Impact *vs* Influence

Weekender

December 10, 2023

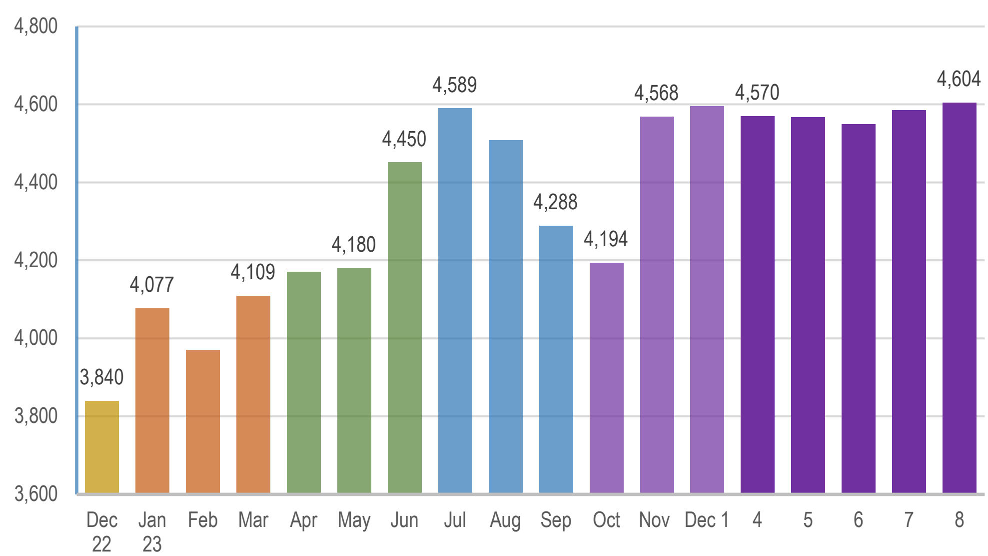
> Life should not be a journey to the grave with the intention of arriving safely in a pretty and well-preserved body, but rather to skid in broadside in a cloud of smoke, thoroughly used up, totally worn out, and loudly proclaiming, “Wow! What a Ride!”
>
> *Hunter S. Thompson*

Good morning, and welcome to the *Weekender* for Saturday, December 9, 2023. Expectations of an imminent recession throughout most of 2023, as telegraphed by most financial market commentators, economists, and strategists, left a lot of capital waiting on the sidelines for most of the year. With a recession nowhere in sight, fear of missing out (FOMO) pushed much of that capital back into the market after interest rates peaked on October 19, 2023, launching one of history’s most spectacular Santa Claus rallies.

Equity markets, as measured by the S&P 500 Index, were flat primarily, higher by 0.2% for the week. While nothing significant, it was enough to bump the index to the highest point of the year. On a year-to-date basis, the index is higher by 19.9%. Very significant.

S&P 500 Index Levels

(Source: Bloomberg)



For most of 2023, seasoned professionals have predicted an imminent recession based on historically accurate talismans. With no recession on the horizon, a chorus of *mea culpa* has erupted over the past quarter. Predictions of recessionary certainty have entirely yielded to a sense of all-clear. For many market pundits, the Goldilocks economy and markets that characterized the pre-pandemic era are on the verge of resurrection. We do not completely buy this emerging storyline.

Nothing about the pandemic and post-pandemic period harmonizes with any other time in modern history. Our view has consistently been that the US economy would not enter a recession without breaking the labor market. The labor market refuses to bend, much less break. But that may change. Look out for our fourth quarter *House View,* where we delve into these issues more nauseatingly and create a storyboard for where we believe the US and global economy may be heading.

