02/14/2024

Quarter in Review

The fourth quarter's headlines focused on the attack on Israel by Hamas, and the subsequent bombing and invasion of the Gaza strip. The Federal Reserve was also a key focus as their language changed dramatically over the quarter regarding rate cuts. For the first time since 1910 the speak of the house was successfully removed and replaced three weeks later. Headlines about China, the Yen and the Argentina election rounded out the news along with several key corporate events.

On October 7th, 2023, Hamas led an attack on both military and civilian targets in Israel that bordered the Gaza strip. The attacked killed over 1,100 people and 150 people were kidnapped, including women, children, and infants. The initial spike in oil prices returned to an $80 handle by the end of the month, fell further in December and stabilized near $70 for crude and $76 for brent by year end. Yields on the 10-year initially fell but climbed again. Only in November did we see the 10-year treasury rate decline substantially touching 3.8%, a level not seen since July 2023. The Israeli concern then and now is for a broader war, and on the 11th, Hezbollah fired missiles from Lebanon. On the 13th of October Israel ordered the evacuation of Gaza city within 24 hours, signaling more bombing prior to a ground invasion. On the 18th the US President's meeting with middle easter leaders was rebuffed as the bombing of a Palestinian hospital sowed outage throughout the region. It was later discovered that in fact a misfired Hamas rocket was the cause. Over October the US moved two carried groups into the region to suppress any possibility of the war spreading in the region. At the same time Islamic Revolutionary Guard backed groups attacked US bases in Syria and Iraq over 100 times. In late November a truce saw a prisoner exchange of Israeli and Palestinians in a one to three ratio. The truce didn't hold, and fighting resumed on December 1st. Houthi rebels in Yemen launched a series of rockets, intercepted by US Naval forces, at Israel. They have further attacked commercial vessels trying to transit the red sea. 14% of the worlds trade goes through this trade route. Even with the US Navy's vessels there, and attack on inland rebels, the Houthis have remained undeterred. With the War in Ukraine now close to two years old, geopolitical risks are higher than they have been this century. Economically the world has already started to bifurcate, more regional conflicts could, and have in the past, led to larger conflicts. The relative calm in the marketplace and economies is somewhat unsettling give the implications of war that spreads.

Moving now to the Fed, in early October the Cleveland Fed President was quoted saying that the Fed would likely have to raise rates one more time during the year. At the time CPI was at 3.7% and PCE was at 3.37% for September. In November the Fed held rates where they were as October saw a 40-bp decline in both the annual inflation numbers. But the fireworks were reserved for the December meeting when they held rates again but released their forward interest rate forecast showing 75bps of cuts in 2024. Both the stock and bond markets rallied. Fed funds futures showed 150 bps in cuts, which flew in the face of an economic soft landing. On a side note, the central bank of Norway was one of the first to start increasing interest rates and will probably be the last to stop, as it increased interest rates again in the middle of December to 4.5%.

In other domestic news Kevin McCarthy was the first speak of the house to be removed from this position by a motion to vacate in history on October 3, 2023. It was started my Matt Gaetz after McCarthy's passage of a continuing resolution on the federal budget. It took until October 25 to elect the next speaker, as Steve Scalise, Jim Jordan and Tom Emmer were all passed over for Mike Johnson from Louisiana.

China has been struggling to prop up an imploding real estate market. In early October its sovereign wealth fund bought stock in some of the country's largest banks trying to shore up their balance sheets. As of the end of October their factory activity fell back in contraction and stayed there for the remainder of the quarter. In December Moody's put China's bonds at risk for a ratings downgrade. As if their stock market needed more help going down, China released rules limiting the ability game companies to encourage players to spend more time and money playing games. Major game firms stock plummeted. Over the quarter the Shanghai Composite Stock Market lost close to 3.75%, and as of this write up is down more, albeit off the lows after major injections of money by the Chinese government.

