

Quarterly Economic and Market Comments September 30, 2023

During and after the global financial crisis of 2008, the World's central bankers lowered interest rates to zero - and even sub-zero - and bought government bonds at an unprecedented pace. Nothing like it had been seen before. In Britain, for example, where the Bank of England has been operating since the 17th century, rates were encouraged to crash decisively through the floor of the previous 325 years and stay there. It was daft and unsustainable. Detractors of the policy generally thought it would lead to consumer price inflation; instead, the inflation came in the form of higher prices for stocks, bonds, and real estate. This was not without negative consequences. To take one example, wealth inequality and consequent political unrest. In the U.S., for instance, the share of financial assets held by the bottom 50% of the population has fallen from 3.1% to 2.3% since 2009 while the share of the top 1% has risen from 28.4% to 35.3%. Nevertheless, rising asset prices make people happy and, as Walter Bagehot, the legendary editor-in-chief of the Economist magazine in the 1860s, famously quipped, "All people are most credulous when they are most happy." Watching the antics of today's central bankers, Bagehot is no doubt rolling in his grave.

Then came the pandemic, together with massive fiscal and renewed monetary stimulus, and the war in Ukraine. Rather suddenly, rising consumer prices became the number one economic problem and central bankers responded by rapidly hiking interest rates. Asset price inflation was replaced by asset price deflation with 2022 being a particularly challenging year for financial markets. The rise in rates and the fall in stock prices caused many to think that an economic recession must be around the corner. However, as often happens when too many are of the same opinion, the American economy held up better than forecast and equity markets generally rallied throughout the first half of 2023. As the economy and markets performed better than anticipated, investor sentiment shifted from expecting a recession to a "soft landing" (i.e., getting inflation under control without a recession and a meaningful rise in unemployment). Over the past year, recession and soft landing have completely changed places in terms of popularity on Google Trends and the number of Wall Street Journal articles that reference a "soft landing" has exceeded the previous record set in 1989/90. It is worth noting that the soft-landing hypothesis back then turned out to be incorrect with a recession lasting from July 1990 to March 1991. In fact, it is unclear if there has ever been a soft landing in the context of the mix of monetary and economic factors at play today.

Just as investors became too bearish a year ago, leading to a rally, so this summer investors had become complacent, leading to a sell-off. Equities were down pretty much across the board in the third quarter, although the declines were typically of the low single-digit variety. Beneath the surface, however, there are a couple of factors worth noting. Despite the third quarter weakness, the Standard and Poor's 500 Index is still up almost 12% year-to-date, but the gain falls to 1% without the so-called Magnificent 7 stocks (Apple etc.), in line with the performance of the Dow Jones Industrial Average (up 1.1%) and the Toronto Composite (up 0.8%). Largely as a result of rising interest rates, relatively high quality, high dividend-paying sectors - utilities, real estate, consumer staples, and health care - have been the big relative losers. Also on the losing end have been smaller capitalization stocks which, as represented by the Russell 2000 Index, are down 18% over the past two years compared to a 1% gain for the S&P 500 and the ratio of U.S. smaller to larger capitalization stocks is at its lowest level since January 2001. However, the main story of the third quarter was the sell-off in bonds, led by long-term U.S. Treasuries which plunged almost 12%, their fourth worst quarterly performance in the past 100

years. Nor was it just an American phenomenon. German yields increased to their highest level since 2011 and, for Japanese yields, since 2013. The blood bath in bonds was partly the result of the Federal Reserve Board in September reaffirming its projection of another rate hike this year and indicating there would be two fewer rate cuts next year. The European Central Bank increased its rate to an all-time high of 4% as well. "Restrictive for longer" was the mantra and the markets were buying it.

But should they be buying it? Economists in general, and central bankers in particular, who are pretty much all economists, do a poor job of forecasting recessions. In a 2019 study, the National Bank of Belgium noted, "Experience shows that commentators tend to downplay signals given by the yield curve. In fact, when asked the question in 2007, 2000, and 1990, and on previous occasions, most economists indicated "this time is different", meaning that "this time" the yield curve inversion would not be followed by a recession. Yet, a recession occurred every time. In a 2018 International Monetary Fund (IMF) paper, the author noted that, "In recession years, forecasts get changed more rapidly, but not quickly enough to be able to avoid large forecast errors." In May of 2008, as the global economy was about to fall off a cliff, the Wall Street Journal wrote, "A story is emerging of earnings resilience. We're in a market transitioning from a bear to a bull." Nor are politicians who rely on economists immune. In January 1974's State of the Union, Nixon declared, "There will be no recession in the United States of America." Unfortunately for him, a recession had already begun, although that was the least of his problems. Following in Nixon's footsteps, German Chancellor, Olaf Scholz, stated earlier this year that "Germany is not going into recession" even as a recession was already underway.

