The Second Coming

Weekender

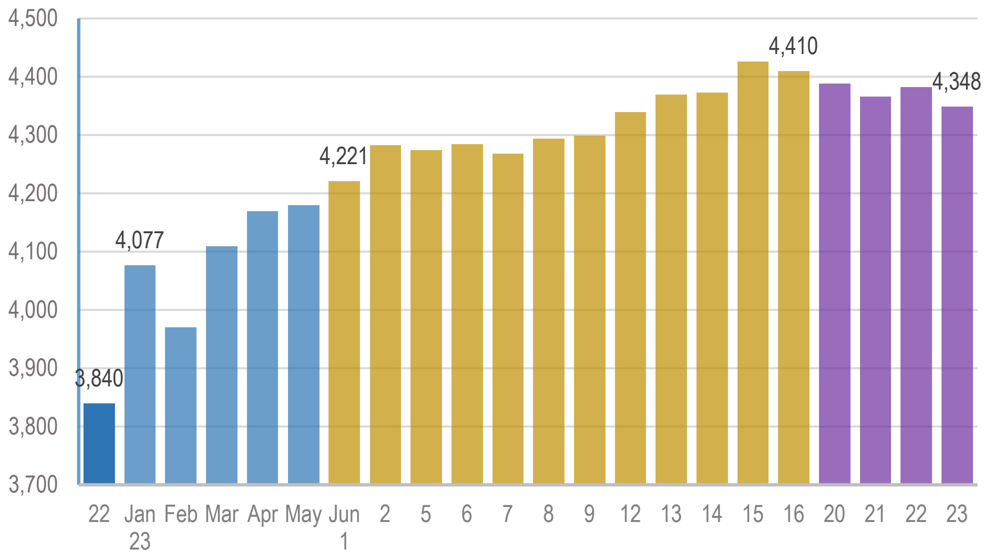
June 24, 2023

There is always light. If only we're brave enough to see it.
If only we're brave enough to be it.

Amanda Gorman

Good morning and welcome to the *Weekender* for Saturday, June 24, 2023. The market's exaggerated expectations about the fantastical future of artificial intelligence could not keep equity markets above water this week. On Friday, the S&P 500 closed its worst week since March as non-US central banks increased their target interest rates to combat what they believed was increasingly entrenched inflation.

S&P 500 Index Levels
(Source: Bloomberg)



Equity markets, as measured by the S&P 500, were lower by -1.4% in a holiday-shortened trading week. AI stalwarts like chipmakers were some of the worst performers on the week. Nvidia, the poster child for the AI revolution, lost only -1.0% last week, which masks the adjustments made more broadly among semiconductors. The Philadelphia Semiconductor Index was lower by -4.5% over the period.

Fed Chair Jerome Powell brought some rain to the equity parade this week by confirming, in his testimony to Congress, that there may be another two rate increases before year-end. That shouldn't have been a big downer because he had said as much on multiple occasions over the past few months. However, when listening to the Fed, equity markets have acted like teenagers rolling their eyes in the face of parental counsel. Fixed-income markets have been listening in earnest.

Treasury Secretary Janet Yellen tried to tamp down a recurring recession narrative by suggesting a consumer slowdown was a necessary precursor to recession and that such a slowdown was nowhere on the horizon. Consumption continues to be robust in the service sector, with prevalent shortages. Manufacturing has been in contraction in most developed countries and China for over six months.

Concerns about the US and global economic outlook were manifested in equity markets by rotating out of equities and into bonds and cash market instruments. In monetary terms, investors pulled more than $5 billion from stocks and added $5.4 billion to bonds. Bond prices fell, and yields rose.

This will be an uncharacteristically short *Weekender*. Our *House View* dissects the US economic and investing environment for the rest of the year and will be our next publication. It will be published in print and video formats.

Economic Narrative

A bevy of economic data confirms that global manufacturing is already in recession. Services, which account for almost 70% of the US economy, continue to grow steadily. Meanwhile, the labor market remains strong and consumer spending robust, although in light of persistent inflation, spending is supported by record-breaking credit card debt.

On Thursday, the Bank of England raised its benchmark rate by an unexpected fifty basis points. European markets now worry that a soft landing is increasingly out of reach for their region. Last week, the US Federal Reserve opted to kick the can down the road and not raise rates anymore. The Fed's hesitancy is based on a desire to wait and survey the damage wrought by recent rate increases before proceeding. We don't question the strategy.

