Ideas and Opinions

Market Update

As of today, the S&P 500 is down about 7.2% year to date, and the Nasdaq composite is down by about 11.8%. With this in mind, we thought we'd take some time to share our ideas and opinions about the current market volatility. Our thought process is to look at things from a super-macro level, followed by a macro level, and finally followed by a micro view and share what we see.

Super-Macro

One "big idea" that we've been communicating for some time is that if we look at the global economy pre-Renaissance age, it was almost impossible to distinguish any economic advancement from generation to generation. You could even go so far as to say the lifestyle of a person living in the 7th century was not much different than that of a person living in the 14th century. But then the Renaissance period came along and with it: scientific reason. The circumnavigation of the world, the introduction of modern banking and the field of accounting, and the polymaths of people like da Vinci and Michelangelo characterized the times. The world was advancing.

Then came the industrial revolution part one, kicked off by railroads in England and steamboats on the Delaware. We no longer were limited in travel by how fast we could walk, a horse could run, or a ship could sail. Part two of the industrial revolution soon followed the US Civil War, and the economy further accelerated with train rails switching from iron to steel, the early days of electricity, advancements in steel and petroleum refining, and the beginning of workers' rights and a more respectable wage. Advancements in farming through both periods also allowed much better support of the population and allowed less labor to be allocated to the farm and more to factories[1]. Now from generation to generation, there was a meaningful difference in one's standard of living.

After World War II we saw the beginning of transistors with Bell Labs creating the point-contact resister in 1947. By the 1950's, just a few generations from when Grover Cleveland in 1893 pushed a button at the Chicago World's Fair to demonstrate electricity, generations were now seeing substantial differences in how they lived. From the 1960's to the 1990's Moore's Law marched forward with relentless advancement, along with medical advancements, workers' rights, and civil rights. The average US citizen could now create some economic independence and a comfortable lifestyle compared to many on the Mayflower, which had a 50% death rate the year after arriving in

1. Jethro Tull is credited with significant advancements in agriculture like the seed drill. https://en.wikipedia.org/wiki/Jethro_Tull_(agriculturist)

America, not to mention indentured servitude for seven years following.

Although the internet and networking had already existed for some time, the introduction of the Netscape Navigator in 1994, inspired by the Mosaic browser, brought internet to the masses for applications such as FTP, graphics, HTML[2], and many use cases that would have never been possible before. Amazon, eBay, Google, Netflix, Facebook/Meta, PayPal, and many others pushed aside the great companies of the time like Exxon, GE, IBM, Philip Morris, and set a new standard for how business is done.

The next phase we turn to is the information age. 2021, 2022, and 2023 together are expected to create more data than the history of all previously collected data, and the 5-year growth rate is expected to be about 19.2%.[3] Software-created artificial intelligence, machine learning, and deep learning are the current technology trends, and if software is eating the world, data is its favorite food.

So far, we've painted a rosy picture that we could extrapolate into the future and reason that if we just stay on the front end of technology and companies changing the world, all is well, and we'll be financially secure. However, there's an opposing force: once a country becomes well off, some additional problems begin to surface that work against us like high taxes, entitlements, and a welfare mentality. Since Keynes and the New Deal were implemented in the 30's, most economic problems have been dealt with through easy money. From a monetary perspective, we're all Keynesians now[4], and from a Fiscal perspective, not many politicians want to be the person that slows the spending; it's the next elected official that's going to take care of that. This all translates into debt, expensive social programs, and drags the economy down from higher growth rates. Japan and Europe are good examples of good intentions creating poor economic outcomes. Ray Dalio does a wonderful job of communicating this issue in 'The Changing World Order: Why Nations Succeed and Fail.'

We're now left with two opposing forces, technological advancement on one hand, and potentially bad economic policy on the other. One good thing about companies compared to citizens or countries is that companies are a lot more adaptive at following the profits. Then the question is: do we head the way of Europe and Japan, or does technological innovation continue to carry the day? We're convinced that innovation will be strong, but as to whether economic policy derails that, we'll have to wait and see.

Current Macro Factors

Record government spending, record monetary stimulus, supply chain congestion, labor shortages, and a few other problems, all overlaid by Covid. If I were the market, I'd be a little edgy too.

Up until recently, the market had been relatively calm from a volatility standpoint for the last 12 months because the Fed had signaled that they would be as accommodative as needed, and Congress continued to pass extraordinary spending measures. We had the wind at our back, and the only thing

2. Special mention to Tim Berners-Lee for the creation of HTML.

3. https://www.statista.com/statistics/871513/worldwide-data-created/

4. Keynesians refers to the Federal Reserve coming to the rescue of all economic problems through flooding the economy with money.

you worried about was when both might end. Well, that time has come.