The Yen lost about 6% to the US dollar in 2023 (over 17% down since the US started hiking interest rates). Since 2016 the BOJ has kept their interest rate negative, despite the rest of the world hiking their interest rates. This despite their inflation rates climbing to over 4% at the end of 2022. Interestingly the BOJ has allowed the rate on its 10-year bond to drift higher from near zero at the end of 2021 to a high of 90 bps on October 30th but finishing the year closer to 60 bps. The BOJ owns roughly 54% of all Japanese government bonds. In contrast the US Federal Reserve owns somewhere close to 20%, up from 9% in 2008. The National debt has risen 3.4x over the last 15 years, but the Fed's holdings have risen 8.6x over the same period.

In late November Javier Milei (a libertarian) won the Argentina's presidency. He has stated he would like to replace the peso with the US dollar and cut public spending. The central bank has almost run out of reserves to prop up the peso. To date he has not switched the country's currency to the US dollar.

On the US corporate side of life October had UBS stating it would cut 10% of its support staff, while Barclays was looking to cuts costs as well. As of the end of October X (previously twitter) was valued less than half of what Musk paid for it, as half of the firm's advertising revenue is gone. In the beginning of November Sam Bankman Fried (founder of FTX cryptocurrency exchange) was convicted of a massive crypto currency fraud and found guilty on seven counts of fraud and conspiracy. The sentencing hearing date will be on March 28, 2024, where he faces up to 110 years in prison. Also in November, after just 13 years in business, WeWork filed for bankruptcy. At one point the stock saw a $548 price, which is now valued at just $0.16 per share. One industry that did see a positive comeback in 2023 was the Airline industry which was able to generate $23.3 billion in revenue last year. International carries will probably continue to do well into 2024 while domestic carriers will struggle with delays, increasing labor costs, volatile fuel costs and congestion, not to mention the grounding of 737 Max. Bitcoin had great 4th quarter up about 58%, and 165% for the year. Still not sure how to classify this asset, doesn't have cash flows, no property as collateral, can't use it to fill up my car, or pay my mortgage, and still wonder when the Central banks or Governments deny it access to the rest of the financial network. In early December Epic won a court battle with Alphabet, which could hurt Apple and Googles ability to charge commissions to game developers. Also, in December Citigroup decided to shutter both its Municipal and Distressed debt desk, this will remove liquidity from both markets.

Markets

Not too surprisingly, after the Fed said they are cutting rates in 2024, but REITs performed the best in Q4 up 16%. This was followed by small cap value stocks up about 15%. Small, Mid, total market growth followed all up about 14% for the quarter. The clear equity winner for the year was growth stocks as the Magnificent 7 market value is now an unprecedented 29%. The S&P 500 was up 26% last year, but the equal weighted index was only up 12%, while without the Mag 7 the index would have been up 8%. Developed Markets and Emerging markets both had respectable 8% years. In Bonds the Long duration index was up over 13% for the quarter but on 7% for the year, while the Barclay's Agg was up around 7% for the quarter and only 5.5% for the year. High yield had a very good year up 13.76% with over half of the return coming in Q4. Global bonds which were down 3.2% for the first three quarters of 2023 rallied over 9% in Q4, and 5.72% YTD. Commodities were down the second worst in the quarter and year, -4.19% and -10.07%, only to be above volatility which collapse -28% for the quarter, and down -43% for the year.

