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Say It Again SAM

A QUARTERLY REPORT ON ECONOMIC VIEWPOINTS AND INVESTMENT STRATEGY

OPERATION BREAK SOMETING

"MONETARY ACTIONS AFFECT ECONOMIC CONDITIONS ONLY AFTER A LAG THAT IS BOTH LONG AND VARIABLE."

\- MILTON FRIEDMAN

Bullish investors have long lived by the well-known axiom of "Don't fight the Fed", but they are now positioned in complacent opposition of existing Fed policy and a deteriorating economic backdrop. The first three months of 2023 reflect a standoff between galvanizing stock market sentiment and increasing stresses on the US economy.

The seeds of a recession were sown last year, but the runway toward an anticipated recession is proving to be long. Heading into its March meeting, the Fed had hiked rates by 4.50% over the course of 10 months without comprehensive damage to the US economy. In fact, the talk of a "soft landing" and even "no landing" were in vogue throughout the first couple months of this year.

However, another old adage among investors is that the Fed hikes rates until "something breaks." Arguably this happened with the failures of Silicon Valley Bank and Signature Bank, and the forced sale of Credit Suisse to UBS.

Importantly, rising interest rates affect different facets of the economy at different speeds, with the most interest rate sensitive sectors, such as housing or autos to succumb first. It is not surprising that "specialty" bank failures came shortly after, although they had more to do with rapid monetary tightening, eroding deposit bases, and asset/liability duration mismatches rather than defaults (for now).

An area of the markets likely to make its way into headlines in the coming quarters is in the Alternative Investment Sector (Alts). Alts are generally non-publicly traded and less liquid assets classes such as Private Equity (PE), Venture Capital (VC) and Private Real Estate Funds. For the most part these sectors have not taken their mark-to-market hits.

For example, the $71 billion Blackstone Real Estate Income Trust (BREIT) had an 8% total return in 2022, even though publicly traded REITs were down -26%. To its credit BREIT has been invested primarily in the two strongest real estate sub-sectors of Industrial and Multi-family. But as investors started to request redemptions (allowed once per month), BREIT raised its "5% gate". A gate is a normal tool used by the Alts world to limit the amount of redemptions and avoid a "run on the Alt fund". January had $5.3 billion in total redemption requests with BREIT fulfilling only about 25% of them. February saw 35% of $3.9 billion requests redeemed, and only 15% of $660 million requests were returned in March.

In addition, there is roughly $1.4 trillion of Commercial Real Estate (CRE) debt coming due over the next two years, in the face of high vacancy rates, new supply with poor absorption, and higher refinancing rates. At the same time, the smaller regional banks, which are one of the largest lenders to CRE have smaller deposit bases, can loan less, and are tightening lending standards.

Looking ahead, the Fed's hawkish resolve will be tested as economic stresses continue to emerge. Before March's "mini" banking crisis, the market was pricing in an additional 0.9% of Fed rate hikes through to next January, including a "probable" 0.5% raise at the FOMC March meeting. However, in just a two-week period the forecast shifted to an anticipated -0.88% in rate cuts over the next year! The 10-year Treasury yield also dropped from 3.98% to 3.39%, marking a downward shift in future growth and inflation expectations.

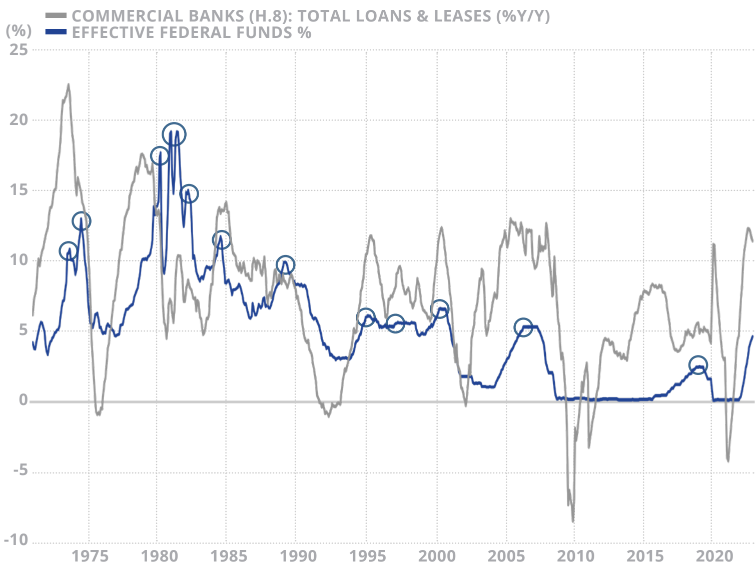
The Fed feels it must kill the inflation monster while it remains small and will continue to walk a policy tightrope in the months ahead. Chairman Powell's messaging has

been consistently clear, even after the banking episode. In a bid to follow through on previous "promises", the Fed increased the Fed funds rates by another 0.25% at the end of March, raising the benchmark rate to 4.75%.

