Stupidity is the Same

Weekender

November 18, 2023

Courage is knowing it may hurt, and doing it anyway.

Stupidity is the same.

And thats why life is hard.

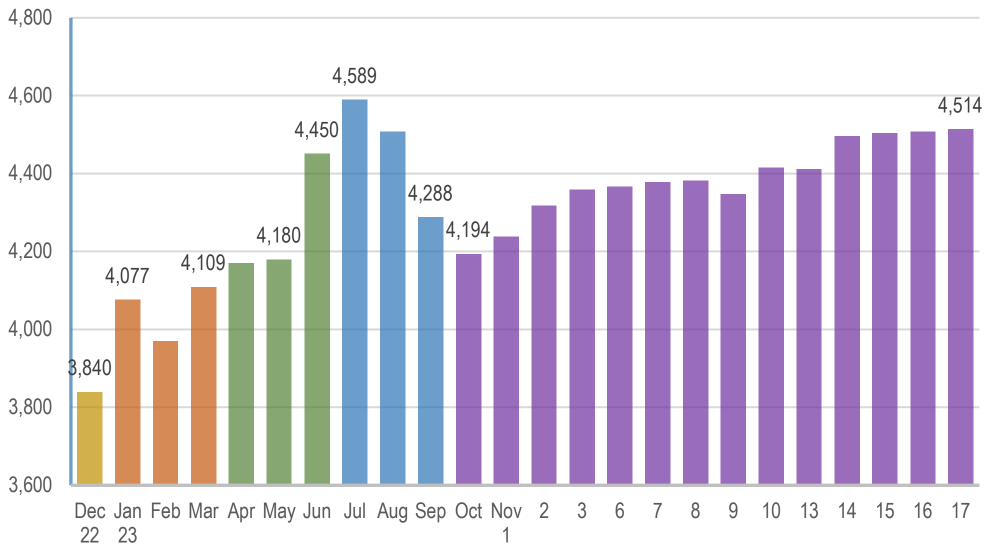
Jeremy Goldberg

Good morning, and welcome to the *Weekender* for Saturday, November 18, 2023. It was another supportive week for determined bulls. Interest rates peaked on October 19, 2023 and have been in freefall ever since. A newfound resolve among many that the Federal Reserve is done raising rates has economists and strategists on their heels, trying to predict when they will begin lowering their benchmark. Financial markets pushed market interest rates lower in anticipation of expected Fed action.

US equity markets, as measured by the S&P 500, rose by 2.2%, a strong return and continuation of a powerful trend. Bonds have also been on a tear. Since market interest rates topped, the S&P 500 has increased by 5.5%. Over the same period, the tech-heavy Nasdaq is higher by 7.1%, and the Nasdaq 100 index, comprised of the largest tech companies, is also higher by 7.1%.

S&P 500 Index Levels

(Source: Bloomberg)



The ratio of the equity value of the 1969 stocks that make up the Russell 2000 Small Cap Index compared to the tech-heavy Nasdaq has never been lower. Tech companies are getting larger and more powerful. Small companies tend to grow large enough to be an acquisition interest to large companies. In our passive investment world, funds are over-invested in names that comprise primary equity indices—the large technology companies. Small companies are the victims.

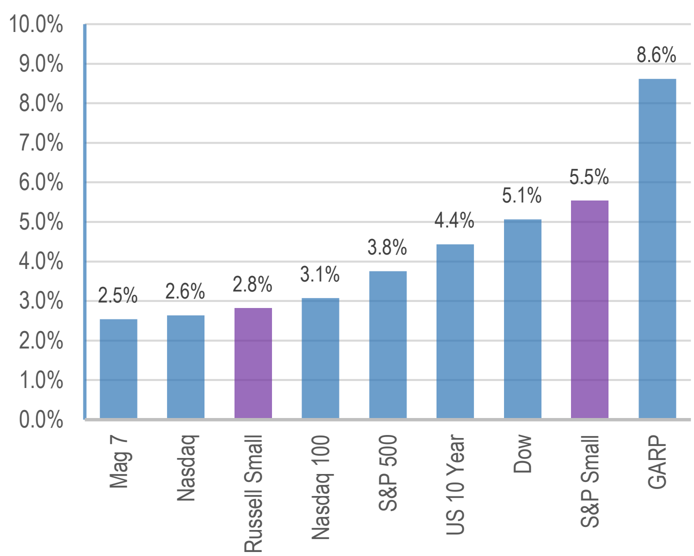
Russell 2000 Market Cap / Nasdaq Market Cap

