RAYMOND JAMES®

It isn't your father's arithmetic

No, we aren't there yet

Gravity remains a constant in the physical world, inertia must yield to entropy. Rockets and markets return to earth. At the apogee, acceleration ceases, momentum disappears, as does gravitational force. Then the arc of flight turns down, acceleration resumes.

The **stock market buy** signal generated by the panic selloff in June is in stark contrast to the **bond market sell** signal for the economy, generated by a persistent and deep yield curve inversion. The rally from the June lows is now in its sixth month.

The conundrum – positive price performance despite the significant, negative, economic dislocation indicated by the inverted yield curve.

These signals have historically been always right (although past performance is no guarantee of future results) – so the current conflict of direction requires explanation(s).

Probably most important factor clouding analyses is the disruption of World's economy by Covid. It was and remains a unique event in modern history.

In the United States, the health emergency turned into a self-inflicted economic catastrophe. Panic in the halls of governments led to the disregard economic reality. A perfect storm of fiscal and monetary excess, too much, too fast, too long. Spurring huge demand in the face of severely constrained supplies funded by massive liquidity – what could go wrong? That "temporary inflation" – we didn't know, was meant in historical terms, maybe a few, handful of years.

In China, they followed the worst of the West's repressive solutions. Now that experiment is ending with horrific human suffering but the prospects for surviving a domestic economic collapse. *The impact of that change on the world economy should not be underestimated.*

Heart or Head?

Sentiment versus Precedent

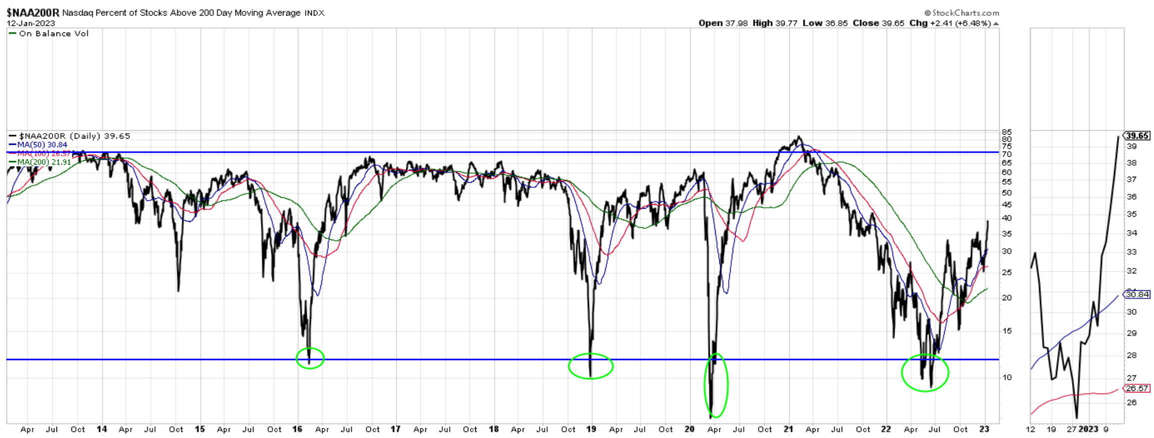
There is a strong correlation between economic growth and stock price appreciation. Historically, the stock market and the economy move in lockstep, except at important economic trend turning points. Stock values remain elevated relative to earnings when measured against cyclically adjusted price earnings ratios, amenable to many interpretations.

Robert Shiller cyclically adjusted price-to-earnings (C.A.P.E.)[1]

Theories based on behavioral Investing have historically been a useful investment approach to analyzing equities.

Emotions can change rapidly and become exaggerated, leading to a readjustment of values when the dust of the selling stampede settles.   The longevity of those changes in attitudes lasts until the investment status quo changes, again.

Market sentiment has experienced extreme readings with greater frequency. A random drunken reel – not an amble from one extreme to another. Stocks have plunged into deeply oversold extremes 4 times in the last 5 years, creating strong buying opportunities. (Just 6 times in the last 20 years!)



Investors threw in the towel on the markets in the first half of 2022. Another – "the world as we know it is ending" panic ensued as real interest rates soared reducing the value of future returns and increasing the costs of debt service. The probability of a significant recession was included in the mix, but secondary to the yield revaluation in price earnings ratios. Uncertainty added to the valuation distortions.

A "perfect" emotional buy signal emerged from this behavior. The market has rallied substantially – despite the longer-term implications of the inverted yield curve.

Those moments of extreme emotions passed into memory. The next episode is yet to unfold, as earnings are beginning to deteriorate beyond forecasts. P.Es should resume their fall as the decline in earnings becomes more apparent.