The market is relearning price discovery now that variables such as inflation and long-term rates may have peaked. A Fed pause would be welcome because the economy and the market would adjust to the new levels and the risk/reward equation would be free of the artificial distortion that has characterized the last 15 years.

However, even if the Fed pauses right now and begins to ease later this year, the constraints on lending activity will be felt much longer. Aside from a strain on mid-size banks in the wake of recent bank failures, aggregate credit contraction typically accelerates after the Fed funds rate peaks. Tighter underwriting, higher loan pricing, and weakening demand have now begun working in concert.

LENDING DECLINES AFTER FED FUNDS PEAK



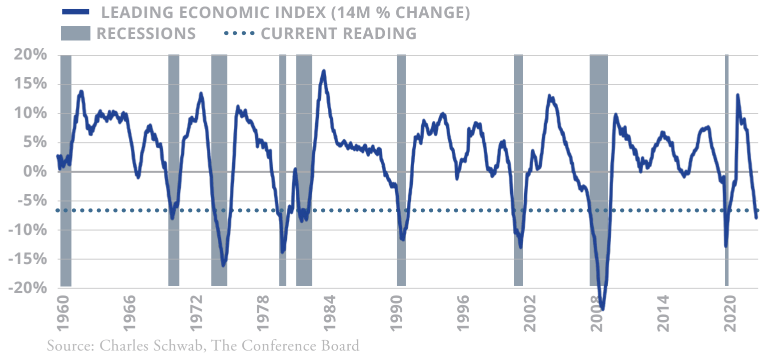
Source: Hedgeye Risk Mgmt LLC, Federal Reserve

ECONOMIC VIEWPOINT

To begin the year, there had been a growing conviction that the economy was in relatively good shape. However, much of the strength in January's US GDP numbers could be explained away by a weather-related glow, statistical updates, inflation adjustments (COLA) and data flow distortions.

The numbers for February with respect to retail sales and industrial production painted a different picture, as did the early survey data on consumer sentiment and manufacturing for March. In terms of real-time data, cargo traffic at the Port of Los Angeles in February fell 43% from last year, the lowest level since March 2020, and February 2009 before that. Port activity at Long Beach (-32%) tells much the same story.

LEI'S DECLINE PRECEDES RECESSION



Source: Charles Schwab, The Conference Board

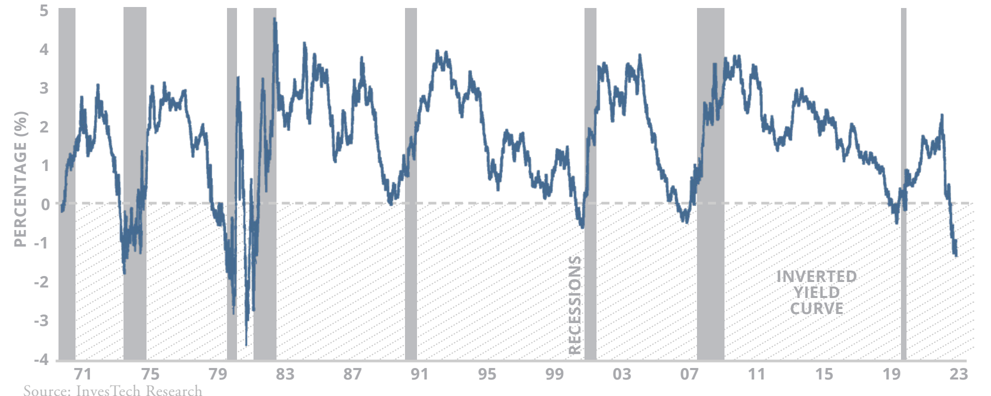
The current slowdown has been more of a "rolling" weakness that is slowly moving through the economy over a longer period. But while the "soft landing" versus "hard landing" scenarios may remain up for debate, it is undeniable that leading economic indicators have declined rapidly and are firmly in recession territory.

A raft of other data series also points to a weakening US economy including declining ISM manufacturing supplier delivery delays, suggestive of declining demand; a collapse in housing affordability and household savings rates; and low readings in consumer sentiment.

