

MacroMania

3rd Quarter 2022 Letter

July 26, 2022

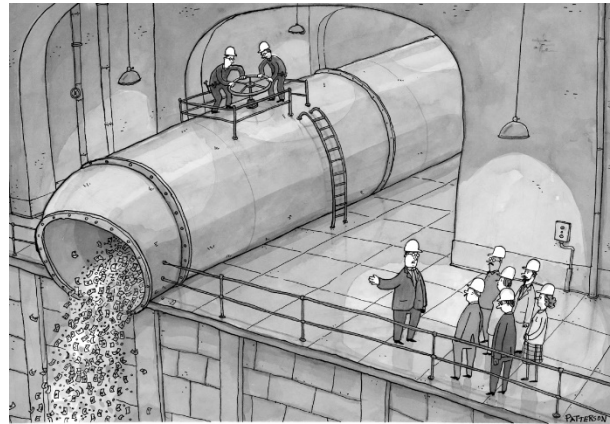
There is so much to talk about this quarter! We dream of reassuringly dull economic times. Until then, we will try to explain the macroeconomic mania present today.

Before jumping into MacroMania, here are a few brief thoughts on year-to-date strategy performance.

By a wide margin in 2022, our Global Equity Strategy continues to outperform the S&P 500 and MSCI All Country World Index.

But the second quarter was dreadful for all global stocks. What started in January with a bursting technology stock bubble now includes a recession sell-off across a broader range of stocks and sectors.

With the worst first-half year loss in 50 years for the S&P 500 - **Is the worst behind us? Unfortunately, we do not think so.**



"And this is where we adjust the interest rate."

It is worth bearing in mind that:

- This bear market is only 7 months old. Since 1929, the median duration of bear markets (peak to bottom) has been approximately 15 months.
- S&P 500 profit margins are falling. And it strikes us as irrational that the S&P 500 price-to-sales ratio (Exhibit A) is higher today than at the peak of the Dot.com bubble.
- 40-year high/rising **inflation conflicts with an economy falling into recession.**

We are planning for better days. But with so many conflicts and economic crosscurrents, it seems unwise to be bullish on the S&P 500.

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MacroMania

We borrowed a medical term to describe the current economic and investment backdrop - MacroMania. For this semantic context, MacroMania is a period of extreme divergent change in macroeconomic conditions. Not since President Jimmy Carter was in the White House has the U.S. economy experienced such a state of MacroMania.

In "A Sea Change" (January 2022) we outlined serious challenges ahead. Specifically, high inflation, soaring wages, and overvalued S&P500. We aren't macroeconomic forecasters, but we thought inflation would be persistent and the tech bubble would burst – both came to fruition. But we did not expect a recession so soon.

Inflation Update

The Consumer Price Index (CPI), the most watched indicator of retail prices, rose on an annualized basis of **9.1%** in June – a 41-yr high. At the wholesale level, the Producer Price Index (PPI) is up +**18.4%**, a 47-yr high. **How did such high inflation happen?**

The Federal Reserve and Congress overstimulated the economy by:

- a.) Keeping interest rates too low for too long;
- b.) Depositing \$2 trillion in bank accounts through covid fiscal policy programs.

Simply put, the U.S. government created a demand shock without an adequate supply of goods and services.

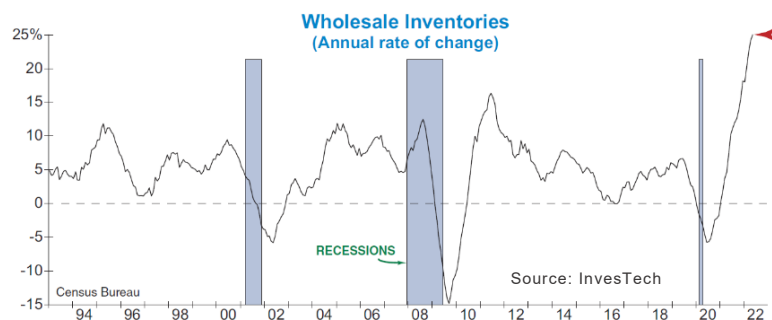
"Today, our view is that we are witnessing currency debasement with too much stimulus in the hands of people chasing too few goods.

"Rethinking Gold" Spectra Letter July 28, 2021

The supply chain was not prepared for this burst of demand. When shelves eventually filled, consumer preferences shifted – this stuff is too expensive! Businesses overstocked shelves and didn't expect price push-back. As a result, inventories bloated. Large retailers reported this phenomenon in April, with inventories growing by 43% at Target, 32% at Walmart, and 26% at Costco.

Beyond the glut of inventory, anecdotal signs of economic stress are emerging. On July 21, AT&T reported a big earnings disappointment, citing that customers are starting to delay paying their phone bills. And isn't it

interesting that soaring prices are also hitting the dating scene? The dating site OkCupid reported that 34% of its 70,000 app users said inflation was affecting their love life.



Moving forward, inventory discounts and cooling commodity prices should ease inflation pressure. We sense that inflation will remain uncomfortably high but peak soon.

