



Fall 2023 Newsletter

The Bond Vigilantes Ride Again

October 6th, 2023

The Stock Market rally hit a wall in September.

It's still feeling the effects in October. The cause of declines was a combination of higher interest rates, an economic slowdown, high valuations, a mountain of debt and, of course, nagging inflation. America's political situation is not helping either. Sadly, e pluribus unum has been forgotten in Washington.

Washington Stays Open; Sort Of

A government shutdown was averted, for now. Congress passed a continuing resolution to keep the Federal government open for another 45 days. So, what does that mean? They kicked the can down the road again. There was no framework for a long-term solution. That's nothing new. We'll be dealing with this again around Thanksgiving.

This time however, for the first time ever, America's Congress will be dealing with these combative partisan issues without a House Speaker in place. Kevin McCarthy was removed from his post. The House of Representatives will cease activity until a new Speaker is named. It's far from clear at the time of this writing who that might be.



Dysfunction and uncertainty have permeated Capitol Hill for years. The Congressional approval rating is a measly 19% when last polled by the American people in August. It's undoubtedly lower now. It's been historically low for years.

The Market has largely ignored the political antics. There's been an immunity built up of sorts. That said, things have clearly gotten worse. The Market is no longer ignoring what's happening in Washington. The consequences are rising with the expansion of time and little action. America's mounting debt and ability to pay its obligations in perpetuity are very much at risk. The Bond Market is sounding the horn. More on that below.

Rolling Recessions

It was widely believed that 2023 would bring a recession. It was the most telegraphed recession in modern history. The thing is; It never showed up. A recession has been averted, at least for now. It's looking likely that the recession has merely been pushed out a year. It's likely a 2024 event.

The fact is, we've experienced a series of rolling recessions since Covid. The 2020s have brought a series of booms and busts. Weakness and strength have rolled through the Economy with unprecedented force. The Global Pandemic disrupted

pretty much everything. Planet Earth got shut down. The Global Economy froze. The impact was impossible to be small. It was big. It still is.

Locked down at home, Americans bought stuff like never before. Electronics, remodels, houseware, new wardrobes; The American people went on a record shopping spree. Supply chains were strained. Factories were shut down. Supply could not keep up with the soaring demand. Prices rose with the scarcity of stuff. It was a Bull Market for Goods and Recession, actually more like Depression, for Services. That was 2020 and much of 2021.



Things opened back up in 2021 and accelerated in 2022. Americans ditched the stuff and hit the road, airports, ballparks and restaurants with reckless abandon. Travel exploded. Experiences were the theme. Prices for flights and hotel rooms soared with the exploding demand. Americans ditched their appetite for goods and exited the home with passionate purpose. There was a boom for services and bust for stuff.

Activity has since cooled. Travel likely peaked in the Summer of 2023. There were record crowds in Europe, in airports and across the country. Consumption at any cost was the theme. It was expensive. But after sheltering in place for so long, people were starving for activities and experiences. That was the Summer of 2023. Americans are now showing signs of hunkering down in the Fall as kids are back in school, and adults are paying the hefty Summer bills.

The one area of strength in the Economy remains jobs. For most of 2022 and 2023, if you wanted a job, you got one. There were nearly twice the number of jobs opened for people looking. It hasn't changed much. The Service industry dominates jobs in America. With so many people out and about across the country, service businesses couldn't find enough workers. They had to pay more to fill the jobs. That's wage inflation, something America had not seen in the 21st century. That meant we paid more, picking up the tab. It's still the case today.

Aggressive Fed

The Federal Reserve has increased interest rates 11 times since the Spring of 2022, taking the overnight rate from near zero to 5.5% during that time. Free money is no more. Bubbles have burst. Inflation, as measured by CPI, fell from 9% to its current 3.5% over that period. Inflation is still high, but it's come down quite a bit in certain areas. But not all. Inflation is still a problem in areas we feel it most.

