ANDINA
ADVISORS

Everything's Amazing ... Nobody's Happy

Weekender

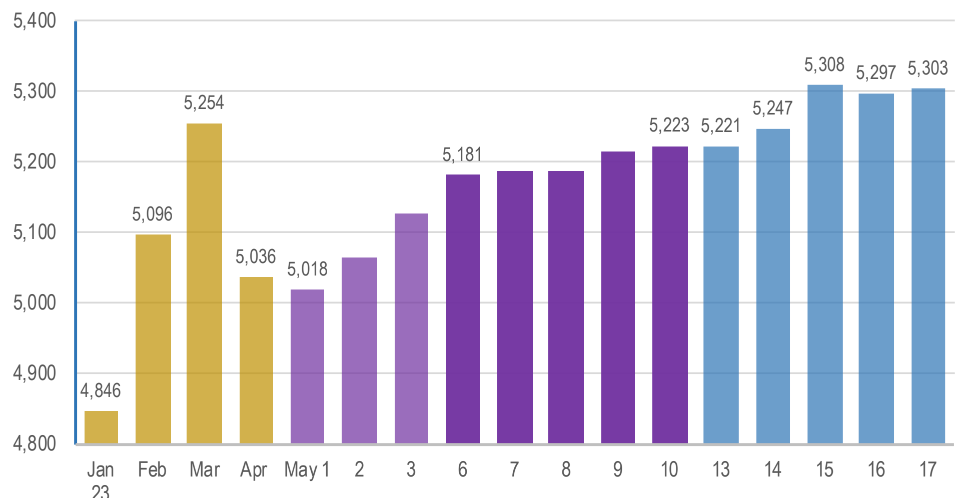
May 18, 2024

I need to listen well, so that I hear what is not said.

Thulisile N Madonsela

Good morning, and welcome to the *Weekender* for Saturday, May 18, 2024. This week, US equity markets, as measured by the S&P 500, rose by 1.5% and 11.2% yearly. In other news, the 128-year-old Dow Jones Industrial Average, comprised of only thirty stocks, closed above 40,000 for the first time. The record came courtesy of a last-minute lurch forward on Friday, capping off a week where slightly lower-than-expected inflation readings stoked hopes that the Federal Reserve would soon take a victory lap on inflation and begin lower interest rates.

S&P 500 Index Levels
(Source: Bloomberg)



Solid first-quarter earnings growth from a wide range of US corporations adds strong fundamental support for the high valuations of technology shares and paints a positive economic narrative. Contrary to the prevailing glum consumer sentiment, this earnings growth suggests an emerging resurrection of Goldilocks, where everything is just right. Economic growth is above trend and expectations. Inflation is trending lower, likely even lower than the data suggests, and interest

rates are not nearly as restrictive as they appear. So why is everyone so glum? Everything is amazing, and nobody's happy.

A clip of comedian Louis C. K. on *Late Night with Conan O'Brien* catches him describing the immediate post-Credit Crisis generation in the doldrums despite living in a nation of plenty. His humorous take on the situation sheds light on the paradox of discontent in a seemingly prosperous environment. A link to the YouTube video is included. It's a worthy e-ticket diversion.

https://www.youtube.com/watch?v=PdFB7q89_3U

As presidential elections approach, political pollsters materialize in every nook and cranny. Most of them are aflutter with the same question: Are you better off today than you were four years ago? On its face, it's an unfair question. We were in "the sky is falling" mode four years ago, busy overreacting to the global pandemic. Most constituents would much rather be where they are today than during the pandemic. But that doesn't mean they like today. So, let's delve deeper into these concerns and see if we can shed some light on the situation.

It seems like everything is amazing, but nobody's happy. Economic growth in the United States is strong, inflation is falling, labor markets are fully employed, and consumers are flush with cash. Meanwhile, polls suggest we are not content. Something is missing.

The University of Michigan released consumer sentiment data for April, which unexpectedly fell and confirmed that consumers are increasingly pessimistic about the future. Our meetings with clients confirm the data anecdotally. Higher gasoline prices in April certainly played a role in the data. More critical is the compelling realization that as the long tail of government pandemic stimulus ends, consumer spending patterns must adjust to the new reality that no longer includes "the kindness of strangers."

