04/21/23

Quarter in Review

January began with Congress' inability to elect a speaker of the house. Despite having the majority, Kevin McCarthy the heir apparent, was unable to convince a group of lawmakers until a 15th vote, that he was the correct choice. Also in politics, the president's aids discovered more classified documents in his possession at multiple locations. China sent a spy balloon over the US, who later shot it down. Question being why didn't the US military recognize the threat earlier and prevent it from entering US airspace and taking images of sensitive military sites? Lastly Japan and the Netherlands agreed to join the US in limiting China's access to advance semiconductor machinery.

On the economic side, Goldman Sachs will reduce its workforce by 6.5%, BOA will pause most hiring except for critical roles and Alphabet (Google) will also cut 6% of its workforce as well. The short selling Hindenburg Research firm release a report siting market manipulation and accounting fraud by companies owned by Gautam Adani, Asia richest man. Over the next several weeks Adani bonds were no longer accepted as collateral at CS and Citi bank, a 100% subscribed stock sale was pulled in the 11th hour, and total market value losses were over $100 billion and bonds were trading in distressed levels.

In the beginning of February Turkey had a 7.7 magnitude earthquake causing billions in damage and claiming the lives of over 57k people. This is the sixth deadliest natural disaster in the 21st century. In Russia, plans to cut March oil production by 500k barrels a day was in response to western price caps. This comes after the already 2 million barrel a day cut by OPEC in late last year. Also, Putin vowed to continue the war in Ukraine now entering its second year. The statement came a day after the US president made a surprise trip to Ukraine. Lastly China told state owned firms to phase out using the big four international accounting firms.

On the corporate side in February Credit Suisse postponed bonus announcements, after already cutting bonuses by 50% this year. Two days later CS shares sank after the lender reported a fifth straight quarterly loss and unprecedented client outflows and warning of a substantial loss in 2023. This would prove to be the canary in the coal mine as CS would eventually fail and UBS would be forced to purchase them for pennies on the dollar. Also, in February Ford made plans to cut 3800 jobs, 2300 in Germany and 1300 in the UK. Just over 2% of its global work force. Since 2018 Ford has cut 30k jobs or 15% of its work force. Finally in February Columbia Property Trust (owned by Pimco) defaulted on 1.7 billion in mortgages on seven buildings in four major US cities. This will be the beginning of a bigger problem in both CMBS and REITS later in the second quarter or half of this year.

The major news for the quarter happened in March with multiple bank failures to include Credit Suisse, Signature Bank and Silicon Valley Bank and Silvergate. Harris Associates, a major Credit Suisse shareholder sold its entire

stake in the lender in the beginning of March. Silicon Valley Bank (SVB) began to collapse as Peter Thiel's Founder Fund told portfolio businesses to pull their money from SVB. On the 10th of March Regulators seized the bank. But bank bailouts are back in style as three days later the Fed, Treasury and FDIC said that ***all*** of depositors' money from SVB would be guaranteed. The largest US banks saw a large influx of depositor cash, for example BOA took in $15 billion in deposits. This obviously pales in comparison to their total deposits (2 trillion for Chase, and 1.9 trillion for BOA), but is still not a small amount for small and medium size regional banks to lose. On March 13th regulators seized Signature Bank. Three days later First Republic Bank was cut to junk by the rating agencies and was looking for a buyer. Instead of the FDIC seizing this lender as well, CEOs of 11 other banks agreed to deposit $30 billion into First Republic Bank. The stock price has not moved since the deposit. By mid-March, Credit Suisse won a $54 billion lifeline from the Swiss National Bank, and by the 20th UBS was forced to buy CS for $3.3 billion, but it came with guarantees and liquidity provisions. Credit Suisse AT1 (Additional Tier 1) Bonds, also known as contingent convertibles or CoCos, of CS were wiped out in the deal while equity holders would get $3.23 billion. Since the ciris started, US Banks have borrowed a combined $164.8 billion from two federal reserve facilities. Finally, First Citizens bank agreed to purchase $72 billion of SVB assets at a discount of $16.5 billion.

The end of March was dotted with several material items from charges against Do Kwon of Terraform Labs for a cryptocurrency fraud that wiped out $40 billion in market value, to the Chairman of Saudi National Bank, CS largest shareholder, resigning "due to personal reasons." But the big news of March was that Former President Trump was indicted by a New York grand jury for directing hush money payments to a porn star during his 2016 campaign.