Inflation is a standard modern economic boogeyman for economic cycles. It is generally a byproduct of too much money chasing too few goods. Excess inflationary demand naturally softens through higher interest rates and a weakening labor market. In response, the Federal Reserve expands the monetary structure to make credit cheaper and encourage demand. Fiscal policy is also engaged through higher government spending designed to keep factories humming and services flowing in the face of a weaker consumer.

But this time is different. Due to the uncertain economic effects of the pandemic, the cure for the recession was applied before the slowdown presented itself. Trillions of dollars in monetary and fiscal stimulus were injected into the US economy to keep it from succumbing to the uncertain but expected ravages of the pandemic. Trillions of the approved pandemic largess have yet to be spent, so we have no clear sense of when or where the economy will eventually land and no longer needs or is driven by external stimulus.

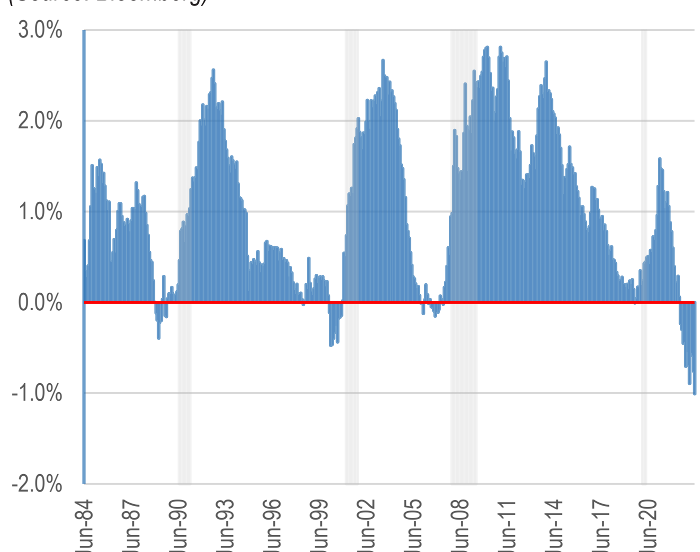
Pandemic largess has been like a fog over the economy, disguising the standard metrics used to gauge its health. Consequently, economic and market participants fly on instruments until the fog burns off and visibility improves. A few reliable readings may be helpful.

The spread between the two-year and ten-year treasury widened to -1.0% at the close of Friday. Inversions almost always preceded an economic recession. This inversion is the deepest in nearly half a century. Bond markets are suggesting serious economic juju magumbo is lurking around the corner.

US 10-Year Minus 2-Year Bond Yield

June 1984 - June 23, 2023

(Source: Bloomberg)

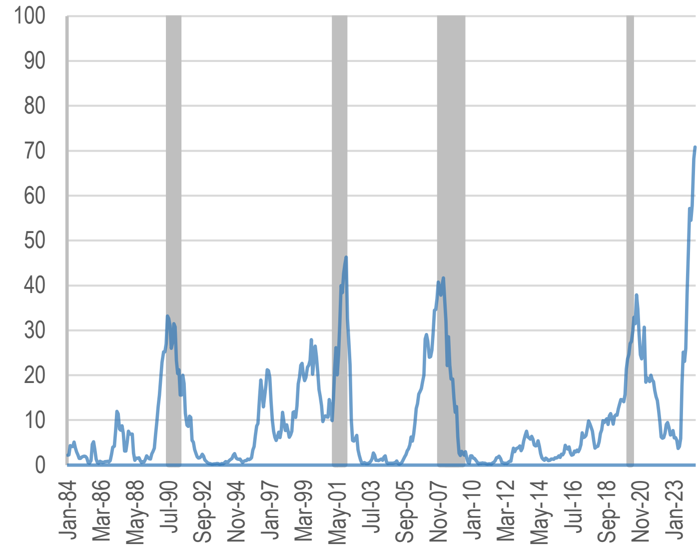


The US Federal Reserve tracks the probability that the US will enter a recession over the next year. Data show a 71% probability that the US economy will be in recession by next summer. Recession probabilities have never been this high. Ever.

