Doug, Ralph, (sitting) Samuel, Alexa, Michelle, Andrea and Chris (standing)

Portfolio Talk

Market Update 4/1/2022

The "R" word (Recession) seems to be more in focus this week as the yield curve shows signs of inverting. That caused us to wonder if you, our clients, understood the meaning of yield inversion. So, during times of rising inflation, one of the tools the Federal Reserve uses is increasing Fed Funds rates, the interest it charges its member banks for borrowing overnight funds (short term cash needs). As they increase Fed Funds rates it tends to increase all rates, such as mortgages, car loans, consumer credit, corporate debt and the list goes on. In the beginning of the Fed action all rates tend to rise, but at some point, the long rates begin to rise less while short rates, those influenced most, continue to rise. Why? The effect of higher rates tends to slow the economy and could slow enough to cause the economy to fall into a recession (negative GDP growth year over year). One of the signals that a recession is looming is when short rates (3 month, 2 & 5 year) treasuries have a higher rate than 10-, 20- and 30-year treasury maturities. This is called an inversion. You'll hear the term 3mo.-2yr spread, 2-10 yield spread, or the 5–30-year spread, these are all ratio's the market looks at to determine if we are headed into a recession. Interestingly, all inversions do not lead us into a recession, however all recessions are preceded by an inversion. That time lag can be as long as 2 years meaning that the interest rate increases take time to slow the economy and therefore reduce inflation.

> Analysts from Goldman Sachs and Raymond James highlighted increasing recession risk in separate notes on Mar. 23 and Mar. 27, joining a chorus of prolific money managers such as Carl Icahn, Dan Niles, Jeffrey Gundlach and more in warning of an impending recession.

This according to CNBC Pro on March 28th. They also gave the Bull case from some other strategists:

> "Curve inversion does not guarantee a recession, and our economists don't expect one. However, it does support our view for sharply decelerating earnings growth and is one more piece of evidence that says it's late cycle." — Michael Wilson, chief U.S. equity strategist.
>
> "A policy mistake that causes a recession is clearly possible, but our baseline is that an inversion without a recession is more likely." – Seth Carpenter, chief global economist.

So, there you have it, the two camps that believe so emphatically that a recession is at hand verses the other that doesn't. What's interesting is that one will be right even though they both sound logical. Which will it be? We believe a recession is probable, but not right away given the unemployment being so low, cash on the side so high ($4 trillion plus) and pent-up demand for housing and consumer products so high. These are things a growing economy are made of. However, inflation will most probably slow our growth at some point, but for now we feel growth will continue. The question is, will GDP growth be equal to or greater than the rate of inflation? If not, we could experience stagflation, a time where the economy spins it wheels and goes nowhere!

Oil seems to also be in focus given it's the currency funding Putin's war in Ukraine. What's so frustrating about this scenario is that the world let him hold them hostage due to their dependency. Case in point is Germany. Their desire to become green overshadowed their understanding that being dependent on oil and natural gas from a dictator could be problematic. They estimate that Germany's energy dependency from Russia is between 30-50% of total need. Now for every barrel of oil purchased the funds go to new armaments that kill Ukrainian citizens including children! This is the unintended consequence! Other countries are also trapped; India, Great Britain and China lead the list. President Biden has agreed to release up to one million barrels a day from our Strategic Petroleum Reserves. This along with the Presidents promise to supply 15 billion cubic tons (bct) of LNG (liquified natural gas) to Europe the remainder of 2022 should soften the imbalance, but not completely. These measures are a band aid approach to a problem that could have been avoided had those in power read the tea leaves. Putin cannot be trusted, and his word is worthless. Hopefully we'll learn from this debacle.