May 19, 2000 - November 18, 2023
(Source: Bloomberg)

From the perspective of valuation, the S&P 500 Small Cap Index free cash flow yield continues to be strong relative to most market indices. At the same time, the Russell Small Cap Index, which includes small companies with less favorable fundamentals, sits close to its larger peers. Small companies will be on our Christmas list as we move into the latter part of the year as we begin thinking about portfolio rebalancing.

Free Cash Flow Yield

November 18, 2023
(Source: Bloomberg)



Please be sure to consult a financial professional before making investment decisions.

Inflation's Last Mile

Equity and fixed-income markets continue to trade on the knock-on effects of cooling inflation. Four measures of inflation, the consumer price index (CPI), producer price index (PPI), import price index, and real wages, all came in softer than expected. Import prices fell by -2.0% compared to last year, registering the ninth consecutive month of import price contraction in 2023. Wages are no longer rising faster than inflation.

Inflation is undoubtedly going in the right direction, but it's still nowhere near the Fed's comfort level and target of 2.0%. Inflation's last-mile journey to the Fed's target of 2.0% will require much more from economic growth in the months ahead.

An accurate view of the path of inflation is the most critical macroeconomic call. All financial markets are currently pricing in a relatively benign glide path over the next year, with the economy landing softly without incident. Even if this is the eventual outcome, we expect meaningful turbulence ahead as the economy slows significantly and the consumer recons with the new realities of a post-pandemic and post-stimulus economy.

Coming in for Landing

Softer inflation implies muted economic growth. For the third quarter, the US economy grew by a whopping 4.9% compared to last year. The economy is now slowing, coming down from cruising speed. To the extent that skies remain clear (i.e., everything is just right), a soft and smooth touchdown is possible.

Boogeymen

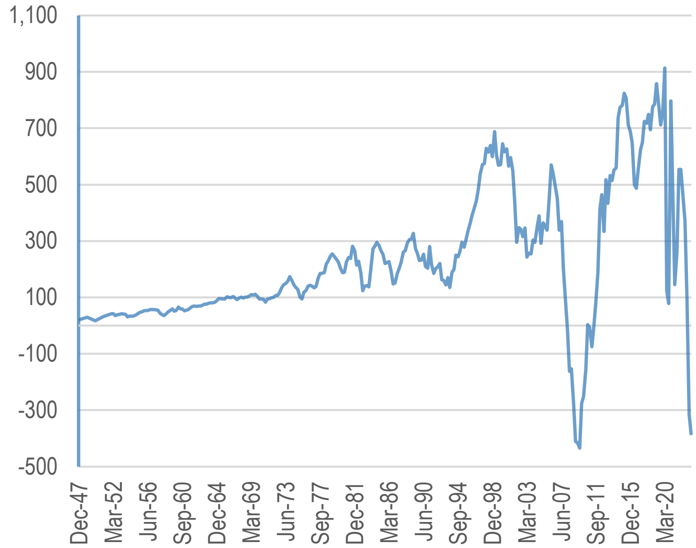
A potential economic soft landing in the United States is now the dominant scenario among economists and strategists. Prevalent scenarios, especially when they reach foregone conclusion status, rarely happen. There are a few boogeymen that are worth watching.

Net savings are now negative for the second time since the data set began. The only other negative time was during the turmoil of the Credit Crisis. Total net negative savings for an economy include the budget deficit, personal savings, and savings within the business sector. Gargantuan government budget deficits are a powerful driver combined with consumers spending down their pandemic-era cash surplus. Powerful recessions usually follow periods of net negative savings.

