The World Entire

Weekender

August 19, 2023

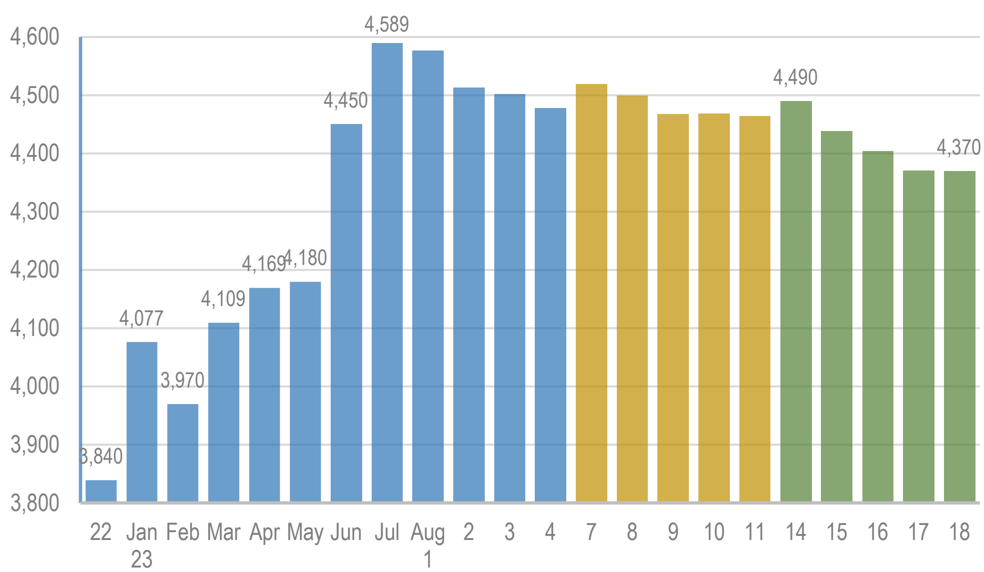
I swore never to be silent whenever human beings endure suffering and humiliation. We must always take sides. Neutrality helps the opressor, never the victim. Silence encourages the tormentor, never the tormented.

Elie Wiesel

Good morning and welcome to the *Weekender* for Saturday, August 19, 2023. Last week's equity markets, as measured by the S&P 500, were lower, registering a decline of -2.1%. The index is down by -4.8% from the beginning of August. The proximate cause for the summer doldrums is the relative stickiness of higher interest rates. More on that in a minute and a lot more next week.

S&P 500 Index Levels

(Source: Bloomberg)



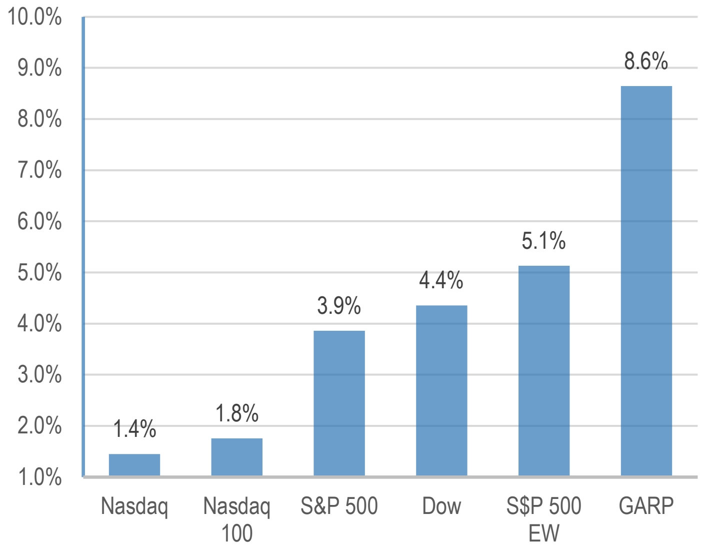
Looking at broad equity categories, the trend we discussed in our last *Weekender* continues unabated. From the beginning of June, the big momentum-driven names that have been the hallmark of year-to-date gains have yielded leadership to the equal-weighted S&P 500 and growth at a reasonable price (GARP). This is a sign that the pricey froth of artificial intelligence is giving way to bargain-hunting in the equity market's more boring but reliable punters.

We have often written about our expectation that this rotation would be forthcoming. It now seems upon us.

