The following are the Exclusive and Sole Opinions of the Author.[1]

June 20, 2023

Are you smarter than Wiley E. Coyote?

The proverbial wall of worry is more like the mountain of doom.

Many indicators suggest that a deep recession is imminent. In anticipation, equity markets declined significantly in 2022. Bear markets usually end after a recession begins and interest rates start to fall. The recession has probably just begun, the FED has yet to "pivot" toward lower rates. Yet the market is advancing, recouping some/most of the declines, very much sector dependent.

The Yang and Yin of monetary expansion driving inflation and recession should be obvious to all. No longer prudent

[1] All opinions expressed by David S, Lerner in this newsletter are solely Lerner's opinions and do not reflect the opinions of Raymond James Financial, Inc. Lerner's opinions are based upon information he considers reliable. Raymond James Financial, Inc, does not warrant its completeness or accuracy and it should not be relied upon as such.

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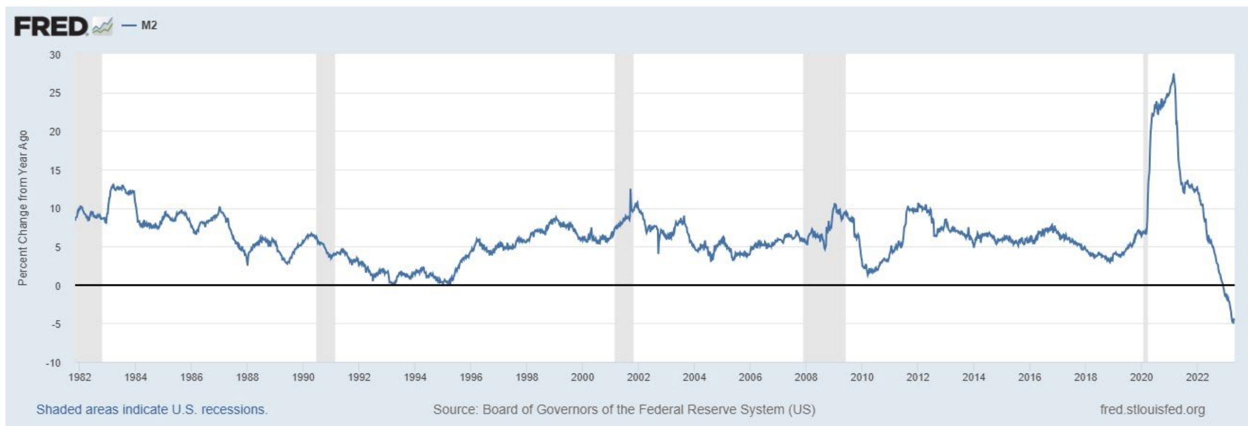
stewards of monetary policy, the FED has taken an outsize role in our economy, more powerful after successive policy failures.

It is a Faustian bargain, turning over the reins of the economy to the FED in return for "controlled" inflation. Increased deficit spending, post-covid, has been repurposed and continued in the oxymoronic Inflation Reduction Act, a permanent baseline spending expansion of two trillion dollars.

The huge money supply expansion in 2020 inevitably translated into high inflation and subsequently high real interest rates. That unprecedented growth and now unique contraction continues to exert powerful effects on the economy.



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In the absence of the FED's largesse, interest rates would continue to rise as the money supply contracted until the harsh economic discipline of a financial disruption would lead reform.

The market rally relies on a belief that the inevitable can be postponed indefinitely, by FED maneuvers.

Maintaining an illusion of price stability in the face of continued runaway spending and monetary contraction is now the FED's mandate, a shaky foundation for a resumption of a bull market.

The task of fooling most of the people most of the time is becoming more difficult as real incomes continue to fall.

The current market advances began with a significant sentiment low, and once again, as if magic, stock prices stabilized and began rising. Fundamentals and the world situation continued to deteriorate; yet stock prices rose as P.E. multiples expanded.

The initial declines were the most severe in modern times. 2022 was a very bad year for most stocks. The markets peaked late in 2021 and ended the decline one year later. The size and

speed of the decline seemed to validate an economic hard landing as the FED tightened the monetary screws.

Now, large capitalization growth stocks have recovered significantly, but remain marginally below the price peak. Investors have turned more optimistic, prices reflect that psychology, even if fundamental do not.

The advance has been very narrow, only large cap growth has recovered - most stocks remain in negative territory.

Historically, these indexes have consistently outperformed the S&P 500, setting the stage for a reversion.

