House View

Weekender

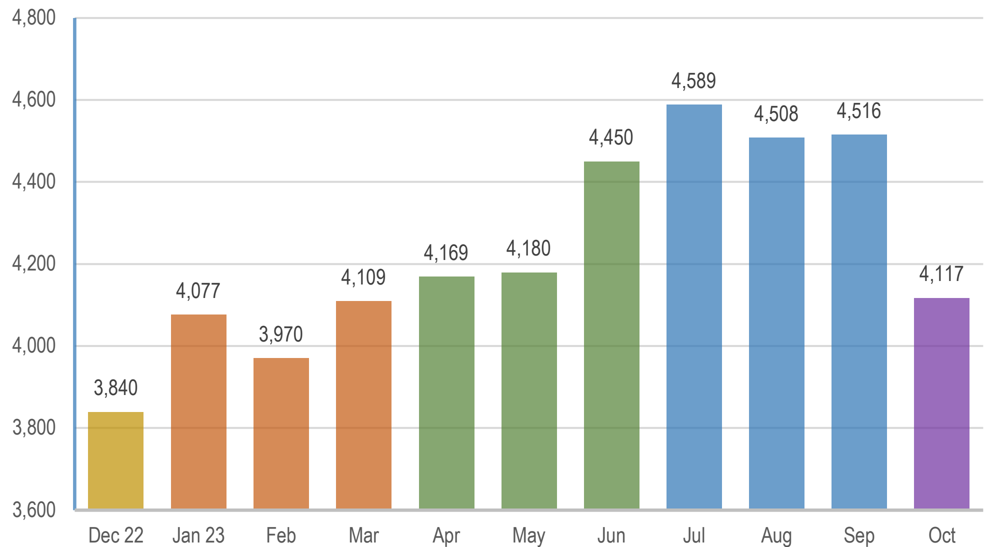
October 28, 2023

If Joan of Arc could turn the tide of an entire war before her 18th birthday, you can get out of bed.

E. Jean Carrol
For My Students

Good morning, Good morning, and welcome to the *Weekender* for Saturday, October 28, 2023. On the week, the US equity market, as measured by the S&P 500, was lower by -2.5%. Equity and bond markets were negatively impacted by interest rates that continue to rise. On a stock-by-stock basis, missing earnings estimates for the third quarter and telegraphing a less-than-stellar outlook for the future resulted in severe price punishment.

S&P 500 Index Levels
(Source: Bloomberg)



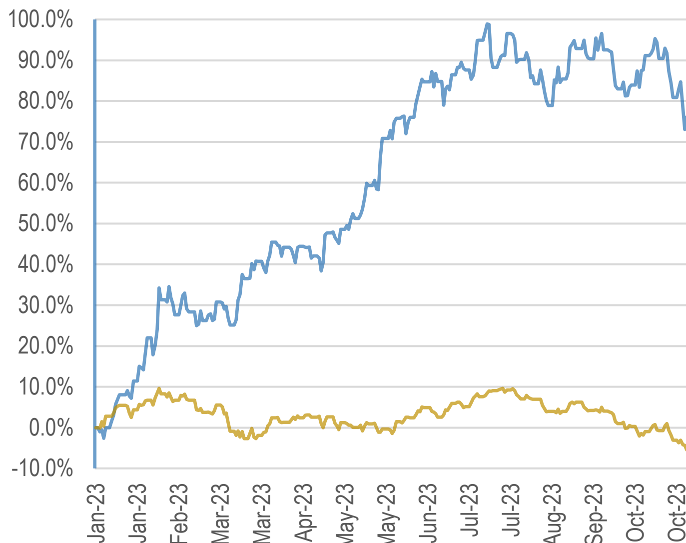
Financial markets have had a lot to digest over the last month. Geopolitical flare-ups are pushing the world past the point of no return. The global kumbaya that grew out of the fall of the Soviet Union has gone up in smoke, leaving no remnants from which a Phoenix may emerge from the ashes. History does not suggest that global strife leads to financial market disloca-

tions. However, this time is very different. A tapestry of global interconnections, including supply chains, capital markets, and crossholdings, will be torn apart over the next generation, ushering in a generation of global unrest on a population of leaders and citizens utterly unprepared for the challenge—more on that in the next *Weekender.*

