PCM
Peak Capital Management

Masking the Inevitable

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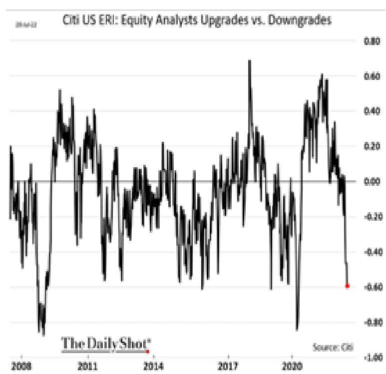
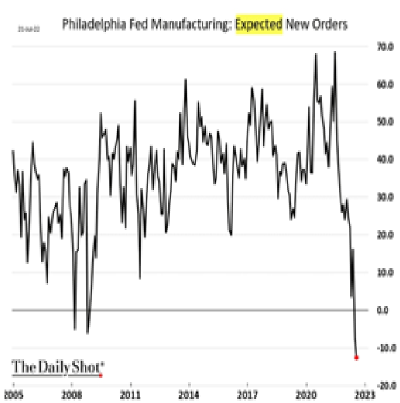
We seem to live in a world of 'disconnects' both in society and financial markets. Since the PCM Report is dedicated to the economic topics, I will keep my focus there. Our problems and imbalances today largely stem from disastrous conclusions drawn by the Fed years ago. When the Great Recession happened in 2008-2009 the Fed took never-before contemplated steps to "rescue" the economy from the abyss and avoid a Depression. In hindsight, some of those actions should be lauded for the positive impact they made.

The problem, in my humble opinion, is the Fed became power drunk on the new tools at its disposal and refused to put these new tools, only to be used in times of true crisis, back on the shelf. Quantitative Easing (QE), for example, helped get through a short-term liquidity crisis but became a mainstay of Fed policy. If the economy even appeared to faulter, the Fed did not hesitate to reenact tools (economic manipulation and repression) that should be reserved for catastrophic times. Having the power, and ability to deploy, at its fingertips led to some disastrous decision making such as categorizing inflation 2 years ago as transitory.





The economy was already strong enough to normalize rates in the more than a decade following the Great Recession, but the Fed refused to do so. The policy driven recession of 2020 caused by the reaction to Covid required short-term action but again the Fed was incapable of knowing when to take away the punch bowl. The markets were acting drunk with speculation and the Fed just kept pouring. The process of becoming sober is likely to be far more painful for the markets than a short stint at a Betty Ford clinic.

The charts above paint a picture of both concern and inevitability. In short, they are ugly and a warning as markets remain near their highs. Let me briefly break down each chart and the likely impact.

Charts show long-term averages, and you can use that data to compare against prior recessions. If you were to overlay market performance during contractions it is not pretty. Analyst Upgrades/Downgrades tend to be a leading indicator for the markets as companies provide guidance ahead of earnings reports. Analysts downgrade stocks when they expect earnings to miss expectations that typically lead to lower prices in the future. Downgrades have been falling precipitously over the last 6 months and are at levels only exceeded during the 2009 and 2020 recessions with no sign of bottoming.

> "...the Fed became power drunk on the new tools at its disposal and refused to put these new tools, only to be used in times of true crisis, back on the shelf."

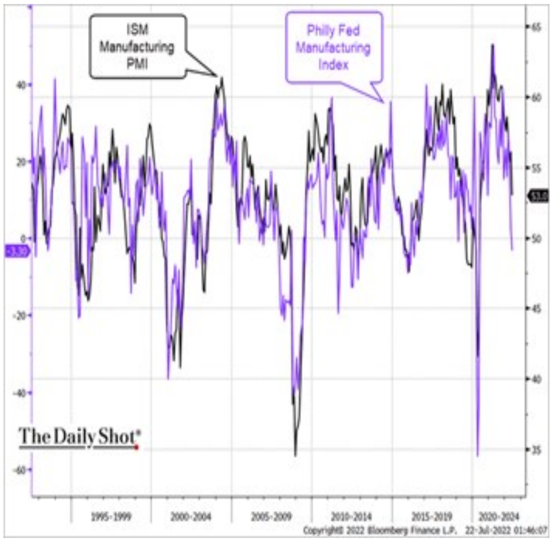
Housing is an important aspect of the economy and virtually every indicator on housing shows rapid decline. It is more of a lagging indicator of impact on GDP but a leading indicator when estimating consumer behavior. This chart shows new home sales dropping to stark levels in response to higher mortgage rates. Data for refi, a key source of consumer liquidity for spending, has fallen even more dramatically. Many homeowners are over leveraged in real estate and face higher interest rates, higher taxes, and less discretionary income for spending.

