ANDINA
ADVISORS

Doldrums

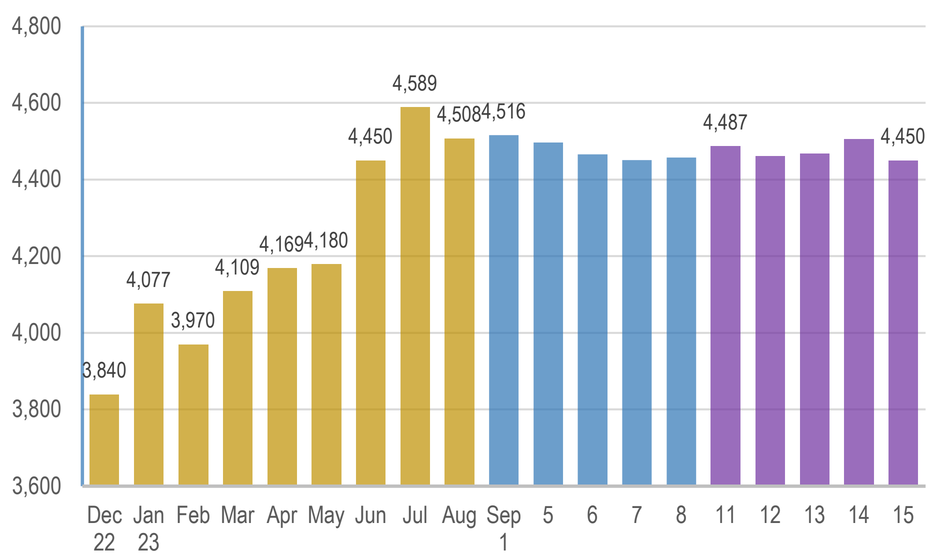
Weekender
September 16, 2023

Your time is limited, so don't waste it living someone else's life. Don't be trapped by dogma – which is living with the results of other people's thinking.
Steve Jobs

Good morning, and welcome to the Saturday, September 16, 2023 Weekender. Happy birthday to my older brother, Chris who has always been such a remarkable example to me.

As measured by the S&P 500, US equity markets were mostly flat, falling -0.2%. The market's relatively flat performance belies a week chock-a-block full of economic data.

S&P 500 Index Levels
(Source: Bloomberg)



Economic Summary

Last week's economic data, which we will discuss in more detail briefly, showed inflation at the consumer and producer levels pivoting. Instead of continuing to freefall toward the Federal Reserve's 2.0% target, it's now moving higher. Most of the pivot comes from cyclical factors like higher energy prices. Still, it's increasingly likely that these cyclical factors will remain stubborn in the face of a strong economy and tight labor market.

Labor market data continue to show no signs of decay. Around the edges, there is softening. Job openings are coming down, albeit from extremely high levels. The rate of employees quitting has also fallen. But the softening is nothing like we would expect to see in an economy knocking on the doors of a recession.

So, where is the recession that so many economists expected? It was pushed off by record monetary and fiscal stimulus, a lot of which continues to flow through the economy. A degree of general economic malaise and softness is coming as prophesied. The US consumer is stretched by inflation, spent stimulus, increased indebtedness, and a coming return of student loan payments. But the consumer continues to be buoyed by the remnants of pandemic liquidity.

Money market balances are at a record, paying yields of approximately 5.4%. Consumer funds in checking accounts are also trillions of dollars higher than pre-pandemic levels. A the same time, consumer savings as a percent of disposable income is plumbing record lows, and consumer credit card balances are at all-time highs. Although below pre-pandemic levels, consumer delinquencies are rising fast. We expect this to accelerate as soon as the burden of student loan payments is added to the backs of consumers.

We are not expecting or predicting a deep and dislocating economic recession. The labor market will not permit it. However, we expect inflation to remain higher than the central bank's target for the foreseeable future, keeping interest rates restrictive. Higher inflation and a slowing economy suggest stagflation will be our operating narrative.

As far as equity markets are concerned, the giddy days of the promise of artificial intelligence are being moderated. Deploying artificial intelligence throughout the economy like the internet before it, is going to be very expensive. As we have stated many times before, the early winners are those providing the picks, shovels, jeans, and tents for the coming gold rush. Intermediate winners will become apparent as their use cases collide with a path to profitability. You and I will be the final winners.

Artificial intelligence will likely be no more a boogeyman than the internet, personal computers, and locomotives in their respective times. In fact, AI may transform the human condition from being a factor of production (labor) to being tamed and exploited to finally being humanity's raison d'etre predicted by many futurists. Enough fuzzy thinking.

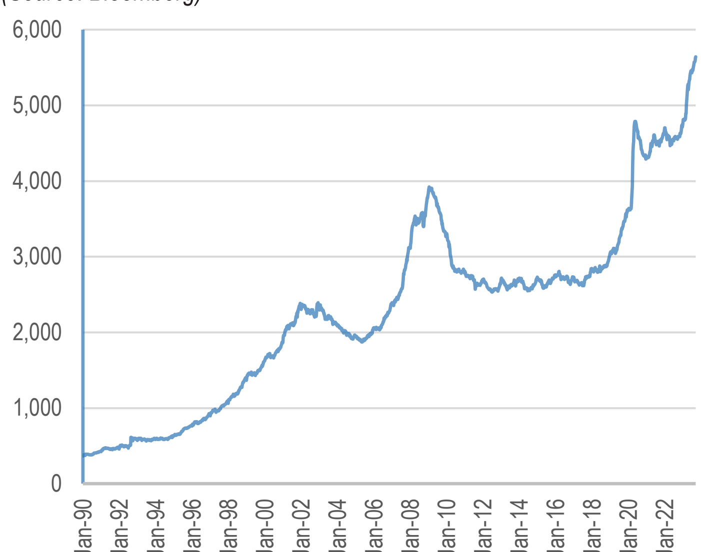
Market Summary

In aggregate, corporate profits have declined over the last three quarters. We have experienced an earnings recession, by definition. This was expected. But