So yields have gone up, but the unemployment rate has barely budged from 5-decade lows. Over 300K jobs were created in September, blowing away estimates. The Market was expecting a continuation of the slowdown, with half those numbers estimated. The unemployment rate stayed at 3.8%. What's more, prior months were revised higher, indicating the sustainable strength in jobs. This is great news for the Economy. Having a job and a steady income is a really good thing. But the Market is worried about the choking effect of higher rates. Yields jumped on the news, indicating the Fed will not abandon its rate hike campaign anytime soon.



The cost of the things America's Economy needs has gone up. They've gone up a lot. That's people, money and energy. Wages, Interest rates, Oil and Gas.

Labor Unions are flexing their muscles. Strikes are the result. They're taking place from coast-to-coast. Higher wages are the drive. The United Auto Workers (UAW) want a 40% wage increase. It's become a big theme this year and they're joining the party. Unemployment is low and wages have gone higher. Unions have been the most active in decades. American Airlines increased wages for its pilots by 40% last month. Dockworkers along the West Coast ports just got a 32% bump in pay. UPS employees just got an 18% raise. Kaiser employees followed suit with a strike of their own. 75,000 workers walked out from Kaiser facilities across the country, making it the largest Health Care strike in American history.

Fitch downgraded America's credit rating. The Market didn't flinch. Congress ignored the implications, something they've gotten really good at. With now \$33 Trillion in Federal debt and a budget deficit accounting for 8% of GDP, America's Economy is at risk. We've never seen debt like this. What's worse, the cost to service it has skyrocketed with higher interest rates. Interest payments alone to service America's debt will cost nearly \$1 Trillion in the new fiscal year. The cost to pay the debt accounts for 15% of America's GDP. It's never been higher.

The Bond Vigilantes Return

Higher yields finally matter. The 10-Year Treasury yield hit 4.8%. That's the highest since 2007, before the Financial Crisis. It was 1.5% 2 years ago. It was under 0.5%, a record low, early on in Covid. The last time the Bond Benchmark yield jumped this much was exactly 30 years ago. As a reminder, when yields go up, bond prices go down. The spike in yields in 1993 was called the Great Bond Massacre led by the "Bond Vigilantes." The Bond Market rebelled against irresponsible government spending. Bond Vigilantes is a term coined by famed investor Ed Yardeni. I've spent considerable time with Ed over my career. The Vigilantes are riding again.



In 1992, the United States had a then-record \$290 Billion budget deficit. There were no signs of slowing and no plans to pay it off. The Bond Market took over, sending stock prices lower and forcing Washington to address the mounting debt. It worked. By the end of the decade, not only did Washington balance the budget, the United States had a surplus.

That period of disruption will always be remembered for Clinton strategist James Carville, who said that he wanted to be reincarnated as the Bond Market in his next life because it can intimidate anyone. Carville also gave birth to the famous campaign line, "It's the Economy stupid." Those words are circulating again ahead of next year's election.

The Era of Zero Rates is Over



Interest rates are the price of money. The price of money has gotten expensive. It happened fast. Asset prices generally fall when rates rise. It makes it more expensive to buy stuff. Higher rates are a tool, a cooling agent if you will, for overheated asset values. They tend to pop bubbles. That was the case last year. It's never immediate, often taking time to work through the system. Things started looking a little bubblicious again over the Summer as the AI theme captivated the Stock Market. That bubble got pricked too.

The era of zero interest rates is over. Higher-for-longer is now the theme. The yield curve remains inverted, meaning shorter maturities yield more than longer dated. It's backwards. It's been that way for a year and a half. It's usually a sign of pending recession, though never an effective timing signal. That said, the spread between 2-Year and 10-Year Treasuries are the least inverted since the March banking crisis. The yield on the 10-Year has spiked of late, while the front-end of the curve has stayed constant. The relentless rise in yields and the tightening of financial conditions has put some serious pressure on assets. Both the Stock Market and the Bond Market reflect that stress.

Energy Fuels Everything

Energy prices have been a major overhang for consumers and the Market, Crude prices spiked to nearly \$100 per barrel. The price of gasoline jumped over 10% in August and continued into September. Expensive energy slows growth across the globe, especially for China, whose economy is already under pressure from its bumpy rebound since its zero-Covid policy. OPEC+ wants higher Oil prices. Their production cuts have been aggressive. So far, it's worked out for them.

