Spring 2023 Newsletter

We are officially one-quarter into 2023, and it already feels like a year's worth of activity.

The last words I wrote in our 2023 Outlook piece in January still have merit in our minds. There was a great deal of angst after a brutal year for investors in 2022. We stated:

"A rally to start the year would catch most by surprise. We could see that play out: The Economy keeps slowing, the Bond Market tells us inflation is less of an issue and the Fed will ultimately end its choking rate-hike campaign. That would provide more breathing room for stocks for another Bear rally before ultimately bottoming out. That's our base case right now. We're staying nimble. One thing seems certain: The volatility will continue in 2023. We are prepared and positioned accordingly."

Market volatility has definitely been the theme thus far, as an explosive January gave way to some gain evaporation in February. Investors grappled with the still stubbornly high inflation and a shock with some banking failures not seen since the Financial Crisis, a decade and a half ago. March brought back some of the gains. But the rallies have resulted in lower highs. A breakout has been restrained. Fakeouts were the result. The Bear Market from 2022 still has claws.

A Digital Bank Run

A new crisis emerged, 2023 style. $42 Billion was pulled from Silicon Valley Bank in a flash. It was a digital run on the bank, forcing its failure. That has never happened before. It's been reported that an additional $100 Billion would have left had the Feds not stepped in. Few were prepared. On social media, fact and fiction spread like wildfires. It's easy to yell fire in a crowded virtual room. We need a better understanding of the world we live in.

The demise of Silicon Valley Bank, followed by Signature Bank of New York, sent shockwaves through the financial system. This, after Silvergate - the crypto bank - shut down a week prior. Fear of contagion spread fast. Money flowed away from the smaller regional banks, landing at the Big Banks. A coordinated emergency backstop for deposits from the Feds cooled the angst. But it hasn't been eliminated.

Fortunately, these bank failures were not driven by a crisis in credit. Loan defaults were not the cause. They were driven by the aggressive Fed rate hikes and a concentration of large deposits. Silicon Valley Bank was unable to meet the sudden withdrawal requests. Something went terribly wrong in oversight, at every level.

Stress Spread Beyond Our Shores

Below the surface, stress has been building. The inverted yield-curve has wreaked havoc for lenders that borrow short-term and lend long. The math stopped working as short rates rose. The havoc spread beyond our shores. It's worse overseas.

Credit Suisse was finally taken out in what looked like the slowest financial train wreck of our lifetime. It's been challenged for a decade and a half. Without a deal, Credit Suisse would've almost certainly collapsed. The ultimate takeout price of $3 Billion was a 98% decline from Credit Suisse's peak in 2007. The hope is the Swiss bank's struggles have been contained. We shall soon see. Deutsche Bank is the next global banking concern on the radar into April.

Many question the true health of the US Economy. The banking turmoil has increased the likelihood of that hard landing scenario the Fed wanted to avoid. The swift action from the government may limit wider contagion among financial institutions. But the impact will be felt throughout the Economy. Banks are expected to tighten lending standards even further now, while interest rates were already at multi-decade highs. That could slow growth to stall-speed.

Inflation Slowed – It Hasn't Left

Inflation is proving to be sticky. Though it continues to slide from the 9% peak last year, it remains high. The 6% increase in the Consumer Price Index in March is the lowest in 18 months. Commodity prices have fallen quite a bit. These are key inputs to goods and services we buy every day. The Fed is sticking to its goal of 2% inflation. It's a long way from there, but certainly moving in the right direction.

The cause of this 40-year high inflation was multi-factored. People want to make it political. Everything is political these days. That is certainly part of it. But it's more complicated than that. The fact is, America concluded a 2-decade run of importing deflation. That came mainly in the form of cheap goods from Asia and job outsourcing. Covid killed that.

Supply Chain Strain

The rise in inflation started out with free money from the Federal government while everyone was stuck at home in 2020. People started buying stuff; Lots of stuff. Demand for electronics, appliances and basic goods surged. Wardrobes changed. Remodels and add-ons at home took off from coast-to-coast. Home offices and the need to work virtually created huge demand for basic materials and digital devices. Home delivery skyrocketed too.