Small businesses continue to be the true growth engine of the U.S. economy and the latest results from the National Federation of Independent Business (NFIB) is troubling. The Index has fallen every month this year and has been below the 48-year average for 6 consecutive months. All 10 components of the Index are in decline and most concerning when considering what is in front of us is that owners who believe conditions will be better 6 months from now fell to -61%, the lowest level in the 48-year history of the survey.

Lastly, manufacturing the U.S. is in the midst of a massive decline even as the need to move supply chains closer to home has never been greater. The Philly Fed Manufacturing Expected Orders index has fallen to levels much worse than in 2008 or 2020. New Orders, Conditions, Cap-Ex Spending all show equivalent declines in manufacturing activity.

This dire report is not to suggest the world is coming to an end but rather to warn investors not to become complacent simply because the market has so far been resilient. Markets often remain resilient right up to the point they are not. The current Administration, rather than dealing with the imbalances and economic problems facing Americans, is choosing to try and redefine what a recession is and put lipstick on this economic pig.

Collapse of Manufacturing



The decline of manufacturing happening in the economy is briefly highlighted in the Introduction of this report. That chart showed the Philly Fed Manufacturing index, but data geeks might have questioned why we did not refer to the more widely followed ISM Manufacturing PMI. It is true the ISM index has not fallen as far as the Philly Fed index but the correlation between the 2 data series is above 95% over the last 30 years. The ISM data has not yet fallen below the contraction level of 50 but the trend suggests that will happen in the coming month or two. There are many compelling reasons for manufacturing to be expanding, most notably to correct supply chain issues that have devastated the economy since Covid lockdowns occurred around the world.

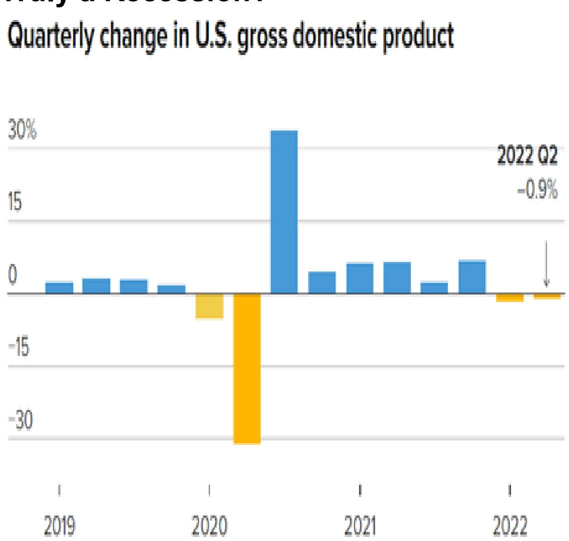
- A bit of good news in the data is the Prices Paid and Prices Received components of the survey. Both aspects had risen to levels 50% higher than seen in the last 20 years but have fallen back near 2017 levels.
- In a good news/bad news situation, Unfilled Orders have fallen dramatically from +40 to -10. This means supply chain issues are largely resolved for small business but demand has deteriorated.
- Manufacturing Cap-Ex spending is an important component to GDP forecasts and a leading indicator for employment opportunity. It is troubling to see spending expectations fall from +40 to +5.

