sustained increase in domestic consumption and a whopping 15% increase in exports. The export number is not completely clean since last year's pandemic shut-downs played a role.

Instruments

Among instruments, Bitcoin was the best performer on the back of several reports suggesting that

Weekly Instrument Returns

April 24 - 28, 2023
(Source: Bloomberg)



within a year, the cryptocurrency could be as high as $214,000. We call BS on that.

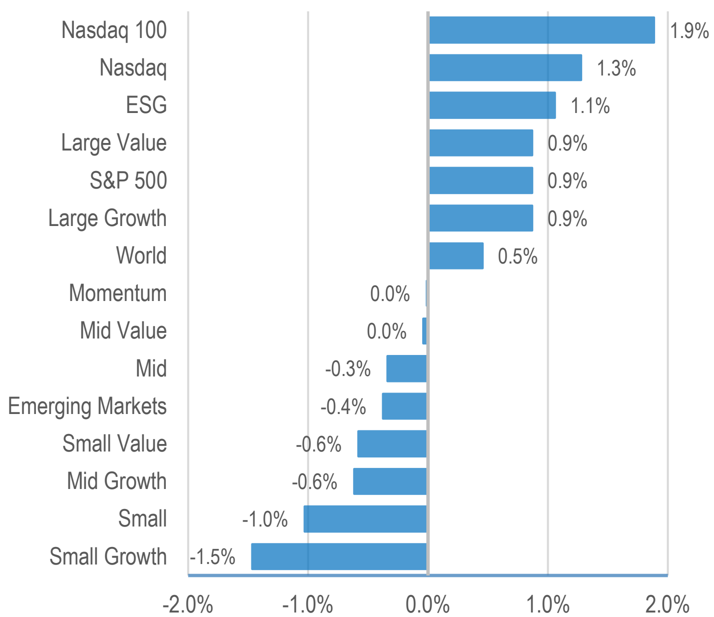
Real estate performed admirably as residential home prices rose, new home inventory remained tight, and buyers continued to snap up homes in the face of higher mortgage rates. Bonds beat out stocks as interest rates fell on the week, with two-year yields at 4.00% on Friday's close.

Among equity instruments, it's no surprise that the big technology names making up the Nasdaq 100 were the best performers. Value continues to beat growth, and momentum, which now includes many financial firms, was soft.

Weekly Equity Instrument Returns

April 24 - 28, 2023

(Source: Bloomberg)



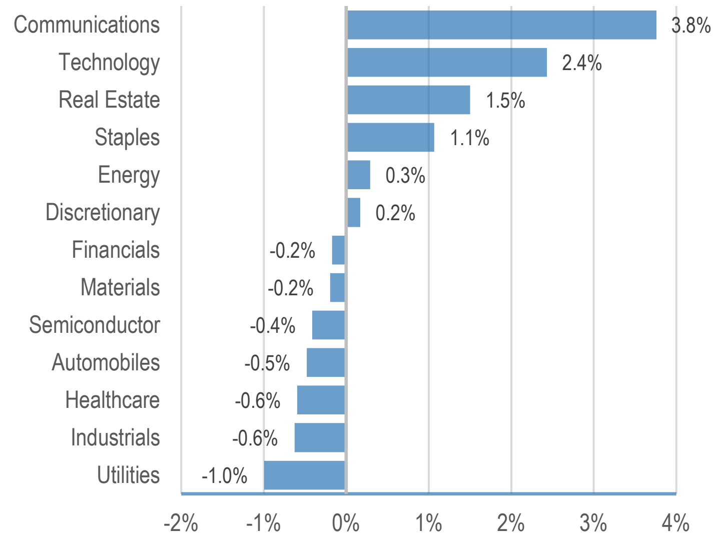
Sectors

Sector returns were a mixed bag with no significant fundamentals providing direction. Communications and technology took the lead, consistent with the trends mentioned earlier in this *Weekender.* Sectors that generally offer some protection during recessions were the poorest performers.

Weekly Sector Returns

April 24 - 28, 2023

(Source: Bloomberg)



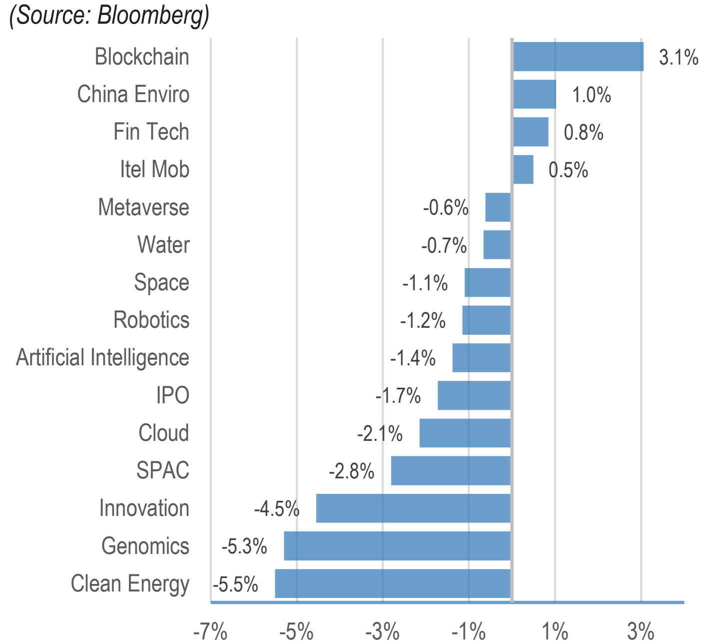
Themes

Themes were split on the week, although mostly lower.

Weekly Theme Returns

April 24 - 28, 2023

(Source: Bloomberg)



One More Thing

One more thing. So why canaries? John Scott Haldane, who some regard as the father of oxygen therapy, was credited with the idea of using canaries to detect dangerous carbon monoxide in coal mines. Canaries need large quantities of oxygen to live and fly at extreme heights where humans would be incapacitated. Their unique adaptations mean they can absorb oxygen when inhaling and exhaling through specially adapted air sacks. Consequently, within a toxic mine, they get twice the dose of carbon monoxide, providing miners with an early warning of danger.

Like most loaded catch phrases today, "canary in the coal mine" is well-worn. We may have contributed to that.

For the benefit of all amateur ornithologists, in 1986, government mandates declared an end to the use of canaries in mines.

That's it for this *Weekender*. Have a wonderful-week.