

Separation Anxiety

3rd Quarter 2023

October 15, 2023

It was a semi-boring, sweltering summer. Boring is fine, but we look forward to falling coconuts and our envy-of-the-world winter weather.

Both Julia and I took our families on road trips this summer. With small children, these are busy trips, not relaxing vacations. We created great memories, but this summer tradition allows us to see different economic zones and gauge the economic pulse. Our trip observations of long lines, local conversations, and thrifty choices gave us a perspective that data alone can't capture.

Our takeaways - **staffing up, crowds up, service mediocre, and prices WAY up!** If a recession is imminent, as Exhibit A chatter might suggest, we didn't see any signs of it on our travels.

Across states, particularly in Florida, it is hard to see signs of an economic slowdown. But that's normal. Recessions are an adjustment process that happens slowly - then all at once.

Our upbeat travel **anecdotes do not square with recent consumer data. This has created a strange economic separation anxiety.** Lagging economic indicators like Gross Domestic Product (GDP) and unemployment show some weakness. But increasingly, these lagging observations are at odds with leading consumer data: rising essential goods spending, mounting consumer debt, and depleted savings.

Wall Street and government economic forecasters have noticeably separating views on a pending recession. This is a departure from early 2023 when the consensus was nearly unanimous that a recession was imminent. Today, views are more disparate, described as a potential economic soft-landing, no-landing, and even crash-landing.

Consider this fun fact – any economist or investment professional with 15 or fewer years of experience has never seen the lead-up to a recession. But even luminary forecasters can miss the mark and sometimes by a lot.

Goldman Sachs recently lowered its recession odds to just 15%. This upbeat forecast attracted considerable attention. But there was little media memory that its former chief



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strategist missed the 2008 Great Recession and predicted the S&P 500 would hit 1675 by the end of 2008. The global financial system collapsed within months of her forecast, and the S&P 500 closed 2008 at 903, nearly 50% off from her prediction.

Similarly, the former Federal Reserve (Fed) Chairman Ben Bernanke, in January 2008, made a bold call that the Fed was not forecasting a recession. And let's not leave out the current U.S. Treasury Secretary Janet Yellen's forecast in October 2007, just two months before the global financial crisis began, "The most likely outcome is that the economy will move forward toward a soft landing." Whoopsie Daisy!

Bloomberg's Chief Economist, Tom Orlik recently observed: *"When everyone expects a soft landing, brace for impact. That's the lesson of recent economic history – and it's an uncomfortable one for the U.S. right now."*

All this is to say economic forecasting is challenging and complex. The **uneventful Summer has turned into a very unstable Fall**. The complexity of what influences the financial system today almost defies comprehension: high U.S. asset valuations, aggressive interest rate hikes (Exhibit B), U.S. political turmoil, the end of decades of easy money policies, and wars in Europe and the Middle East.

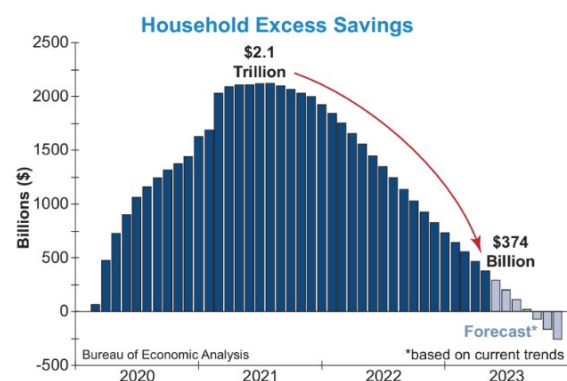
Notwithstanding current complexity, our **macroeconomic** thesis is that the pandemic was an unequaled financial boon for the consumer. Deficit spending of \$8.7 trillion (2020 to 2023) with over **\$2 trillion in cash transfers to households** caused prices – everything from eggs to boats to Taylor Swift concert tickets – to skyrocket. The YOLO (you only live once) spending of government-sponsored savings has muted the negative effects of 11 interest rate hikes.

On average, interest rate hikes take 12 – 18 months to negatively affect the economy. Based on that rule of thumb, we said in January 2023 that a recession should play out by the 4th Quarter of 2023. That could still be right, but the official arbiter of U.S. recessions' starting and ending dates is the National Bureau of Economic Research (NBER) committee. After prior period revisions, the NBER might declare a recession 6-months after a recession starts. GDP is the perfect example of a lagging indicator because the horse has already left the barn when NBER declares a recession.