The Treasury Yield Spread, the difference between the 10-year and 3-month yields fell to -0.88% in March. This inversion of long-term and short-term rates is a primary warning signal that is at depths not seen since the middle of 1981 – and well beyond levels that have always preceded recessions.

Despite continued hawkish talk from the Fed, the tolls of monetary tightening on credit and consumption are

TREASURY YIELD SPREAD (10-YEAR MINUS 3-MONTH)



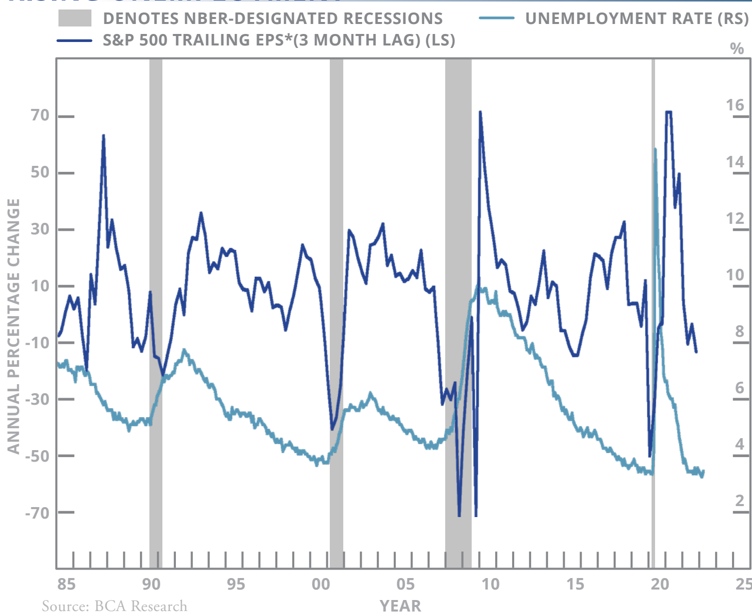
Source: InvesTech Research

evident. Even if the Fed feels it cannot afford to "pivot" back to reducing interest rates until inflation is absolutely under control, it might pause to assess the impact of existing monetary tightening decisions.

The Fed's Senior Loan Officer Survey for the quarter showed looming contractions in the supply of credit across all forms of business and household loans. Not just back to 2020 levels, but back to readings that coincided with the 2001 and 2008 recessions. Another part of that same survey shows a retrenchment in private sector credit demand. A simultaneous contraction in both the supply and demand for credit is a harbinger of future declining economic output.

A normalized inflation rate around 3% or less by the end of 2023 would be a welcome development, but the damage has already been done to real incomes and the American consumer is getting squeezed. While the rate of change in prices will continue to decelerate, the actual price levels for goods and services are noticeably higher than just a few short years ago. At the same time, credit card levels are at all-time highs and the US personal savings rate is now at its lowest level in 60 years except for the period preceding the global financial crisis of 2008.

CONTRACTING PROFITS SIGNAL RISING UNEMPLOYMENT



Employment is always the last man standing as the economy makes the transition from expansion to contraction. As a lagging indicator of economic activity, today's labor market remains one of the only areas to show resilience. However, as funds for business projects dry up on the back of tighter lending conditions and demand for loans collapses, the unemployment rate begins to rise.

After ticking up 0.2% since January, the unemployment rate could quickly surpass its 12-month moving average in the coming months. This has historically been a prelude to additional swift increases in the unemployment rate, coinciding with recession. Contracting profits also signal the start of rising unemployment, and today's earnings recession sets the stage for additional layoffs.

Initial unemployment claims have yet to tick up meaningfully. However, continuing claims have risen. This suggests that companies may be slower to higher and the gap between job openings and job seekers has begun to close. As the march to a recession progresses from housing, to banking, to profits, initial unemployment claims will be a data point to watch.

INVESTMENT STRATEGY

The major stock indices wrapped up a positive quarter. This will be cheered as good news, confirming the stock market's recovery from last year's bear market and resiliency in the face of stubbornly high inflation, rising interest rates, declining profits, war and even bank failures.

The S&P 500 has been oscillating between a broad range of 3,800 and 4,200 since early November, with no true catalyst to take it higher and just enough support to keep it from revisiting prior lows. However, much of the recent performance has been driven by an incredibly narrow number of stocks. Noteworthy is that Apple and Microsoft were responsible for more than 1/3 of the S&P500's gain in Q1, and just seven of the largest tech companies accounted for 90%. Broader measures of the stock market, such as the 2,400 company NYSE Composite Index, were essentially flat.