Housing Slowdown

It is no surprise that we are experiencing a slowdown in the housing market. The cost of capital for both consumers and builders has risen considerably over the past year. With rising interest rates, the cost of a 30-year fixed-rate mortgage (see corresponding chart) has doubled to roughly 6% from the lows of around 3% at the end of 2020. Likewise, supply chain issues have pushed the cost of building supplies and labor considerably higher. Sentiment has fallen based on the National Association of Home Builders. However, comparisons to the housing collapse of 2007-08 are likely unfounded. Conditions today are dramatically different than what we experienced during the Great Recession.

- One major difference today is that lending standards are much more stringent. There are far fewer delinquencies today than there were leading up to the Great Recession. The average credit score today is much improved compared to a decade ago. Likewise, the degree of leverage is much lower today.
- Moreover, homeowners are sitting on record amounts of equity given the runup in housing prices over the past couple of years. While the rate of overall price increases may slow somewhat, we likely won't see a collapse in home valuations like we did in 2007-08.

Truly a Recession?



Source: Bureau of Economic Analysis

At the end of Q1, we saw Gross Domestic Product decline by 1.6% On July 28th, we received economic data showing second quarter GDP also declined by 0.9%. This decline marks the second consecutive quarter of negative GDP readings, commonly referred to as a recession. However, the Biden Administration is actively trying to downplay that very reality. In contrast, IMF Chief Economist Pierre-Olivier Gourinchas said, "The world may soon be teetering on the edge of a global recession" and is warning that the outlook for the economy is "increasingly gloomy". While there may be different opinions on the state of the economy, consensus is that Federal Reserve will have their hands full as they try to navigate the current economic environment to a "soft landing".

- A recession has been historically defined as "a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters."
- Last week on "Meet the Press", Treasury Secretary Janet Yellen communicated that "This is not an economy that's in recession, but we're in a period of transition in which growth is slowing".
- The drop in GDP was a result of a broad swath of factors, including inflation, decreases in inventories, residential and nonresidential investment, and government spending.

Macro View – Putin's Grip on Europe

Last week, Russian gas giant Gazprom announced that it would reduce natural gas supplies through the Nord Stream 1 pipeline. The reduction in supply is due to maintenance of a turbine along the pipeline Gazprom communicated, however, many in Europe are skeptical. Already combating rampant inflation, war in Ukraine, and troubled supply chains, Germany is now seeing natural gas flows from Russia falling to 20% of its capacity, which is already down more than 40%. S&P Global Market Intelligence noted in a report last week that "High energy costs are pushing Western Europe toward recession". Germany's reliance on Russia for natural gas is particularly troublesome as the government is growing increasingly concerned that it will have trouble keeping the lights on this coming winter. And while Europe struggles to find alternatives such as U.S. natural gas, they simply cannot replace their lack of supply fast enough.

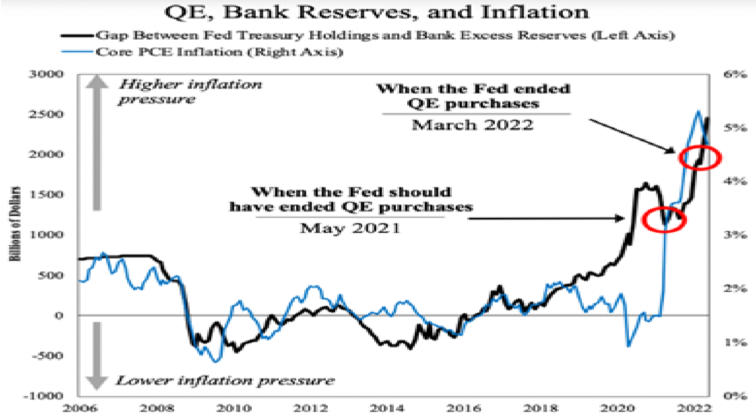
Source: Reuters

Taking Stock – Strength of the American Consumer

Despite roaring inflation, the American consumer is still strong. In an interview with Jim Cramer, Bank of America CEO Brian Moynihan communicated that "Data through last Friday basically says that for the month of July … [spending] is up about 10 percentage points from last year's July first three weeks. And the transaction growth is 6% to 7%, so that means it's growing". With the rise of the US Dollar, many Americans are taking advantage of the opportunity to travel internationally, specifically to Europe, after being restricted from doing so for more than a year. Additionally, he added that consumer's bank account balances have increased by more than 3 times since before the COVID pandemic for medium-income earners. And although inflation has been historically high as of late, consumer's cash flows still remain relatively positive.