October brought a major reversal, with the price of Oil falling back to the low \$80s as I type. The best cure for high prices is... high prices. Demand is slowing. \$6 gas in California will do that.



Gasoline stockpiles in the United States increased by 6.5 Million barrels. That was the biggest weekly increase since January of 2022. Finished motor gasoline supplied, which is a proxy for demand, is down to 8 Million barrels per day. That is the lowest mark this year and the lowest seasonal mark in 25 years. The Economy is definitely cooling.

Consumers and Credit

Americans are sitting on record credit-card debt levels and delinquencies are on the rise. There is now over \$1 Trillion in credit card debt, an all-time high. It also comes with 20% interest payments. Credit cards are the kind of debt that can bury consumers.



Middle and higher-income consumers have curbed discretionary spending. That's from a study by Morgan Stanley. It's happening as Federal student loan payments activated after a pandemic-era pause for over 3 years ended. 40 Million Americans combine to owe over \$1.6 Trillion in Federal student loan debt. That could lower consumer spending by \$9 Billion per month. That, in turn, would lower GDP growth to 1.7% this year, and result in a 0.3% decline next year.

There has never been a circumstance in which an entire lending market was turned off and turned back on again. Morgan Stanley polled 69% of borrowers expecting to cut back on discretionary purchases once payments restart. Areas impacted would be apparel, restaurant and travel/leisure spending. Many Americans have depleted those pandemic savings and are shifting consumption patterns.

America's AA-Rated Government

Moody's warned that a US government shutdown would reflect negatively on its credit rating. That said, it acknowledged that government debt service payments would not be impacted, and a short-lived shutdown is unlikely to disrupt the US Economy. So, there's that.

A government shutdown would underscore the weakness of the current US institutional strength and stability relative to other AAA-rated nations. A shutdown would reflect political polarization continuing to put pressure on US fiscal policymaking, particularly during a period of declining fiscal strength, persistent fiscal deficits, and deteriorating debt availability. The dysfunction in Congress and removal of the House Speaker add substantial fuel to that fire. The vacancy substantially increases the risk of another government shutdown in November. If Congress can't govern itself, how is it expected to govern the nation and address the serious issues? The already complicated situation just got more complicated.

Fitch downgraded America's credit rating from AAA to AA in August. It cited political standoffs and last-minute budget resolutions for the cut. You may recall that S&P cut America's AAA rating back in 2011, during another period of political brinkmanship. Moody's is the lone agency holding the United States at a AAA credit rating.

The Dollar soared 7% in the 3rd quarter, matching the monster move from a year ago, which ultimately resulted in a 20% rise in 2022. Money tends to plow into the Dollar for safety in risk-off situations. Dollar strength suggests the Market is still not worried about these negative forces in Washington, at least not yet. But a strong currency definitely impacts sales overseas and squeezes spending. Companies with large revenues generated outside the US will feel the pinch. The Stock Market has been pricing it in, to an extent, already.



Geopolitics and Cold War

As the World's two largest economies move increasingly farther apart, companies have responded. The politics of Covid shined a bright light on vulnerabilities. Among them were supply chains. Many companies are relocating their business operations to friendlier regions. Reshoring manufacturing to North America has gained momentum. Those that covet the Chinese customers are doubling down on diplomacy to maintain good relations. A big step in diplomacy could come with a meeting between the Chinese and American Presidents in November in San Francisco. It's yet to be determined whether this happens.



The new Chinese-Russian strategic relationship has these nations closer than any other period in five decades. But China finds itself in a difficult spot now. Not only is it facing friction with the Western World, China is struggling internally to get its economy going again.