Conditions precedent

The fundamentals are bleak, leading indicators are strongly signaling a recession.[2] The exception is employment, deteriorating, but still seen as evidence of economic strength, seeming to hold up in the face of the FED's campaign to increase unemployment.

[2]https://www.conference-board.org/pdf_free/press/US%20LEI%20PRESS%20RELEASE-Dec%202022.pdf

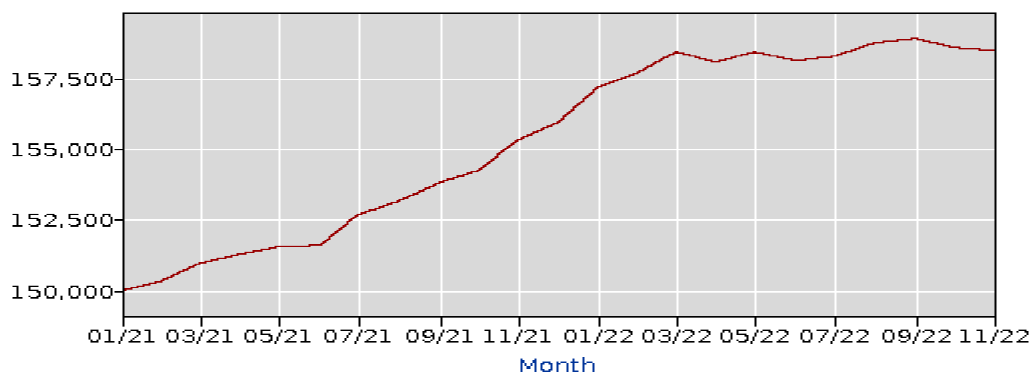
The unemployment rate is a lagging indicator, perhaps more so than ever, after the distortions in the workplace caused by Covid.   Beyond the headline numbers are some negative trends.

A portent of higher unemployment is the months long divergence of the household and establishment surveys[3].   The debate about which survey is more accurate is interesting but obscures the fundamental fact that the household series has been less robust than the establishment survey.[4]   The household survey shows that far fewer net jobs were added since March of 2022.[5]

Historical patterns suggest the rosier establishment survey should follow the household survey lower. Labor hoarding is giving way and employers are reducing headcounts as prospects for an economic slowdown grow. The job situation can change quickly as openings contract and terminations expand.

Household Survey (Seas) Employment Level

Employed, over 16, in thousands



Since the Great Recession of 2008 temporary workers have expanded as part of the labor force.[6] These jobs are the most sensitive to economic trends. The last three recessions

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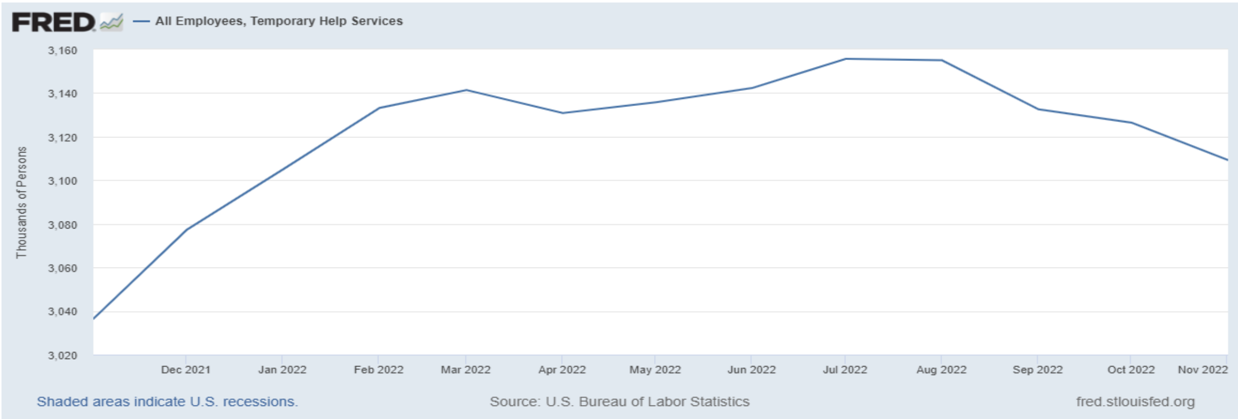
3 https://www.bls.gov/news.release/empsit.tn.htm#:~:text=%2D%2DThe%20household%20survey%20has,counted%20separately%20for%20each%20appearance.

4 https://www.forbes.com/sites/greatspeculations/2022/12/23/upon-further-review-that-hot-labor-market-is-really-ice-cold/?sh=444bdae672b5

5 https://data.bls.gov/pdq/SurveyOutputServlet

6 https://www.bls.gov/opub/mlr/2021/article/temp-help.htm

followed a downturn in temporary workers. Another ominous turn in the employment statistics.