And supply could not keep up with demand. Supply chains were strained. Backlogs mushroomed. The port of Long Beach was stuck. Prices paid for labor and goods skyrocketed. Once America re-opened, demand for goods shrunk while demand to get out and about surged. That brought prices of goods down while prices for services soared. That's where things stand heading into Spring.

Cheap Money Encourages Bad Behavior

Of course, the Fed is complicit in the runaway inflation. They kept rates at zero despite the economic recovery. Cheap and accessible money encouraged bad behavior. The money supply was loose. Bubble-like conditions developed. Then they burst. After being late to act, the central bank went big on tightening. There are fears that the Fed moved too far, too fast with its aggressive rate increases. The fear was something would break. Silicon Valley Bank broke. The hope is that it's isolated and contained.

The US Economy has been surprisingly resilient. GDP grew at a 2.7% clip in Q4 of last year. Q1 2023 is expected to grow even faster. Estimates have increased to 3.2% growth in the March Quarter, up from the initial forecast of just 0.7% back in January. The question is whether it can last past Summer.

America is Open for Business

A large part of the economic resiliency comes from the super-strong Job Market. The unemployment rate ticked up to 3.6% in February. It's still near fifty-year lows. The Labor Market continues to run hot, which has set a higher floor for inflation. America is open for business. Anyone who wants a job can pretty much get one. Companies still can't find workers. Job openings outstrip available workers nearly 2 to 1. That's driven labor costs higher.

Travel and entertainment continue to be white-hot. Americans still have the itch to go out and about after the extended period of sheltering in place. That trend is showing little sign of slowing. Flights are jammed. Restaurants are crowded. Spring Break is now here. Summer is around the corner. This increased spending is inflationary. It's kept prices higher. This has perplexed the Fed for months.

Housing Drives Spending Too

Higher interest rates mean higher home mortgage rates. That put a ceiling on housing prices. It's pretty simple: a 7% mortgage buys a lot less house. The fast move from 3% mortgages to 7% created a shock to the system. Buyers froze. Prices fell.

But America needs houses. There are not enough. It's been a multi-year issue of low housing supply. That leads to higher prices, which was absolutely the case in 2020 and 2021, which brought another housing bubble. For the vast majority of Americans, their home is their largest asset. People naturally feel richer when their home value is going up. Of course, the reverse is true too. People tend to spend more when they feel rich. Consumer spending accounts for 70% of economic activity.

The Spring selling season will be another tell for the health of America's Economy. 40% of annual transactions take place from March to July. The school year is an obvious driver there. Taking it a step further, there are substantial high-paying jobs tied to housing from coast-to-coast.

Automotive Indicator

Used cars have been a key measure of inflation. You may recall that demand for used cars soared in the early days of Covid. Public transportation shrunk. Used car prices saw astronomical gains as new cars were backlogged due to a shortage of chips. New cars that were available sold at MSRP or higher.

Elevated car prices fell from the Covid highs, but they are back on the rise again. Inventories are low and there's an uncharacteristically large number of leases getting bought out. Customers are trying to avoid high new car prices and the higher interest rates on car loans. Used vehicle inventory is down over 20% from a year ago and more than 25% from pre-pandemic levels. Used car sales volume is not expected to return to pre-pandemic levels until 2026. The Used Vehicle Value Index jumped 4.3% in February, the biggest monthly increase since 2009.

What's Next Fed – Hike, Cut or Pause?

The Federal Reserve indicated it intends to raise interest rates again, before a pause. Fed Chair Powell said they plan to keep rates on hold thereafter. The Market doesn't believe it. As March came to an end, the Market assigned a 43% probability of a pause at the May meeting. The Market also expects the Fed to start cutting rates by Fall. With inflation still elevated in certain areas and a Stock Market showing some buoyancy in early Spring, the Fed seems highly unlikely to reverse course and cut. That is, unless there's a reason. The Bond Market's yield-curve inversion suggests there will be a reason. That reason wouldn't be Bullish.