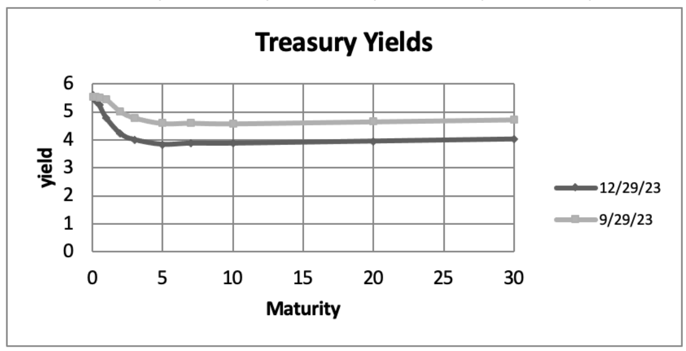
Interest Rates

The **Fed's balance sheet was down to $7.7 Trillion as of the end of December.** This was $290 billion less than September and $838 billion for the year. Not the $95 billion per month in Treasuries and mortgage-backed securities promised, more like $70 billion or $25 billion short, per month. Year-to-date they have only reduced it by $81 billion and we are already into February.

An interesting observation is that as the Fed is removing this liquidity from the market and both reserves and M2 are climbing. The best explanation I have read is here (https://wolfstreet.com/2024/01/19/feds-balance-sheet-qt-liabilities-rrps-1-78-trillion-from-peak-to-590-billion-but-reserves-rise-to-3-6-trillion-as-liquidity-drains-and-shifts/). Wolf Richter explains that banks are gaming the system (shocker I know). The Bank Term Funding Program, set up in March of last year to provide liquidity to ailing banks, is now being used as an arbitrage. They can borrow at the BTFP at a lower rate, and then deposit those funds in their reserve accounts at the Fed and make the spread (roughly 60 bps when the article was written at the end of January.) The money never leaves the Fed, this is shadow QE. So, although reserve balances have fallen since December 2021, they are going back up again from money essentially "created" at the fed on collateral that has fallen in price since the Fed has been raising rates. So once again a bank bailout just an invisible one to the common person on the street.

The December Fed meeting led to most of the market fireworks, but spreads began reversing any Q3 widening earlier on. Spreads came in around 75 bps from the 2-year and going all the way out to the 30-year

Years	12/29/23	9/29/23	Difference
0.08	5.6	5.55	0.05
0.24	5.4	5.55	-0.15
0.5	5.26	5.53	-0.27
1	4.79	5.46	-0.67
2	4.23	5.03	-0.8
3	4.01	4.8	-0.79
5	3.84	4.6	-0.76
7	3.88	4.61	-0.73
10	3.88	4.59	-0.71
20	3.955	4.66	-0.705
30	4.03	4.73	-0.7



As of December, the 2-10s spread was at 35 bps, not the October 15 bps, but still not widening out again.

The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 6.61% at the end of December, down up 60 bps from the September number, but it peaked at 7.79% at the end of October. The 15-year conforming balance rate was 5.93% at the end of December, down 79 bps as of the end of September, and peaking in the end of October 7.03%. Since January though mortgages rates have since held relatively steady.

Leading Economic Indicators

The Conference Board's leading economic indicator index (LEI) stood at 103.1, down 2.9% over the past six months and over 7% for the year. Although the rate of decline is less, the LEI is still in negative territory. What the confidence board is obviously worried about here, is if we don't head into a recession then the predictive power has declined significantly for the index. Are the weights wrong, the underlying data points or a combination of the two. The coincident indicator is currently at 111.7, and unlike the leading index, it expanded 1.1% over the second half of the year. The Lagging indicator moved to 118.4 declining again but up 0.6% over the past six-month period and over the past 12 months.

Jobs

Nonfarm payrolls for Q4 were 680k, after the annual revision in January. This is up almost 3.056 million jobs for 2023, in contrast to the household survey which is only up 1.9mm. This compares to a nonfarm (establishment survey) gain of 4.5mm in 2022 compared to a household survey of only 3.1mm. The two surveys differ in many ways (https://www.bls.gov/web/empsit/ces_cps_trends.htm#concepts), but the adjusted household and payroll surveys have been really close since about 2004. The financial industry has been concerned with the quality and timing of some of the data, in leu of many other hard data points that are flashing recessions. As it stands now, the payroll survey is 3.4 million jobs higher than the adjusted (https://www.bls.gov/web/empsit/ces_cps_trends.htm#adjusted) household survey. Although not the first time the surveys have differed and not the largest, investors are losing faith in the most widely watched US data point. In fact, the January job's report just reported this month was 4 sigmas greater than the consensus.