Currently, two of the biggest tools the Fed can use to stimulate the economy are in the midst of change. Stimulating the economy through purchasing bonds in the open market, known as quantitative easing, is expected to wind down by March, and the first increase in the Fed Funds rate is expected in March as well. The Fed does this to slow the economy and cool inflation, but if things are bad enough, Paul Volcker taught us you're better off taking a recession to resolve high inflation.

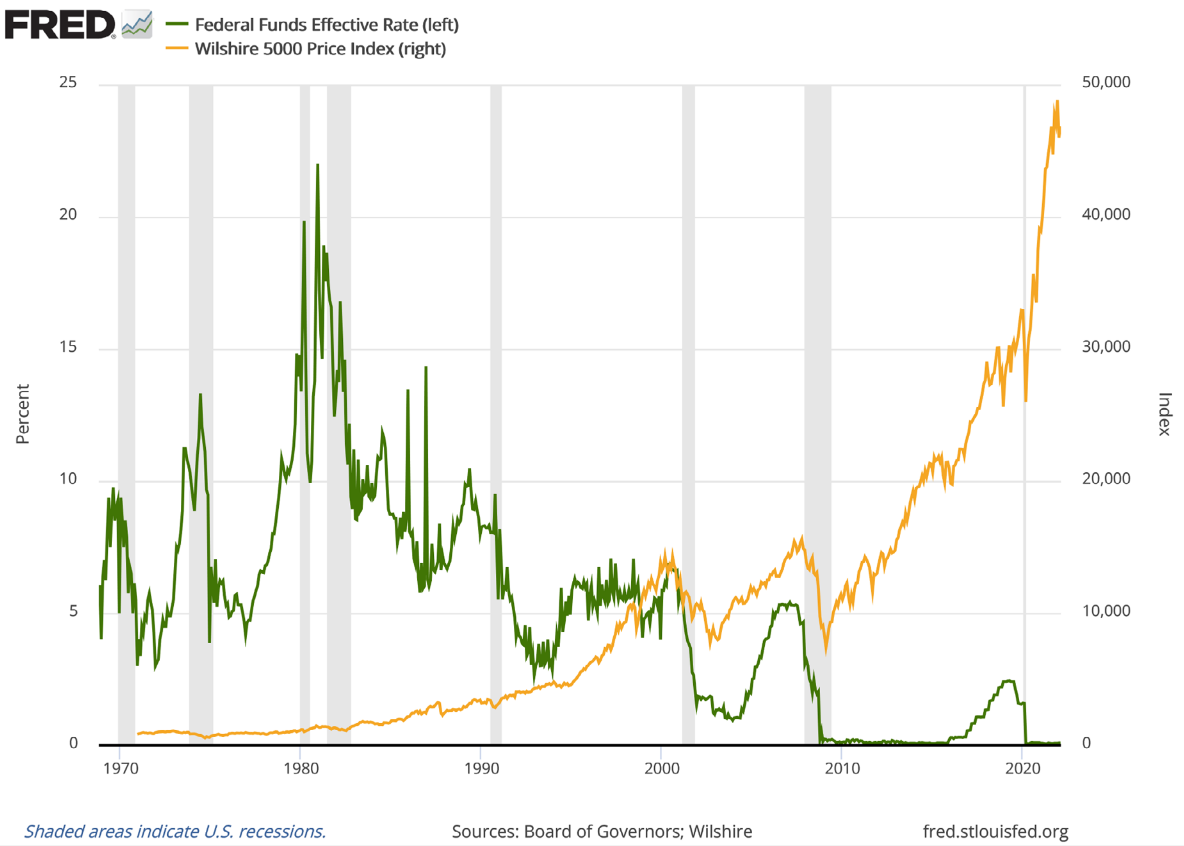

Figure 1

Figure 1 illustrates the Fed Funds rate overlaid with the Wilshire 5000 index. Notice that in all periods, during the beginning stages of increasing the Fed Funds rate, the market generally does well. The problem lies in the late stages of tightening. In the '85 and '93-95 periods, the Fed was able to tighten policy without sending the economy into a recession, and you might also notice that the Fed was tightening before the '20 recession. So, would we have had a recession even without Covid? We'll never know.

Next, we might want to know what the cycle looks like at this point. Currently, projections indicate the Fed will increase the Fed Funds rate 7 times this year at 0.25% per increase, followed by additional hikes in '23 and '24, although we would not put much weight on the later periods.

The next big question is inflation. Up until a few months ago, the Fed and market analysts were aggressively communicating the opinion that inflation was transitory rather than persistent. However, over the last 60 days, parts of the market and the media have started pushing the idea that inflation is here to stay. Many believe, including us, that this has had the effect of spooking the market. However, one thing that we like about market-based indicators versus the media, is that market-based indicators are investors placing bets, not just what the media says. Two of our favorite indicators are the 5-year TIPS breakeven spread (figure 2), and the 5-year forward 5-year breakeven spread. The first gives us investors' inflation expectations for the next five years, and the second gives us the inflation expectation starting in five years for the subsequent five years.