University of Michigan Consumer Sentiment

January 2019 - April 2024

(Source: Bloomberg)

In this *Weekender*, we discuss changes in market and economic narratives. Particular attention is given to the historical role of the Federal Reserve and the increasingly volatile global political environment. We encourage you to discuss financial ideas with a qualified financial advisor before making financial decisions.

Market Narrative

The past three weeks have been a rollercoaster of market data, offering no clear direction and causing significant unease for financial markets that thrive on stability. At the start of the year, equity and debt markets were uniformly poised, anticipating the Fed's declaration of victory over inflation and the subsequent rate reduction. However, for the fifth time in eighteen months, economic data refused to yield to the financial market's desires. Inflation remained stubborn, and the Federal Reserve had to revise its rate-cutting plans, opting to maintain higher rates for longer.

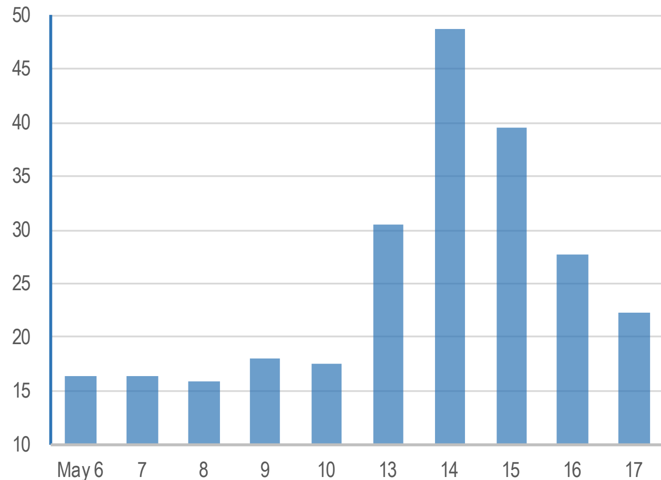
Stupid is as Stupid Does

In the market playbook of "stupid is as stupid does," pandemic-era meme stocks gave their last deep breath before demise last week. Showing the irrational nature of markets and investors, 'Roaring Kitty" posted for the first time in three years. By the end of the week, most of the gains had evaporated. The story of Roaring Kitty and the meme stock kerfuffle is now memorialized in movie form in a picture titled *Dumb Money.*

Game Stop Stock (GME)

May 6 - 17, 2024

(Source: Bloomberg)



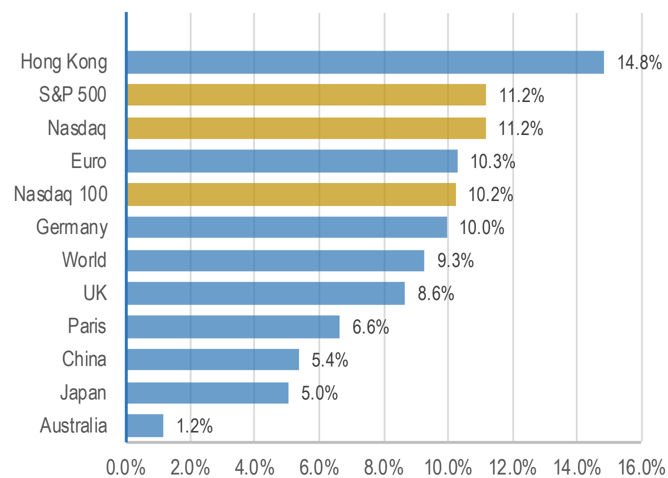
Mid-Year Returns

Mid-year equity returns for 2024 are coming in strong. Hong Kong's gains and leadership are primarily due to catching up from the last two years of underperformance. After that, the US and developed Europe are leading.

Year-to-Date Country Returns

January 2 - May 17, 2024

(Source: Bloomberg)