Markets

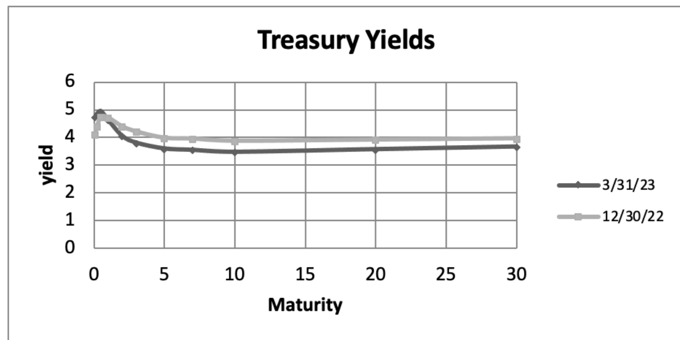
Growth Equity rebounded in Q1 with the Russell 3000 Growth index up 13.85% for the quarter. Large cap tech was the main culprit as the trade was definitely into longer duration equity as people fully believe in the Fed pivot. They are almost daring the Fed daily that they will flip and come to the rescue again, as inflation comes off the highs. Value stocks didn't perform well, as small cap value lost almost all their January and February gains in March. Surprisingly developed market Equity was up over 6% for the quarter along with large cap emerging market stock up 4.2%. On the fixed income side US long duration debt was up 5.76%, while intermediate bonds were up close to 3%. High Yield and Tips were both up over three, but this was due to stocks rising and duration, not that credit was looking better. The January rebound in REITs was short lived but were still up on the quarter 2.73%, while commodities were down -4.51%.

Interest Rates

The **Fed's balance sheet rose $154 billion during Q4. The banking crisis made short work of QT for the quarter.** Although many will state that no bonds were purchased, only credit lines were given to banks, and that money

velocity didn't rise, the simple fact was the apes were right. The first sign of stress the Fed wet itself, panicked and made promises to back everything. The Fed has increased the target rate by 50 bps over the quarter, and it looks like it will add another 25 bps in May. The front end of the curve rose again, this time as the back end came in almost 40 bps from the 2s to the 10s. Speaking of the 2s – 10s spread peaked on March 8th and has since been falling, which is typically a harbinger of bad things around the corner. I wonder if the equity market will ever catch up with the fact of the re-inversion of the treasury curve and what that means. The Fed is caught, and it knows it.

Years	3/31/23	12/30/22	Difference
0.08	4.74	4.12	0.62
0.24	4.85	4.42	0.43
0.5	4.94	4.76	0.18
1	4.64	4.73	-0.09
2	4.06	4.41	-0.35
3	3.81	4.22	-0.41
5	3.6	3.99	-0.39
7	3.55	3.96	-0.41
10	3.48	3.88	-0.4
20	3.575	3.925	-0.35
30	3.67	3.97	-0.3



The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 6.27%at the end of March, down 15 bps from December (But it peaked over 6.73 in early March). The 15-year conforming balance rate was 5.54% at the end of March, down 14 bps as well from December.

Leading Economic Indicators

The Conference Board's leading economic indicator index (LEI) stood at 108.4 as of the end of March. This is down 1.2 percent in March and down for the past twelve months. Only two of the ten components contributed positively to the index, Stocks and New Orders for consumer goods. Guess where both of those are headed over the next quarter. Non-financial components were down the most both in March and over the past twelve months, with Business conditions, ISM new orders, and building permits affecting the index the most. As credit continues to the tighten, and the consumer gets hit, this will only get worse. Looking at the last three recessions the LEI is down to levels where recessions began or were already well underway. I don't see a rebound in LEI for another 3 to 6 months depending on the Fed's actions.

Jobs

Nonfarm payrolls for Q1 were up 1.034mm, a rather larger and unbelievable number given the number of layoffs over the past two quarters. Looking at the not seasonally adjust numbers we are down about 827k jobs over the

quarter. Challenger, Gray & Christmas reported another large round of layoffs this quarter of 270k (last March the number was 56k). This was also the highest quarterly total since Q1 2020. Temporary help services reversed the down trend in January and February, but March saw another down month. The four-week moving average for unemployment insurance claims stands at 240k, with the latest report at 239k. This is higher than the 178k a year ago but still smaller than the 56-year average of 368k. (pre-pandemic shut down average was 350k).

The Jolts report for February lost over 632k job openings between January and February. It currently stands at 9931 as a preliminary number. This is almost 6% of job openings and a major month to month revision. The March numbers won't come out until early May, but forecasts are for lower by another 200k.

Manufacturing added a whopping 10k for the quarter and that was all in January. Since then, it hasn't added anything. In fact, the ISM employment numbers dipped to 46.9 in March, the lowest level since August of 2020. There are a lot of indexes that are pointing to a slow down and recession and this is one of them. I am more inclined to believe we will start to see the unemployment rate start to tick up in the coming quarter.

Industrial production

Q1 IP was up 1.53%, compared to a revised lower Q4 number of -1.98% (65 bps lower). Capacity utilization dipped below 80 again in December and stayed below that for the entire first quarter of 2023. **Durable Goods Manufacturers' New Orders** was down in both January and February reversing the entire gain in December. Looking at New Orders over the last twelve months they are up 1.6%, excluding Defense and transportation it is up 1.34%. I expect this number to drop significantly as we head into the recession.