It is unlikely that China was totally surprised by the Russian invasion. It is, however, likely that China was surprised by the aggressive, coordinated response by the West. I think it's safe to say most of the World was surprised that the NATO alliance strengthened to levels that rival the early days since its inception, following the Second World War. But support and patience in Ukraine are sliding in certain areas. Continued American support will certainly hinge on the outcome in Congress. And of course, what happens in Ukraine will no doubt play a role in the future for Taiwan. Hot and Cold Wars are likely to last for a while longer.

Investing Overseas

We are invested in international markets again, something that hasn't been a prime focus for a while. International investments have lagged the US for over a decade, but that trend seems ripe for reversal. Demographics are compelling in many regions overseas, where growth is faster and seemingly more sustainable. International stocks are much cheaper and tend to pay higher dividends. We have already rotated some money in this area. We plan to increase our exposure over the course of the decade.

Japan and India have increasingly become America's most important strategic allies. The 3 nations make up $\frac{3}{4}$ of the Quad, the Pacific alliance designed to counter China's aggression. We see increasing value and investment opportunity in both nations.



Japan is a turnaround story. It's been the 3rd largest economy in the World for years. But its Stock Market has been in a downtrend since the late 1980s. That was a period of economic boom for the Asian nation. It ended in bust. Japan has faced a series of lost decades for investors.

Japan is attractive for investment for a variety of reasons. First off, it's cheap. The Nikkei Stock Market trades at a significant discount to the S&P. Japan has a stable consumer base and its economy, already export-oriented, is benefitting from a manufacturing shift away from China. Japan is a very tech-savvy society, with many companies embracing robotics and automation to account for its aging labor force. Perhaps most importantly, Japanese leadership has become more pro-business and shareholder-friendly. We see a pretty long runway ahead for Japanese investments.

India is the World's most populous nation. It passed China earlier in the year. More significantly, India's population is much younger. The majority of Indian people are under the age of 30. The Indian government has invested enormously in education and infrastructure. India has also been the recipient of supply chain shifts away from China, which has been strained by symptoms of both Covid and Cold War.

With an annual GDP of \$3.5 Trillion, India is now the World's 5th largest economy. It outpaces the United Kingdom and France, trailing only the United States, China, Japan and Germany. Its economy is also growing the fastest of the bunch, estimating 6%+ growth in 2023. India is expected to surpass Japan and Germany before the decade ends, putting them at number 3.

AI is the Way

Microsoft and Nvidia have emerged as the leaders in the Artificial Intelligence boom. Alphabet takes issue with that, having been considered the early and largest adopter of AI. It's still very early days, but these companies are clearly in it for the long haul and will compete aggressively for the prize.

Amazon has been surprisingly quiet about its AI activities of late. Of course, it was an AI leader with its Alexa rollout a decade ago. Amazon just made a bold move by partnering with AI-startup Anthropic, while also making a sizeable investment in the San Francisco company.

Anthropic created an AI model named Claude. The company touts its ability to perform a range of tasks. Claude is able to produce sophisticated dialogue and creative content generation, as well as complex reasoning and detailed instruction. Equally important is the high degree of reliability and predictability of its tasks. Claude will use AWS (Amazon Web Services) as its primary cloud provider for workloads.



AI has the potential for disruption, displacing some jobs and creating new ones as it transforms the global labor force. It's already happening. Of course, the hype has gotten a little euphoric. Expectations often get ahead of themselves. But the opportunity and trends are real. The results will be impactful. JP Morgan CEO Jamie Dimon is on record saying that AI might result in a 3.5-day workweek. The implication is productivity will increase that much. It's certainly a bold prediction.

Co-pilots: They're rolling out rapidly. These co-pilots aren't flying airplanes. They're driving Artificial Intelligence. These co-pilots are AI companion tools that are integrated within workflow software designed to increase employee productivity, accuracy and efficiency. These AI applications accounted for \$2.2 Billion in revenues across industries in 2022 but are estimated to reach as much as \$200 Billion by 2027. That would be some serious growth.

The economic impact of AI could be even more rapid and transformative. As humans and machines combine intelligence, there are potential benefits for both workers and businesses in old and new industries. Productivity gains from AI could boost wages and corporate profits. The internet changed the landscape at the turn of the century as companies embraced the web to survive and, in many ways, thrive. Every company became an internet company to an extent. They had to. The internet was a gamechanger. AI could be even bigger. We're definitely investing there.