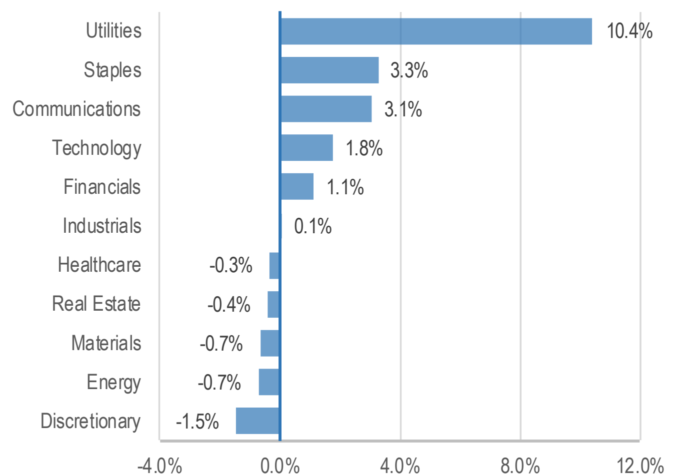
Rotation Continues

Hidden within the broader indices is continuing capital rotation from higher-valued tech stocks into more protective areas. For example, since April 1, Utility stocks have levitated by 10.4%. Expected demands for power from artificial intelligence, electric vehicles, and updates required for power infrastructure that is almost a century old in many places is a theme that has begun to take off but has a long way to go. We believe this theme is likely to grow for at least a generation.

Sector Rotation Being Fulfilled

April 1 - May 17, 2024

(Source: Bloomberg)



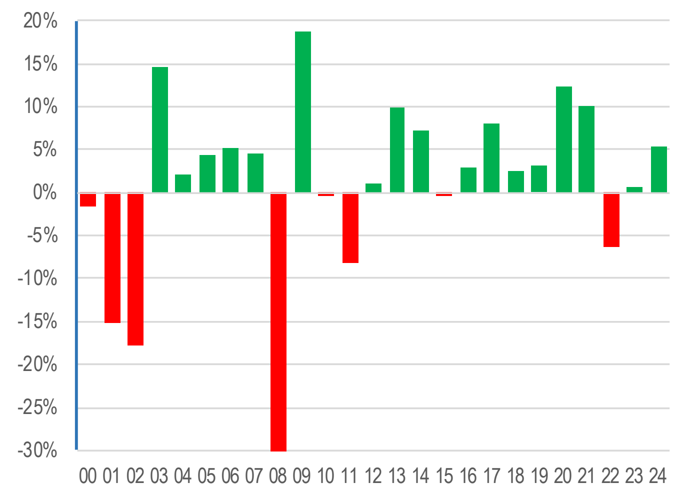
May, May, Go Away

Narratives often and maxims sometimes rule financial markets. One maxim is "sell in May and go away." This diddy refers to stock market outperformance from November to April and underperformance from May to October. However, for the last twenty-five years, May stock market returns, as measured by the S&P 500, have been negative only 32.0% of the time. Most maxims may be pithy and cute, but they rarely hold up. While markets are mean-reverting by nature, their journey to and from the mean is never the same.

Period Returns by Year

May 1 - October 31

(Source: Bloomberg)



Despite the challenges, there are signs of potential growth. The expectation of declining interest rates has led to a surge of capital into Treasury and corporate bond markets. In this buoyant market, billions in new issuance

have taken advantage of the retail demand, led by the US Treasury's insatiable need for cash. This influx of capital could pave the way for future market growth, offering hope to investors.

While our current investment strategy remains unchanged, we are increasingly mindful of a growing sense of market vulnerability. The buoyancy of higher equity markets has been fueling positive consumer sentiment, prolonging a spending spree initiated by government stimulus, amplified by consumer credit, and depleted savings. However, it's important to note that any significant strain in the labor markets could end this equity party abruptly.

Economic Narrative

We have recently written about concern that the seeds of stagflation are beginning to germinate. Stagflation exists when inflation is high and economic growth is low. Inflation seems persistently sticky and, in many data sets, strengthening instead of waning. However, looking past headline inflation numbers suggests inflation in most areas is well within the Federal Reserve's comfort zone.

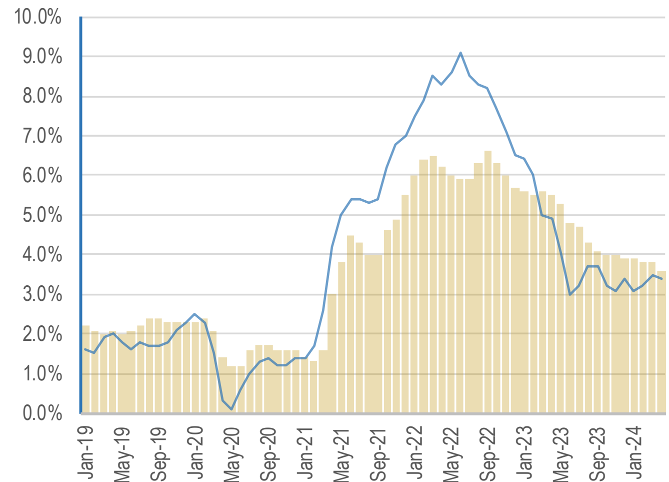
Economic softness is settling among lower-income consumers as demand for name-branded products yields cheaper house brands. Last week's first-quarter earnings release showed increased demand among higher-income customers as they shifted from more luxurious supermarkets and opted for Wal-Mart's house brands. Labor markets remain taut, although worker demand is more nuanced when the data is parsed geographically. Inventories remain much higher than historical levels. Steep discounts going into the holiday selling season may be required to clear it before holiday stock arrives at the end of summer. Discounts will dent peak profit margins, a powerful catalyst for solid earnings in the first quarter.