Today's market optimism is being driven by a belief that the Fed has already won its inflation battle, and an imminent pause (or reversal) in rates will fuel new highs ahead. While the rebound in market sentiment seems convincing – just as it was in early 2001 – today's risks remain uncomfortably high. The combination of resilient inflation, a tapped-out consumer, a deflating real estate market, and numerous recession warning flags makes this a particularly challenging time.

The bear market in stocks probably has a 2nd act to play out. Any celebration on the part of the stock market will ultimately shift to concerns about slowing growth and imminent recession. If growth does stay resilient, so too will inflation, inviting further rate hikes.

While equity valuations are less rich than they were in 2021, they are still not priced for a US recession. If risks to growth continue to materialize and begin to impact corporate profits, that would begin pushing up multiples like price to earnings ratios (P/Es) once again, putting additional downward pressure on lofty prices in this ongoing bear market.

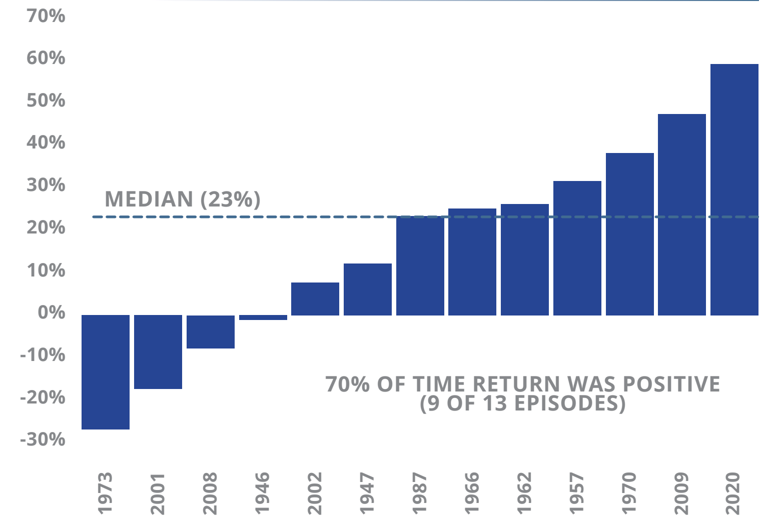
Markets typically bottom well into a recession, months after a pause in rate hikes, and after the unemployment rate has risen well off the bottom.

Fixed income is more attractive today than has been in about 15 years. Two-year treasury yields hit a 16-year high in March. In addition, high quality bonds may be more attractive than stocks in a slowing economy. However, corporate credit spreads have yet to widen as a corporate default cycle looms. Massive leverage exists in the system that needs to be cleared, and defaults in the lower tiers of corporate credit quality have yet to happen.

While the peak in inflation occurred last year and it has been trending in the right direction, the Fed is torn between its well-broadcasted goal of bringing inflation back to 2% and its imperative to maintain financial stability. Bond markets have been pricing in a Fed "pivot" of reducing rates by year's end, but he current labor environment and Fed commentary suggest otherwise. The labor market will have to deteriorate significantly before the Fed begins easing.

A potential scenario would be a Fed pause, followed by a wait-and-see approach in 2023; nonetheless the overall trajectory of monetary policy will continue to be data dependent. Even if the Fed stopped hiking now, 4.75% of previous rate hikes will continue to move through the US economy regardless. More unseen vulnerabilities may still come to light. In 2001, the Fed started to cut rates, but that did not ward off a recession or lengthy bear market.

As long as the forecast is murky, there are many reasons to stay defensive. The path for sustained, strong equity performance remains narrow, with inflation on the one side and recession on the other. Despite strong sentiment in the stock market during the quarter, we remain cautious and favor conservative allocations. This includes firms with strong balance sheets, ETFs of defensive sectors, the use of high-quality debt and cash equivalents.



Source: Angeles Investments, Goldman Sachs

We continue to be optimistic about allocations in our portfolios because of the long-term potential and stability of the companies and sectors owned, and the potential opportunities to acquire more at attractive prices ahead. History shows that short-term recessionary periods provide opportunities to improve the risk/reward ratios in the portfolio, and that durable market recoveries typically follow ultimate market bottoms.

The stressors of rising interest rates have been accumulating and the pressure in the system is increaslingly elevated. Recent bank challenges triggered by declining asset values that are funded with fickle, uninsured deposits are simply the latest symptom. Markets are slowly beginning to anticipate further tightening in credit availability and deteriorating credit quality at both the household and corporate levels. As inflation remains above its target, economic growth slows, and labor market imbalances persist, conservative allocations and patience continue to make sense.

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