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Psychology works against investors – trends take precedence over valuation. Investors are prone to focus on the short term, a psychological bias.

A.I. is the fad of the moment, an object of distraction, leading the technology sector. Is A.I. truly additive or is it a substitution or mere extension of existing technology? Is IT spending going to increase or be shifted? Don't know, but in my opinion, A.I. is an extension of existing technology not a paradigm change. A

smarter version of SIRI or Alexa should hardly move the profit needle, if at all, at their enormous parent companies.

A glistening bauble, attracting the most investors and investment at post mark-up prices. The curse of emotional investing at high valuations is repeated. Cloud computing capacity and the mass data sets required for A.I. are dominated by a few incumbents, that are fierce competitors. The current monopoly in A.I. chip sets is certain to be challenged by competitors and/or new technologies. A review of the price history of the dominant company in the aftermath of video gaming and crypto mining demand peaks should not be ignored.

Turning from the excitement of the moment to long term trends is sobering. The adjectives of fastest, steepest, largest are all applicable – but even that undervalues the consistency of the correlations over the last 20 years. Some events are truly rare – e.g., significant yield curve inversions and serious recessions. Others more frequent, lesser variations support the negative interpretation of the long-term data.

Each chart is worth thousands of words.

Not a Haiku.

Extreme yield curve inversion

Bank Failures

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Credit Contraction

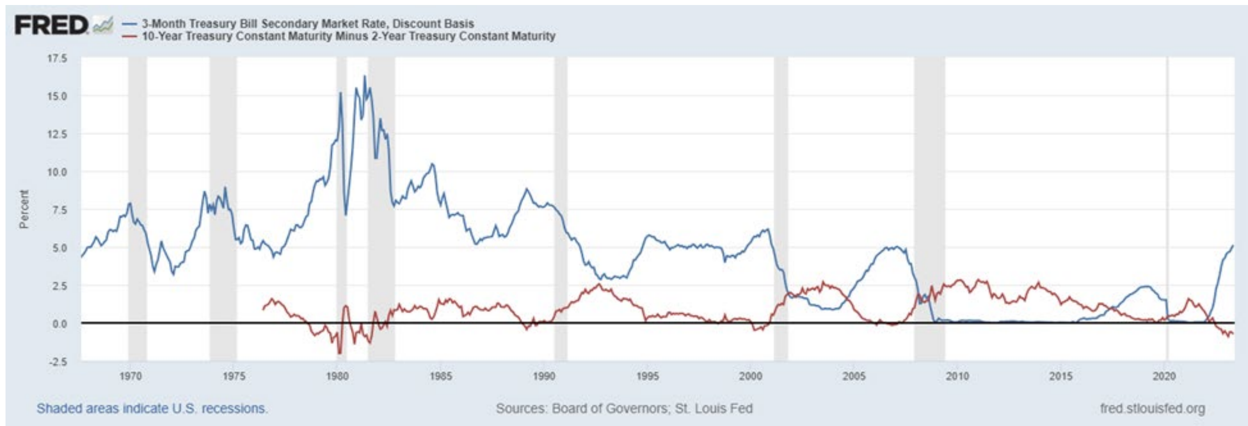
Leading Indicators

Employment

1980 and 2008?

Rapid and large interest rate increases

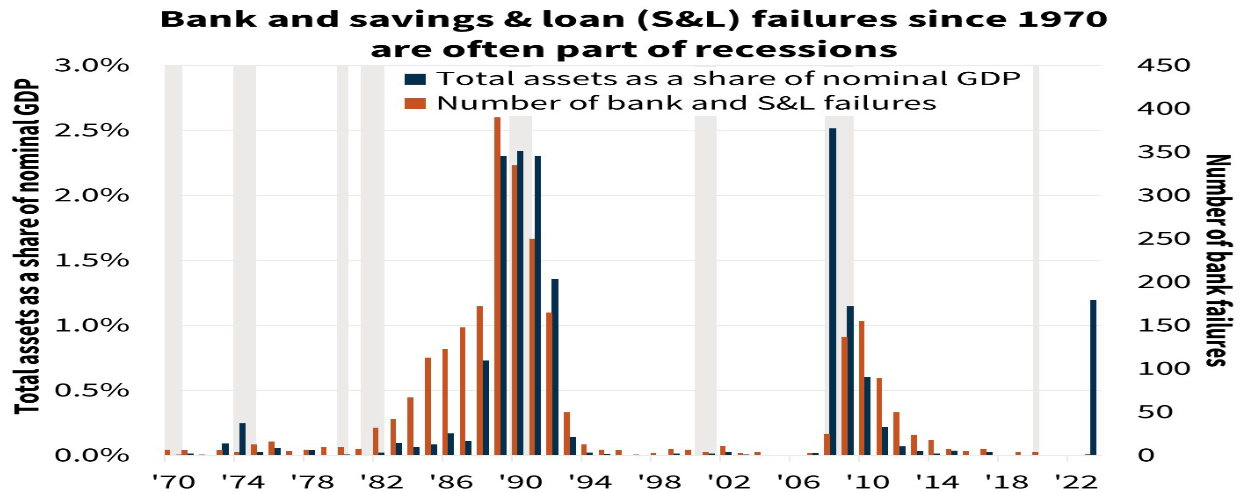
Rapid and large interest rate increases are rare, 1980 and 2008 are the only similar periods of comparable magnitude and speed. These and milder credit crunches preceded recessions (shaded regions) in the modern era. **The ultimate level of economic impairment is probably directly correlated to the size and speed of the rate increases**.