Debt Ceiling

With all of the attention around the banking crisis, pushed to the backburner is the looming debt ceiling. It's not going away. The United States has $31 Trillion in debt. The mountain of debt is larger than its annual economic output, which was $25.5 Trillion in GDP in 2022. Washington needs to get its house in order. Spending more than you make violates requirement #1 for responsible finances. America's debt-to-GDP ratio has been over 100% since Covid, with seemingly no plans to pay it down.

As a reminder, the debt ceiling crisis refers to a situation where the government reaches the limit of its borrowing authority and is unable to pay its bills. This can happen when Congress fails to raise the debt ceiling in a timely manner, or when political disputes and negotiations delay the process. With this highly partisan and painfully divided Congress, the issue of the debt ceiling is likely to go well into the final hour.

How will the Market respond? So far, it's largely ignored the situation. Treasuries have done nothing but rally in this young year. That's the most important sign. Ultimately, we think there is very little chance of an American default. But with this Congress, the chance has to be viewed as greater than zero.

Summer of 2011

The closest the United States has ever come to defaulting was in the Summer of 2011. Market volatility spiked as the deadline drew closer. Standard & Poor's downgraded the US credit rating for the first time ever. The Stock Market fell 19%. Congress eventually reached a compromise in early August, raising the debt limit just days before the country would have defaulted. Importantly, both Treasuries and the US Dollar rallied. That was the Market sending the clear signal that America was still home to the risk-free asset.

Raising the debt ceiling is considered a "must pass" bill. Our Washington sources believe it could be an attractive vehicle to attach other legislation that might not otherwise pass on its own. The debt ceiling bill could become a vehicle for a deposit insurance/banking bill. Members of Congress, from both parties, will be looking for concessions from the other side and a banking bill could push Republicans to support a bill in return for spending concessions from the Democrats. It's expected to get ugly and cause stress. But a debt default should ultimately prove avoidable.

America has been kicking cans down the road for years. At some point, this has to stop. International investors have been moving away from Treasuries. Foreign ownership fell from 39% to 29% of total since before Covid. It's something to consider. Where did that money go? Well, central banks around the globe bought $70 Billion of Gold just last year alone. Gold is universally coveted. But there is absolutely no alternative to the US Dollar. The Global Financial system runs on the US Dollar.

Geopolitics – They're Heating Up

The world is experiencing cold wars and hot wars. The Russian invasion of Ukraine entered its second year. There are seemingly no signs of resolution on the horizon. War fatigue plagues all involved. China created a 12-point plan for peace. President Putin expressed a willingness to discuss China's peace plan for ending the war in Ukraine, though US Secretary of State Antony Blinken said that the "world should not be fooled" by the plan.

Eastern Alliance – China and Russia

Russian President Vladimir Putin and Chinese President Xi Jinping have developed a close working relationship. They call each other "Dear Friends." The Putin and Xi alliance is characterized by a mutual respect for each other's leadership and a shared vision for a multipolar world order. Both leaders have emphasized the importance of upholding state sovereignty while resisting Western influence. Russia and China have increased their strategic cooperation in recent years, particularly in the areas of energy, trade, and military cooperation.

This Russian–Chinese relationship has evolved. Russia has become a bit subservient to China as Xi offers Putin credibility and enhanced global standing. Russia is a 20th-century power with a 20th-century Economy tied to fossil fuels. China is trying to build a 21st-century Economy, with aspirations of dominating the Digital Age. Russia will adjust with Chinese assistance, but it will be poorer and technologically backward.

Russia has surpassed Saudi Arabia to become China's top Oil supplier. Imports rose 24% to nearly 2 Million barrels per day in the first two months of 2023. Of course, Russian Oil comes at a steep discount to the global Market price due to heavy sanctions applied. The Chinese seem quite content to seize the opportunity.

That said, China has 10X trade revenue with Europe and the US than it does with Russia. China cares about its Economy. It doesn't want to crush that. It seems to be making a bet that the West will bark but won't actually bite when it comes to economic trade. It's a calculated yet risky bet China makes. America is moving away.