Relative Returns

June 1 - August 18, 2023

(Source: Bloomberg)

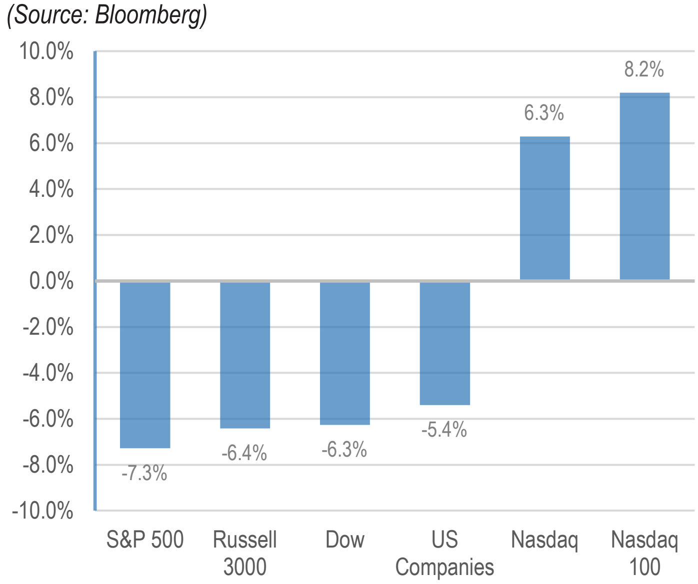


With most US companies having reported their second quarter 2023 results, we can confirm that the earnings recession is closing its third consecutive quarter. This is a graph of second quarter 2023 earnings compared to last year. Technology, which is often the case and the primary reason for their enduring multiple premia to the rest of the market, continues to experience earnings growth. We expect the earnings recession to end over the next two quarters, driven chiefly by base effects.

2nd Quarter Earnings Growth

Year-over-Year Comparisons

(Source: Bloomberg)



Most client investment portfolios are equity-heavy, and our *Weekenders* tend to spend the bulk of their words and weight on stocks versus bonds. However, something is happening that hasn't happened for more than two decades. The graph below shows the total return in US dollars on a basket of global bonds. The steady decline in interest rates that began on the heels of the Credit Crisis has ended, at least for the near term. However, even in the longer term, we believe expectations of a return to the post-Credit Crisis interest rate environment are unwarranted. More on that next week.

Global Bond Total US$ Return

January 2, 2009 - August 18, 2023

(Source: Bloomberg)

Please be sure to discuss any financial decisions with a financial advisor.

Economic Narrative

Over the last two weeks, a bevy of economic and market data has been released that supports our forward view of where we are headed in the coming year. Consumer credit rose much higher than estimates. But most of it came from increased non-revolving loans on cars and other durable goods. Credit card debt, a reliable indicator of the consumer's mood, actually fell. Consumer inflation came in slightly softer than expected, while producer inflation, a talisman for future consumer inflation, was hotter than predicted. The labor market continues to surprise to the upside. Jobless claims show no sign of the type of labor market weakness typical of an economy going into recession. Retail sales remain strong, housing demand remains robust despite mortgage rates of around 7.0%, and most automobiles are sold before they hit the dealer lots. What's not to like? Maybe Goldilocks has returned. Or perhaps it's an apparition.

China

While the US economy is the most potent component of global economic output, weakness in the second-largest economy can outflank the rest of the world. China's economy has been on an unprecedented growth trajectory since the early 1980s. While the path has been bumpy at times, the general trend and societal impact has been remarkable. But the trend is beginning to bend, and not in a good way. Its property sector, which sits at the intersection of finance, construction, and household wealth, is crumbling at its foundation. Property is also essential to the Middle Kingdom because it accounts for almost 20% of the nation's economic output.

But it's not just property. China's growth engine has been fueled by becoming the preferred export country in the world. Cheap labor and cheap capital have been substantial competitive advantages. Both are now more a mirage than a reality. Since the pandemic reopening, China's exports have been falling precipitously.

The point? Over the last decade, China has accounted for more than 40% of global economic growth. Approximately 22% came from the United States and 9% from euro countries. Communist party leaders have been trying to orchestrate an expansion of China's consumer base instead of relying on exports to drive growth. It was working before the pandemic shutdowns. But as interest rates have increased, an already limp property sector has fallen. Designed to obfuscate the market, property owners are not permitted to sell their properties at a discount, masking the real problems.

With large swaths of the economy controlled by state-owned enterprises unwilling or unable to be transparent, it's challenging to get a clearer picture. But we know that a sneeze in China will cause the flu in countries that have tied their rising star to them.

Last week, in a moment of unprecedented cognitive clarity, President Biden referred to China's economy as a "ticking time bomb." The fallout would be significant and long-lasting if China's economy does blow. We believe the fuse is short and has been lit by deflation, not inflation. Prices in China are falling. Deflation destroys a consumer's incentive to spend because if prices are falling, prices will be lower if the consumer waits. Government overseers are a bit limited in terms of options. Having spent the last three years silencing the country's entrepreneurial class, they have lost the ability to breathe life into its animal spirits. Moving away from a Western symbiosis and into the arms of the world's bully class doesn't inspire the confidence that consumers need to increase their spending.