We believe we are already in a state of stagflation. Inflation remains high, and growth is slowing. However, inflation is falling in almost all areas where interest rates do not determine affordability. Counterintuitively, if the Federal Reserve were to lower rates, sticky inflation in housing and related expenditures like furniture and durable items, like automobiles, would fall, bringing headline inflation much closer to the Federal Reserve's acceptable level. Comparable memories of pre-pandemic prices versus levels today continue to make consumers uneasy. But today's price levels compared to last year are increasingly banal. Inflation, from a forward-looking perspective, is coming close to being tamed.

Consumer Price Index (Blue) and Core (Gold)

January 2019 - April 2024

(Source: Bloomberg)



Surprise, Surprise, Surprise

At present, economic output in the United States is expected to grow by 4.0% in the second quarter compared to last year. If we hit that mark, it will be a stellar performance. We are concerned that the year's second half will slow considerably. The Citi Surprise Index measures whether economic data meets expectations or surprises to the upside or downside. At present, the surprise is negative.

Citi United States Economic Surprise Index

May 11, 2023 - May 17, 2024

(Source: Bloomberg)

The US economy continues to work through the vestiges of stimulus largess injected during the pandemic. We do not expect the economy to find its actual run rate until it begins to run on its own steam, which may not be until early next year. In the meantime, the economy and financial markets will be subject to manipulation.

Real Estate

Residential real estate remains strong despite scant housing inventory. However, inventories for existing homes, new single-family homes, condominiums, and co-ops are slowly rising. Consequently, pricing remains firm.

Commercial real estate is living an alternate reality. Burnet Plaza, the tallest building in Fort Worth, Texas, was recently purchased via foreclosure for $12.3 million, approximately $12.30 per square foot, less than one-tenth what it would cost to build the structure. Three years ago, the building sold for $137.5 million. Marquis commercial properties nationwide are auctioned at steep discounts or flipped back to creditors. Regional banks, the primary lenders for commercial property, will undoubtedly be affected.

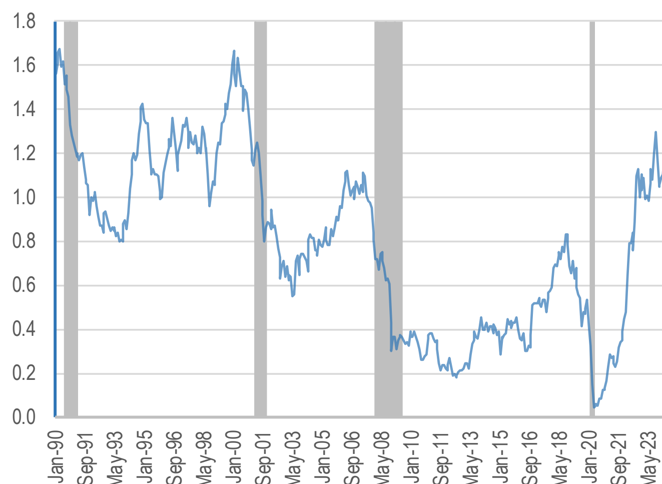
Labor Continues Mostly Taut

One of the most compelling indicators of US economic resilience is the labor market's steadfast refusal to yield to higher interest rates. The aggregate US unemployment rate currently stands at 3.9%, a figure that, while slightly higher than before, remains shallow compared to prevailing interest rates. However, California's situation is a cause for concern within these aggregate numbers. The state, which accounts for approximately 11% of the nation's labor market, holds the highest unemployment rate in the United States at 5.3%. This is a significant concern, but the overall resilience of the US labor market should provide a reassuring backdrop for investors like you.