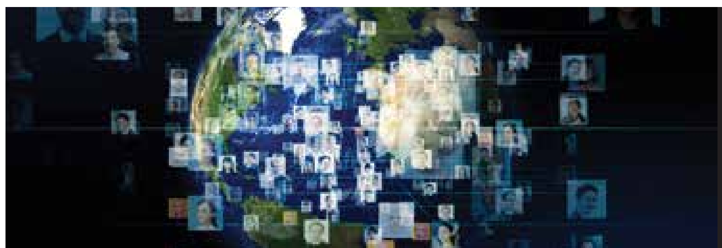
New Cold War? China, America and Taiwan

The United States and China are by far the most important strategic relationship in the 21st century and this Digital Age. There are no other nations even close. Comparisons are naturally drawn to the Americans and Soviets during the Cold War, which gripped much of the second half of the 20th century. Sure, there are some similarities. But today's Cold War, if it can be called that, is quite different.

President Xi effectively annexed Hong Kong in 2020. It's believed that Xi felt empowered after doing so with relative ease and little consequence. It's quite similar to the way Vladimir Putin felt after annexing Crimea in 2014. It's been said that Xi's aggressive crackdowns on the Hong Kong protesters were a deliberate message to Taiwan. It's no surprise, China has been watching the activity in Ukraine with a close eye.

Taiwan has emerged as a hotbed issue between these 21st-century superpowers. Taiwan produces 90% of the global supply of advanced semiconductors in circulation. Global defense systems are run with chips made in Taiwan, including the United States military. If China invades Taiwan by force, it could disrupt the availability of semiconductors when the supply is already struggling to meet demand. That is something the United States will not tolerate. Tensions keep building. Taiwan will be an issue far beyond 2023.

The World Order Has a New Face



China is mediating diplomatic relations between sworn enemies Saudi Arabia and Iran. Beijing is trying to play global peacemaker, a role the United States has served for decades. China has pursued stronger relationships with the Iranians and Saudis, largely on an economic basis. Beijing covets Middle Eastern Oil. But China sees the bigger picture. Peace broker status puts Beijing in a category that only Washington really possesses. It's yet another alternative path from the 20th-century norms. An increased role for China means a decrease for America. That's significant. And we mustn't forget, China plays the long game.

The world order has a new face. Demographics favor the southern hemisphere and Near East. Western influence seems to be shrinking as Europe, Japan and the United States age. China has an aging issue too, but it is reaching out to the younger generations as a source of strength and guidance.

Populations in the Middle East, Africa and Southeast Asia are young and need investment and resources. China is obliging. Beijing is fixated on creating an alternative to Western norms. While Europe deals with its generational challenges and America fights itself, China keeps planting roots around the globe with increased influence. This is an issue today. The results will be felt tomorrow and beyond.

Innovation Still Reigns

The United States continues to be the most innovative nation in the world. America has led the digital revolution. It's critical that it maintains that status as competition is always fierce. Innovation is always investable.

Tech Stocks took a beating in 2022 after experiencing bubble-like conditions in the prior years. Tech has made a comeback early in 2023, but valuations can get stretched and growth has become hard to maintain.

The iPhone Moment for AI

Artificial Intelligence got a kickstart in the new year. A platform called ChatGPT took the world by storm with digital capabilities rivaling human output in a fraction of the time. It's been called the "iPhone moment for AI." Microsoft is an early investor. Google was caught off guard and has since moved swiftly to compete in the age of AI. Companies are converging. Start-ups are disrupting. Artificial Intelligence is here and it's only going to get smarter.

Accelerated computing has changed the digital landscape. New applications created new generations of innovations from personal computing to cloud to mobile and now AI. Oil was the prize in the 20th century. In this 21st century, the Digital Age, is dominated by data. It's the new prize.

Machines are learning. Artificial intelligence is expanding. The data is now writing the software. Pretty much every industry is embracing these innovative solutions, which are expected to increase the effectiveness and efficiencies in our daily lives. It's enhancing how we shop and how we communicate. Digital solutions expand our energy supplies and enhance modern medicine. Of course, it's all extremely investable.