Sadly, China's leaders have chosen their current path deliberately. Perhaps they expected different outcomes. If so, they were not paying attention. Having eschewed the friendship of the West in deference to Russia, North Korea, and Iran, the rogue state status of their new bedfellows will continue to rub off on the Middle Kingdom.

Recession

Many economists predicting a recession have been forced to change their tunes or at least sit on their hands in light of continued strong economic data. Extrapolating from previous economic cycles to this one is foolhardy. We have never been here before. As we have discussed previously, during the pandemic, the government's largess gave the US economy a massive stimulatory lift, creating a tidal wave that continues to push it forward. As the tide recedes, a new normal will be revealed. It's going to be different from before the pandemic.

Since the credit crisis, interest rates have been in a concerted downturn. Almost instantly, they have popped up to where they were fifteen years ago. The impact of higher rates has a lagged effect, which we have only started to see in places like real estate and car loans. Residential real estate has been remarkably resilient because there is so little inventory, and most homeowners are unlikely to trade in their low-interest pre-pandemic mortgage. Car purchases have been similarly resilient. But in other areas, a recession is already in full swing.

Inflation is coming down slowly. Several sticky inflationary forces, primarily concerning housing, have yet to hit the numbers. As these are fully reflected, we expect the consumer price index (CPI) to align with the Fed's targets. That could take a year. Deflation in China will help producer prices fall in line over the next six months. On the demand side, we believe the consumer is getting more and more stretched. But it's a tale of two cities. Consumers who bring in more than $150,000 annually are flush with cash. Below that threshold, pain is accumulating and will be exacerbated by the return of student loan payments at the end of next month.

Recent consumer credit data showed an alarming increase in non-revolving credit. Most of this is attributed to automobile purchases. Credit card debt showed contraction, suggesting consumers are preparing for tighter budgets ahead, likely a reference to ending the student loan moratorium.

For most of this year, we have written about the prospect that the US and global economy will eventually need to find a new normal. The pre-pandemic normal was rooted in low inflation, accommodative interest rates, modest but steady growth in consumer spending and corporate earnings, and a labor market that was persistently fully employed. These were the conditions that created what was known as the Goldilocks economy.

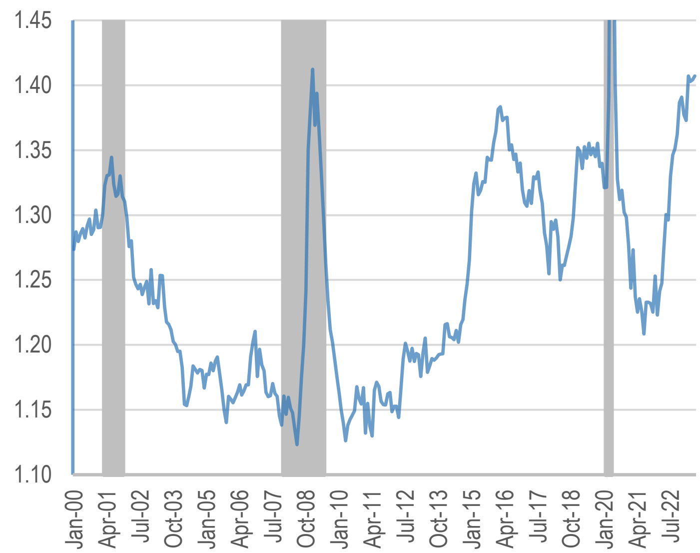
As mentioned, we believe a tale of two economies will characterize our new normal. Families that earn less than $150,000 per year are already in contraction. Having spent all their ill-gotten pandemic booty and pushed spending to their credit-constrained limits, the reinstallation of student loan payments over the next couple of months will be the straw that breaks the camel's back. Households who opted for practical degrees leading to employment instead of the giddy joy of an art history degree will be in a much better position.

We fear the US economy has responded to market signals and overshot. Pandemic shortages and cash piles pushed new orders and demand to unsustainable levels, resulting in higher prices. Prices are now falling, and wage growth exceeds inflation. Inventories remain much higher than sales. We are awash in most products, except housing and automobiles. Excess inventory will lead to discounting and lower profits. As a canary in the coal mine, drive by a boat or recreational vehicle dealer lot and see how stuffed they are with product. The impact of this oversupply has a significant lag and has yet to be felt.

