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The market adage, “Make the trend your friend”, is often quoted and implemented in tactical or dynamic investment portfolios. The ability to correctly identify a trend, particularly early, provides the potential for gains as long as the trend remains intact. Portfolio managers all have their preferred trends they like to track or follow. Some are price-based such as moving averages while others utilize a combination of volume, volatility or other risk factors.

There are also closely followed trends for the overall economy; from unemployment to GDP or consumer confidence, trends help investors gauge what the future may hold. The challenge for investors today is knowing which trends to follow as almost never before have I seen so many apparently conflicting trend occurring at the same time.

Author and statistician Nassim Taleb made the study of Black Swan events popular almost 20 years ago. Black Swan’s are events that theoretically are so rare that they are effectively never expected to occur. However, because there are essentially an infinite number of events that could be labeled as Black Swan’s, it seems every couple of years something happens in the economy or markets that has never occurred before.

Following that logic, it is therefore predictable that we will experience something in 2023 that has never happened before regarding a potential recession. Never before in U.S. economic history have we had so many data points that suggest a recession is looming. Confidence, Sentiment, PMI Manufacturing, and Treasury Spreads are all at levels where every prior occasion the economy went into recession. Contrast that with current employment data that shows the unemployment rate below 4%. Never in U.S. economic history has there been a recession when unemployment was below 4%. Something will have to give.

Trends today appear to be unreliable as reversals occur on practically a weekly basis. U.S. growth stocks have been trending lower for some time, but small cap value has been trending higher since October 2022. Investors are stuck between long-term data that shows the stock market drop on average about 40%, peak to trough, when the U.S. enters a recession. We are only about half-way to that magnitude of correction from the December 2021 market high. There are

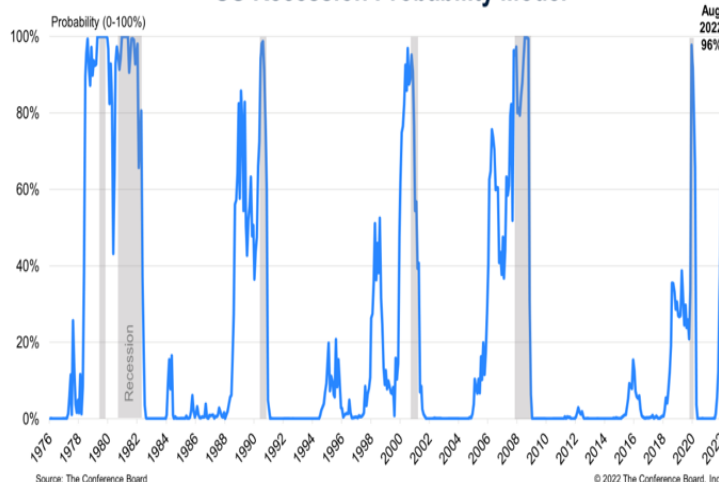
equally signs of ‘green shoots’ suggesting a bottoming may have occurred and economic data will accelerate in a positive direction. If this turns out to be accurate and not head fakes, investors will not want to miss out on what could be strong and rapid rally in equities back to prior highs. We know that one group of data and trend lines are lying, but we don’t know which one.

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The mixed messages coming from the Fed are certainly not helping matters. Many market participants and analysts expected the Fed to sound a relatively dovish posture following the February rate hike as it was presumed the Fed

had gotten close to their terminal rate in the fight against inflation. Instead, Powell remained rather hawkish and suggested the Fed was more than willing raise rates higher than economists were forecasting. If true, the risk of recession greatly increases as higher rates and tighter financial conditions likely leads to a broad economic contraction. Conversely, if the Fed pivots and communicates a 2.5 percent or even 3 percent core inflation rate is acceptable, the Fed may be very close to ending rate hikes and the potential for a ‘soft landing’ (i.e., no recession) would greatly improves.

US Recession Probability Model



The only market adage more quoted than ‘make the trend your friend’ is probably ‘don’t fight the Fed’. We predict that we are back to a time where the equity market direction is likely to be highly correlated with Fed policy. Two more quarter-point rate hikes and most economists believe a recession may be averted. However, when the minutes of the last Fed meeting were released, it was clear some of the Governors with a vote believed the Fed should hike 50 basis points which explained Powell’s more hawkish tone.

Courtesy of the Atlanta Fed, the data from GDPNow has been one of the more accurate forecasting tools for economists and portfolio managers on forward GDP prints. This chart just confirms the market confusion hovering between slight contraction and slight growth in the overall economy.