Fixed Income – Stoking Inflation

Back in late 2020, Core PCE was 1.6%, and Federal Reserve chair Jerome Powell communicated he was becoming concerned about disinflation. As a result, the Fed purchased more than $110 billion in US Treasuries and mortgage bonds in an effort to bring inflation up to their 2% target. However, later in 2021, core PCE surpassed 2% and continued to climb. But rather than ending their bond buying program, the Fed continued to purchase bonds up until just recently. In March 2022, Core PCE came in at 5.2% and should have been a clear sign to the Fed once again to stop buying bonds. Hindsight is 20/20, but it is clear now that the Fed waited far too long to reduce its bond purchases along with raising interest rates. And unfortunately, we will now face consequences for months to come due to the Fed's failure to act.



Technical – Historical Support

In our July PCM Report, we noted that the 10 Year Treasury Yield hit more than a 10 year high of 3.483% and that equities might not "bottom" until long term treasuries began to decline. Since the high, the 10-Year has fallen more than 23% to around 2.66% while the S&P 500 TR Index has risen around 7% at the time of this writing. So, have we truly bottomed, or are there still new lows to be made on the downside? If you look at the chart below you will see the 10-Year Treasury yield going back to 1982, which is currently near a support line going back more than 40 years. It would be reasonable to believe we could potentially bounce on that support level. However, only time will tell as we continue to digest economic data and effects from interest rate hikes going forward.

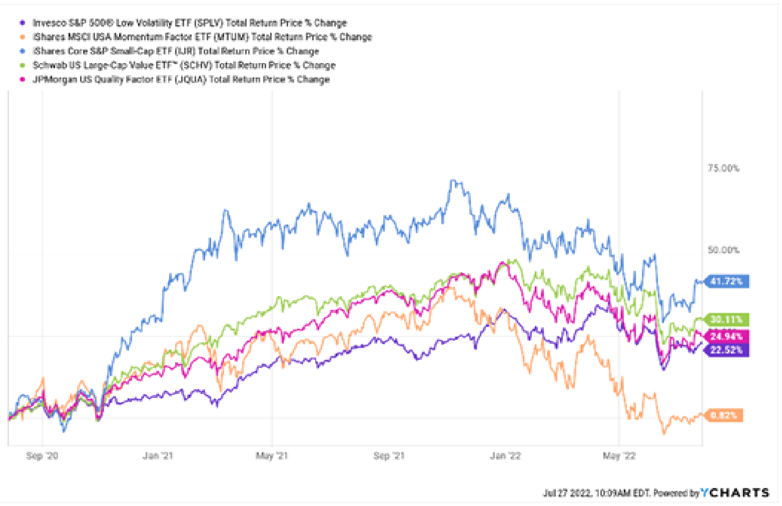
Performance Review

Clint Pekrul, CFA

As markets continue to be quite volatile, we thought it would be appropriate to provide a broad overview of performance by various asset classes. Performance reflects the total return of various asset classes (as represented by various exchange-traded-funds). Returns are through July 27, 2022.

With changing inflation expectations and interest rates, relative performance across equities, bonds and commodities can become quite fluid. Below we highlight returns over the past two years for to help capture the effects of the onset of COVID and the subsequent supply chain issues and soaring inflation.

