TILDEN | Capital Management

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Quarter in Review

The main topics this quarter were centered around interest rates, inflation, and recession. The Russian and Ukraine war continues with missile attacks on both sides, and even into Russian territory, but faded from the top spots. Although an errant Ukrainian missile from their missile defense landed in Poland sparking WWIII panic as it was initially reported as coming from Russia.

The Federal Reserve raised their funds rates to the range of 4.25%-4.50%, or 1.25% over the quarter. They slowed their pace of interest increases from 75 bps to 50 bps. Expectations are for the Fed to increase interest rates two more times at a 25-bps point amount in Q1 2023. Inflation (CPI) has declined in the Q4 from 8.2% to 6.45% on annualized basis. In the months of November and December month over month inflation was negative. The drop in inflation was mainly caused by reductions costs for energy and used cars and trucks. Food and shelter continued to increase.

The Fed has begun to ease up on the gas of increases to the funds rates as inflation has tapered, but for the second quarter in a row missed their quantitative tightening targets, this time by $41 billion, lower than the miss in Q3 of $72 billion. I have only read one article about this. Increases in interest rates are important but reducing the Feds balance sheet by a trillion dollars a year is a much bigger story, and they keep missing! So far in January they have reduced the balance $80 billion (95 is the monthly target), we will see on Thursday how much they reduced on February 1st of this year, which just so happens to be the same day as the funds rate announcement.

Other central banks also started to slow the rate of their interest rate increases. In October the bank of Australia only raised interest rates by 25bps while the central bank of New Zealand raised by 50 bps. The ECB raised 75bps in October and then 50bps in December also slowing its pace. But the big shock came in December when the Bank of Japan allowed its 10-year bond to rise from 25 bps to 50 bps, a possible flinch to the foreign exchange pressures. The Fed, ECB and BoE all have meetings in the beginning of February.

The UK had a bang-up October for politics and the BoE. PM Liz Truss dopped her plan for tax cuts on October 3rd, on the 6th Fitch lowered the UK credit outlook to negative, on the 11th the BOE said it would extend its emergency gilt buying program to stave off pension failures, only to state a day later it would end the program that Friday the 14th. Then on the 19th the BOE stated that is will start its bond *selling* program in November but would exclude long dated gilts at first. And to top it all off Prime Minister Liz Truss resigned on the 20th. Oh, and the UK has 10.50% annual inflation and a 1.9% GDP.

In late October the Hang Seng index saw biggest loss since 1994 after Xi Jinping stacked the leadership ranks with his loyalists, ensuring anti market policies could easily be enacted. Then in November China ordered a seven-day lockdown for iPhone City, the plant operated by Foxconn. By late November their Covid Zero policy was still in effect as a city near Beijing closed schools, locked down universities and asked residents to stay home for five days. Covid cases continued to spike as they were trying to relax measures. Violent protests erupted in China's iPhone city as workers fled the lockdown and clashed with police, in late November. Protests continued for several days, deemed the most significant since Tiananmen crisis more than 30 years ago. These protests could reduce iPhone production by 6 million units over 12 months. Several days into December China starting to ease Covid restrictions in response to the protests and economic downturns, but within a week after relaxing them Covid rapidly spread through Chinese households and offices. Instead of staying home most people went to hospitals eventually overwhelming them. Early January economic data is pointing to a recovery in China, but the finance community has historically taken their data with a grain of salt.

In corporate news major tech firms missed their earnings estimates in late October, while banks had very good quarter, with caveats that they expect credit losses are on the horizon. On the 28th of October Elon Musk completed his $44 billion purchase of Twitter and fired Parag Agrawal the CEO among other top executives. On the same day Amazon fell 21% in after-hours trading and another 14% in premarket trading after a disappointing earnings report. In early November Twitter laid off about 3700 people or about half its work force, Lyft planned to lay off 13% of its workforce or 683 people, Meta (Facebook) is planned on firing thousands of workers, while Amazon and Apple looked to pause hiring. Also in November, CVS, Walgreens and Walmart agreed to pay more than $12 billion to thousands of state and local governments accusing the chains of mishandling opioid painkillers. Credit Suisse was downgraded to one level above junk and Maersk shipping said that demand will shrink by as much as 4% in 2023 year. Walt Disney shares jumped 10% in pre-market trading after Bob Iger replaced his successor Bob Chapek as CEO. He will serve for 2 years. Disney's stock has declined 41% in 2022. Chapek will leave with $23 million in pay and benefits.