Figure 2

Based on what we see, for the next five years inflation is expected to be about 2.70%, and that's down from a high expectation of 3.17% on November 16th. This tells us that even though the headline inflation numbers have been high, the market started reducing 5-year expectations a few months ago.

Inflation expectations for the five-year period starting in five years have dropped even more, with the current estimate at 1.98%, down from an October high of 2.41%. Keep in mind that the Fed has an inflation target of 2%, therefore expectations are back below the Fed's target if we go out five years. Treasury bonds can also give you an indication, and although the ten-year treasury yield has risen to 2.00%, its pre-Covid level was about 1.85%. As for the 30-year Treasury, this creates an even more compelling argument that inflation may moderate. Its yield is still historically low at 2.32%.

The last indicator that we'd like to mention is the yield curve. Although this sounds a bit complicated, it's quite understandable and can be very insightful. Primarily we're interested in whether short-term bond rates are lower or higher than long-term bond rates. The most common way to measure this is the difference between the 2-year Treasury yield and the 10-year Treasury yield. If the short-term bond yield is below the long-term bond yield, the market expects growth. If the short-term bond yield is higher than the long-term bond, the market expects economic slowing or perhaps a recession.

Figure 3 illustrates this comparison. Notice in the chart the spread is currently above zero, thus from this indicator, a recession is still a ways off. Notice too that for all periods prior to a recession, the indicator went negative about 6 to 18 months before the actual recession. Let's fast forward, if the Fed does raise the Fed Funds rate seven times this year, that will increase the short-term rate by about 1.75%, and if the 10-year yield stays the same, we may have an "inverted" yield curve. Looking at history this means, on average, a recession would follow sometime around March of 2024.

Figure 3

Micro

Consumer Demand

The largest driver of economic demand is the consumer, and by most measures, consumers appear to be quite strong. The key data points that have been getting some attention are consumer savings, the personal savings rate, wage pressure, employment, and the household debt service ratio.

Regarding consumer savings and the savings rate, figures 4 and 5 below do a good job of illustrating what's happening.