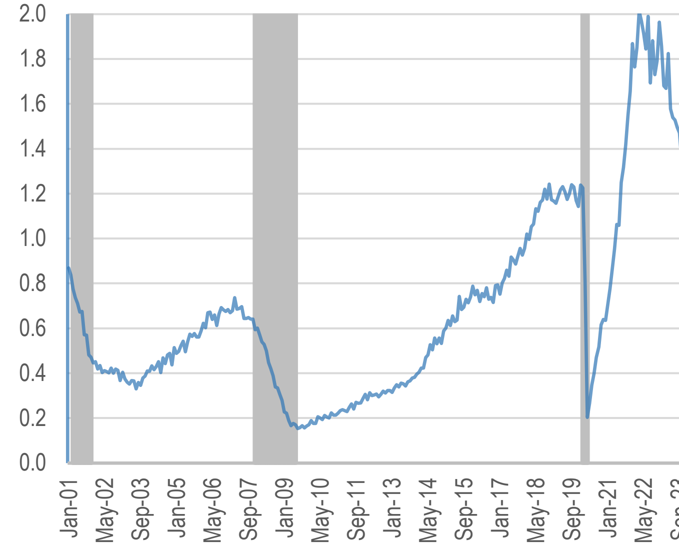
Next week, several essential economic data points will be released, including consumer and producer prices and indications of economic activity in the US, Europe, and Britain. The Federal Reserve will also hold its last rate-setting meeting for the year. Financial data released recently portray a consumer that continues to spend, thanks in considerable measure to credit, a sturdy job market that refuses to bend, and inflation that continues to temper gradually.

On Friday, the employment data came out for November. Headline numbers suggest the economy created approximately 199,000 jobs in November, higher than expected. But looking deeper inside, the headline number shows that two areas—government and healthcare, drove the gain. An artifact from auto-related workers going to work after the UAW strike was also added. The unemployment rate dropped from 3.9% to 3.7%, which surprised many, suggesting there is still a lot of turbulence underneath the headline number. Job openings continue to exceed the number of unemployed by a historically substantial margin.

Job Openings per Unemployed

January 2001 - November 2023

(Source: Bloomberg)

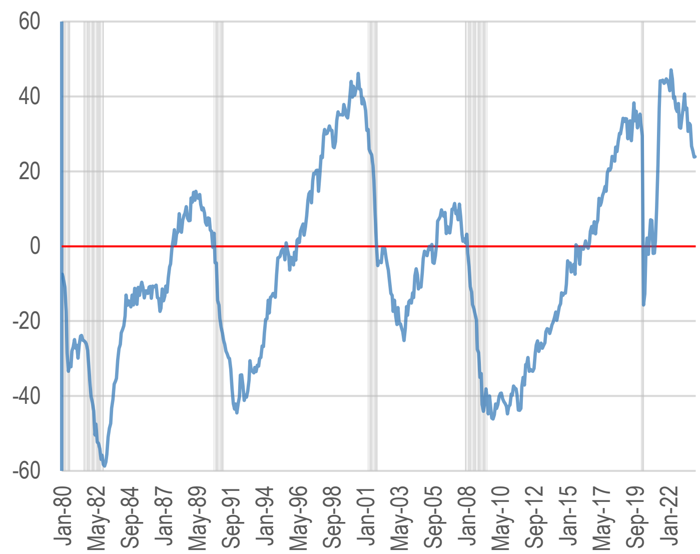


Labor markets are beginning to show a relative degree of slack. The Conference Board's measure of the difference between jobs being plentiful and hard to get shows a softening labor market. Fed officials have repeatedly telegraphed their desire to see the job market come into balance with inflationary pressures. Recent inflation data show a softening, and now job data, although nowhere near inflationary levels, is coming off the boil. Consumer confidence also rose for the first time in four months.