The last piece of news almost not worth mentioning is another part of the Crypto world evaporated. Sam Bankman-Fried, now awaiting trial on an 8-charge criminal indictment which he could face up to 115 years in prison, lost Billions of investor money via his FTX crypto exchange and its investment arm Alameda. To add insult to injury a hacker stole 288 million from FTX in November and it now is sitting in Ether while bankruptcy proceedings began.

PS: as of the end of November total debt of households, businesses and governments stands at $290 trillion worldwide, and interest payments will just increase as central banks continue to raise interest rates.

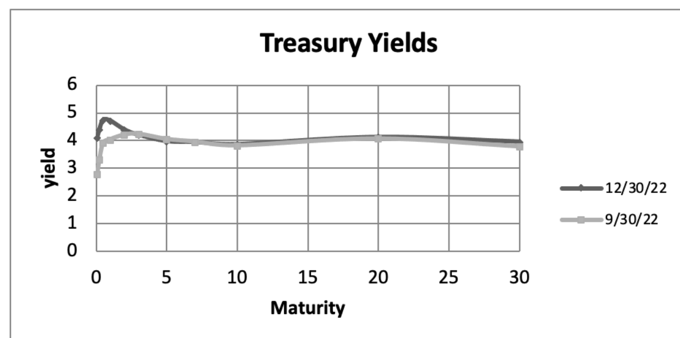
Markets

Equity markets finished the year in the red, with US large cap value performing the best down -7.5%. Mid and Small cap performance was -12% and -14.5% respectively. Non-US developed markets value performed the best overall, down only -4.95%, but large cap emerging markets were the worst in the equity space down just over -20%. With interest rates rising long duration bonds were down more than the past 34 years. Long bonds were down over -27%, with medium term bonds down about half at -13%. Short term bonds were down only -5.5%, while TIPs and High Yield bonds were down about -12%. Global bonds were down close to 19%, while the only positive returning bond section, 1-3 month T-Bills were up 1.5% on the year. In the alternative space Real Estate REITs were down -24.5% along with their growth equity counterparts. The star performer for the year was Commodities, up 18.8% for the year.

Interest Rates

The **Fed's balance sheet fell $244 billion during Q4 to $8.4 trillion, short of the $285 billion target.** The Fed has said their terminal rate will be closer to 5% now. The Fed fund rate currently stands between 4.25 and 4.5%. They will likely increase by another 25 bps in each of their next two meetings and then hold. The front end of the Treasury curve rose along with the fund rate increases for the quarter, with the one- and three-month T-bills up over 1%. But anything over a 2-year note didn't move. The market is saying not only with the Fed stop increasing the Fund rate but will start to cut sooner than they planned. Although the 2s-10s spread finished the quarter at only -53bps, 14 bps lower from September, the inversion of the curve reached -84bps in early December, it now stands at -69bps at the time of this right up. Negative spreads have signaled the coming of a recession, but not as quick as after the curve normalizes after an inversion. Ten Year bonds have been well bid into the new year (currently 3.52%) while the 2-year has remained almost the same (4.20%) since September, causing the increased inversion. Historically the curve normalizes with the front end dropping. I have not witnessed the curve normalizing by the back-end steepening more and the front end remaining intact. Let's pray this time isn't one for the history books!

Years	12/30/22	9/30/22	Difference
0.08	4.12	2.79	1.33
0.24	4.42	3.33	1.09
0.5	4.76	3.92	0.84
1	4.73	4.05	0.68
2	4.41	4.22	0.19
3	4.22	4.25	-0.03
5	3.99	4.06	-0.07
7	3.96	3.97	-0.01
10	3.88	3.83	0.05
20	4.14	4.08	0.06
30	3.97	3.79	0.18