A Looming Recession

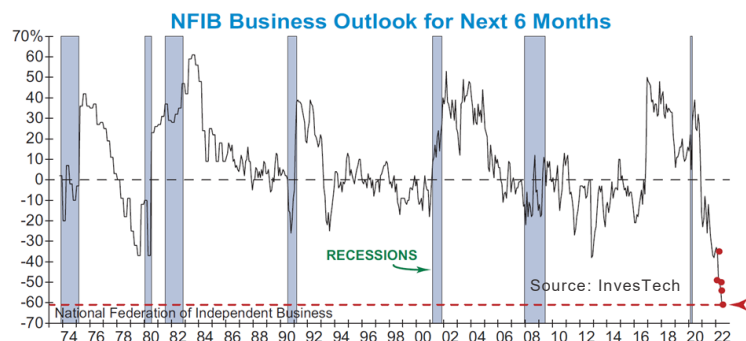
With fully stocked product shelves consumers are struggling to afford, U.S. Gross Domestic Product (GDP) is turning negative. The definition of a recession is two consecutive quarters with negative real GDP. In Q1 2022, the U.S. experienced a -1.4%

decline in real GDP. And now, the Atlanta Federal Reserve Bank GDP forecasting model predicts a -2.0% real GDP decline for Q2 2022.

Inflation is politically toxic. We fear the Fed will overcorrect with restrictive monetary policy, causing a nasty recession. It is entirely plausible that the Fed believes the only way to curb 40-year high inflation is to squash demand and cause a mild recession. If this is their plan, it would not be the first time the Fed has induced a recession to get inflation under control.

With government data time lags and revisions, the U.S. could be in recession now. Leading economic indicators confirm that economic activity is falling.

One of our favorite indicators of future business activity is the Business Outlook Survey from the National Federation of Independent Businesses (NFIB). This six-month outlook survey of future business conditions plummeted to the lowest reading on record. Since the early 70s, less pronounced declines have predicted recessions.



Despite this troublesome inflation-growth conflict, it is part of the Fed's job to keep an upbeat narrative. We never believed the Fed's "transient" [temporary] view of inflation in 2021. Today, we are nearly certain a recession will be reported soon, and comments from the Fed and Treasury once again seem detached from reality.

Chair Powell Says U.S. Economy Is in Strong Shape, Fed Can Avert Recession – Bloomberg, 6/29/22

Fed's Bullard Says U.S. Recession Unlikely and Expansion is in Early Stages – Bloomberg, 6/24/22

Fed's Bostic thinks recession can be avoided even with further interest-rate hikes – MarketWatch, 7/11/22

The Fed Pivot

Last year, the Fed dismissed inflation risk until high prices overwhelmed the economy. Late to the inflation fight, the Fed is on a war path of tightening monetary policy to slow inflation. And now, the Fed dismisses the risk of recession with indicators heading south.

With mid-terms just around the corner, we suspect a few more (.50% to .75%) Fed Funds rate hikes before the Fed **pivots back to stimulating** a weak economy. When the Fed pivots back to stimulating, stocks could recover quickly. See Exhibit B - Fed balance sheet growth and S&P 500 price chart.

There are still many signs of frothy excess in the economy. If the Fed doesn't pivot policy to stimulate the economy, there could be pressure across a spectrum of assets that depend

on low-interest rates to survive. Moreover, if the Fed does not pivot, there are credible concerns that, without raising taxes, the U.S. will struggle to service the national debt and entitlement programs.

With a tough set of trade-offs, we believe the Fed is in a policy cul-de-sac with few options to normalize economic conditions. We worry the **Fed Pivot** will become the **Fed Teeter-Totter** that doesn't resolve the inflation-growth conflict anytime soon.

Strategy Change

It is hard to know how this economic conflict gets resolved. A Fed Pivot would make politicians and investors happy in the short term. If conditions deteriorate further, our best guesstimate is that Fed Pivot occurs sometime in the 4th quarter.

With economic risk this high, we reduced equities in July. It surprised us that the small-company segment of the stock market held up so well after the Q1 GDP print of -1.4%. Related to the National Federation of Independent Business (NFIB) survey on page 3, smaller companies are more sensitive to recessions than larger companies. As a result of the NFIB survey, we cut U.S. small-cap exposure in half and kept proceeds in the money market fund.

We also raised cash by selling an international small-cap and a mid-sized company mutual fund/ETF. Stocks are cheaper with higher yields in the Eurozone, but we fear a series of rolling crises are on the horizon for Europe. A two-decade weak Euro might seem like a positive for Eurozone export demand. However, industrial materials are generally tied to US\$. This US\$ strength is a further hardship to inflation, energy rationing, and the "Unintended Consequences" (April 26) of the Russia-Ukraine War.

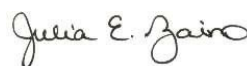
It is too early to know how this inflation-growth conflict plays out. We DO know that risk levels are high, our portfolios are well diversified, and our strategy has shown performance resilience in a tough year.

With so much to talk about, please don't hesitate to call. We look forward to providing you with another thought-provoking topic next quarter.

Very truly yours,



Scott A. Roads
Founding Principal



Julia E. Zaino
Principal

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Exhibits

A. S&P 500 Price-to-sales today vs. dot.com bubble peak. Source: Bloomberg



B. Fed Balance Sheet Growth and S&P 500. Federal Reserve balance sheet in white and S&P 500 index price in yellow. Source: Bloomberg



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