Rough Seas

Weekender

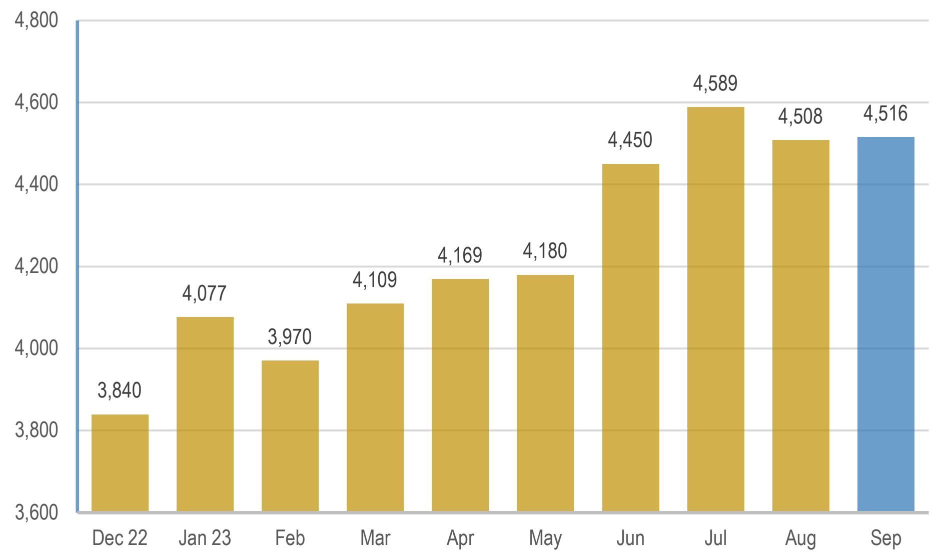
September 30, 2023

The dogmas of the quiet past are inadequate to the stormy present.
The occasion is piled high with difficulty, and we must
rise with the occasion. As our case is new,
so we must think anew and act anew.

Abraham Lincoln

Good morning, and welcome to the *Weekender* for Saturday, September 30, 2023. As measured by the S&P 500, equity markets were marginally lower by -0.7% last week. For the past two months, equity markets have been softer. However, the moves lower should not be interpreted as a correction. Most broad index moves lower came from a blow-off of the froth of large technology companies with heavy weights in indices like the S&P 500.

S&P 500 Index Levels
(Source: Bloomberg)

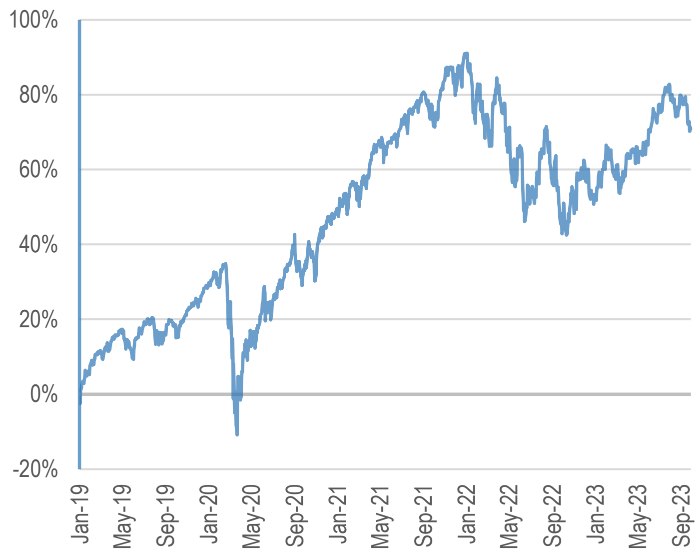


From January 2, 2019 to the present, the S&P 500 is higher by 70.8%, generating a stellar average return of approximately 14.2% annually. Over the same period, profit growth averaged 7.3% yearly for a 36.5% total. The disproportionate increase in market value versus earnings is attributed to higher valuations. On January 2, 2019, when markets and the global economy were in the midst of what was called a Goldilocks economy and market, the S&P 500 traded at 15.6 times its projected earnings. By the same valuation metric, the index currently trades at 19.6.