Yield curve inversions stand nature on its head with deleterious impacts on businesses reliant on a normal curve – banks and other financial institutions. Leverage is a two-edged sword now

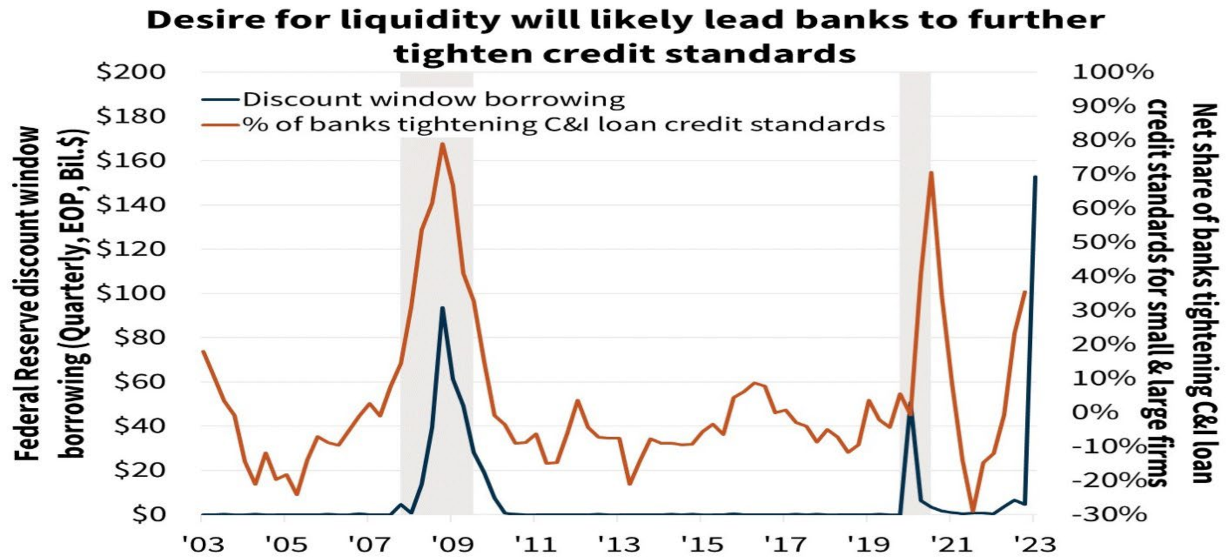
slashing through wide swaths of leveraged businesses and financial vehicles.

Bank Failures



Credit Contraction

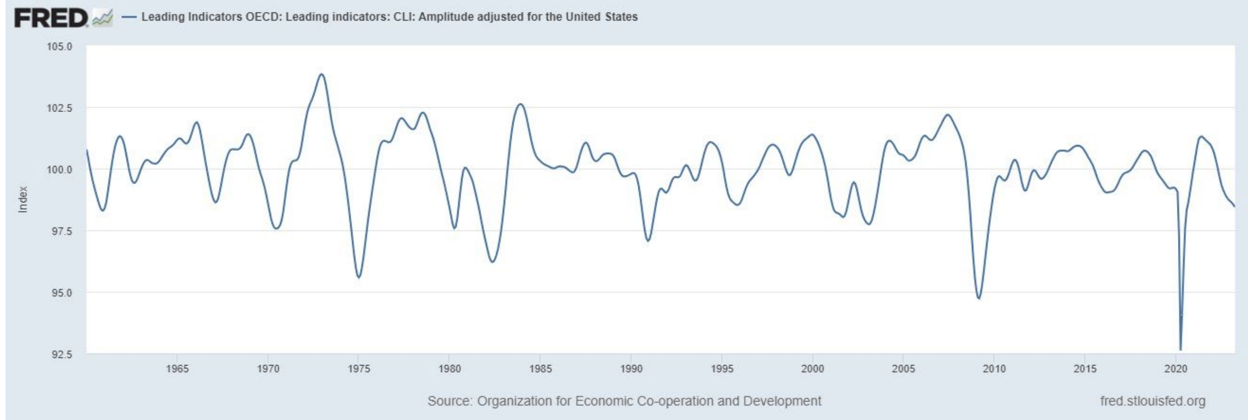
This in turn leads to a “credit crunch” depriving the economy of the funds needed sustain and increase and growth in the private sector.