However, an important leading indicator shows that consumer excess saving is gone. Worse, all the **"free money" was very expensive**. The \$1 in January 2020 is now worth \$0.80 in 2023 buying power. Said another way, all the government stimulus and money printing stole \$0.20 of **every** American dollar in just over 3 years.

Depleted excess savings are serious enough, but other stress signals are building:

- Inflation is falling but is still above the historical average.
- Oil is headed back towards \$100 per barrel with minimal leverage from Strategic Petroleum Reserve sales (Exhibit D) to offset Middle East production cuts.
- Consumer debt is mounting – over 70% higher than 2008.

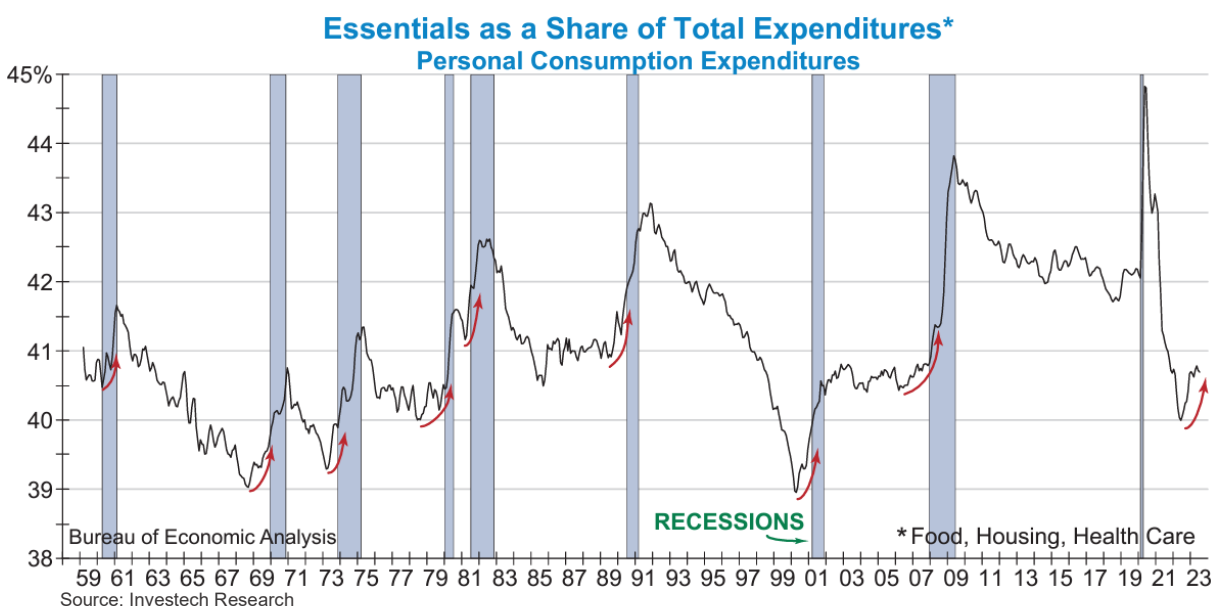


- Loan delinquencies are rising to near 2008 levels, which creates tighter credit conditions (Exhibit E).
- Student debt loan payments resumed on October 1st.

The **consumer is the backbone of the economy**, and anecdotal signs of pocketbook stress are echoed in corporate quarterly earnings calls:

- Home Depot 2Q2023 Earnings Call: “After three years of unprecedented demand in the home improvement market, we continue to see softer engagement in big-ticket discretionary categories like patio and appliances...”
- Nordstrom 2Q2023 Earnings Call: “We continue to see a cautious consumer.”
- Dollar General 2Q2023 Earnings Call: “Our core customers continue to tell us they feel financially constrained. Her savings are gone, and she is certainly still living with the inflationary pressures.”

Preferring data over anecdotes, the chart below is the most intriguing of all the leading consumer trends we’ve studied recently. It shows an upward shift (red arrows) in spending on essential goods (food, housing, and health care) versus non-essential goods and services. This pattern is consistent with the lead-up to recessions (blue bars).