So, to say we should take prognostications by the Federal Reserve or other economists with more than a grain of salt is a giant understatement. Nevertheless, as we are seeing today, central bankers act on their forecasts, their actions affect the markets, and currently this is putting downward pressure on stock and bond prices. The two factors which could alter the present dynamics - and they are flip sides of the same coin - are consumer prices and the global economy and markets. "People hate inflation," said Fed Chair, Jay Powell, during his recent press conference and it seems clear the Federal Reserve will be reluctant to change course without more evidence that consumer price inflation is under control. A study published last month by the IMF found that successfully resolving inflation shocks in the past required tight monetary policy lasting for an average of three years. Looking at more than 100 inflation shocks globally, failure to deal effectively with inflation was most often the result of "premature celebrations" when inflation receded and central banks eased policy. Inflation has indeed receded. The UNFAO World Food Price Index is down almost 25% from its record 2022 highs to its lowest level since March 2021 as Bloomberg notes that "U.K. stores cut food prices for the first time in more than two years." Rents in the U.S. are 1.2% lower than a year ago, the biggest yearly decline since December 2020. At the cycle peak, rents were up 18% year-over-year. In China, home prices in the 100 largest cities were down 34% in August from a year earlier. The inflation rate in the Eurozone decelerated to 4.3% in September from 5.2% in August and a peak of 10.7% in 2022. In the U.S., the many different inflation gauges are running over the past three months at a rate of between 1.5% and 3.5%, down from a range of 3.5% - 5.5% at the end of 2022. So, a lot of heavy lifting has been done on the inflation front, but there remain several factors that suggest the fight is not over, two of which are the price of oil and wages. The dollar-adjusted price of oil jumped 30% over the past six months, reflecting steady demand and ongoing supply cutbacks by Saudi Arabia and Russia, cutbacks that cannot be offset by sales from the U.S. Strategic Petroleum Reserve which sits at a 40-year low. One reason for consumer prices remaining under control throughout most of the 21st century was the movement of manufacturing capacity to low cost/low wage China. Since Covid, that process has reversed. A recent survey by the American Chamber of Commerce in Shanghai found the lowest percentage of respondents optimistic about the five-year outlook for business in China since the survey

began in 1999. In August, exports to the U.S. from China declined 10% from the previous year while shipments to Europe and Japan fell by more than 20%. To some extent, manufacturing is being “friend-shored” to countries like Mexico, but U.S. companies are also taking advantage of the massive subsidies in the ironically-named Inflation Reduction Act to set up shop in the U.S. One consequence of this, in the context of an economy where the ratio of job openings to unemployment is double the historic norm, is to give labour bargaining power which they have lacked for a long time. American Airline pilots won a 46% wage increase over the next four years and UPS workers got 48% over the next five. Screenwriters, actors, autoworkers, 75,000 Kaiser health-care workers, culinary workers (threatening to strike Las Vegas hotels and casinos) - the list of workers flexing their muscles goes on. On April 1st, the minimum wage for fast food workers in California will jump 30% to \$20 per hour. Of course, workers are faced with a rising cost of living which, in the U.S., includes health care. The average U.S. family health insurance premium, covered increasingly by worker contributions, has increased from \$6,000 in 2000 to \$21,000 in 2022. Once again, this is not just an American phenomenon; in fact, unit labour costs in Europe and the U.K. are rising at twice the rate of the U.S.