Leading Indicators

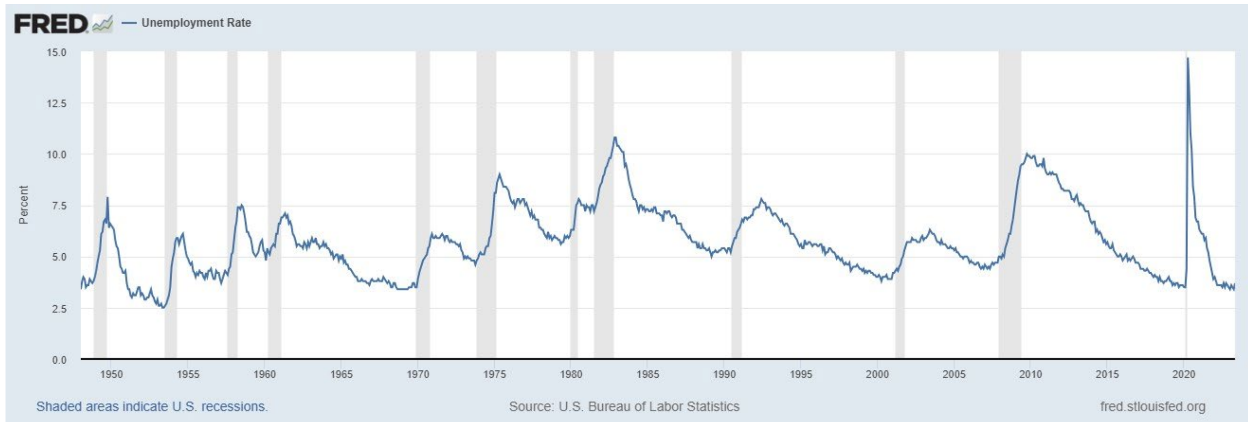
"The Conference Board publishes leading, coincident, and lagging indexes designed to signal peaks and troughs in the business cycle for major economies around the world." This set of data has fallen for more than a year, forecasting a recession. [2] OECD data confirms the decline, the long term chart provides perspective for the short term Conference Board Data.

[2] **The Conference Board Leading Economic Index®** (LEI) for the U.S. declined 0.6 percent in April 2023 to 107.5 (2016=100), following a decline of 1.2 percent in March. The LEI is down 4.4 percent over the six-month period between October 2022 and April 2023—a steeper rate of decline than its 3.8 percent contraction over the previous six months (April–October 2022).
"The LEI for the US declined for the thirteenth consecutive month in April, signaling a worsening economic outlook," said **Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board.** "Weaknesses among underlying components were widespread—but less so than in March's reading, which resulted in a smaller decline. Only stock prices and manufacturers' new orders for both capital and consumer goods improved in April. Importantly, the LEI continues to warn of an economic downturn this year. The Conference Board forecasts a contraction of economic activity starting in Q2 leading to a mild recession by mid-2023."



Employment

Strong reliance on the jobs numbers as evidence of the economy's strength has an alternative interpretation: unemployment has routinely troughed below 4% prior to recessions.



The unemployment rate is a composite of two indicators. These diverged in the May report. The unemployment rate rose from 3.4% to 3.7% in the Household data. In the same report, the Establishment data indicated a significant growth in jobs.

Because the household data is maybe more sensitive to employment changes – the increase from 3.4% to 3.7% is notable.

Many sensitive data series are showing that the labor market is softer, confirming the household survey direction.

Working hours are falling.