Yet, **predicting a recession is NOT the most important investment consideration**. It is far more productive to understand broadly where we sit in the economic cycle: early, mid, or late. Then, consider how inflation and monetary policy might influence the duration of the business cycle. Because inflation was not a problem for 20 years (cheap imports), monetary policy became extremely accommodating, extending the cycle and creating asset bubbles.

Our **investment** thesis is simple: **asset classes have yet to adjust** significantly to the current world where the 20-year U.S. Treasury pays 5% (Exhibit F), and inflation still is well above the historical trend. After a range of 0% to 2% for rates and inflation over a decade, this is a sea change for asset allocators.

If this thesis seems abstract, here is an example. A salesperson pitched us the XYZ Global Real Estate Fund* a few weeks ago. The fund had \$3 billion in diversified commercial property investments with a good history. But the red flag is – the fund had an average distribution/yield of 4.97%.

Why would anyone buy a risky, leveraged, semi-transparent, semi-liquid real estate fund paying 4.97% when the 20-year U.S. Treasury bond pays 5%?

Calendar year net returns¹ (%)

	2020	2021	2022	YTD 2023
Class T (with sales load)	-0.80	22.21	3.29	-4.93
Class T (no sales load)	2.78	26.58	6.99	-1.50
Class S (with sales load)	-0.78	22.45	3.38	-4.93
Class S (no sales load)	2.80	26.82	7.09	-1.50
Class D (with sales load)	1.81	25.24	6.00	-2.60
Class D (no sales load)	3.36	27.12	7.60	-1.12
Class I	3.59	27.48	7.90	-0.94

Distribution rate³ (%) *We changed the name to "XYZ"

Class T	4.59
Class S	4.66
Class D	5.18
Class I	5.45

In a 5% Treasury world today, we might be interested in the fund if it yielded 9% to compensate for risk. To get to 9%, this fund's value needs to drop 40% or more to pique our interest.

As investors pay closer attention to uncompensated risk, this example and other asset classes (junk bonds, venture capital, commercial real estate, private credit) are vulnerable to impairment from higher interest rates.

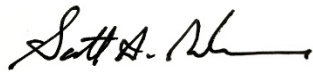
How vulnerable are stocks to a recession? Economic growth may seem to drive corporate earnings, but that linkage is weak. Value stocks have done fine across most recessions – see Exhibit G. Growth stocks have done okay through most recessions except after the 2000 dot.com bubble burst. With a similar value vs. growth difference today (2000 dot.com bubble valuation extreme), we remain optimistic about value investing. With ample potential catalysts for the value style, we believe value has a long runway to outperform the S&P 500.

So, what are the key takeaways:

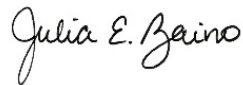
1. The lead-up to a recession is always confusing and complex. This is particularly so today because government spending has muted the recession process.
2. Consumers, representing 70% of nominal GDP, show signs of stress. Excess savings are nearly depleted, inflation has changed spending priorities, and credit delinquencies are rising. Taken together, we believe these are leading indicators of a slowing economy.
3. Instead of trying to predict recessions, it is more useful to grasp that the U.S. economy is in the late stage of the business cycle. This late stage, plus inflation and interest rate hikes, calls for a defensive portfolio posture.
4. Today's investing focus should be **avoiding uncompensated risk and vulnerable assets** that have not yet repriced downward to the reality of 5% U.S. Treasury yields.
5. The economy is not the stock market. The value style (our style) can do fine through recessions, particularly when tech bubbles pop and the investment mood and sentiment shift to immediate dividends and cash flows.

These are interesting times and not in a good way. We promise to send more upbeat pieces once we get through this high inflation-rising interest rate climate. Thank you for your ongoing trust and support. We look forward to growing your hard-earned money and believe this is a great time to be a value-oriented investor.

Very truly yours,



Scott A. Roads
Founding Principal



Julia E. Zaino
Principal

Israel-Hamas War - As you all know, the Palestinian militant organization Hamas barbarically attacked citizens of Israel on October 7th. Israel has declared war on Hamas, the U.S. has pledged support by sending capital, and U.S. military assets are underway in the Eastern Mediterranean Sea. This is an extremely dangerous and fluid situation, with Israel promising a “complete siege” on Hamas-occupied Gaza.