Last year's bear market turned tail and ran early this year, lifted by pressure from seven large companies called the magnificent seven—Apple, Microsoft, Google, Amazon, Nvidia, Tesla, and Meta. Looking at cumulative returns from the beginning of the year, an index of the magnificent seven is higher by an astonishing 76.1%. Meanwhile, the equal-weighted S&P 500 is lower by -5.5% over the same period. Almost all the gains in the magnificent seven can be attributed to a haze of wishful thinking that obscures rational thought and analysis regarding artificial intelligence.

Cumulative Returns of the Magnificent 7 (Blue) and S&P 500 Equal Weight (Gold)

January 1 - October 27, 2023
(Source: Bloomberg)

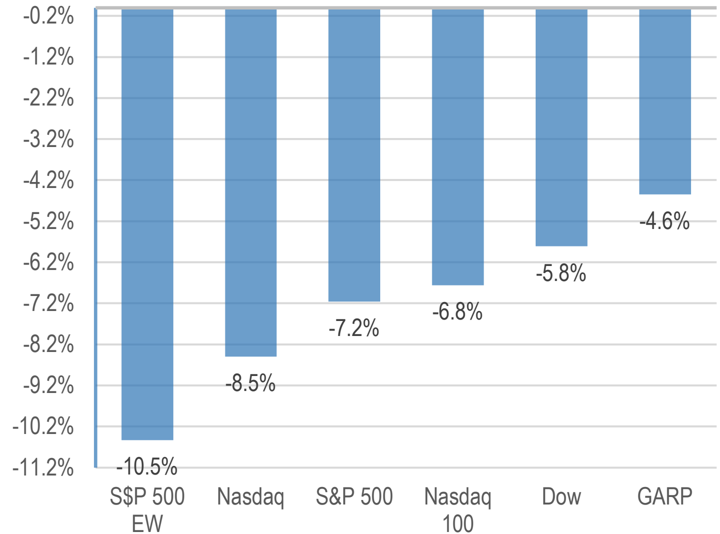


At its most rational, AI-related increases are attributed to attempts by investors to discount the profit potential from artificial intelligence. Ven Ram of Bloomberg suggests that the fair value of the Nasdaq index is approximately 11,101, sporting a price-to-earnings multiple of roughly 27.1. Friday's close for the index was 12,643, suggesting unsupported artificial intelligence skullduggery of approximately $3 trillion in market value. Using Ram's analysis, the Nasdaq fair value is about 12.1% lower than its current levels.

Looking at equity performance from the beginning of the third quarter, significant indices were all lower. Growth at a reasonable price (GARP) was the best performing while the riskier sides of the equity landscape suffered. This is a trend we have discussed in previous *Weekenders.*

Third Quarter to Date Returns

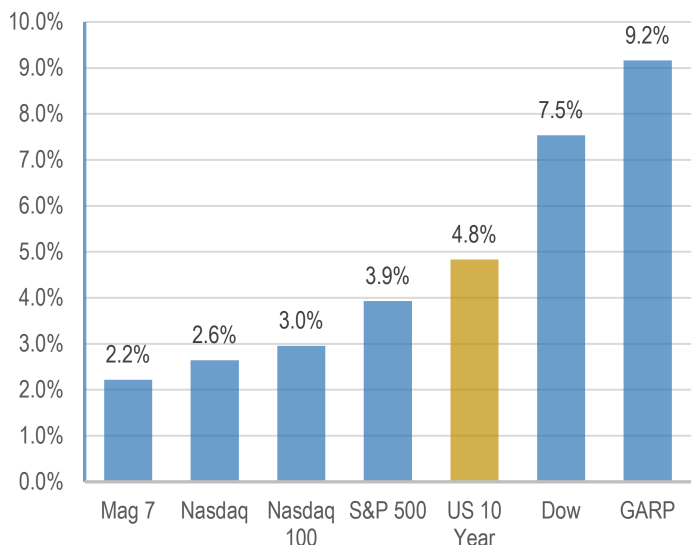
July 3 - October 27, 2023
(Source: Bloomberg)