Recession Probability

January 1984 - May 2024

(Source: Bloomberg)

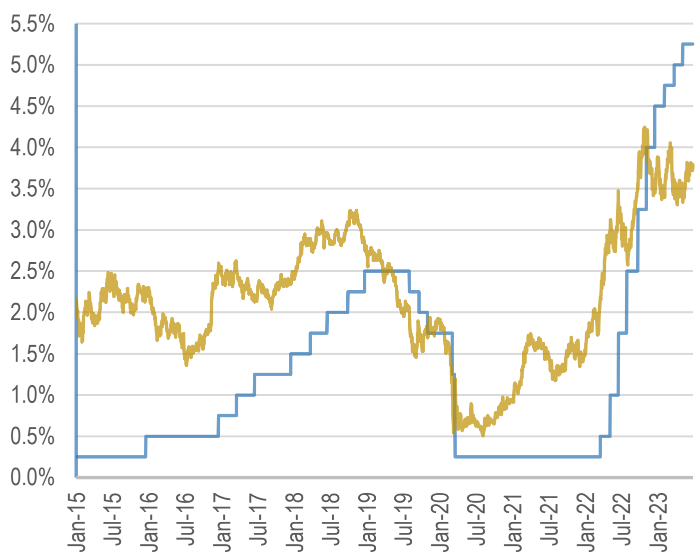


Federal Reserve policy determines policy interest rates used as a guide by financial markets. Over the last six months, market interest rates have stubbornly resisted moving in tandem with the Federal Reserve. Financial markets expect a lower rate environment soon, likely the byproduct of economic softness.

Fed Target Rate (Blue) and 10-Year Bond Yield (Gold)

January 1, 2015 - June 23, 2023

(Source: Bloomberg)



Countries

In a seismic case of "keep your friends close and your enemies closer," Yevgeny Prigozhin, head of the Wagner mercenary group and former ally of Vladimir Putin, turned Russia's Ukraine invasion over to the Russian military and began marching toward Moscow to topple his ex-friend Putin. To burnish his autocratic bonne fides, Turkey's president Erdogan announced that Turkey, a NATO member, would back Putin. The swift move of events dumfounds the global intelligence apparatus. However, with hindsight, Prigozhin has come off as a master tactician.

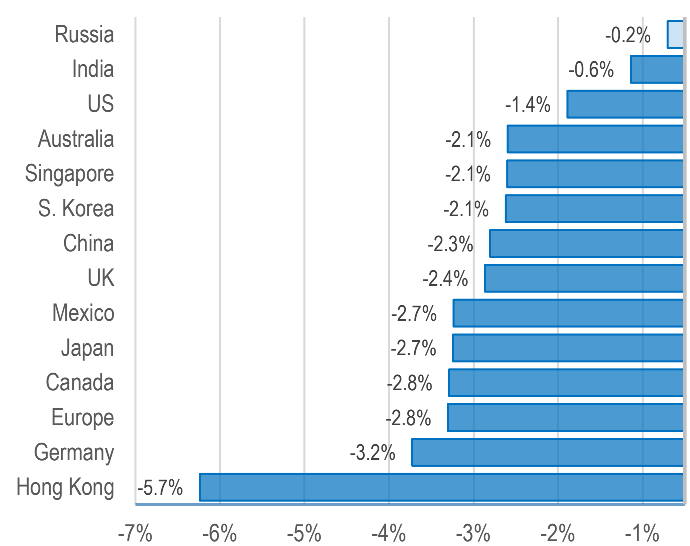
Russia immediately moved to restrict internet access in areas of the country where Wagner was moving. The situation remains tentative and fluid, and the next twenty-four hours will be critical. However, the difference between Prigozhin and Putin for the Russian people and the rest of the world is measured only in degrees. Both are self-serving despots.

At the time of publication, Prigozhin and his Wagner mercenaries halted their advance on Moscow with only 200 kilometers to go. Without bloodshed, his point was made, and Putin blinked. Strife within Russia will be primarily positive for Ukraine as it will distract Putin away from his international adventures and forces him to keep the local wolves at bay.

Weekly Country Returns

June 19 - 23, 2023

(Source: Bloomberg)