Jobs Plentiful to Hard Ratio

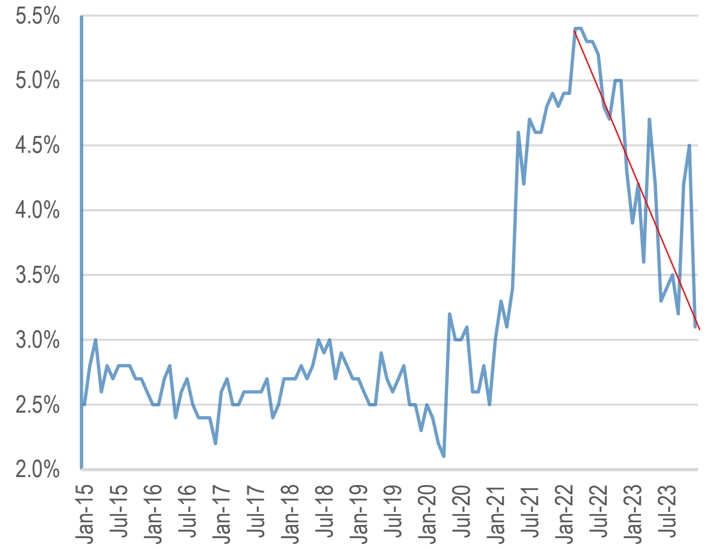
January 1980 - November 2023

(Source: Bloomberg)



As part of the employment data, hourly wage growth accelerated to its fastest pace in July. This supports the idea that getting inflation low enough to match the Fed's target will take longer than most market players anticipate or would like. Even so, consumer inflation expectations for the future fell much more than expected.

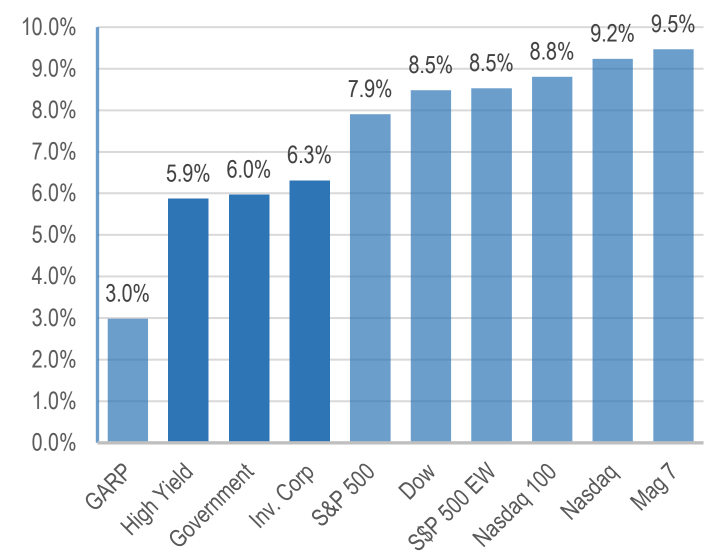
Consumer 1-Year Inflation Expectations
January 2015 - November 2023
(Source: Bloomberg)



Fixed Income

For most of the year, fixed income has been in the doghouse. While coupon payments were higher than their pre-pandemic levels, higher interest rates more than offset the income by punishing bond prices. But fixed income has been on a nice run since October 19, 2023, when market interest rates peaked.

Periodic Returns by Category
October 19 - December 8, 2023
(Source: Bloomberg)



Investment grade corporate bonds have been leading the way higher by for bonds, higher by 6.3% since the interest rate peak in October. Increased investment flows into bond funds continue to put upward pressure on prices. We expect this pressure to accelerate going into the end of the year as the supply of bonds tapers down. Increased demand is not from sovereign players but from natural buyers looking for yield. All of this is coming at a time when the Federal Reserve continues to shrink its balance sheet by whittling down the bonds in its portfolio. Without this woodwork, the net demand would be much higher.

We expect the bond run to continue for two reasons. First, corporate bonds are still trading below par value with no broad indicators of credit stress on the horizon. Second, high-grade credit is a preferred safe-haven asset in what many believe will be a softer economic environment in the months ahead.

Variable Lags

Economists constantly remind us that monetary policy is subject to variable lags. The loan default rate is beginning to rise as interest rates remain much higher than their pre-pandemic levels. According to Moody's Investors Service, loan default rates hit 5.4% in October, a level typically associated with sharp economic slowdowns or recession. Following its current trajectory, the default percentage will likely hit 6.0% in the next few months, nearly doubling its 3.3% average since 1996. We expect defaults to continue to rise going into 2024.