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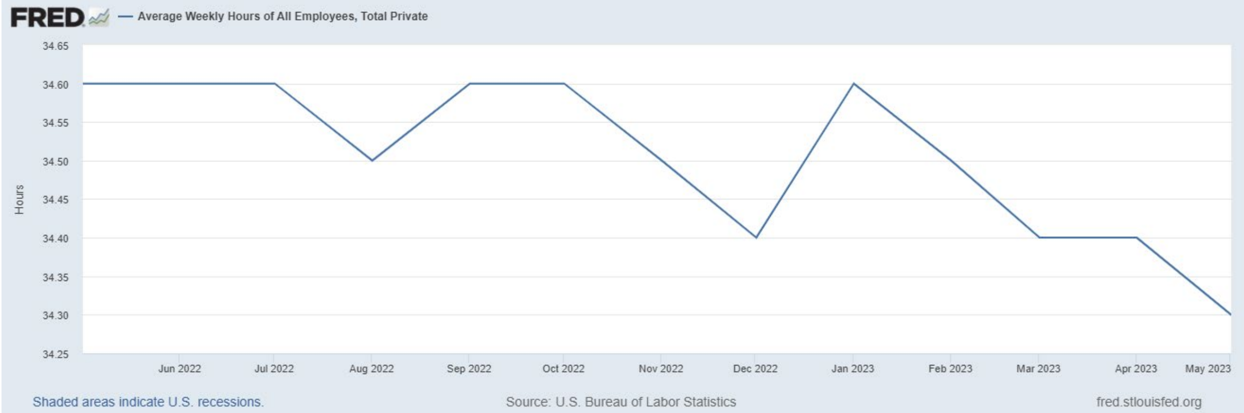
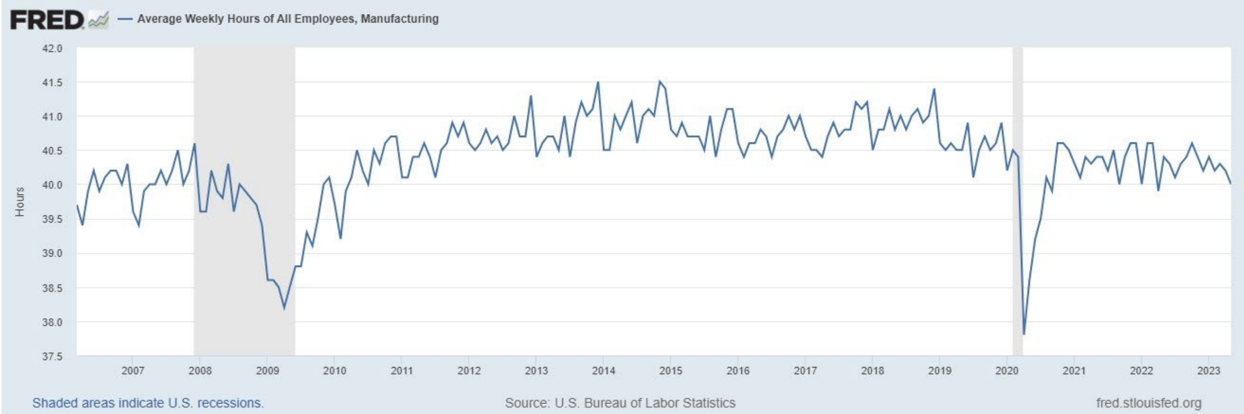




Continuing unemployment claims are elevated. Initial unemployment claims are rising.

CONCLUSIONS

1980 to 2008 to 2023

There is no single diagram or chart of the interplay of economic indicators that can accurately predict the short-term behavior of the economy. Many long-term indicators, particularly the yield curve inversions and Leading Economic Indicators suggest a significant recession is likely. Short term employment indicators are now beginning to rollover in line with leading indicators.

GDP divergences from the GDI

The headline focus on positive Gross Domestic Product is only half of the equation. A complete picture includes the complement, Gross Domestic Income.

US gross domestic **product** (GDP) is the total expenditure on all finished goods and services. The US gross domestic **income** (GDI) is the total of all income earned from the production of finished goods and services. GDP and GDI should be equivalent measures of economic output, because one person's expenditure is another person's income.

Modest divergence is normal and often reduced by revisions over time – but that is after the fact. Averaging the two measures is one compromise to get current readings.