In rising interest rate environments, it's often helpful to look at equity valuation from the perspective of yield. We prefer free cash flow yield since it puts value and growth stocks on equal footing. The US government ten-year bond currently yields 4.8%. Only the Dow and GARP indices provide a higher yield. Free cash flow yields on the magnificent seven and the

Free Cash Flow Yields

October 27, 2023
(Source: Bloomberg)



other prominent equity indices do not give a positive risk-adjusted return, nor do they cover the loss from inflation.

Leading segments of the equity market, like the magnificent seven, are significantly overvalued. As we move closer to year-end, we suggest portfolio rebalancing away from overvalued stocks and toward those with pricing power, solid balance sheets, and strong unit growth. As interest rates stay higher for longer and are likely at or near their peak for this cycle, a healthy allocation to high-quality fixed-income instruments will likely provide income and capital appreciation throughout 2024.

Economic Narrative

In this *Weekender,* our economic narrative summarizes the House View, which provides a little perspective on where markets and the economy may be headed over the next 12-18 months. In this section, we will summarize six elements: 1. Consumer; 2. Earnings; 3. Interest rates; 4. Inflation; 5. Real Estate; 6. Labor; and 7. Recession.

Consumer

Approximately seventy percent of US economic output is driven by the consumer, so getting an accurate read on the consumer is essential for understanding the forward path of the US economy. Simplistically, consumption is caused by a combination of ability and willingness to spend. Ability comes from being fully employed with wages that rise, in real terms, regularly, preserving purchasing power. Willingness can best be described as "wanting to spend," which can be tracked using consumer sentiment and confidence. Rising stock and real estate prices enhance the wealth effect, which gives consumers a better sense of their prospects. Falling inflation adds to the positive juju.

US consumers continue to manifest a remarkable willingness to spend. Their savings are depleted, credit cards maxed out, and inflation is taking a bite out of their purchasing power, but the spending continues. Some economists see this environment as confirmation that the economy is on solid footing. Others see it as the harbinger of bad times ahead. The death rattle before the economy starts falling apart. Disparate data support each view, although we expect the paths will begin to diverge shortly.

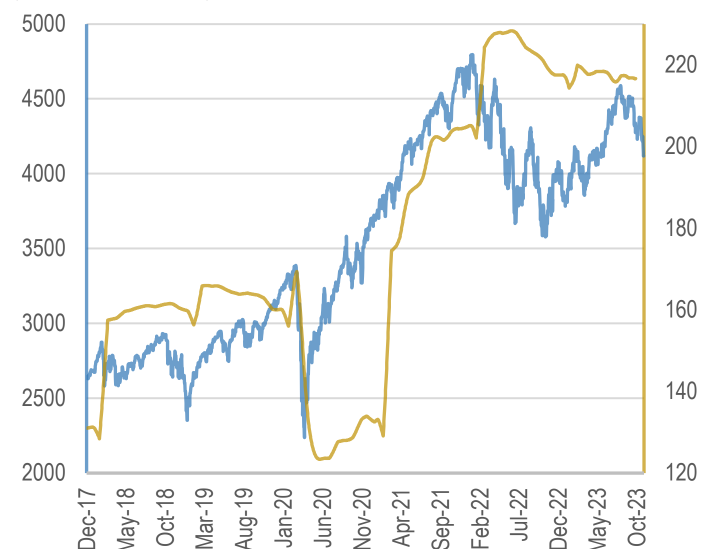
As long as the labor market remains robust, the consumer can and will spend. In practical terms, however, the resumption of student loan payments, higher interest rates, and persistent inflation will eventually slow consumption, which we expect after the holiday season ends.