Money Market Balances

January 1, 1990 - September 16, 2023

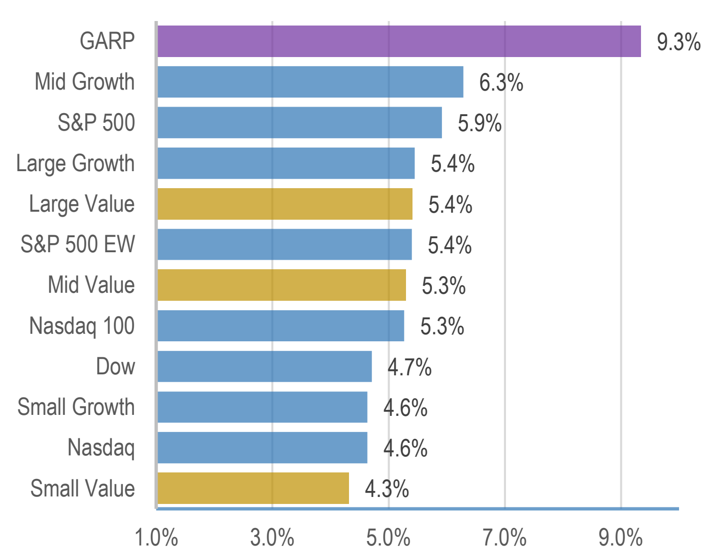
(Source: Bloomberg)



Relative Returns

June 1 - September 16, 2023

(Source: Bloomberg)



we did not expect the market melt-up sponsored by artificial intelligence. However, a rotation has occurred since the beginning of June, driving outperformance in actively managed fundamental asset classes like growth at a reasonable price (GARP) versus passive indexed equity alternatives.

Interestingly, market moves in GARP classes have not been felt in small capitalization names. In fact, small company price levels have not been this low, relative to the largest technology companies in the Nasdaq 100, since 2000 when the internet bubble burst, and small company outperformance dominated markets for the next five years.

Russell 2000 / Nasdaq 100

January 1, 1996 - September 16, 2023
(Source: Bloomberg)

One way of looking at valuation is to measure the free cash flow yield of a stock or equity index. The free cash flow yield of the Nasdaq 100 is close to its all-time lows, suggesting it has never been more expensive than it is right now, the gold line. The US government's ten-year bond yield is higher than the Nasdaq 100 free cash flow. The Nasdaq 100 is priced for perfection. We believe that model is unlikely in a stagflationary economic environment.

Free Cash Flow Yield of Nasdaq 100 (Gold) and US Government 10-Year Yield (Blue)

January 1, 1996 - September 16, 2023
(Source: Bloomberg)

Fed and Markets

The Federal Reserve and the fixed-income markets are currently in a tug of war. From mid-2020, financial markets began pushing yields higher, the gold line, anticipating moves by the Federal Reserve, the blue line. As of today, Fed actions continue to tighten, but financial markets are not along for the ride. Instead, markets began to pause long before the Federal Reserve, trading a future interest rate expected to be much lower than today.

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

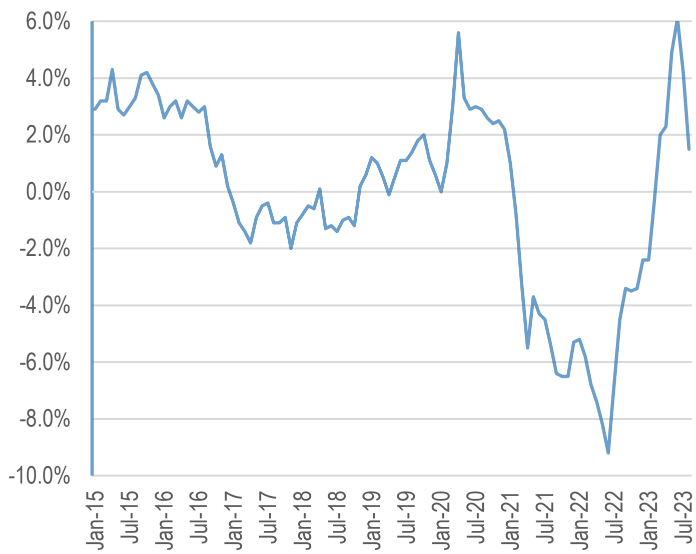
June 1 - September 16, 2023
(Source: Bloomberg)

Inflation

The consumer price index (CPI) and the producer price index (PPI) came in hotter than expected, heavily influenced by higher energy prices. In our view, the shift in prominence was more important than the levels of each indicator. When consumer prices rise higher than producer prices, corporate margins expand, and profits grow. The reverse is happening now. We expect the plethora of product inventory to continue to push product prices lower as retailers are forced to discount aggressively going into the holiday selling season presenting a target-rich environment for willing consumers.

CPI Minus PPI

January 2015 - Augus 2023
(Source: Bloomberg)



Earnings

Equities continue to perform well in the face of diminished profit expectations. We believe that earnings expectations for 2024 and 2025 will need to be adjusted lower in the coming months, making extreme valuations increasingly challenging to support. That said, we continue to find beautiful buying opportunities in the regular and mundane parts of the market which have been largely overlooked in the frenzy of artificial intelligence.

Conclusion

That's it for this *Weekender*. Next week, we will highlight some deep analysis we have been doing on portfolio construction and passive investing. Have a wonderful week.and welcome to the *Weekender* for Saturday, August 19, 2023. Last week's equity m

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.