Cumulative Returns of the S&P 500

January 2, 2019 - September 29, 2023

(Source: Bloomberg)

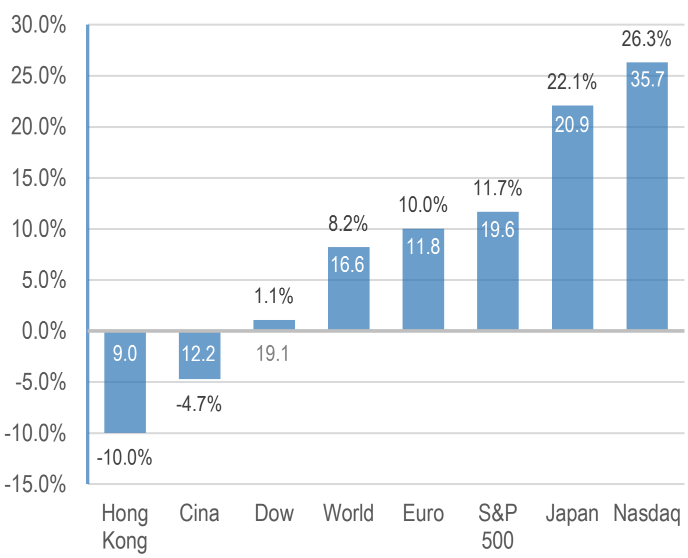


On a year-to-date basis, the tech-heavy Nasdaq is higher by 26.3%, a robust gain driven predominantly by a handful of companies tied to artificial intelligence. On a valuation basis, the Nasdaq trades at 35.7 times next year's earnings estimates. During the pre-pandemic and post-credit crisis period from 2012 – 2019, the Nasdaq traded at an average of 22.0 times projected earnings. The Nasdaq currently trades at a 62.2% premium to that average. We believe selective parts of the equity markets are meaningfully overvalued and priced for perfection, which is never a wise betting position, especially going into a period of economic softness.

Year-to-Date Returns

PE Ratios in Bars

(Source: Bloomberg)

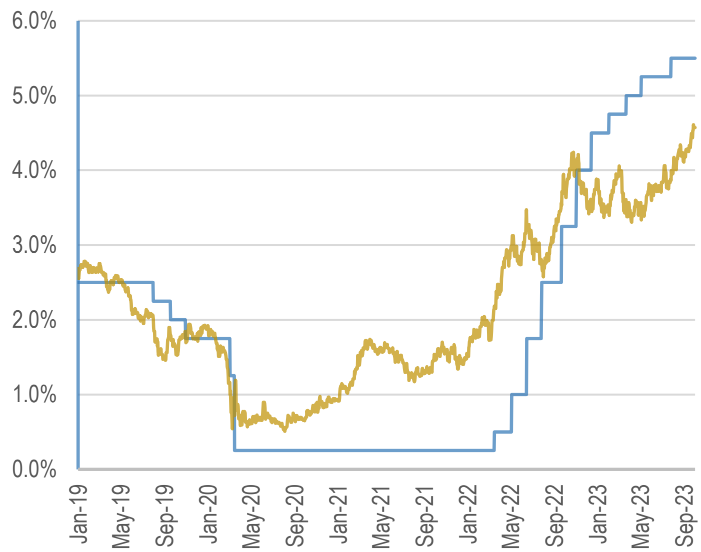


From the beginning of the year, we have suggested taking positions in high-quality fixed-income securities, held to maturity, to benefit from their income-generating characteristics. As Federal Reserve targets and market interest rates rise, fixed-income prices have taken a beating. Rate levitation has been a function of robust economic data forcing fixed-income markets to convert to the Federal Reserve's "rates will stay higher for longer" doctrine.