Bond Market Signals

The Market ran into a brick wall to start March. That wall came in the form of 4% on the 10-Year Treasury yield. Upon impact, stocks and bonds went in opposite directions and fast. Stocks fell sharply. Bonds rallied. That is quite different from last year, when both declined together. It was pretty rare.

An inverted yield-curve has been a reliable leading indicator of a pending recession. They just aren't good timing mechanisms due to a long lag time. The Bond Market has been signaling trouble for a while. We are listening closely.

Treasuries have returned to their safe haven status again. That's different from 2022, the worst year in history for the Bond Market. Bonds have rallied in 2023. Ditto for Gold. These are areas where money tends to flow, seeking safety. We have been aggressively positioned here. 5% Treasury yields on the front-end of the curve were too tempting to pass up. We really like bonds here.

Earnings Drive Stock Prices

Stocks aren't cheap. The S&P 500 is trading at 18X estimated earnings for the year. That is significantly above the historical average of 15X. What's more problematic is that the estimates are likely too high. Estimates have come down quite a bit in recent weeks. They just haven't come down to what we believe ultimately manifests.

Another measurement for valuation is the earnings yield on the S&P. It is basically the reverse of the P/E (Price to Earnings) ratio, with the "E" as the numerator and the "P" as the denominator. The earnings yield is currently less than 1% above the 3-month Treasury yield. That is the smallest gap since 2001. That should keep a lid on the rally heading into Summer. Higher interest rates and slowing growth is not the typical backdrop for multiple expansion. It usually leads to multiple contraction. We see that happening.

Above anything else, it's earnings that drive stock prices. They need to stop going down first before they start growing again. The Market will anticipate that turn. We will learn a lot when companies start releasing their report cards in April.

Mega-Cap Tech to the Rescue

March brought a mega-cap Tech rally. Apple and Microsoft combined now account for over 13% of the total value of the S&P 500 index. This is the highest concentration for these top 2 holdings in history. Investors are seemingly finding comfort in these 2 proven winners who are sitting on a mountain of cash and don't need to borrow to continue to operate their massive businesses.

There is some serious concentration of leadership in the Stock Market. The top 7 holdings account for all of the 2023 gains thus far. That is incredible. Bull Markets have broad participation and breadth. It seems to us that a handful of stocks are masking the unresolved issues beneath. We think that resolution on some issues happens this Summer into Fall, before setting up what could be a strong, sustainable new Bull rally into 2024.

Bull-Bear Brawl

Wild swings keep shaking investor confidence. And there is a clear distinction again between what the Stock Market and the Bond Market are saying. The Bond Market is clearly saying that more trouble lies ahead, and a recession is inevitable, if not imminent. We cannot forget that recessions are a necessary part of the cycle. Fighting it or pushing it out generally makes things worse.

The Stock Market seems to be looking past all this, thinking that the 2022 correction ran its course, and a soft economic landing is in store. The Bulls think the Fed is the rescue squad again. Bears Market rallies create a great deal of Fear of Missing Out. FOMO is on the rise. Bear rallies suck people back in. It pays to stay disciplined. We're more inclined to believe the Bond Market over the Stock Market. Bonds have been a great place to be in 2023.

It's also important to point out, the Stock Market has basically gone sideways for the last 10 months. 4K on the S&P and 32K on the Dow have been magnetic levels that stocks have swung around for months. There hasn't been any forward progress. Time and patience are required as the cycle plays out.

Bear Markets are all about survival. This Bear is 15 months old and is showing more life ahead. Playing defense with quality companies that are profitable, have little debt and pay dividends tend to hold up best. We are there. In terms of sectors, we continue to like Health Care, Consumer Staples and Utilities as they embody those characteristics. This is a Value lean for us.

It's been nice to see green on the screen in 2023. We just don't trust the sustainability of the strength into Summer. We believe there will be better opportunities ahead to re-embrace Growth investments in size. We're just not there yet.

The Bull-Bear brawl continues. The Bear has the upper hand. The Bull is fighting back. It looks like a few more rounds are required for resolution. We are long-term investors equipped to deal with short-term issues.

That's precisely what we're doing.