Inventory to Sales Ratio

January 2000 - June 2023

(Source: Bloomberg)

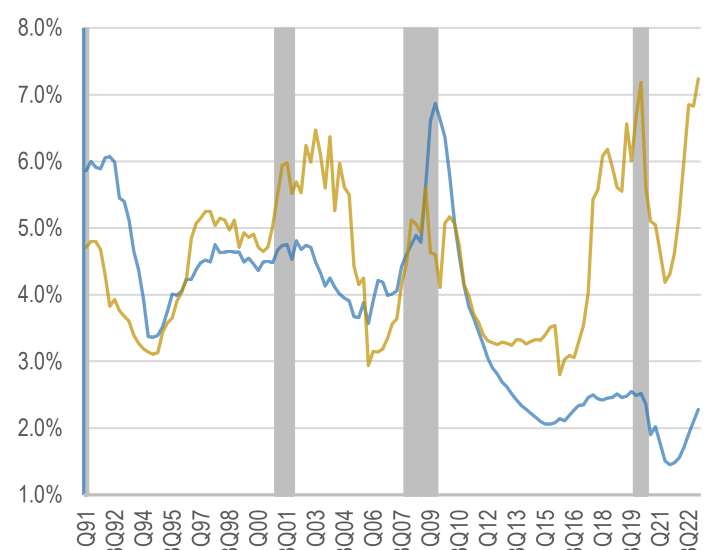


Consumption will slow as the marginal consumer begins to pull back in the face of depleted savings, maxed-out credit, and sheer spending exhaustion. While delinquency rates are still low by historical standards, they rise fast from the low they hit during the pandemic. The same phenomenon is playing out

Credit Card Delinquencies

1Q 1991 - 1Q 2023

(Source: Bloomberg)



in non-revolving consumer loans. This data does not necessarily portend a pending catastrophe. However, it is suggestive that the US consumer is beginning to experience some considerable stress. Below is the delinquency rate on credit cards. The blue line is for credit cards issued and managed by the largest 100 US banks. The gold line is for those issued and managed by all other banks.

One More Thing

On April 9, 1940, at approximately 4:00 a.m. Nazi armed forces invaded Denmark in what most considered a surprise attack. Quickly overwhelmed, unprotected by geography, and under an imminent explicit threat that its civilian populations would be bombed without capitulation, King Christian X and the entire Danish population gave in to an occupation that lasted until May 5, 1945. Denmark was necessary to the Nazi war machine because it produced much of the food required to supply the German army.

During the German occupation, King Christian X became a famous symbol of resistance. He rode daily through the streets of Copenhagen unaccompanied by guards and greeted people. On one occasion, he saw a Nazi flag flying and asked a Danish guard to remove it and install the Danish flag, which he did. A local Nazi leader told the king that he would remove it and replace it with the Nazi swastika. The king replied that he would have it removed again. The Nazi leader promised to shoot the soldier if he did so. King Christian responded, “Then I will be the one to change it.”

Until Germany imposed martial law on Denmark in August 1943, Danish leaders espoused a general attitude of cooperation with the Nazis. Under martial law, the Germans began preparations to transport Denmark’s 7,800 Jews and 686 non-Jewish spouses to concentration camps. In anticipation of the move, German diplomat Georg Ferdinand Duckwitz tried negotiating with Sweden to take them. Sweden refused to do so without German approval, which never came.

On September 28, 1943, Duckwitz leaked the Nazi’s imminent plans to Danish leaders, who communicated the strategies to the acting chief rabbi Marcus Melchior. At the early morning synagogue services on September 29, Denmark’s Jews were warned of the planned German action and urged to go into hiding. Without central coordination, Danish civil servants at many levels independently pursued measures to hide the Jews.

Most of the Danish Jews were smuggled out of Denmark over the Oresund Strait to Sweden, who by this time were convinced of the need to take them in and facilitate the one-hour water transit from Zealand to Sweden. They were transported in fishing boats, rowboats, and kayaks.

Of the 580 Danish Jews who failed to escape to Sweden, 464 were arrested, and most were taken to the Theresienstadt concentration camp in German-occupied Czechoslovakia. Every week, Swedish and Danish Red Cross members would inquire at the center about “their Jews” and demand an accounting of each by name. Approximately 425 of the interned Danish Jews survived. As the war ended, they were transported back to their Danish homes in white buses. As they approached their towns, the roads were lined by their Danish townspeople weeping and waving handkerchiefs.

As many Jews returned to their homes, they found them cleaned and prepared for their arrival. It was common to find an envelope on their table with money and a note expressing gratitude for their safe return and sorrow that they had not protected them.

Almost all of us are now armchair quarterbacks to the Holocaust. But our times are no less consequential if less significant. Before us are myriad ideas and events that count. Our active role in each of them will be consequential. An insightful statement at the end of the movie *Schindler’s List* comes from a combination of the Talmud and other sources. Schindler is told, “Whoever saves one life saves the world entire.” That we can do.

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