Earnings

Corporations are at the front end of third-quarter earnings releases. In the last three quarters, earnings have fallen compared to the year-ago periods. We expect the "earnings recession" to end this quarter. Approximately 27.1% of US public companies have reported third-quarter profits. In aggregate, sales are higher by 1.6% and profits by 4.2%. If the trend continues, it will be the first growth in earnings in a year.

Most companies that have reported third-quarter results have provided clouded guidance about the fourth quarter and 2024. Investment strategists had been projecting significant earnings growth going into 2024, which now seems suspect. Corporate margins will begin to shrink in the fourth quarter and extend through most of next year. Bloated inventories will force price concessions and keep the lid on profit growth while costs remain persistently high.

S&P 500 Levels (Blue) and EPS Estimates (Gold)
December 1, 2017 - October 27, 2023
(Source: Bloomberg)



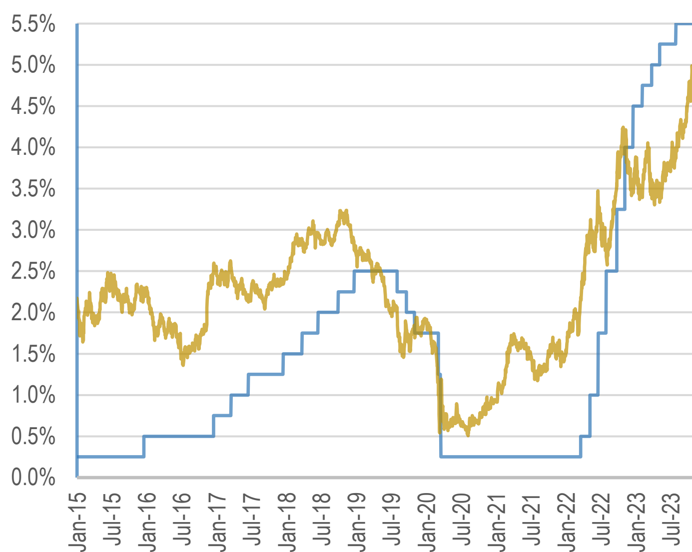
Interest Rates

Pricing pressures in equity and debt markets over the past month have been driven by a realization by financial markets that the Federal Reserve was not likely to pivot on rates at the first sign of economic weakness. In the graph below, the gold line represents yields on 10-year US government bonds, and the blue stairstep line is the upper bound of the Federal Reserve's target interest rate. Market rates are playing a bit of catch-up to the policy rate. While the policy rate is rising or close, market rates have a bit farther to go.

Fed Target Rate (Blue) US 10-Year Bond (Gold)

January 3, 2015 - October 27, 2023

(Source: Bloomberg)



In the face of higher rates, the US treasury is issuing record debt to cover deficit spending. Peak issuance is pushing bond prices lower and interest rates higher. Continued selling of government securities from the Federal Reserve balance sheet has a similar impact. Treasury head Janet Yellen pretends that Federal borrowing is not to blame for higher rates. But given her track record of acting inflation was transitory, her comments are spurious.

We believe financial markets have not yet resolved that the post-credit Crisis era of perpetually stimulative interest rates has ended. As rates persist higher for longer, the investment world will be forced to reset, raising the hurdle for all investment categories. Short of a powerful recession, we do not believe interest rates will return to their previous lows. Higher for longer is the expectation for the future, as it was in the past.