Domestic Equity by Factor



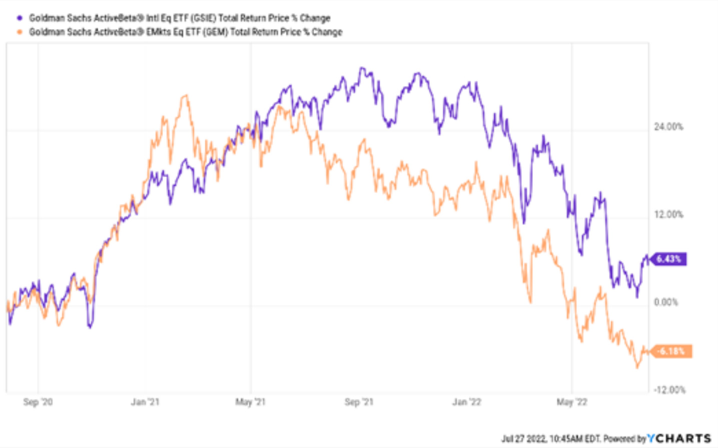
In general, small cap stocks have delivered cumulative returns of roughly 40% over the past two years, having rallied considerably in the second half of 2020. However, small cap stocks are particularly vulnerable to rising interest rates and have struggled on a relative basis so far in 2022.

Low volatility stocks were out of favor in 2020 as investors favored more volatile high-growth names. However, on a relative basis, low volatility stocks, which tend to consist of more defensive names, have held up reasonably well on a relative basis. On a cumulative basis, low volatility stocks are higher by roughly 20%.

Conversely, momentum stocks, which were riding high off the COVID lows of 2020, have been materially repriced in 2022 as interest rates have moved higher. As a group, momentum stocks are more-or-less flat over the past two years.

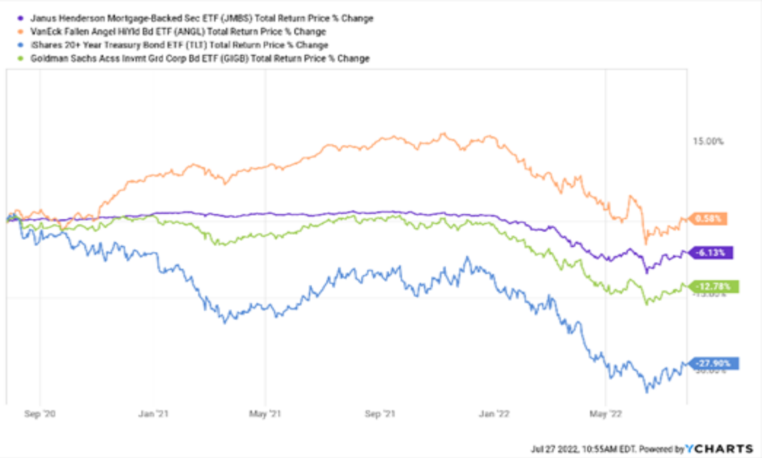
Value and high-quality stocks seem to have delivered the most consistent returns over the past two years. Investors in part turned to value names after the market plunge in 2020. Likewise, high-quality names, which tend to outperform during recessions, have fared rather well so far in 2022. Value and high-quality stocks have delivered cumulative returns of roughly 30% and 25%, respectively over the past two years.

International Equity



Continuing a longer-term trend, international stocks underperformed their domestic counterparts over the past two years. In general, growth prospects overseas are not on par with the U.S. Likewise, we've seen significant currency headwinds in 2022. International developed and emerging markets have delivered cumulative returns of roughly 5% and -5%, respectively, over the past two years.

Fixed Income



Not surprisingly, fixed income returns are generally negative for the year. Longer duration Treasury bonds are considerably lower but have rallied somewhat recently due to heightened recession expectations. On a relative basis, mortgage-backed and high-yield bonds have outperformed given their shorter duration.

Perhaps the Fed will achieve a soft landing and supply chain issues will be resolved to help bring down inflation. Markets could turn more favorable for the remainder of the year. For now, as always, we recommend staying diversified and managing the risk you take in your investment portfolio.

Q: How might the mid-term election change your outlook on the markets?