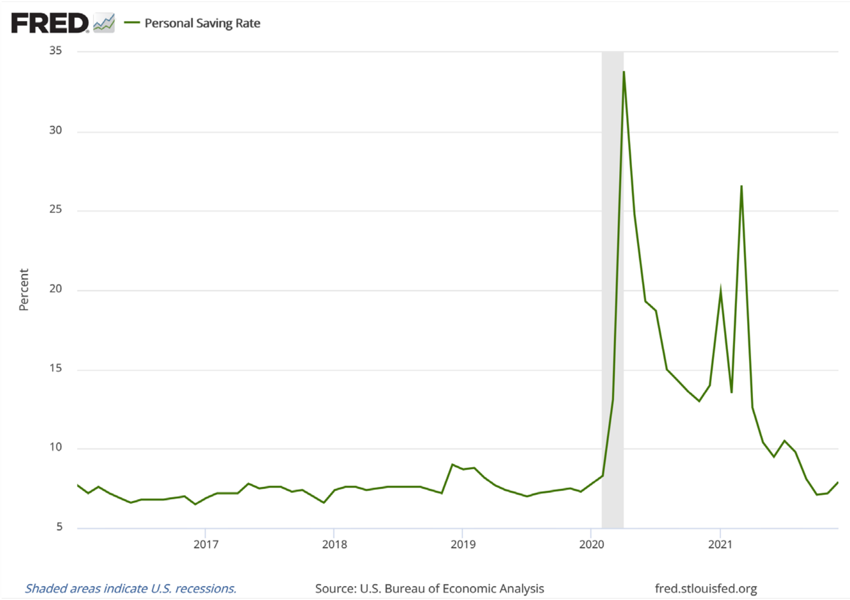

Figure 4

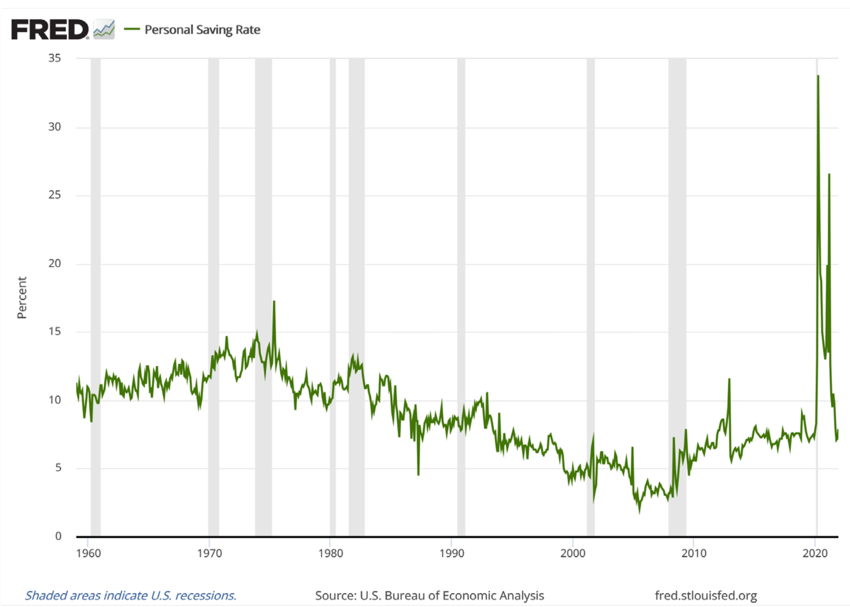

Figure 5

The personal saving chart shows us that the consumer still has quite a bit of cash built up from earlier in the pandemic, and yet the personal saving rate has materially declined which may decelerate some of the inflationary pressure (they're already spending at high levels, with not much room to go higher).

One irony of consumer spending prevalent in these charts is what's called the Paradox of Thrift. This theory posits that personal savings is a drag on the economy during recessions because peoples' concern about the economy slows spending just when they should spend more to stimulate the economy. The opposite is true when times are good. Consumers extrapolate those good times into high spending, just when less spending in the economy is needed to reduce overheating and inflation.

Both charts illustrate what we would expect, and from this data the consumer still appears to have plenty left in the savings tank, but may not accelerate spending much from here.

We also consider several other indicators related to the consumer: net worth, credit scores, and consumer confidence. Average net worth and credit scores appear to be quite strong, while consumer confidence is an area of concern. However, we would anticipate that the recent low consumer confidence readings are related to exhaustion around Covid and the recent Omicron spike, as well as to recent high inflation.

Earnings

A few weeks ago, one of the FAANGs reminded us just how vulnerable high PE growth stocks can be to a small change in tide as Netflix reported a deceleration in subscriber growth. This deceleration, along with general Fed interest rate concerns, led to a 20% plus single day decline. One important observation is that the move in Netflix is as unique as it might seem. Cross-sectional volatility, which is used to determine what's happening under the surface compared to what's happening to the market as a whole, is showing significant variance. Some examples of this are that while the market, as measured by the S&P 500 Index, is off about 8% from its highs, many stocks are down 30-40% or more from their highs. Salesforce, Netflix, Zillow, Peloton, T-Mobile, and Starbucks are good examples of this. We recognize that these names are more growthy in nature, but the number of stocks that are down more than the market average is considerable.

Yet, if we look at S&P 500 earnings estimates for 2022 and 2023, we are still seeing a greater number of increases than decreases. At the end of the day, a company is worth the present value if its lifetime earnings and terminal value. If companies can continue to improve earnings, that will solve a lot of investor problems.

One reason for last year's outstanding S&P 500 performance is that we saw estimates for 2021 earnings increase substantially. In December of 2020 compared to December of 2021, earnings estimates increased from 168.82 to 203.92, a 20.8% increase. If we continue to see increases in earnings estimates, that should help stocks considerably, all else equal.

Conclusion

We started with a very macro view to communicate two ideas: the economic progress that is currently underway thanks to technology is nothing short of incredible, and we contrasted this against the idea that as countries get rich, take on debt, and increase non-productive activities like entitlement programs, growth can become more challenging. However, given time and perspective, day-to-day and month-to-month moves are usually not as important as staying committed to the long-term and one's objectives.

We also looked at the current macroeconomic factors, mostly monetary policy, and concluded that rate increases are on the way. We further mentioned that markets can be volatile in monetary transitions, and historically it's not so much the beginning of monetary tightening that's the problem, but the end of the tightening cycle if the Fed takes things too far.

Lastly, we talked about micro factors specific to the consumer and earnings. From our perspective, the consumer appears strong, and for those that choose to work, wage pricing power is apparent and something workers haven't seen for some time. Earnings estimates for the market continue to push higher. Remember that company earnings are measured nominally, and if companies have pricing power, high fixed costs, operating leverage, and fixed rate financial leverage, a little inflation can power earnings nicely.

Success

The biggest factors we see for investor success are having clear objectives and an appropriate risk level. Couple this with always having cash flow for your personal lifestyle, and the market can never force you to do something you don't want to, which can be the most damaging. All in all, based on the ideas and opinions above, we don't feel overly concerned with the recent market pullback and volatility, but of course that can change.

As always, if you have any questions or concerns, please don't hesitate to get in touch with your advisor.

Sincerely,
Garde Capital, Inc.