US 10-Year Bond Yield / Unemployment Rate (U3)

January 1990 - April 2024

(Source: Bloomberg)



In April, the labor market appeared to downshift slightly, adding only 175,000 jobs, far less than expected. Related data showed wages rose by 3.9%, the slowest increase in almost three years, although the rise was still much higher than the Federal Reserve target for inflation of 2.0%. Economic data is known for being loaded with oddities. Typically, January and April data suffer from seasonal adjustments. When the data is cleansed of requisite data demons, the number of jobs created aligns with expectations at approximately 240,000.

With its 5.3% unemployment rate, California unfortunately holds the unenviable position of having the highest rate in the country, significantly above the pre-pandemic average of 4.1%. The pandemic has profoundly impacted the state's job market, with its ratio of job openings to unemployed persons currently standing at only 0.71 compared to a national average of 1.3. The state's recent implementation of a $20 per hour minimum wage is expected to limit further job openings at the lower end of the income scale, potentially exacerbating the situation.

California's higher-paying industries need to improve. Professional services, which include sectors like accounting and engineering, are being decimated after a pandemic stimulus-fueled rush. California is not an example worth emulating.

Earnings

Approximately 90% of the S&P 500 members have reported first-quarter earnings, surpassing expectations. With around eighty percent of the S&P 500 members having reported first-quarter earnings, sales for the first quarter are up by 3.7%, while profits have increased by 5.3%. These figures are respectable but could be more exceptional. Furthermore, with valuations nearing their peak, 5.3% earnings growth is far short of overwhelming.

Earnings are expected to remain solid through the end of the year, which is a fundamental reason we remain fully invested. However, we expect a slowing economy and rationalization of corporate margins to historical levels for the rest of the year.

We have received several questions about why we focus on profits and cash flows in our stock selection process. The primary reason is that stock prices are very tightly connected to earnings. The second reason is that corporate profits increasingly drive economic growth, directly and indirectly. Corporate profits as a percent of economic production in the United States are currently at all-time highs.

US Corporate Profit Percent of Economic Output

1Q 1950 - 1Q 2024

(Source: Bloomberg)

Targeting Inflation

In the late 1980s, New Zealand was suffering from persistent inflation. By 1988, inflation had plummeted from 15% to approximately 10%. Pressed during a television interview, the country's finance minister, Roger Douglas, suggested that he would not be content until inflation was between zero and one percent. Upon further clarification, he disagreed that acceptable inflation would be two percent or less. Like falling dominoes, Canada and England adopted two percent as their inflation target, and many other central banks soon followed. In the United States, the two percent target was adopted by Fed Chair Ben Bernanke in January 2012.

One would expect that the two percent target resulted from thorough empirical examination or peer-reviewed academic rigor. Nope. When the target was adopted in the United States, the Federal Open Market Committee (FOMC) of the Fed said, "The Committee judges that inflation at the rate of 2%, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate." That's it.

Before the credit crisis, the US central bank had principles. Now, it is data-dependent, meaning that every time economic data is released, it gauges the direction and force of the prevailing economic winds before making a statement or decision.

We believe the Federal Reserve will begin cutting rates later this year, but it won't matter. Usually, they cut rates to revive a faltering economy. The economy is slowing as it runs out of pandemic-fueled excess and is returning to its regular run rate. Pushing rates lower by 25-50 basis points will not set a new thermostat for the economy. It will just crack the windows and let some fresh air in.

One More Thing

One more thing. Rational casual observers of politics, geography, or sociology believe in a degree of American Exceptionalism. If that seems a stretch, read the 2022 *book The End of the World is Just the Beginning* by Peter Zeihan. When you finish, you'll be a believer. It is not that Americans or America is inherently better than any other people or place. However, in the aggregate, something exceptional results from the American brew of disparate ingredients that make us up. To many, especially those looking in from the outside, America is a shining light on a hill to which they aspire and are drawn. Many within her borders can only focus on how she falls short of lofty ideals. Legitimate errors in practice and principle certainly stain her history, but it does not diminish her relative exceptionalism in relative or absolute terms. Exceptions do not disprove a rule.

Last week, the presidents of China and Russia met to solidify their tight relationship. At the end of their meetings, they issued a joint statement condemning the United States as the cause of all the world's problems. Anyone who looks upon this budding romance without concern should revisit the lessons of history.