Economic News

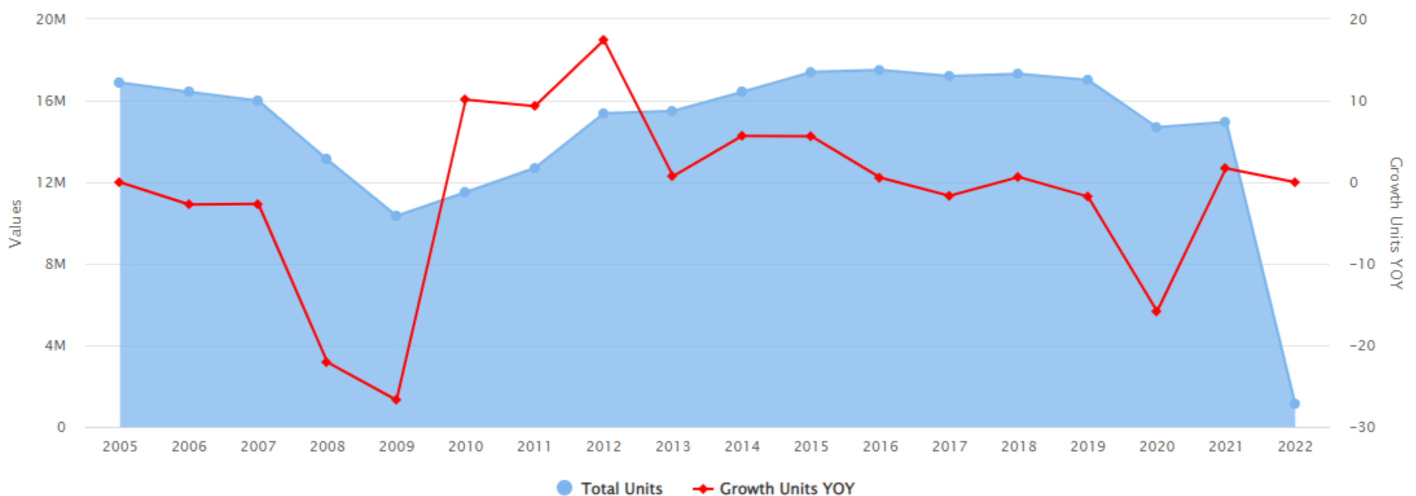
- Monday:
  - Trade in goods, advance report for Feb. -$106.6 billion vs. -$107.6 billion previously…holding steady.
- Tuesday:
  - Case-Shiller national house price index (year-on-year) for Jan. 19.2% vs. 18.9% previously…still strong.
  - FHFA national house price index (year-on-year) for Jan. 18.2% vs. 17.7%...validates the Case-Shiller Index above.
  - Consumer confidence index for March 107.2 vs. 107.5 expected and 105.7 previously…still high even with the Russian/Ukraine war!
  - Job openings for Feb. 11.3 million vs. 11.1 million expected and 11.3 million previously…staying stubbornly high!
  - Quits for Feb. 4.4 million vs. 4.3 million previously…the Great Job Resignation continues, however those resigning are upgrading their employment as evidenced by the unemployment rate at a 50 year low!
- Wednesday:
  - ADP employment report for March 455,000 vs. 450,000 expected and 486,000 previously…very good!
  - Real GDP revision (SAAR) for Q4 6.9% vs. 7.0% expected and 7.0% previously…very good!
  - Real gross domestic income (SAAR) for Q4 5.1% vs. 6.4% previously…maybe wage inflation is slowing after the initial pop.
  - Real corporate profits (SAAR) for Q4 -4.0% vs. 8.0% previously…if this persists it could be problematic!
- Thursday:
  - Initial jobless claims for March 26, 202,000 vs. 195,000 expected and 188,000 previously…within the margin of error.
  - Continuing jobless claims for March 19, 1.31 million vs. 1.34 million previously…further evidence that the job market is robust and tight!

- Nominal personal income for Feb. 0.5 vs. 0.5% expected and 0.1% previously…holding steady, but still high.
- Nominal consumer spending for Feb. 0.2% vs. 0.5% expected and 2.7% previously…slowed, but still healthy.
- PCE price index for Feb. 0.6% vs. 0.5% previously…still high and we look for this to come down with rising rates leading to reduced demand.
- Core PCE price index Feb. 0.4% vs. 0.4% expected and 0.5% previously…in line!
- PCE price index (year-on-year) for Feb. 6.4% vs. 6.0% previously…still high as all the other inflation indicators are revealing.
- Core PCE price index (year-on-year) for Feb. 5.4% vs. 5.4% expected and 5.2% previously…in line.
- Real disposable income for Feb. -0.2% vs. -0.4% previously…could be a leading indicator that inflation may be slowing?
- Real consumer spending for Feb. -0.4% vs. 2.1% previously…could be indicating that the economy is slowing?
- Chicago PMI for March 62.9 vs. 57.0 expected and 56.3 previously…this is indicating that businesses are not slowing down and are planning to expand/grow!

- Friday:
  - Nonfarm payrolls for March 431,000 vs. 490,000 expected and 678,000 previously…still solid growth!
  - Unemployment rate for March 3.6% vs. 3.7% expected and 3.8% previously…very good but showing a very tight employment market!
  - Average hourly earnings for March 0.4% vs. 0.4% expected and 0.0% previously…in line.
  - Labor-force participation rate, ages 25-54 for March 82.5% vs. 82.2% previously…still growing!
  - Markit manufacturing PMI (final) for March 58.8 vs. 58.5 expected and 58.5 previously…still indicating a growing economy!
  - ISM manufacturing index for March 57.1% vs. 59.0% expected and 58.6% previously…also showing growth.
  - Construction spending for Feb. 0.5% vs. 1.0% expected and 1.3% previously…slower than expected and previously, but not bad.
  - Motor vehicle sales for March 13.6 million vs. 14.1 million previously…slowing mainly caused by supply chain disruptions. Take a look at the chart below, woefully under previous years!

UNITED STATES TOTAL AUTOMOTIVE GROWTH CHART

Below is the unit volume sales and unit growth rate of the vehicle industry in the United States.



Source: GOODCARBADCAR Automotive Sales and Data &Statistics

So, what we're facing is a time where economic data vs. market reactions diverge. Why, because the markets try to be forward looking while the economic data tends to be real time. What this means is that we should expect choppier markets going forward while interest rate increases filter through the economy, and we witness their effect. Will we have a soft landing where the Fed can orchestrate a slowing of inflation without causing the economy to contract (recession). Or will we have a hard landing where the economy slows quickly, companies start to pullback and begin laying off employees and the economy falls fast into recession. No one knows, but the data so far does not suggest a hard landing. We'll be watching for evidence of a slowing economy and whether to implement strategic changes. But for now, we're staying the course.

Earnings will be released fast and furiously over the coming weeks. COVID seems to be felt more in China as they lockdown Shanghai vs. the rest of the world. And finally, Russia is having a very difficult time in Ukraine, and it doesn't look likely to change anytime soon. We pray for the Ukrainians!

Stay safe!

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