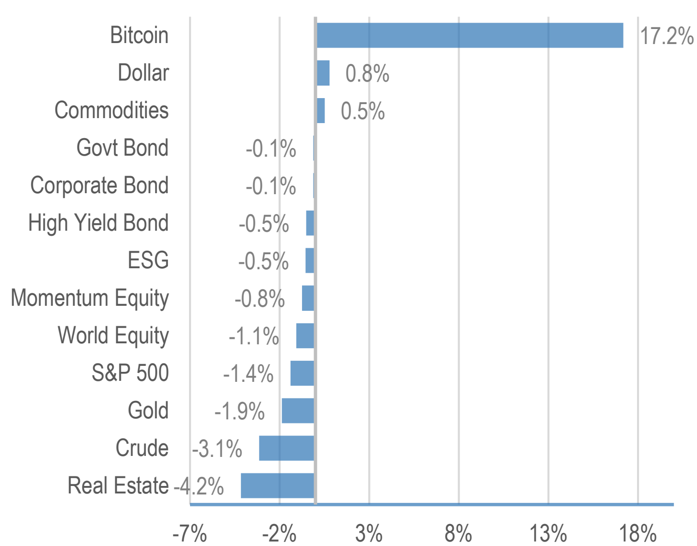


Hong Kong, the preferred route used by most global investors to gain exposure to China, fell by -5.7%. The Middle Kingdom is now in full stimulation mode. After exiting their pandemic lockdowns, a return to robust growth has yet to be discovered. In fact, among younger cohorts, unemployment is now almost 20%.

Instruments

Bitcoin was the best-performing instrument by far last week. Several prominent financial institutions announced they would create structured vehicles permitting clients to take and hold cryptocurrency positions. Regulators also announced a series of initiatives to bring crypto out of the dark recesses of financial markets and into the light.

Weekly Instrument Returns
June 19 - 23, 2023
(Source: Bloomberg)

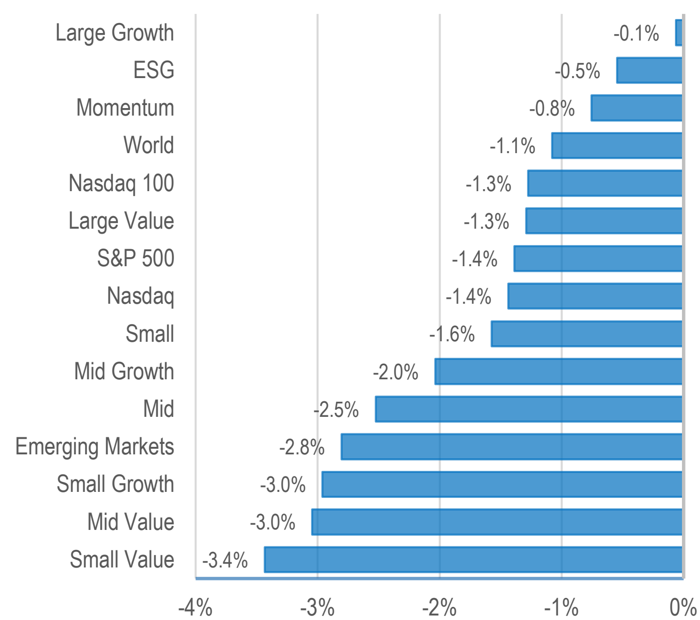


Nassim Taleb, author of the seminal book *Black Swan,* summed up his views on cryptocurrencies last week in an interview with CNBC. He said, “Let’s look at crypto. Is it being used for real transactions? No. It is a cult of business. It did exactly the opposite of its mission as an inflation hedge because it collapsed…its not good for real money laundering because it’s very traceable. It’s pretty much the first time in the history of the world we have a cult coupled with a financial instrument.”

Meanwhile, countries whose economic systems and currencies are dependent on or linked to the US dollar find the dollars hard to come by and are forced to pay with an alternative, the Chinese Yuan. Argentina’s central bank dollar reserves are at their lowest levels since 2016. Without dollars, it is turning to yuan. So are many of the country’s largest manufacturers. We expect the de-dollarization trend to continue worldwide over the next few decades, resulting in a falling dollar and a more persistent higher level of inflation.

In the equity space, all areas were lower, although the moves were remarkably uneven. In every category, value fared worse than growth, although crucial growth areas, like semiconductors, were among the most brutal hit.

Weekly Equity Instrument Returns
June 19 - 23, 2023
(Source: Bloomberg)