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

January 2, 2019 - September 29, 2023

(Source: Bloomberg)



Housing

While economic data support the view that the economy is strong and the labor market fully staffed, cracks are beginning to show in many areas. Most notably the consumer. Here is a staccato review of fundamental economic data from the last fortnight. Regional economic data suggests significant economic contraction ahead. Home prices are rising modestly in the face of higher mortgage rates while demand is softening considerably. Low housing inventory is keeping the sector afloat. While real estate is generally considered regional, mortgage borrowing is a national phenomenon. The housing market seems precariously dependent upon a strong labor market and persistent consumers.

Inflation

By most measures, the rate of decline in inflation is slowing. Higher energy prices have played a role. Crude oil prices are now above $90 per barrel. But it's not just oil. A broad basket of raw commodities is 2.6% higher than at the end of May. Residential home prices are rising, and wages are rising in real terms. We are not expecting an inflationary resurgence. However, we believe the easy inflation success is over. Pushing inflation lower from its current level will cost much more.

Consumer

Consumers have been remarkably resilient throughout the pandemic and post-pandemic normalization of the last two years. Herculean pre-pandemic stimulus goosed demand and kept labor markets fully employed. However, as we have highlighted in previous *Weekenders*, consumer weakness manifests in several areas, especially among the young and those in lower-income households. As a canary in the coal mine, the 60-day plus delinquency rate for subprime auto loans in July rose to the highest level ever, according to S&P Global Ratings. As a particular concern, delinquency rates are rising when the labor market is fully employed, which is abnormal. We believe consumer caution is warranted.

Consumer debt quality is also declining as the delinquency rate on credit cards rises to its highest level in over a decade. Over the coming months, short of a successful Hail Mary pass from the Biden administration, additional consumer stress will be piled on by the resumption of student loan payments. Many consumer product companies find themselves over-indebted after a pandemic credit binge. A looming debt maturity cliff awaits many of these companies in 2024.

Interest Rates

The Federal Reserve's insistence that rates will remain higher for longer will keep market interest rates stubbornly high, creating a challenging environment for companies and consumers needing to refinance cheap pandemic-era debt. We anticipate high-yield loan default rates will rise significantly over the next two quarters. We believe fixed-income exposure should be concentrated in high-quality borrowers.

Mortgage rates rose closed at 7.7% on Friday, a level unseen since the turn of the century. While residential real estate sales have slowed, home prices remain steady despite thin inventories and other perverse incentives. We expect this to continue as long as the labor market remains taut.

US 30-Year Mortgage Rates

January 5, 2007 - September 29, 2023

(Source: Bloomberg)

Economy

The US economy has not yet returned to or found its new normal. When it does, it's more likely to land on the old normal than a new one. We believe the new normal will be much like the old one before the credit crisis. Inflation will be more persistent and interest rates higher than during the post-credit crisis period. Harder to quantify is the impact of a global economy increasingly fractured by nationalistic fervor as the global kumbaya following the fall of the Berlin wall in 1989 fades into memory.

The Citi US Economic Surprise Index tracks recent economic releases and whether they exceeded expectations. The tide has turned and is now retreating, suggesting economic softness is approaching. A continued build of retail inventories at unprecedented levels suggests consumers will have the upper hand going into the holiday spending season and corporate margins will be compressed by deep discounts needed to exhaust the bloat.

Citi US Economy Surprise Index

January 3, 2023 - September 29, 2023

(Source: Bloomberg)

We believe that the US economy is at an inflection point. Consumer exhaustion is approaching, and high levels of indebtedness provide little room for maneuvering to higher ground. Higher interest rates and inflation will likely be with us for the rest of this year and next. If the labor market remains resilient, a recession may be avoided. If it doesn't, all bets are off. We will not likely know which direction the labor market will follow for at least two quarters. Until then, we continue to favor diversified portfolios that lean heavily on quality.

Conclusion

That's it for this *Weekender*. Next week, we will publish our summary of our fourth quarter House View. Have a great week.

Disclosure Statement

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