I do not expect the mid-term elections to dramatically change the short-term outlook on the markets, the die has been cast in terms of recession and I expect that the markets will eventually trade at a level that represents that reality. Legendary investor Benjamin Graham was famously quoted as saying, “In the short term the stock market behaves like a voting machine, but in the long term it acts as a weighing machine". Earnings is what the market weighs and they are likely to be poor in the aggregate for the next year or two.

Longer term, however, the mid-term results could provide to be very impactful on the markets and inflation. A considerable amount of inflation today is tied to energy prices, something we have demonstrated the ability to alter in a short period when the U.S. became energy independent a few years ago. Energy inflation goes beyond the price at the pump or heating oil prices, everything delivered to retail or grocery stores has had upward price pressure because of transportation costs. Shipping containers from overseas are still at nearly 100% more expensive than a year ago. New leadership in Washington could result in a change of sentiment that would be very positive for a market outlook. The GOP faces more challenges in the Senate where more Senators on the right are up for reelection while expectations remain very high the GOP will retire Nancy Pelosi as Speaker.

Regardless of the outcome of the mid-term elections, I don’t think it changes the likelihood of a recession later this year or early 2023. The election results will not have any impact on the Federal Reserve’s monetary policy. Unless some exogeneous event occurs, the central bank is going to continue to raise interest rates until inflation comes under control, although there remains considerable doubt that they will achieve their goal. Inflation seems to be more of a supply chain issue that the Federal reserve cannot address through demand side monetary policy.

Likewise, one mid-term election is not going to resolve the fiscal issues this county faces that have been percolating for decades. Generally, I think the market is expecting a Republican majority in both houses of Congress. If this indeed does happen, we will almost certainly have no major legislation passed under the Biden presidency. The markets might view inaction from a deadlocked Congress as a positive, given that investors dread uncertainty. In fact, we might experience a short-lived bear market rally. However, if the Democrats retain control of both houses, we might experience a spike in volatility. If one party retains control of fiscal policy, there could be major legislation passed that in turn would affect the overall markets.

Q: Have Treasury Yields Peaked?

I would say yes, at least until the end of the recession we just entered. The yield on the 10-year UST peaked in June at a yield of 3.48% after rising from just 1.75% in February and 2.75% in May. We are now back at a yield of 2.68% below February’s level and with a clear trend lower as the market prices in a slowing global economy. Given the latest CPI print was 9.1%, real Treasury yields are near a record low at -6.4%. The drop in yields has allowed long-duration Treasuries to recover about 5% of the year-to-date losses but they remain lower on the year by about 20%.

It is very likely, in my opinion, yields will test and likely move below the low of 1.75% on the 10-year during the recession meaning better returns and more effective hedging of equity portfolios. The spread between High Yield bonds and Treasury ballooned from a historically low 3% at the beginning of 2022 to 6% briefly in early July. The spread seems to be stabilizing around 5% but I expect upward pressure on that figure as the world increasingly comes to grip with the global economic slowdown we are entering. The sweet spot for fixed income investors seems to be high quality, long duration for more aggressive investors and high quality, intermediate duration for more conservative investors. Diversification from bonds is returning which should help all investors.

It sure seems like it. If you look at the 10-year benchmark Treasury rate, it seems to be capped in the 3% neighborhood. If you trace the yield from the all-time low of roughly 0.25% in March 2020, we have accelerated higher particularly in the first half of this year. The market rapidly priced in inflation expectations and the corresponding rate hikes from the Federal Reserve. So, it is really no surprise that we have seen the entire yield curve move higher.

But now it seems the markets are weighing the greater likelihood of a recession, which has resulted in a slight pullback in longer-term yields. Today we are trading at roughly 2.8% on the 10-year Treasury compared to approximately 3.5% back in June. What we are experiencing now is a yield curve inversion whereby shorter-dated rates are at higher levels than longer-dated rates. The short end of the curve reflects monetary policy, but the long end is telling us a recession is eminent. We may very well have peaked for the 10-year rate as inflation has already been priced in and the probability of a recession somewhat anchors long end of the yield curve. Of course, the unknown is if inflation runs hotter than expected. Such a scenario could reprice long-term rates higher.

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