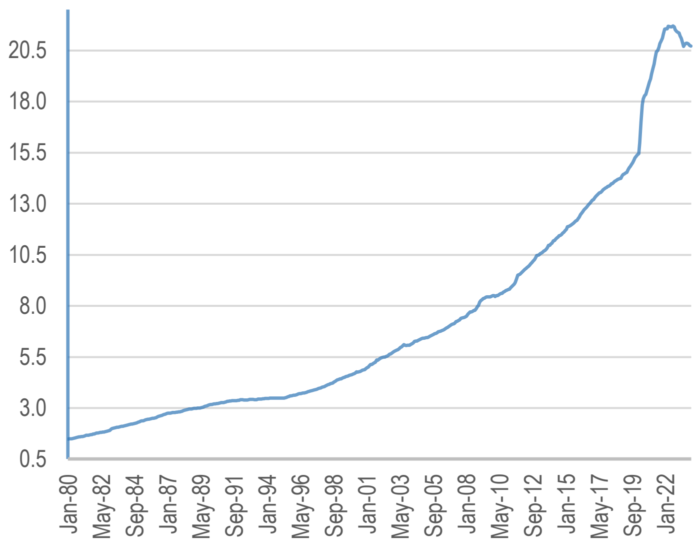
Money Supply

One more preview of our upcoming House View. Money Supply, using the M2 measurement, has stopped growing. To be sure, money supply growth was beyond excessive during the run-up to the pandemic, which followed excessive expansion after the Credit Crisis. But we have never been in a prolonged period of monetary contraction. Like today. Theoretically, the implications are apocalyptic, and many "would-be" cult leaders are urging a bunker mentality in an attempt to sell newsletters. But the reality is that we don’t know what the impact of a fall in money supply will be. More on that in the House View.

US M2 Money Supply

January 1980 - October 2023

(Source: Bloomberg)



One More Thing

One more thing. Since the beginning of December, several notable people have shed their mortal coil. Among them are those who have impacted the world extensively. Sadra Day O’Connor was the first woman chief justice. Henry Kissinger played a decisive role in shaping the global power map. Rosalynn Carter was a powerful advocate for myriad causes and a fierce wife, friend, and advocate for her husband, President Jimmy Carter. Charlie Munger was the consummate churlish uncle and a powerful counterforce who made Warren Buffett better at everything. All of them played large on the world stage. Their views and actions had globa impact.

On Thursday, I attended a memorial for David Quarnberg, a sibling of thirteen and a younger brother to my grandmother, Nola Inez Quarnberg. By any worldly assessment, Uncle Dave lived a small life. He was born and raised in Scipio, Utah, a town of 500 people. He served in the Navy during World War II and the Korean Conflict. His impact on the world was almost invisible to anyone who was not a direct relative or next-door neighbor. But his influence was profound and poignant for those who took the time to know him. As I get older, influence plays much more powerfully than impact.

Uncle Dave’s funeral was odd. There were no spiritual moments where the afterlife was stressed. Although raised in a spiritual home, Dave had given that up for Lent, and the funeral arrangements were no double bent to his wishes. Instead, everyone in the room shared stories of how my uncle influenced their lives. My attire was uncomfortably formal in a room of cowboy hats and pointed boots with the telltale signs of recent action. There were very few tears. A lot of hugs, laughs, and tender stories.

My high school years were spent in California, so it should come as no surprise that my senior English class was titled *Literature, Death, and Dying*. As part of the class, we wrote our prospective eulogy and epitaph. Mine was filled with achievements and daring adventures. As we approach the end of the year and celebration of the birth of Jesus Christ, I will be pensively re-writing and repositioning the rest of my years.

Hunter S. Thompson summed it up. “Life should not be a journey to the grave with the intention of arriving safely in a pretty and well-preserved body, but rather to skid in broadside in a cloud of smoke, thoroughly used up, totally worn out, and loudly proclaiming, “Wow! What a Ride!”

Conclusion

Thats if for this Weekender. Our next weekender will be a summary of the year-end House View. It will be published December 30, 2023. Have a wonderful Christmas holiday.

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