Temporary help service contracts 53k jobs in Q4 and 212k jobs for all of 2023. The participation rate declined to 62.5 but the yearly average was 62.6, still lower than pre pandemic, and not moving a muscle. So, the only way we can have flat participation rate and increasing employment is either 1) the jobs numbers are made up, or 2) the base is expanding... and how would the base expand if birth rates have been in decline or flat since 1950 you ask. (https://www.bls.gov/opub/ted/2023/foreign-born-workers-were-a-record-high-18-1-percent-of-the-u-s-civilian-labor-force-in-2022.htm).

The JOLTS report for December shows there were 9.0 million jobs available down another 324 thousand jobs since September and down over 2.2 million jobs over the year. (Remember the response rate for this survey is 32%). Since 2013 the average number of jobs available were in a range from 5 to 7.5 million jobs. This lasted all the way until the pandemic. And then in 2021 they exploded higher to over 11 million jobs available. Since January of 2021 the response rate on the survey began to drop substantially while during the same time the number of job openings increased. However, as of July 2022 this response rate has not increased while the jobs openings have continued to fall. The question for me then is whether the BLS has been able to better estimate the job openings with less data or are these numbers still not an accurate representation of availability in the marketplace. Anecdotally, firms don't seem to be hiring as much, and in fact are letting people go, so it begs the question, how accurate really is this data.

Manufacturing added 2k for Q4 and 22k jobs for the year, in compared to 359k jobs all of 2022. Most of the striking auto workers in October came back in November. But the slowdown is obvious. Since the Pandemic manufacturing has added 200k jobs, and we are at a high not seen since the great financial crisis in 2008.

Manufacturing still only makes up 11% of GDP, and if the objective was to "onshore," more jobs in order to secure a more diversified source of goods, the economy doesn't seem that changed.

Industrial production

Q4 IP was down -0.82% but was up 0.98% for the year thanks to strong Q1 and Q3 numbers. Capacity utilization peaked in September of 2022, and fell each month in Q4 to 78.6%. This is far from the pandemic low of 64.6% and close to the long run average or 80%. **Manufacturers' New Orders** saw almost all of the sub-indexes I follow (Durable goods, Durable Goods Excluding Transportation, Durable Goods ex transport and defense, and Nondefense Capital Goods Excluding Aircraft) hit highs as of December 2023, except Durable Goods excluding defense which maxed out in 2014. All these numbers are seasonally adjusted but not adjusted for pricing, so I went back in removed the inflation portion simply using durable goods CPI (https://fred.stlouisfed.org/series/CUSR0000SAD) to see if we have indeed ordered more goods than prior to the pandemic. After inflation Durable Goods New Orders were up 9% since January 2020, Excluding Defense up 12%, Excluding transportation up 5%, Ex Defense and Transport up 8%. **Nondefense Capital Good Excluding Aircraft, a proxy for business investment, was flat or 0% over the same time period, whereas Manufacturers' new orders for consumer goods and materials was up 15%. This means that firms haven't increased their investment at all in three years while consumers have ordered more durables during the highest inflation time period in most of their lives...**

Housing

New Home Sales were 615k per year as of the end of December, the low for the year, and down 3.3% since 2022. The median sales price of house sold at 417k didn't change much from Q2 but is off the Q4 2022 high of 479k. **Existing homes sales for December were 3.78 million,** the lowest level back to 2012. Mortgage rates have slowed down the transactions for sure. Case Shiller 20 city index was up 5.1% as of November even with mortgages climbing through November. Building Permits are slightly elevated vs their long run average, while housing starts 1460, and single-family housing starts 1027 are right in line with their long run averages. So new housing is still being bought but the secondary market has collapsed. Housing affordability as reported by the Atlanta Fed here (https://www.atlantafed.org/center-for-housing-and-policy/data-and-tools/home-ownership-affordability-monitor) was slightly better in November but still well below their threshold. The drivers of this have been the increase in interest rates and price changes.