Iran is deeply involved with Hamas and likely supported the attack. So far, this is not a multi-front war, but members of Congress have suggested that the U.S. should threaten Iranian oil infrastructure. If Iran is proven to have pulled the strings in this attack, we expect oil prices to move much higher, and our capital markets could be negatively affected.

The financial media has compared this event to the 1973 Arab-Israeli war that led to the Arab Oil Embargo. Oil rose 300% in that embargo, and markets suffered significant losses. So far, what is different now is that other Arab nations involved are on the sidelines. Whether this extends or not to other Arab nations, oil supply dynamics are extremely tight. We expect prices to climb past \$100 per barrel, further stressing the global economy.

This Israel-Palestinian conflict dates back thousands of years. For a modern-day background of the land conflicts and failed peace accords/treaties, we would suggest:

[Foreign Policy "The Geopolitics of Palestine, Explained"](#)

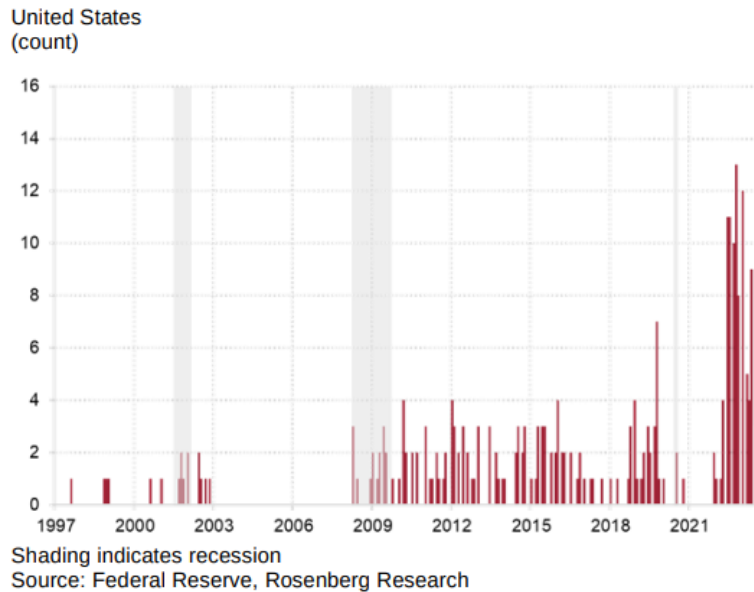
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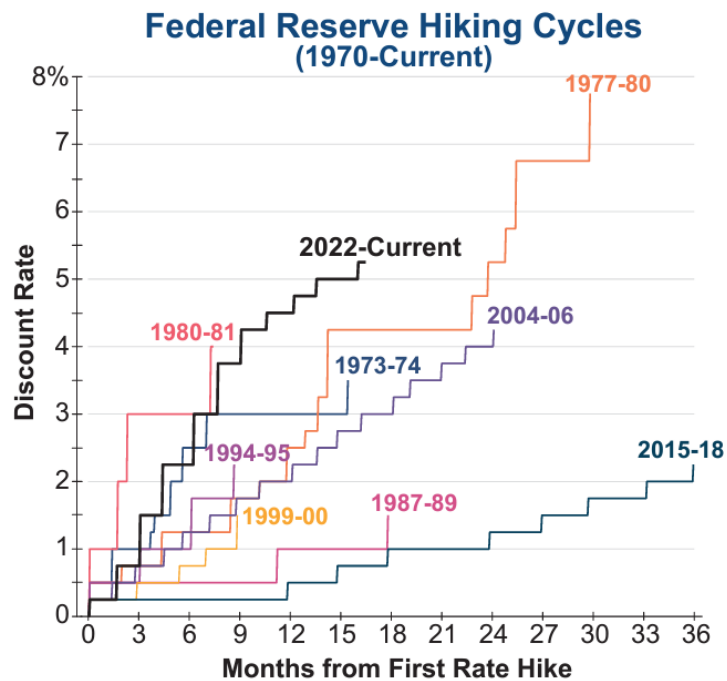
Exhibits

- A. Federal Reserve Beige Book – 12 district survey report published eight times a year with Rosenberg Research tracking mentions of recession.