Net Negative Savings

4Q 1947 - 2Q 2023

(Source: Bloomberg)

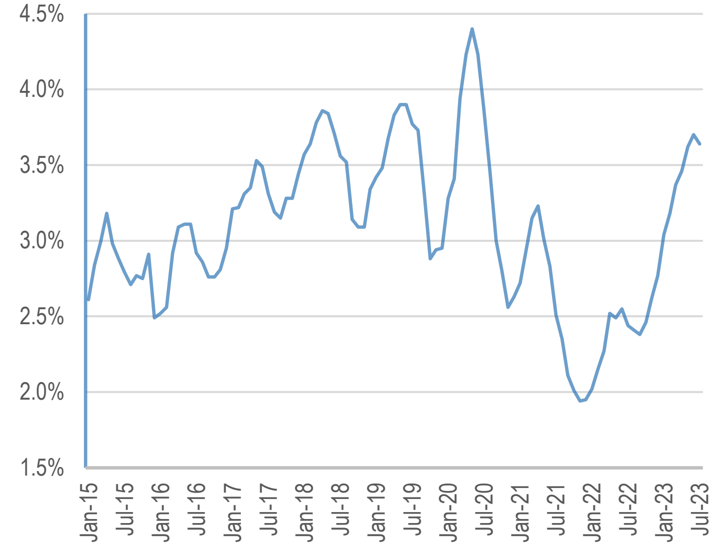


Another tale of things that go bump in the night comes from credit markets. Default rates for US high-yield corporate debt are creeping up to 5.0%, a level typically followed by economic recession. Rising default rates suggest monetary policy lags are beginning to be felt in the real economy. Consumer credit defaults are also on the rise. It is still nowhere near the recession level, but this time is different, and on the margin, the consumer is getting stressed.

Consumer Credit Default

January 2015 - July 2023

(Source: Bloomberg)

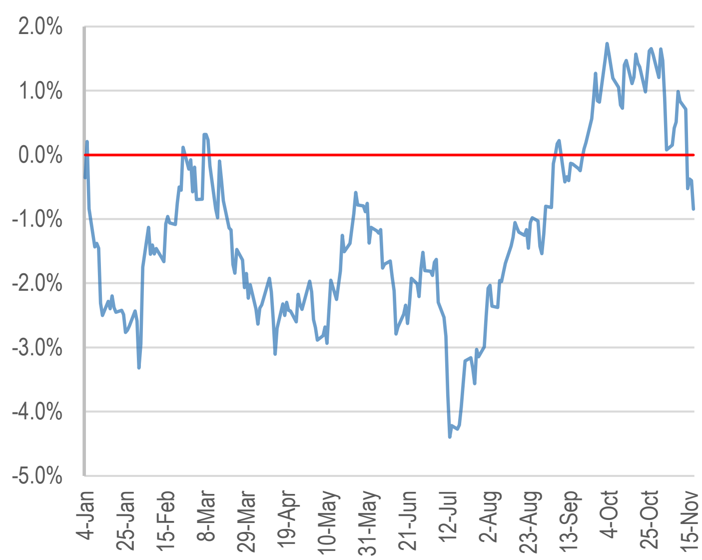


With the Federal Reserve's target interest rate hovering at or near its peak, financial markets are actively trading market rates lower, trying to avoid any potential drop in Fed guidance. This week's inflation and economic data provided plenty of support for this trade. As already mentioned, inflation seems to be trending in the right direction. Retail sales are on a plateau, and the labor market, as measured by continued unemployment claims, suggests it's getting harder for unemployed people to find jobs. All of these factors buttress the peak rate hypothesis. The fact that inflation is still well north of the Fed's 2.0% target moats the view that rates may stay at this level for

US Dollar Index, Cumulative Year-to-Date Return

January 3 - November 18, 2023

(Source: Bloomberg)



some months. All these factors combined have taken the air out of the dollar.