The Consumer

The **Conference Board's consumer confidence index stood at 110.7 in December**, almost the exact same level as December 2022. University of Michigan Consumer Confidence told a different story up about 10 points over the past year it was 69.7 in December, with inflation expectations the lowest (3.1%) since March of 2021. Turning to **Personal Income and Outlays**, the BEA reported that personal income was up about 4.69% for the year, while disposable personal income was up 6.92%. Personal consumption was up 5.9% for the year while the savings rate was up about 8.5%.

All these items are before inflation, so just like durable goods orders I looked at the period post pandemic without inflation. Personal income was only up 4% since January 2020, along with disposable income, and Personal Consumption Expenditures was up on 8%. Compare this with Real Personal Consumption Expenditures on durable goods was up 8.54% (or 32% since the pandemic) which aligns with durable goods orders above and with a personal savings rate of 3.7%. Looks like people really spend money on durable goods, again during rising inflation... I don't get it. Household Debt topped 17.5 Trillion in December (https://www.newyorkfed.org/microeconomics/hhdc.html) Non housing debt has grown from $2.2 Trillion in 2004 to $4.89 trillion in the past 20 years, with Student loans growing from $260 billion to $1.6 trillion, no wonder Gen Z all lives at home still. Delinquency rates are starting to rise at 9.7% for credit card balances and 4.2% for auto loans. Student loan delinquency rates have plummeted thanks to the moratorium, but this should start to rise as well now that this is over. Lastly **Total Consumer credit reports from the Federal reserve** reached 5 trillion (in line with the NY Fed). In 2021 and 2022 this increased by about 350 billion in each year. In 2023 this was only 116 billion, with 87% of the increase in revolving debt (credit cards). Will the consumer ever die?

Inflation

October – 3.24%, November- 3.14%, December – 3.35%

In the third quarter inflation started to rise again, thus spawning many Regional Fed Presidents to talk about one more rate hike in Q4. But Inflation dropped and then hung around 3.25% for Q4 and let the Fed produce a dot plot that showed 75bps of cuts in 2024. In December the CPI report showed that food continued to increase at 2.7% while Energy declined by -2%, with all sectors down except electricity. Core is why the Fed has been cautious about rate cuts and continued to preach about one more increase right up until the December meeting. With Shelter up 6.2% on the year and 0.5% in December, and Transportation services up 9.7% for the year, "sticky" inflation isn't cooling enough for the Fed to start its cuts. Especially when their quantitative tightening is being offset by an increase in reserves and M2, while the consumer seems alive and kicking.

In Closing

The December Fed meeting sealed the Santa rally, as the market anticipated 150bps in cuts in 2024, despite the Fed only showing 75bps. This might have been a bit premature as January's inflation data just came out hotter than anticipated and tanked the market (both bonds and stocks, yay correlations of 1!)

You know something has jumped the shark when Wall Street finally capitulates and agrees to start making an ETF for it. In this I mean Crypto, and as soon as Wall Street said they were in, the crypto marketplace screamed higher. It will be interesting to listen to call the crypto heads talk about how it is a good inflation hedge now, but correlation isn't causation boys and girls, and as soon as the Fed capitulates other asset classes will rebound. I wonder if the regulators will then look at the leverage amounts at some of these crypto marketplaces or whether another FTX will happen again, this time to an ETF in a bunch of 401-Ks...

My client's portfolios are back to neutral with allocations in stocks and bonds, and nothing in volatility anymore. The truth is in the model that I built 14 years ago, and I tactically destroyed my performance by not listening to it. Hubris is not your ally in this job, removing the emotion is. The allocation is there to protect against large moves to the downside, let's see how we do this year.