CHART 7: Beige Book Mentions of Recession

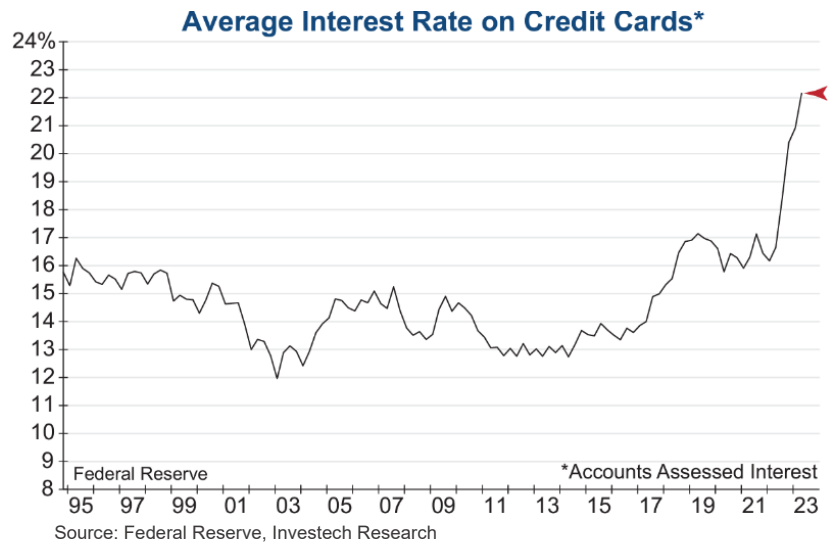


- B. Prior period Federal Reserve Hiking Cycles

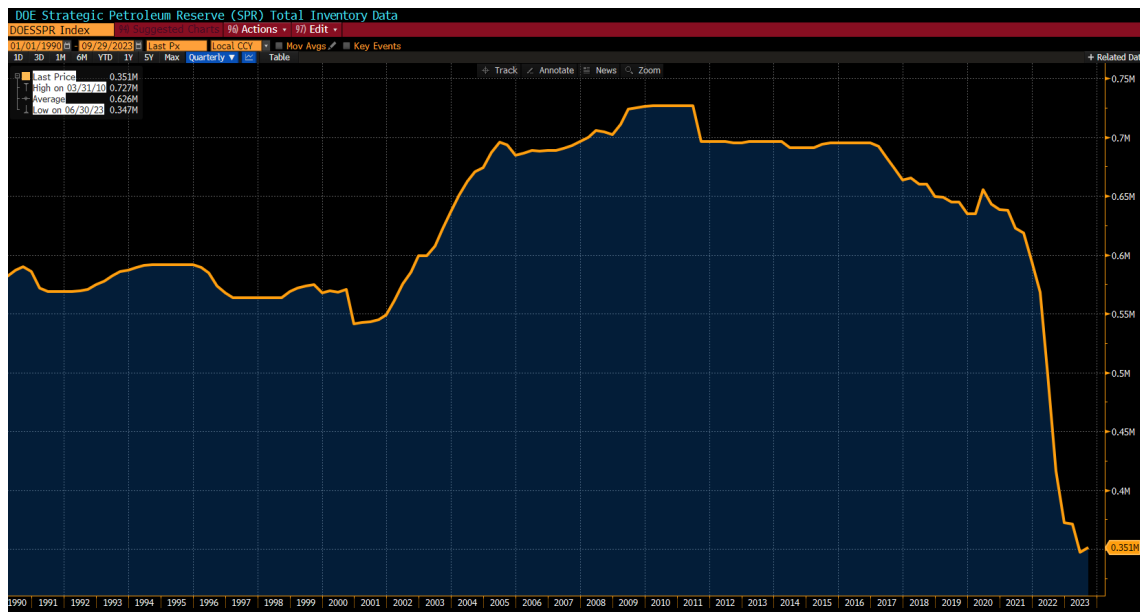


Source: Investech Research

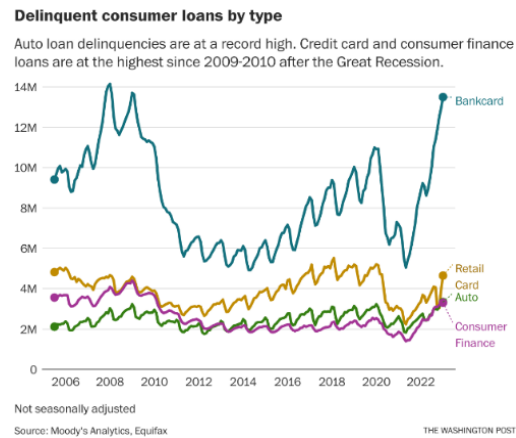
C. Average Interest Rate on Credit Cards – 16% in 2020 to 22% in 2023