Industrial production has regained some of its fourth quarter losses, but looking at the ISM surveys, I think we are heading toward a downturn here, and Q1 was an anomaly. Manufacturing hires have stalled, credit is extremely tight, and capex is flat to down. Industrial production should remain flat to down for the remainder of the year.

Housing

New home sales were at 640k per year to end February, up 1.1% from January but down 19% from last February. The median sales price of new homes sold in February was 438k, a 2.7% increase from January, and a 2.53% increase from last February. The median sales price in 2021 was 397k or 16% less than today. **Existing homes sales for March 2023** were down 2.4% from February and down 22% from last March. This despite the huge pop in January. As mortgage rates start to rise again is looks like housing continues to cool off. The Case Shiller 20 city index as of January 2023 was down -0.58% for the month, down -2.27% for the trailing three months, and up 2.55% for the last 12 months. House prices are starting to decline. House prices look to be in a much more precarious position than 2006. The previous rise took 15 years vs our current rise of 11. The current valuations got close to

60% more than in 2006. The previous decline took almost 6 years and ended in 2012. My bet is that it will fall a lot quicker unless the Fed steps in and buys more mortgages. The Fed currently owns about 20% of the mortgage market and are trying to decrease this amount. I won't hold my breath.

The Consumer

The **Conference Board's consumer confidence index stood at 104.2 in March**, well off the 109 of December, but off of the February lows. My bet is that this goes lower following the short-lived banking crisis in March. The University of Michigan index also rallied a bit in February but went back down in March to 62. Its preliminary April number has again started to climb. (Some points of reference, the CB number was 130, and Michigan was 100 pre pandemic lockdown.) **Retail Sales were up 1.9% for Q1**, but all of that came in January. Most recently we saw this number fall by 1% in March. Turning to consumer credit, February saw the smallest increase in total and revolving credit since early 2021. The sheer amount of debt taken on in 2022 eclipses any yearly increase in the past decade by at minimum 44%. As interest rates rise, the debt burden will become too great on many households that have replaced stimulus checks with credit cards. The consumer will start to default on both mortgages and credit cards over the next six months.

Inflation

January – 6.41%, February – 6.04%, March 4.98%

CPI continued to fall in Q1 on a year over year basis. The main reason for March's large decline was the energy sector. The issue, and the main reason the Fed will not stop hiking in May, is that core CPI hasn't moved since December. It has been stuck at 5.6% as shelter only begins to slow down. With energy rising again in April, the CPI number should probably pop above 5% again. The decline in medical services and used cars aren't enough on a weighted average basis to really dent Core inflation. Unless rents start to come down drastically, we are going to be stuck at a low 4% inflation rate for a while.

I think the Fed believes that core is stuck, and despite the mini bank crisis they will get to their 5.25% target on the fed funds rate come hell or high water. The question becomes when they pivot and start to decrease again. The market is convinced that it happens before year end as we start to head into another recession.

In Closing

The Fed flinched this quarter as three US banks went under, and depositors shifted money from regionals to majors. Credit Suisse's demise should not come as a shock to any of us, after years of mismanagement and an ethos stuck somewhere in the late 80s to early 90s. Hubris kills as quick as ignorance. And now as the next real economic event is prepared in one of the three major rings of the circus, the clowns will entertain us with the infamous Kabuki debt ceiling theater. As the total debt continues to grow and interest rates continue to rise, inflation won't be able to eat away at the value of the debt quick enough. Default may not be possible, but the de-dollarization in the world economy is. And thus, the US' ability to fund its consumption will either be far less in quantity or far more expensive than before. For the first time in a hundred years has the currency been challenged. Economic sanctions, of countries that don't play ball, have been avoided, the seizing of the reserve currency has not had any of the effect the west was hoping for, and polarization of the world has become real. These are tangible, non-financial product problems that most of our leadership is ill equipped to handle, similarly to the pandemic response.

The rally in equities has enabled the Market Cap to GDP ratio to sit at 150% the same as in December (and the height of the dot com bubble). The Shiller PE Ratio is still at 30… nothing has changed in equities. And why should it, the Fed hasn't meaningfully reduced its balance sheet. Financial conditions are tighter yes, but if unemployment doesn't tick up, people can still limp along and pay the minimum required balance on their credit cards. They can still buy those 55 inch $200 TVs.

I have completed the lengthening of duration in the portfolios. I currently hold about 30% of the portfolios in long duration assets, 60% in floating rate debt and rest in volatility and cash. The portfolios are yielding around 4.35%. If either the stock market takes a much need punch in the nose, or the Fed capitulates and starts cutting I will rotate out of floating rate bonds and into equities again. I am in no real hurry here; we are heading into a recession and despite their best efforts the Fed will not orchestrate a soft landing with all the geopolitical chaos. It will all end up looking like Elon's SpaceX Starship after a couple minutes of test flight.