My father and brother served in the active military, and I honor and respect their sacrifice and that of many others who protect us daily. By a twist of fate, my generation has avoided full-scale military mobilization. While I registered for the draft on my eighteenth birthday, my life has been relatively free from any expectation of mandatory military service—a remarkably unusual lottery.

After the devastation of World War II, countries around the world were forced to take sides. Allied powers fell behind the United States, as did others who aspired to democratic ideals. Some were threatened, coerced, or chose to take sides with the Soviet Union. For over forty years, a Cold War ensued, with most of the world living under a veil of mutually assured nuclear destruction if either of the two decided to move past their persistent saber rattling and go at it in earnest.

China's economic re-engagement with the world toward the end of the 1980s coincided with the collapse of the fall of the Berlin Wall and the disintegration of the Soviet Union as a block of communist states and ushered in a period of global relief. Finally, it seemed that countries could all rise together, with each focusing on their comparative economic advantages within progressively democratic

political systems. Francis Fukuyama wrote his influential book *The End of History and the Last Man* in 1992, which described a global kumbaya with all nations marching toward the endgame of liberal democracy and the prevailing new world order.

It was a heady time, well-deserved in the minds and hearts of those who survived the paranoid years of the Cold War. However, global chess pieces shifted from political to economic without a nemesis to combat. Ardent Russian communist party members became billionaires, now called oligarchs, running private enterprises that used to belong to their comrades in the struggle against capitalism. Resources, once dedicated to defense expenditures, were now free to fund a bevy of social programs, finally putting the "liberal" in liberal democracies.

For twenty-five years, it seemed the world was headed for Valhalla under Odin's synthetic leadership of what liberal designers called "the new world order." But it did not take long before the cracks began to form. In what seemed to many as a surprise as it unfolded on election night, British voters chose to forgo European Union membership on June 23, 2016. Looking back, Brexit pulled the finger from the dyke ushering in a new wave of nationalism around the world.

Today, we stand closer to the threshold of global conflict than at any point since the Cuban Missile Crisis in 1962. Award-winning historian Rufus Fears leans contrary to prevailing ideology. In his view, striving for liberty and freedom is not the driving force of change in the world. Yearning for power is. Looking at the global chess match being played in this context demands that we all start paying attention. Post-Soviet states are being used as pawns in the first round by being forced to choose between NATO alignment or Russian domination. Long-neutral Finns and Swedes have quickly shed their post-World War II indifference that lasted almost a century and promptly joined the NATO alliance. Meanwhile, China, anxious to flex its muscles on the world stage, and Iran, perpetually seeking some degree of global relevance, have cast their lots with Putin. Iran will never matter globally and has little to lose, but China is risking everything.

Cozying up with Russia endows the Middle Kingdom with influence in the United Nations while putting Iran in the friend zone. This gives them plausible deniability by engaging the Islamic Republic to do its wet work in places where it can't afford to be noticed. However, any attentive observer knows that China has been building its global network with small, generally resource-rich nations for decades to loosen other countries' attachments to the United States.

Talking about potential threats can easily conjure war-mongering criticisms, resulting in appeasement. The historical embodiment of this strategy goes to Neville Chamberlain, who thought he created "peace in our time" by appeasing Adolf Hitler. Winston Churchill, Chamberlain's successor, was notoriously skeptical of Hitler and persistently doubted his intentions. We would do well to be wary. We are not in Kansas anymore.

Historical analogs are the spline of storytellers because they can be applied in changing environments. Negotiating our way out of a conflict and onto a path of steady relations will require a deft hand at the rudder. But it also requires willing counterparties. No such helmsperson appears to be waiting on the horizon. Putin's nationalistic gripes, aims, blames, and strategies bear remarkable similarities with those of Adolf Hitler. The continuation of hostilities in Israel and Gaza accentuates the difficulty in diplomacy. China struggles with a demographic cliff from which there is no landing, an economy built of straw, and the need to save face at every level.

If truth is the first casualty of War, she died long ago. However, the willingness and ability to accept truth is the crux of persistent and effective diplomacy. A durable peace will be an illusion until the truth is spoken, acknowledged, understood, and embraced.

Conclusion

That's it for this *Weekender*. Have a wonderful week.
That's all for this *Weekender*. Have a wonderful week.

Disclosure Statement

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