Inflation

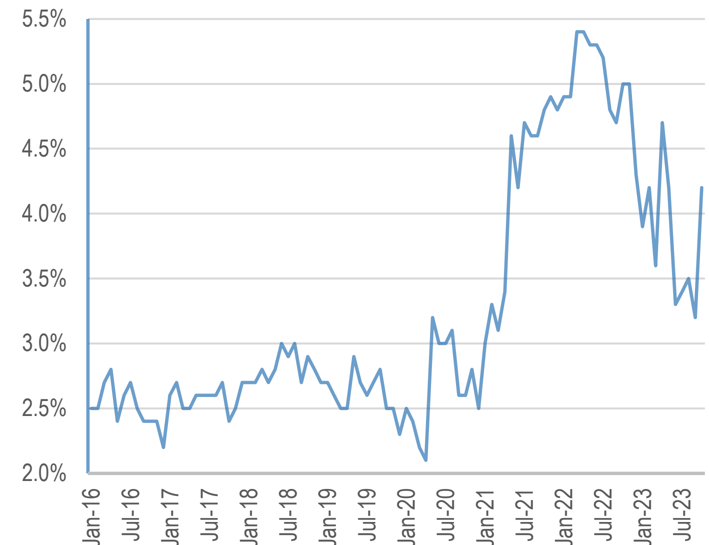
By any estimation, inflation has fallen considerably from peak levels in June 2022. September's reading for the consumer price index (CPI) was 3.7%. Our concern is that the easy gains are booked. Compelling inflation lower toward the Federal Reserve's target of 2.0% will take longer and cost more. A lot more.

Inflation expectations for the next year unexpectedly rose to 4.2% last month, suggesting consumers no longer think inflation will get close to 2.0%—another support for the higher for longer interest rate narrative.

One Year Consumer Inflation Expectations

January 2015 - September 2023

(Source: Bloomberg)



We believe product inflation will continue to fall as bloated inventories are sold at steep discounts. Services inflation continues to hold firm, and demand for services remains robust. We expect inflation to remain well above target levels, which will force the hand of the Federal Reserve.

Real Estate

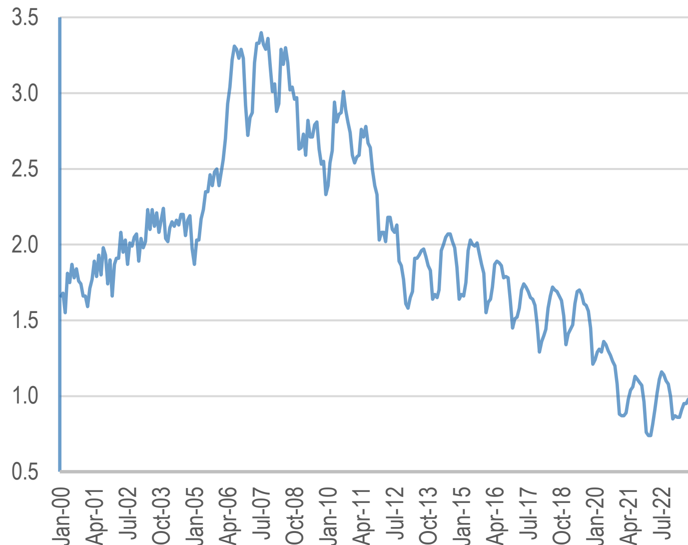
Historically, economic downturns in the United States include significant declines in both housing and automobiles. But this time is different. Housing and automobile inventories are at or near all-time lows while demand remains strong. But, affordability is at record lows, and mortgage rates are at their highest since the turn of the century. Home prices remain stubbornly high. Many wonder whether the drop in home values similar to what happened in the Credit

Crisis is likely anytime soon. We don't think so. Market dynamics in the single-family real estate market have virtually no similarities to the overbuilt bubble of 2008—09.