The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 6.42% at the end of December, down 28 bps from September. The 15-year conforming balance rate 5.68% at the end of December, down 28 bps as well from September. Freddie Mac stopped providing 30- and 15-year points and the 5/1 arm rate as of November 17, 2022 and changed their methodology. (https://www.freddiemac.com/pmms) It is now based on thousands of applications they receive from lenders, instead of the traditional lender survey. This change in methodology looked like it accounted for a 40-bps reduction in rates on that day. **At the time of this write up though, 30-year FRM now stands at 6.13% as housing has cracked and house prices have started to decline.**

Leading Economic Indicators

The Conference Board's leading economic indicator (LEI) stood at 110.7 in December, now down for the past 9 months in a row. The bulk of the fall is coming from the non-financial components of the index, Consumer Expectations for Business Conditions, new orders, and building permits. Their expectations for 2022 GDP of 1.5% fell short, as preliminary Q4 numbers show us up only 0.96%, a substantial miss. The CB Coincident indicator is now at 109.3, climbing but at a much slower rate. The CB Lagging indicator stands at 117.9, still climbing at a pretty good clip. January will probably see a reversal in the LEI as stocks have rebounded, but the new orders reduction my offset some of this. Claims continue to fall so this as well should either increase the LEI or at least not detract from it. I believe that this will only be a one-month anomaly it should continue its downward trend in February.

Jobs

Nonfarm payrolls for Q4 were up 742k or 4.5mm for 2022. Historically the US has been known for relatively clean economic data, although there was an occasional questionable data point here and there, but nothing was so blatantly wrong, or potentially biases like some emerging market data. **However there has been a rather large divergence between the Payroll and Household surveys this year of over 1.3mm jobs created.** What seems to be happening in the payroll data is the double counting of people as they start multiple jobs, but the birth death adjustment seems to be consistently adding jobs during a time when people are getting let go. You can see this is the Challenger & Christmas Job cut data as an ever-increasing amount of people are being fired. Temporary help services peaked in October and have been receding ever since. Unemployment claims have been in the low 200ks for all of Q4 (maybe techs have nice severance packages). Something is wrong with the unemployment data, and whether it is purposedly being manipulated or simply caused by ineptitude I cannot determine. My guess is a very larger adjustment will need to be made in the next quarter, probably after the Fed has finished its rate increases.

The JOLTS report for December showed 11.012mm jobs available, retracing its Q3 losses. This is still about 4 million jobs available that weren't there prior to the pandemic. Since the Nonfarm payroll amounts are now above

the pre-pandemic levels, where did those jobs come from? Are the Nonfarm numbers wrong? The hire rate in December was 4% where the turnover rate was 3.8%.

Manufacturing added 50k in Q4 and was revised up Q3 by 4k to 90k. All in for the year we added 379k in 2022 and have begun to stall. My prediction that we would start to see a reduction in nonfarm in Q4 didn't happen, but it did in the household survey. Manufacturing only hired 16k people in November and December. And with the latest ISM survey now out this could stall even more. As with most information now I am more and more concerned with bias and lack of objectivity. Give me the data and let me decide how to interpret it.

Industrial production

Q4 IP was down -1.33%, compared to the revised lower Q3 number of 0.85% and second revised Q2 number of 0.36%, both down about 15 bps. Each month in Q4 was negative. **Capacity Utilization fell to 78.75% as of December** like IP also declined in each month of the quarter. **Durable Goods Manufacturers' New Orders were up 4.5% in the quarter**, due almost completely from transportation orders. December was the largest increase with 5.6% for new orders.

Industrial production has slowed, capacity is falling again, and with the exception of a large transportation order in December is looks like manufacturing is also slowing. Everything from the December '22 and January '23 ISM survey is either at 50 or below. If we aren't already in a recession, we should be by the end of Q2 '23.

Housing

New home sales were at 616k per year to end December, recovering slightly from the revised 550k number in September. We are still below the long-term average, but I am surprised at the rise given where interest rates are. The Case-Shiller composite 20 city home price index was up 6.78% ending December on an annual basis and has been falling since its April high of 21.22%. This index last went negative in in March of 2012, over 10 years ago. The National Home Buyers Index continued to fall from 46 in September to 31 in December, although January saw some respite climbing back to 35. Housing starts fell throughout Q4 2022 to 1.382mm over the past 12 months, with single family home starts near 909k, but climbing through the quarter, from the 800k level. I am not convinced the housing bubble is close to bottoming, even though mortgage rates continue to decline. The 30-year mortgage rate is now 1.25% above the Fed Funds rate, and like the 2-10s treasury spread has been a decent predictor of coming recessions over the past 40 years.