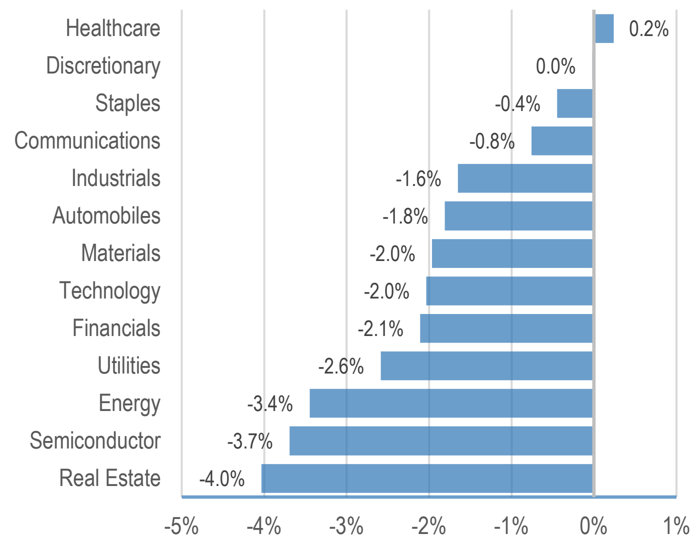
Sectors

Last week, real estate was the poorest-performing sector, driven mainly by a building narrative that interest rates will remain higher for longer. A continued drumbeat of data suggesting significant weakness in commercial real estate pushed the area lower. Meanwhile, home builders are hitting highs. It’s an odd real estate market. Semiconductors were lower as the AI buzz began to wear down a bit.

Weekly Sector Returns

June 19 - 23, 2023

(Source: Bloomberg)



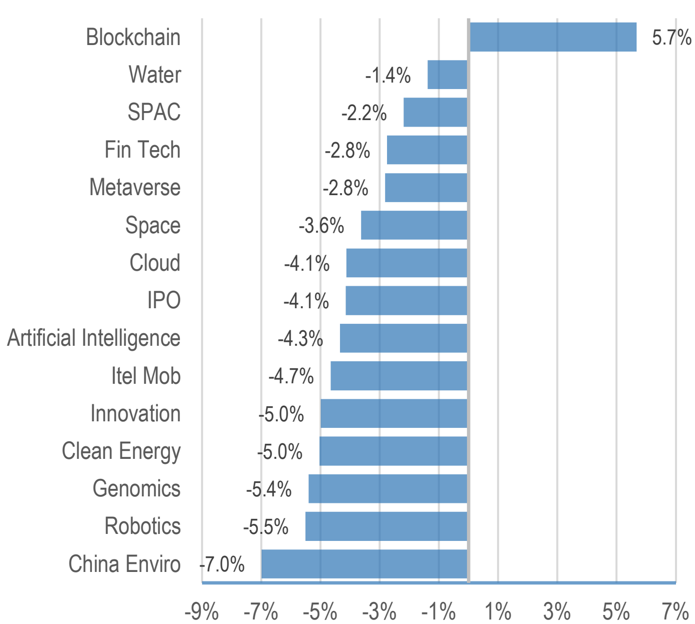
Themes

Given the strength of Bitcoin, it's hardly a surprise that the blockchain theme was a top performer among themes. All the others were lower.

Weekly Theme Returns

June 19 - 23, 2023

(Source: Bloomberg)



One More Thing

One more thing. In late May, the US Surgeon General, Vivek Murthy, announced that social media posed a "profound risk of harm" to adolescents' mental health. He urged parents and families to limit how social media was used and suggested that governments set stricter standards for social media companies. His office produced a 19-page document summarizing their position. No one could disconnect from their devices long enough to pay attention.

Last week, a small non-military submarine carrying five passengers to the wreckage of the Titanic suffered a catastrophic failure. All the passengers were lost. The story of the lost sub and Friday's catastrophe announcement captivated news and social media sites all week. One trending meme suggested that losing a group of wealthy sightseers was good for society. "Eat the rich" was a trending hashtag.

A writer for the *Los Angeles Times,* Jessica Gelt, noted: "Like a digital Tower of Babel, social media is evolving into an increasingly ugly and chaotic space – a real-time repository for our worst impulses, uninspired musings, scatological humor and ill-formed thoughts that should be kept to ourselves." Social media has been a primary contributor to the decline in civil discourse at every level of human engagement. As a remedy, regular social media fasts may be helpful.

I am generally not inclined to conspiracy theories or cataclysmic pronouncements. There is so much good in the world that is unknown and unheralded. But our current social structure is deteriorating quickly. William Butler Yeats unknowingly summarized our predicament in poem.

> Turning and turning in the widening gyre
> The falcon cannot hear the falconer;
> Things fall apart; the centre cannot hold;
> Mere anarchy is loosed upon the world,
> The blood-dimmed tide is loosed, and everywhere
> The ceremony of innocence is drowned;
> The best lack all conviction, while the worst
> Are full of passionate intensity.

Disclosure Statement

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