Single Family Inventory

January 2000 - September 2023

(Source: Bloomberg)

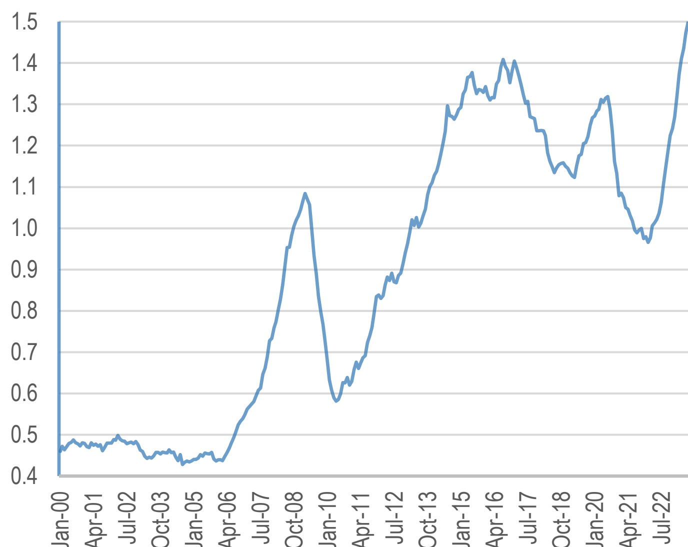


The ratio of apartment units to single-family units under construction has not been this high since the 1970s. Part of this comes from household formations that do not expect starting a family and having children, preferring a bachelor pad to a backyard. Consequently, relying solely on single-family units available for sale may not be a reasonable measure of supply or demand. Even so, lack of supply relative to other economic cycles supports prices.

Ratio of Multi-to-Single Family Units

January 2000 - September 2023

(Source: Bloomberg)



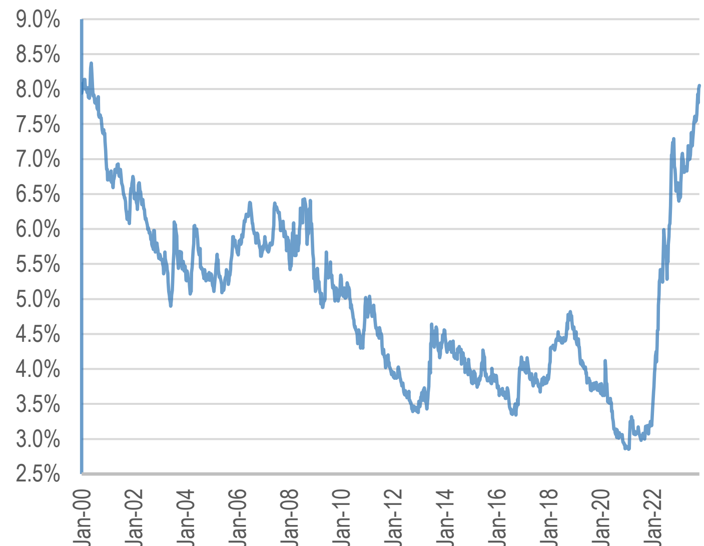
The pandemic easy money and stimulative interest rates pushed residential home prices to their peak in June 2022. Building materials, including labor, were in short supply, but cost pressures, except labor, are beginning to return to their pre-pandemic levels while home prices remain elevated. Fat margins for builders have enabled buyer incentives, taking some of the sting out of higher mortgage rates. But as rates continue to rise, builders are no longer able to fill the gap.

Mortgage rates, taking their cue from the Federal Reserve, have increased at the fastest clip on record. A brutal market for residential real estate will become increasingly more challenging. At Friday's close, mortgage rates were 8.05%, unheard of since the turn of the century. Higher rates are crimping affordability, which is cutting into home buying. Previously owned homes, which account for almost 80% of total home sales, dropped to the lowest level since 2010. Contracts to buy homes are being canceled at the fastest clip in a year.

US 30-Year Fixed Mortgage Rates

January 7, 2000 - October 27, 2023

(Source: Bloomberg)



Pent-up demand for single-family homes is being addressed through the new home market. However, with mortgage rates at current levels, even new home demand is softening. Few new home buyers have experienced an increase in incomes that matches the jump in monthly payments from higher prices and higher interest rates. In past economic cycles, such dramatic rate increases by the Federal Reserve would have led to dislocations in the labor market, leading to employment-driven relocations and an increase in list-

ings. This time is different. The labor market remains resilient.