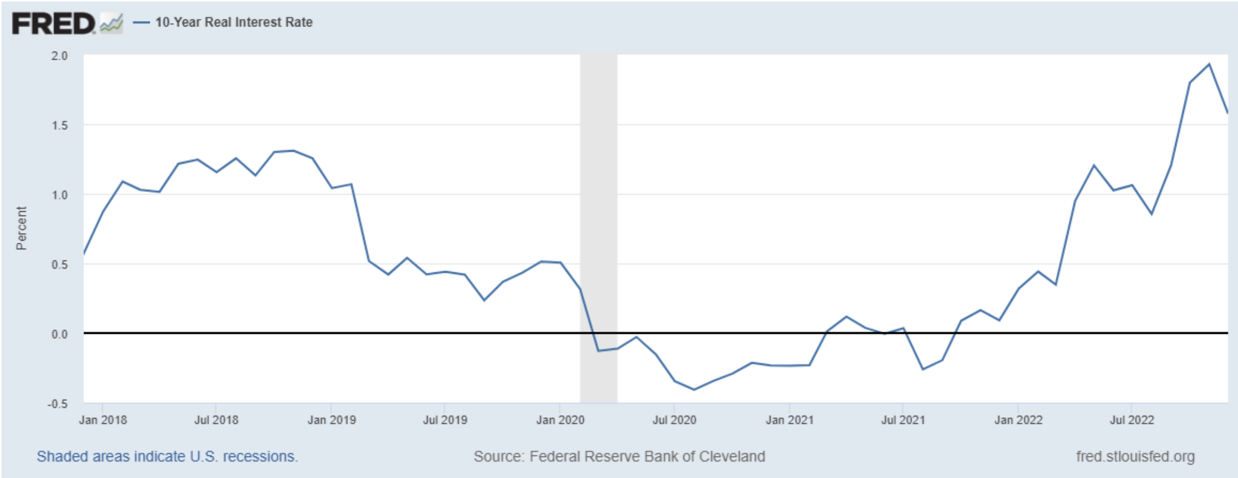
The FED's interest rate increases are beginning to increase unemployment and underemployment, intended as another "transitory" change.

The impact of the FED's move to real interest rates is also a substantial brake on the economy, beyond raising unemployment. Real interest rates raise the bar for achieving returns on investment.

The end of negative real interest rates.

"A *real interest rate is an inflation-adjusted interest rate…. real interest rates are much more informative than nominal interest rates about the stance of monetary policy.*[7]"

[7] https://fredblog.stlouisfed.org/2022/05/constructing-ex-ante-real-interest-rates-on-fred/?utm_source=series_page&utm_medium=related_content&utm_term=related_resources&utm_campaign=fredblog



Real interest rates[8] turned sharply positive after several years of very low and finally two years of negative real rates. Monetary policy is no longer permissive, it is "restrictive."

The yield curve reflects investors' beliefs about rates of inflation over time. <u>The curve becomes inverted when it embeds lower inflation expectation over time, which comports with lower economic growth rates.</u>

The two-year 4.5% treasury yield now represents an expected real return over two years - nominal rates are expected to exceed inflation over the period. (4.5%-3% =1.5% real). The ten-year nominal rate of 3.5% also represents a real return – suggesting even lower inflation rates than over the next two years (3.5%-2%=1.5% real)

The restoration of real interest rates is exposing excesses in the investment world, until now hidden from view by a lack of regulation and the ability to easily find additional financing for their promotions.

The most absurd concepts were promoted and flourished, until positive real interest rates were restored. Some, like FTX collapsed overnight, others failing, some (many?) are yet to be realized. Private equity, for example, seems ripe for a harsh reevaluation. Repeated fund-raising rounds at ever higher self-derived, hypothetical valuations levels – what could go wrong?

The combustion that started in the underbrush of financial world is now a spreading forest fire. Once the conflagration starts it usually burns until the fire runs out of fuel.

[8] Nominal interest rate minus inflation rate = real interest rate

The rationalization of values based on real rates of interest will continue until equilibrium is established. For some assets, the level of equilibrium will be zero.

The markets appear relatively unconcerned about the possibility of substantial financial instability due to unforeseen structural problems while reaching that equilibrium.

SUMMARY

The June market plunge led to panic readings in momentum and sentiment. Income investments joined equities in the rout.

Those lows culminated the worst first half in recent history, by a wide margin for both the equity and debt markets.

Those fear filled days are past, replaced by moderate unease about the course of the economy and the markets.

The markets are operating under contradictory “signals” – the sentiment and momentum buy signals of June and the persistent sell signal of the massive yield curve inversion.