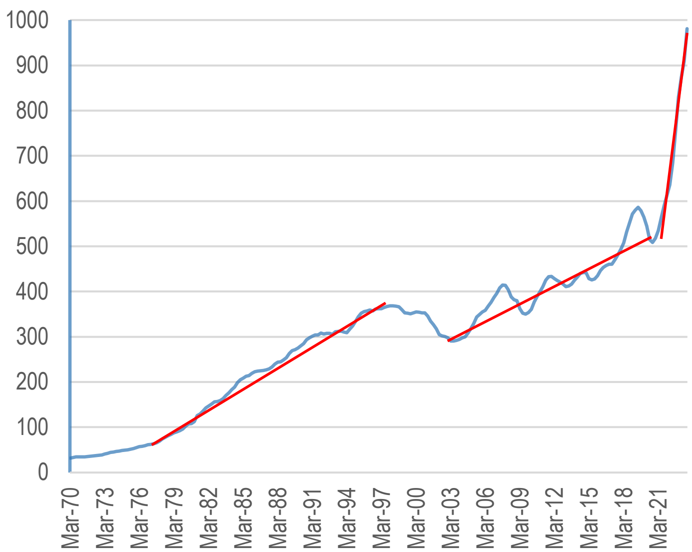
Since peak rates on October 19, 2023, the dollar has been falling. On a year-to-date basis, the dollar index now sports a negative print. Since dollar yields seem to have done all they can, it may be time for investors to look abroad.

And now for something exciting. The US government deficit is in a canibalist phase. Interest costs are approaching one trillion dollars per year. The US Treasury is relying on short-term funding instruments to hope that the prospect of lower interest rates will stop a devastating hangover and allow them to refinance at better rates.

Annual US Government Interest Costs

1Q 1970 - 3Q 2023

(Source: Bloomberg)



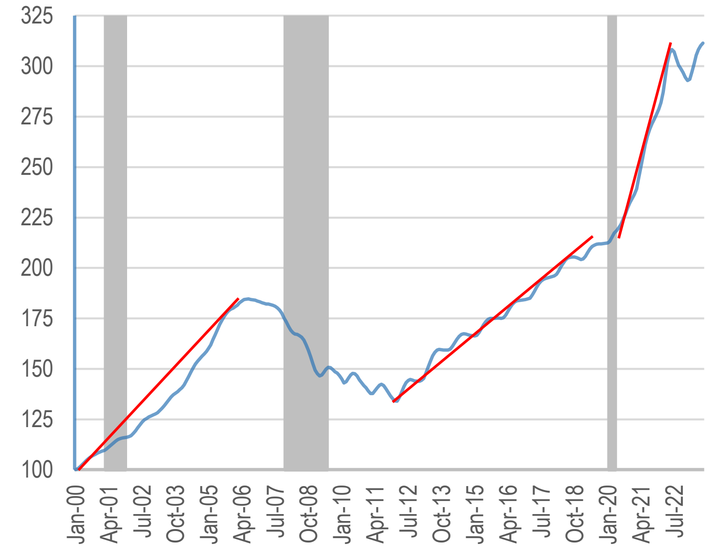
US interest costs account for slightly more than 3.5% of our economic output. That puts us on par with fiscal stalwarts like Italy.

Real estate has its class of Boogeymen. Residential real estate is beginning to lean into higher mortgage rates. While home ownership costs have never been more out of reach for the average American, the national home price index continues to march higher after a nine-month lull. Higher mortgage rates affect affordability for the average family, but scarce inventory continues to lift prices for those who can afford a home. For the military generals interested in fighting the last war, it's doubtful that a repeat of the 2008-09 housing crisis is in the cards. The setup is entirely different. Consider that approximately 40% of US homeowners have no mortgage at all.

Case-Shiller House Price Index

January 2000 - August 2023

(Source: Bloomberg)



A dichotomy exists among homebuilders. The S&P Homebuilder Index has been rising while homebuilder sentiment is close to all-time lows. Decreased build volumes are pulling down sentiment while profitability is lifting the index. Homebuilder gross margins are currently at record levels, increasing from 26.6% in 2015 to 30.2% at Friday's close.

While we believe residential real estate is "healthy enough," commercial real estate is still in the early days of collapse. Foot traffic near stores in metropolitan areas is -15% lower than their pre-pandemic levels. Office attendance remains -30% less. If these trends persist, demand for office space maybe 20% lower in 2030 compared to where it was in 2019. Buildings don't go away, but the owners do, which causes some concern for commercial landlords and regional bank lenders.

Conclusion

Due to the Thanksgiving holiday in the United States, we will not publish a *Weekender* next week. Have a wonderful week, and enjoy your family and friends during the holiday.

Disclosure Statement

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