"Real gross domestic income (GDI) decreased 2.3 percent in the first quarter, compared with a decrease of 3.3 percent (revised) in the fourth quarter. **The average of real GDP and real GDI, a supplemental measure of U.S. economic activity that equally weights GDP and GDI, decreased 0.5 percent in the first quarter, compared with a decrease of 0.4 percent (revised) in the fourth quarter."[3]**

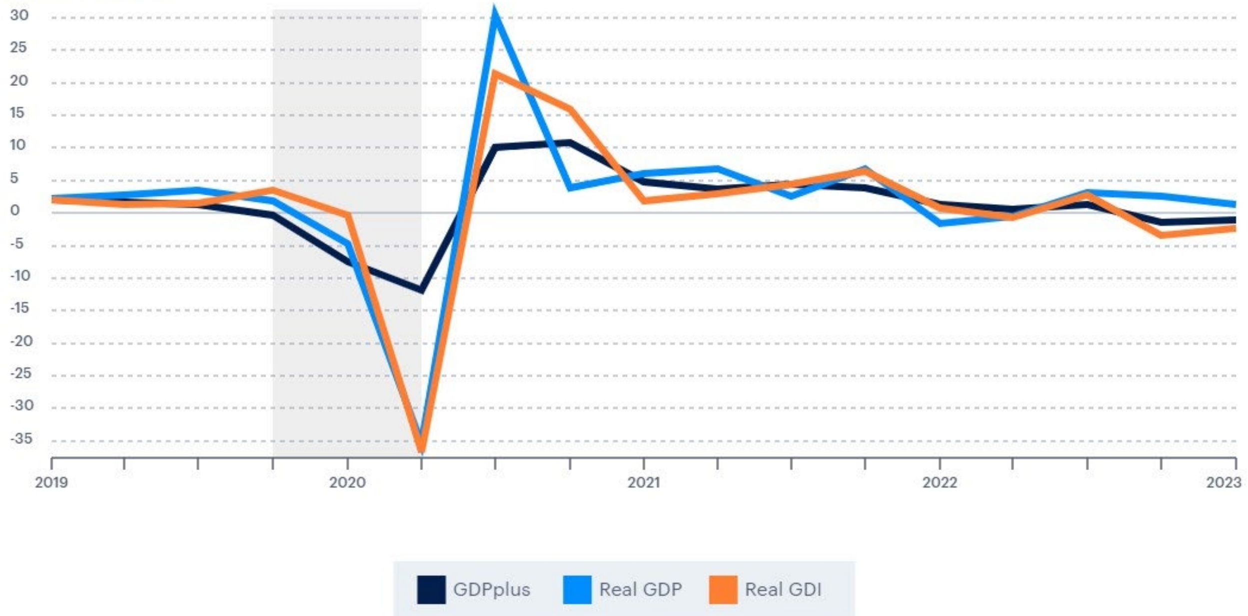
The Federal Reserve Bank of Philadelphia's Real-Time Data Research Center provides another measure "GDP Plus".[4]

[3] https://www.bea.gov/sites/default/files/2023-05/gdp1q23_2nd.pdf
[4] https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/gdpplus

GDPplus: An Alternative Measure of Real U.S. Output Growth

25 May '23

PERCENTAGE (%)



Notes: Shaded areas indicate NBER recessions. The data measure the quarter-over-quarter growth rate in continuously compounded annualized percentage points.
Sources: Bureau of Economic Analysis (BEA) and NBER via Haver Analytics. Federal Reserve Bank of Philadelphia.

The short-term GDP plus is in recession territory, the perspective provided by the long-term chart is worrying. The enormous swings from the Covid lockdown fiasco were aberrant, the 1980 and 2008 downswings appear to be almost “regular” by that measure.

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One enduring mystery of my career is that investors are not more attuned to available information and seemingly purposefully ignore historical precedents in pursuit of short gains. Trading is not investing. It requires a different set of rules and critical discipline to recognize the overall risk level in the markets.

Paradoxically, the best investment opportunities occur when values are low because the level and nature of risk is **perceived** to be very high. *Once trepidation is replaced with confidence*

the calculation reverses. The risks may remain, even increase, but are no longer "top of mind".

" One running gag involves the coyote falling from high cliffs, after momentarily being suspended in midair—as if the fall is delayed until he realizes that there is nothing below him."[5]

In additon to maintaining a balanced portfolio with higher than normal cash levels, trailing stop loss orders may function as a parachute or vaccination to alleviate a signifcant fall in prices.

Lower interest rates would benefit many income oriented strategies as well as equity valuations, which are anticipating the long awaited FED pivot. Higher rates and all bets should come off.

[5] https://en.wikipedia.org/wiki/Wile_E._Coyote_and_the_Road_Runner

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