The IMF study referenced earlier agreed that keeping short-term interest rates fairly high (i.e., 5%, double the expected rate of inflation) is the right thing to do after an inflation shock. However, they found that the tight policy needed to deal with inflation works in large part because of its negative impact on growth. History suggests that, for the missing piece of the disinflation puzzle to fall into place, for oil prices to correct and wage growth to ebb, a recession will probably be required. The weight of the evidence continues to point to this happening, although it is not the Federal Reserve’s forecast. If the majority of the indicators were calling for a recession six months ago, then surely the recent run-up in yields and sell-off in the markets makes a recession more, not less, likely. It is widely believed that the U.S. economy has held up better than usual during this monetary tightening cycle; in fact, 16 months after the cycle began, employment, retail sales, and industrial production are weaker than the norm. Nevertheless, there have been a couple of atypical factors that have kept the U.S. economy afloat this year. First, during the pandemic, the household savings rate soared to 33.8%, as the government sent out cheques to a population with limited opportunities to spend. Since then, people have been whittling down their savings so they were able to spend beyond their income. For example, over the past three months, incomes were up 0.1%, 0.0%, and 0.2%, while spending rose 0.4%, 0.9%, and 0.4%. The amount of “excess” savings (i.e., beyond the pre-Covid trend) still left to be spent is uncertain with estimates ranging from \$200 billion to \$1.3 trillion. Whatever the number, it is a lot less than it was three years ago. It is estimated that about half the growth in GDP and half the employment gains over the past three years are attributable to fiscal stimulus and the U.S. continues to run large federal budget deficits despite an historically low unemployment rate. Secondly, nearly all of the world’s major central banks have been on a tightening cycle for more than a year and the global central bank rate of 5% is the highest since 2000, consistent with anemic economic activity. However, the tightening is not as contractionary as it might seem. First, interest rates started at such a low level. In the U.S., real rates (i.e., after inflation) were so negative that it has taken more than 500 basis points of increases to get the real rate above zero. In addition, homeowners and corporations were, in many cases, able to borrow or refinance when rates were low and are unaffected and even benefit from higher interest rates. Microsoft’s interest expense for example, was unchanged over the past year at roughly \$500 million while its interest income jumped from \$550 million to \$900 million. The impact of higher interest rates varies significantly between countries. For households, the differences can be largely chalked up to homeownership trends and whether mortgage rates are fixed or variable. For businesses, economies with a greater reliance on banks for lending are more affected by rising interest rates. On both counts, the United States comes out relatively favourably helping partly to explain the relative resilience of its economy.

Notwithstanding these factors, Deutsche Bank, perhaps the first major financial institution to project a U.S. recession, is sticking to its guns. Based on an analysis of 34 U.S. economic downturns since 1854, they identified four macroeconomic “triggers” common to past recessions that “have been breached so far in this cycle”. The first is an oil price shock. When oil prices have spiked by 25% over a 12-month period, the U.S. economy has gone into recession 46% of the time. We have already noted the 30% increase in the price of oil. The second trigger is an inflation spike. Since 1854, a 3% rise in consumer price inflation over a 24-month period caused a recession within three (!) years 77% of the time. In 2022, inflation in the U.S. peaked out at 9%. As an aside, since World War II, when consumer prices have risen by more than 5% on an annual basis, the U.S. economy has always experienced a recession. The third trigger is a rapid rise in interest rates. Since 1854, a 2.5% increase in short-term interest rates over a 24-month period led to a recession 69% of the time. Current interest rates of 5% compare to an average Fed Funds rate of 0.6% in the decade ending in 2019. The 5-year rate after inflation has increased by 4% over the past two years, something that has not happened in more than 40 years and, when it did, led to a recession lasting for six quarters. The final trigger is an inverted yield curve (i.e., short-term rates above longer-term rates). Inverted yield curves are always followed by recession, but here there is a wrinkle, for the sign a recession is getting close is when an inverted yield curve actually starts to disinvert. As recently as July, 2-year yields in the U.S. stood 108 basis points above 10-year yields. That spread has dropped to 32 basis points, the least inverted curve in almost a year. Typically, a yield curve inversion ends around the time a recession begins. There is lots of anecdotal evidence and numerous indicators that point to the same outcome as Deutsche Bank’s triggers outlined above. One that bears mentioning is the New York Fed’s own probability of recession model at its highest level in 40 years, yet, somewhat bizarrely, the Federal Reserve expects the U.S. economy to grow by 1.5% in 2024. One country that is likely already in recession is Germany. According to five economic institutes that advise the government, German output will drop by 0.6% in 2023.