Earnings Season



Earnings Season is back again. October will bring quarterly report cards for Corporate America. The Street expects a return to growth, to the tune of 2%, putting an end to 3 consecutive quarters of declines. The real kicker will be expectations for 2024. They're still high, with estimates of 10%+ earnings growth. We still think the Street is overly optimistic. We will learn a lot in October. The Market correction seems to be resetting expectations already. Wall Street is notoriously slow to act.

The big themes for the Q3 Earnings Season will no doubt reside around inflation and spending. Consumer resilience will be closely scrutinized given the many challenges. AI will be front and center as well. Companies have mentioned the theme with increased frequency, which provided a charge into stock prices over the Summer, but more importantly, will show where the opportunity lies for investment beyond the now. Tech has driven the Stock Market in 2023. This check-in will be instructive as to how well Silicon Valley is holding up with the challenges around.

Bond Bulls

The Bond Market is on track for its 3rd consecutive down year. It had never declined in back-to-back years before last year, which was its worst in its history. The weakness has been very buyable. We've been doing just that.



We've been Bond Bulls in 2023. Importantly, it's been very selective. Our strategy has been to concentrate on the front-end of the curve, locking in those 5% Treasury yields staying 2 years and under. It's worked well. There will be a time to take on more duration, going further out on the curve in size. That time is not now in our estimation. But it won't be long. For now, we're staying on the front-end, scooping up those predictable 5% yields with very little risk. We like it there.

Anticipation is Everything

Sentiment is pretty sour again. The Market sure has had mood swings in 2023. Bullish sentiment fell to just 27% to close out September. It fell 14 points during the month alone to the lowest level since the Spring. That previous low took place around the Silicon Valley Bank failing.



Sentiment tends to be a contrarian indicator for top and bottom formation. Investing has always been an emotional exercise. Fear and Greed are the drivers. Rallies tend to get people to chase with the fear of missing out. But fear is generally more powerful, making sell-offs quite extreme. There's nothing like price to change sentiment. Bullishness peaked at 51 to close out July. No surprise, that was the height of the AI boom. There was a serious fear of missing out this Summer. The September sell-off quickly ensued.

Predicting the future is a really hard business. Most won't do it. Anticipation is everything for investing. When we see a consensus building around expectations for tomorrow's outcome, it often pays to go against the herd. That herd has gone from euphoria in 2021 to panic in 2022 to darn near euphoric again in the Summer of 2023, back near panic levels as October set in. That has us sensing opportunity near-term.

Seasonally Strong Ahead

Seasonality historically plays a role in investing. August and September are the worst months on the calendar for stocks.

October, November and December have historically been three of the best months of the year for investors. Over the last 20 years, the Stock Market has brought positive returns 65%, 70% and 65% of the time, in those months, respectively. It doesn't always work. But with so much negativity and a 10% correction in place heading into year-end, the set-up for an oversold rally is there.

The last 3 times the S&P fell at least 1% in August and September, it bounced in October. There was an 8% October rally last year, 8.3% in 2015 and 11% in 2011. In fact, the S&P has been higher in October in 9 of the last 10 times it has lost at least 1% in August and September. There are clearly no guarantees in this business. Investing is hard, particularly with so many negative forces at play. But the Market has a way of playing with investor minds and doing the opposite of what logic might suggest. Investing requires discipline. That discipline gets tested often.



Mega-cap Tech has dominated the Stock Market this year. The Top 7 stocks have accounted for the vast majority of the 2023 gains. 90% of the S&P components are flat or down on the year. The breadth has not been strong or healthy. The Tech Titans have masked the underlying weakness below the surface. It certainly has not paid to be diversified. But that's the way it is.

We anticipate a continuation of this bumpy ride to close out 2023. There's a lot to like and a lot to be concerned about. Realistically, isn't that always the case? We're long-term investors equipped to deal with short-term pressures. We know what to do. We've been doing it for a while.