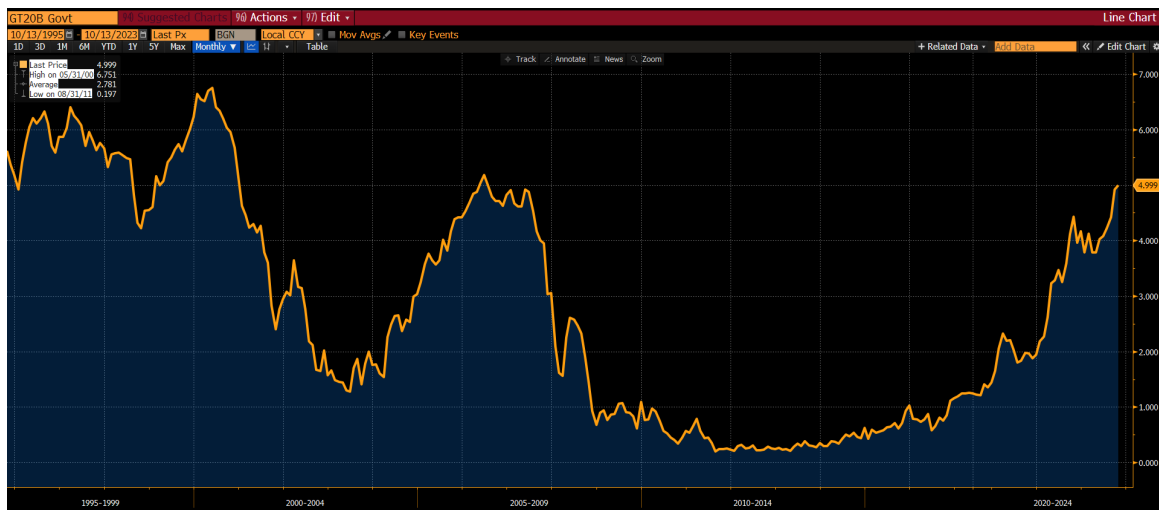
D. U.S. Strategic Petroleum Reserves (SPR) – 650 million barrels in 2020 -to- 350 now.
Oil supply is very tight. In July, Saudi Arabia announced it would reduce crude oil production by an additional one million barrels per day. Soon after, crude prices rose 20%. Depletion of half the SPR with little sign of replenishment gives the U.S. minimal leverage in guide market prices lower with releases from the SPR.



E. Delinquent Consumer Loans

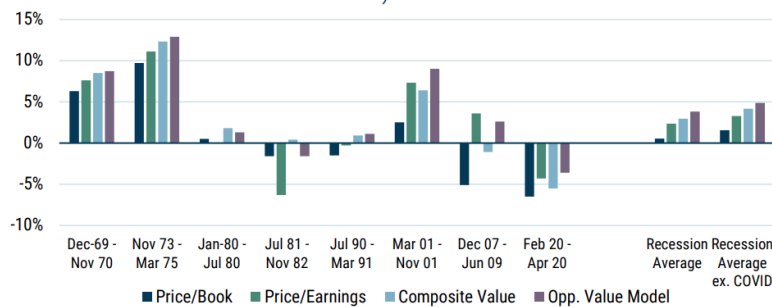


F. Change in 20-Year U.S. Treasury Note – near 0% to 5%



G. Value in past economic recessions as defined by Price/Book, Price/Earning. Composite Value and Opp. Value Models are proprietary definitions of value calculated by Grantham Mayo Van Otterlo & Co.

EXHIBIT 1: RELATIVE PERFORMANCE OF VALUE (CHEAP HALF OF U.S. STOCK MARKET) IN RECESSIONS



Data from 1969 – 2020 | Source: Compustat, Worldscope, NBER, GMO
Robust Value and Opp. Value Model are GMO proprietary value models.

Important Disclosures:

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Spectra Investment Management, LLC

401 SE Osceola Street, Ste 202, Stuart, Florida 34994 Phone: 772-324-5640

501 Palm Street, Ste B-6, West Palm Beach, Florida 33401 Phone: 561-623-8305