Probably most important factor clouding analyses is the disruption of economy by Covid. In the United States, the Presidents, the Congresses and the FED created a perfect storm of fiscal and monetary excess – spurring demand in the face of constrained supplies.

A recovery from this fiasco of profligacy is far from assured. Current policies are contradictory, fiscal excesses continue to run counter to monetary restraint.

Half right is wrong when attempting to manipulate the economy.

CONCLUSION

A Parlay is a single bet that links together two or more individual wagers and is dependent on all of those wagers winning together. The benefit of the parlay is that there are much higher pay-offs than placing each individual bet separately since the likelihood of hitting all of them at once is much less. If any of the bets in the parlay lose, the entire parlay loses. If any of the plays in the parlay ties, or "pushes", the parlay reverts to a lower number of teams with the odds reducing accordingly.[9]

[9] https://en.wikipedia.org/wiki/Parlay

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There Are Alternative to Equities

No need to bet the parlay to win!

The sentiment buy signal and the bond market inversion recession signal are probably sequential instead of simultaneous. The substantial rallies in June and November are probably "adjustments", reducing the rate of decline. (Not a resumption of or a new bull market),

Investor opinions about the future path of the FED policies are constantly revised: How high is the terminal rate? How fast will it be reached? How long before the easing begins? How high will unemployment go? The current consensus approximations, 5% terminal rate, within 6 months, falling by the beginning of 2024 and 5%+ unemployment.

Investment outlooks remain remarkably upbeat, confidence in the forecasts is high – so Fear Of Missing Out (FOMO) continues to drive trading. It seems premature for a genuine market bottom, far too soon for greed to replace fear as an investment motivation.

The waiting is the hardest part
Every day you get one more yard
You take it on faith, you take it to the heart
The waiting is the hardest part[10]

Stock valuations remain far above average, as earnings fall, and prices rise. While PE ratios increase before the end of bear markets and recessions, embracing the recent rally as the inception or confirmation of a bull market is likely premature

Traditional "fundamentals" are alarming, P.E. ratios and earnings projections are still too high for a substantial market low. I continue to look for below average ratios applied to lower earnings. Looking at the S&P 500 – 12-15 times earnings of $200 continues to suggest targets between 2,400 and 3,000– at least 25% below the current level.

THERE ARE ALTERNATIVES TO EQUITIES until the picture comes into better focus.

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[10] "**The Waiting**" is the lead "The Waiting" is the lead single from Tom Petty and the Heartbreakers' album Hard Promises released in 1981.single from Tom Petty and the Heartbreakers' album *Hard Promises* released in 1981. https://en.wikipedia.org/wiki/The_Waiting_(song)

Real interest rates have rebounded from historically negative levels. It happened in an investment instant, promising to provide investment returns for years if not longer.

If you can get 5-6% with reasonable certainty, there is reduced incentive to buy stocks. Recession, deflation, falling real earnings are not the ingredients for as bull market in equities.

Hybrid preferred shares, infrastructure investments, real estate are alternative income investments. Investors can also follow some of the government spending into green utilities and defense.

As a contrarian investor, I was concerned about what I perceived as a uniformly negative outlooks, until the I read this weekend's financial magazine of note[11]. I had momentarily forgotten that Wall Street is always bullish, on something, somewhere. The forecasts for 2023 were benign, positive, with modest variation – no outright negative outcomes. The projected year end price earnings ratio is 19-21. That is a frightening consensus – and I thought everyone, not just major corporation executives, were bearish.[12]

Real returns in real money are now more important than ever. [13] That is one important message of an inverted yield curve. Earnings yield returned to shareholders in the form of dividends represent one avenue, interest payments another, as current interest rates appear to be above future inflation rates.

[11] Barron's – The 2023 Outlook – December 19, 2022

[12] At least two-thirds of CEOs of the biggest companies surveyed said they expected the next six months to bring worsening customer demand, industry conditions, access to capital, and domestic and global growth, the survey from CEO advisory firm Teneo Holdings LLC found. Investors, Big-Company CEOs Split on Economic Optimism, Survey Says https://www.wsj.com/articles/investors-big-company-ceos-split-on-economic-optimism-survey-says-11671507608?st=3pfu2hi75xq06rq&reflink=desktopwebshare_permalink
Two-thirds of chiefs of large firms are bearish about the economy, while investors and heads of midsize firms are more optimistic

By contrast, among both midsize company CEOs and large investors, two-thirds or more expect improvement in the same areas over the next six months, the survey found.

[13] https://www.wsj.com/articles/defensive-stocks-become-hideout-for-investors-in-a-rocky-market-11672277166?st=fyo6h9s48bf97f8&reflink=desktopwebshare_permalink

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