The Consumer

The **Conference Board's consumer confidence index 108.3 in December,** slightly up from September, while the **University of Michigan increased to 59.7.** Both indexes are up for the quarter, but consumers are expecting a recession this year. **Retail Sales were down 1% in Q4**, not too unexpected as stimulus money has run out. Consumer credit has had a banner year. December won't be out until early February, but YTD shows us up **$326 Billion,** (145 billion in revolving and 180 billion in non-revolving). This should exceed any of the past ten years by close to a **$100 billion.** And no one is worried at all. The personal savings rate 3.4%, up from September low of 2.4%, but nowhere near the long run average of 8.9%... Personal Income less transfers expand a whopping 0.25% for the year of 2022. I will reiterate from my last write up that I think the consumer is tapped out, highly leveraged, and praying for a stock market rally to cover their margin calls. With all the tech sector job loss who is going to buy all those soy lattes now?

Inflation

October – 7.75%, November – 7.11%, and December – 6.45%

Looking at CPI, OER (owners equivalent rent) remained the largest contributor to inflation, followed by transportation services (motor vehicle maintenance and insurance), and then by food at home. Those areas that helped reduce the annual inflation number were used cars and gasoline. **PCE declined to 5% in December peaking at just under 7% in June.**

The majority of decline in used cars came almost entirely in the fourth quarter of this 2022 at an average of -2.6% per month. Looking at the Manheim used car index, the declines have stalled and turned into appreciation again. This may take a month or two to work into the CPI numbers. Gasoline and fuel oil was flat for January, so unless food, shelter and transportation services start to decline substantially we may just see a much smaller decline and possibly an increase to CPI for January. If that happens all hell would break loose and the Fed would look to continue to increasing interest rates, maybe even another 50 bps at the March meeting.

In Closing

I have become even more disillusioned with the US securities markets and the information services that our federal governments provide. Whereas most seasoned finance professional, who have been through several recessions and downturns in the securities market, understand the irrationality of the markets and that they are behaviorally driven, this time around the inmates seem to be running the asylum.

We increased the money supply by over 6 trillion dollars in 2 years, that is 40%. It took 2010 to 2020 after the great recession to match that, and from 1983 to 2010 before that. The Feds balance sheet grew 5 trillion dollars over the same time period. At the current rate of reduction, it will take them 5 years to get back to the bloated balance sheet from whence they came! With inflation high we are now reducing the *real* money supply (purchasing power) at a greater rate than we have in decades. The Fed continues to exacerbate the volatility in US and world economies.

The Wilshire 5000 is STILL 150% of GDP, down from 200%, and the Shiller PE Ratio as of the time of this write up is still 30… median 15.91. The only reason that inflation peaked at 9% was that the bulk of this money is sitting in securities and not the hands of the populous. We saw very well what happens when congress prints checks, and now credit card debt is rocketing because people are trying to sustain their standard of living while everything (except used cars) costs more.

Stocks have rallied hard in January of this year after a tough year last year, and just Wednesday after the Fed chair's comments were deemed dovish as he downplayed the loosening financial conditions, the market threw up all over itself in a panic bid. There is still too much money outstanding and investors tripping all over themselves to get back in before the pivot.

I started to lengthen the portfolios' duration out in late December and should finish sometime in February (out of floating rate bonds and into long duration). I am obviously not sold on equities yet for all of the above reasons. I recently reread Seth Klarmen's twenty investment lessons of 2008, a forgotten list from a forgotten time. The list also includes ten *false* lessons, the last two about the government (aka the Fed) and its (in)ability to control short- and long-term interest rates and that they will always rescue markets. If you get a moment look it up. The list ends with a great quote about economics from Friedrich Hayek a famous Austrian/British economist (https://en.wikipedia.org/wiki/Friedrich_Hayek). Emphasis mine.

"The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design. To the naive mind that can conceive of order only as the product of deliberate arrangement, it may seem absurd that in complex conditions order, and adaptation to the unknown, can be achieved more effectively by decentralizing decisions and that a division of authority will actually extend the possibility of overall order. Yet that decentralization actually leads to more information being taken into account."