What are the implications of all this for financial markets? The past few days have seen record volumes in TLT, the go-to bond ETF for long-dated Treasuries. The ferocity of the sell-off in bonds in recent weeks is a bit hard to understand. The alleged catalyst was the Federal Reserve’s claim that they were going to keep short-term interest rates “higher for longer”. “If we ease too soon,” said Atlanta Fed president, Raphael Bostic, “we won’t get to 2% (inflation) - and we have to get to 2% - that’s non-negotiable.” Surely, if inflation is brought under control, that’s good news for bonds. Similarly, the restrictive policies to bring the rate of inflation down may well hurt the economy, also good for bonds. Meantime, since the pandemic lows, yields have soared - in the case of 10-year U.S. Treasuries, from 0.4% to 4.8% - and bond prices have been crushed, with the above-noted TLT price cut roughly in half from its high. This is by far the longest and deepest bond bear market in history with the result that the largest bond ETF now has a negative return over the past seven years. Over the past 100 years, 10-year U.S. Treasuries have recorded a negative return in two consecutive years only twice and the losses were marginal. Unless bonds rally strongly in the fourth quarter, they are on track for an unprecedented third consecutive negative year with a cumulative loss of 25%. Apart from their abysmal performance over the past three years, there are three other reasons to think bonds could do better. First, there is finally some value in bonds after more than a decade of there being little or no value. The yield on U.S. Treasuries is roughly in line with its long-term average and is close to a “fair value” of 5% based on prospective rates of economic growth and other factors. Secondly, investors are underweighted in bonds and sentiment towards bonds as opposed to stocks is at this lowest level in more than two years. Finally, while many borrowers have been shielded from the full impact of higher rates, this will change as time goes by. For example, about one-third of Canadian mortgages have seen their payments increase to date, but this will rise to nearly all mortgages over the next three years.

“Even if rates stabilize at the current level, they are likely to break the economy”, opines State Sheet Advisors.

The outlook for equities is more complex. While the S&P 500 has held up relatively well since stock prices peaked at the end of 2021, owing largely to the Magnificent Seven, beneath the surface there has been a meaningful correction. The Renaissance Index of IPO (Initial public offering) stocks is 60% below its February 2021 peak. Pandemic favourite, Peloton, which hit the market at \$29 in September 2019 and soared to \$171 where it traded at more than 20 times sales, today trades at \$4 with a price-to-sales ratio of 0.6. Smaller capitalization stocks, which normally trade at a premium to the bigger S&P 500 stocks, today trade at a discount and are cheaper than at any time in at least the past 40 years. At the other end of the spectrum, many big, good dividend-paying blue-chip stocks have fallen in sympathy with falling bond prices. On a short-term basis, the stock market as a whole is technically oversold with every S&P 500 sector ETF trading below its 50-day moving average. When the August/September period is unkind to stocks, the low for the year is typically in late November with most of the damage done by early October. Interestingly, whenever the S&P 500 has been up at least 10% through July, but fallen in August and September, like today, the fourth quarter has never been down. If bonds were to rally, stocks are set up to follow suit, especially perhaps those impacted by rising interest rates. However tempting it is to anticipate a typical year-end rally in equities, the outlook is by no means risk free. On the one hand, bonds might not rally in any significant way. This would be a problem for stocks because the equity risk premium (the earnings yield on stocks less the 10-year U.S. Treasury yield) has gone negative for the first time in many years and is lower than it was at the 2007 stock market peak (i.e., stocks are no longer cheap relative to bonds). At the end of 2021, just prior to the Federal Reserve’s aggressive monetary tightening cycle, 75% of S&P 500 companies had dividend (not earnings) yields greater than T-bills. Today, fewer than 30 S&P 500 stocks have higher yields than T-bills. On the other hand, if bonds do rally because the economy is weak and central bankers are changing their tune, this may not be obviously good news for stock prices which historically do not bottom out until a recession is underway. Unlike bonds, where investors are underweighted, investors are heavily weighted in equities and stocks have tended to underperform bonds when investors have been more optimistic towards stocks than bonds as is the case today. While many of the speculative favourites of the past cycle have been crushed, it could be argued that equity investors have remained generally too complacent. SentimenTrader’s Risk Appetite Index hit its highest possible reading of 1.0 on September 1st (i.e., the most risk-seeking possible), higher amazingly than the previous extreme in April 2021. Then there’s Open AI, the company behind ChatGPT, looking to sell shares at 90 times sales, and Nvidia, the AI-friendly semiconductor stock trading at more than 30 times sales (but which at least has earnings). Perhaps investors are not sufficiently wary given the economic and monetary backdrop. While the sell-off in equities has no doubt created opportunities, it may be premature to ignore totally the risks that a possible recession could bring with it.

Our quarterly comments may contain predictions or forecasts (“forward-looking statements”) concerning our beliefs and opinions with respect to the future. Forward-looking statements necessarily involve risks and uncertainties, and undue reliance should not be placed upon them. There can be no assurance that forward-looking statements will prove to be accurate, and actual results and future events may differ materially from those anticipated in such statements.