We believe the resilience of residential housing is about to end. Mortgage rates in the 8.0% level erode affordability to the point that new household formations will be increasingly pushed to apartments and condominiums, leading to an increase in the supply of single-family units and a mild softening of home prices. We don't, however, see a looming crisis in residential real estate. Commercial real estate is another matter altogether.

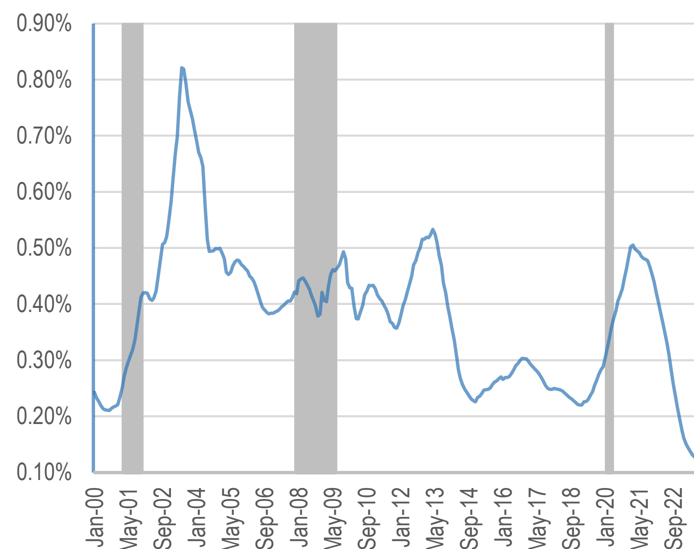
Labor

Over the short- to medium-term, the strength of the US economy depends upon the persistent support the labor market gives it. Every economic pundit, myself included, has been flabbergasted by the labor market. It has defied every known economic model and theory. At present, there are almost two job openings for every job seeker. Jobs are not being shed as predicted or expected. Some of this is undoubtedly due to a demographic shift where the baby boomers used the pandemic as an excuse to stop working. Remote work also changed how we hire and account for work.

Jobless Claims / Labor Force

January 2000 - September 2023

(Source: Bloomberg)



We expect that as long as the labor market remains fully employed or even close, the prospect and probability of a meaningful economic downturn is low. However, we expect a considerable slowing in economic growth in the three quarters ahead will eliminate enough jobs to take a little of the edge off a hot labor market.

Recession

On Wednesday, third-quarter economic output was released, showing that US economic output rose by 4.9% compared to the same period last year. Such a print is more common in China than in the United States. The gain was driven primarily by a strong consumer that continues to spend in the face of daunting uncertainties. As far as spending goes, it was green arrows all around. Spending on goods and services showed robust growth compared to previous quarters, where services were in pole position.

While the "R Word" usually refers to recession, it now describes resilience. Most of this resilience comes from the fact that trillions of dollars were put into the economy during the pandemic, and the sugar high created has not yet worn off. Indeed, hundreds of billions of dollars approved by Congress have still not been released into the economy. In another ode to "this time is different", government stimulus is usually applied after the recession is visible on the horizon. This time it was applied before it was even conceived.

As stated previously, as long as the labor market remains intact, a deep recession can be avoided. We expect a short-term stagflation environment where inflation remains above target and economic growth slows. However, potential side winds are likely to come from allied economies that are already in or certainly approaching recession, especially those in Europe. Faltering aggregate demand on the Continent will impact the US economy to some degree. China's banking and financial system is also tender and, without significant government support, could sink the ship of state. The guns versus butter trade-off is also likely to foment considerable changes if wars and skirmishes abroad expand.

Conclusion

That's it for this *Weekender*. Our next Weekender will take on the new world order. On November 3, we will publish our first quarterly magazine called the *Bucket List*. We hope you like it. Have a wonderful week.

Disclosure Statement

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