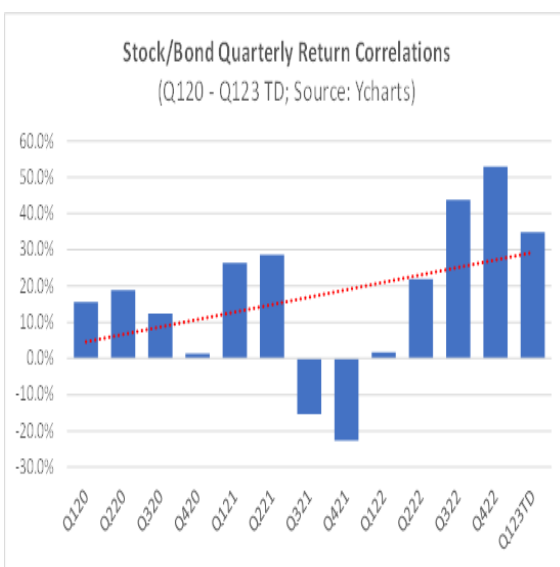
Spreads Blowing Out



The Treasury Dept enacting ‘emergency measures’ has become somewhat commonplace, but the latest version is making many bond traders nervous. Treasury bonds have long been considered a ‘safe haven’ for investors as the most liquid and stable sovereign debt market. Debt ceiling forced government shutdowns in 2011 and 2013, which ultimately led to a downgrade in the U.S. sovereign debt rating, saw credit default swaps increase 8-fold from historical levels. The cost of insurance on a U.S. government debt default typically costs less than 0.1% but has risen to 0.7% today. Deficits are projected to be an unsustainable 5% of GDP for the coming years. With Republicans having taken control of the House and many deficit hawks among their ranks, traders are concerned about legislation raising the debt ceiling passing before the economy is harmed.

- Federal debt held by the public is set to hit an all-time high in 2028 on the current trajectory with further increases as far as the eye can see.
- The Congressional Budget Office has consistently under-estimated future debt levels. As recent as 2009, the CBO forecasted debt to GDP of 57% in 2023 rather than the 98% actual.
- The budget cannot withstand the rising debt service costs at current rates meaning either taxes will have to move substantially higher or drastic budget cuts will be required.

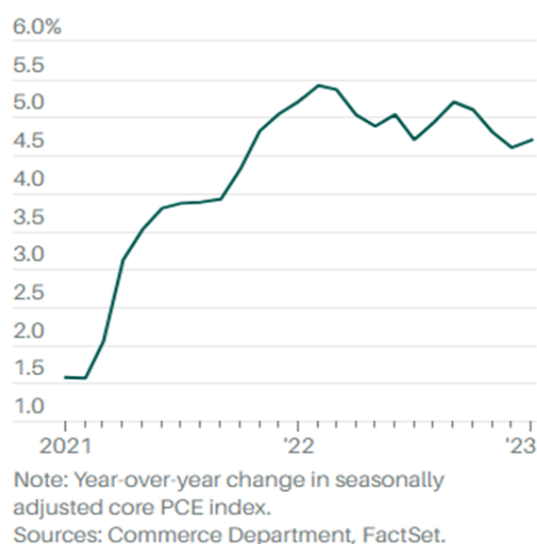
Stock and Bond Correlations



Last month, we wrote about the importance of return correlations when building portfolios. Historically, investors combined stocks with bonds to manage overall risk and maintain a diversified portfolio. The average return correlation between the S&P 500 Index and the Bloomberg Aggregate Bond Index from 2005 through 2022 was approximately -0.02, based on daily observations. Today, we see return correlation estimates as high as 0.5 (see chart) between the asset classes, which is well above the longer-run average. The results are not surprising given that we have lifted off from the zero bound in interest rates.

- With the lift off from zero, bonds were inevitably going to repriced downward. Likewise, higher rates proved a headwind for stocks in general as leverage became more expensive. Both equities and fixed income valuations declined in unison, particularly in 2022. The question is when will bonds again be a diversifier to equity volatility?
- Theoretically, as new bonds are issued at higher rates, they will provide sufficient competition for investor dollars, particularly when risk-adjusted equity returns are unfavorable. It is likely in the near term, when we get more clarity from the Fed, we will see the correlation figures fall back to more normal levels.

Persistent Inflation

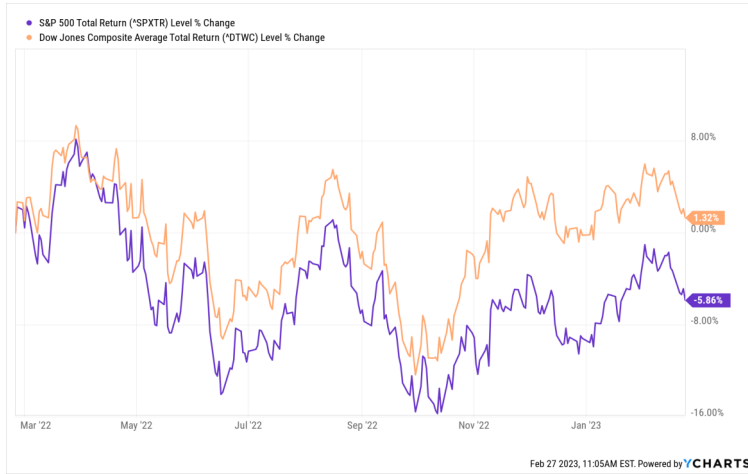


Last Friday, the core personal consumption expenditures price index, the Federal Reserve’s preferred measurement of inflation, rose by 0.6% for the month of January and up 4.7% year-over-year. This increase came in above economists’ expectations and as a result, fueled market’s concerns that the Federal Reserve will not only have to continue to raise interest rates, but also maintain higher interest rate levels for longer in order to combat inflation. As a result of the news, all three of the major indices fell sharply, with the tech dominated NASDAQ leading the pack and finishing the day down by more than 1.6%. And with Friday’s decline, the S&P 500 is set for its worst week since December 9th of last year.

- The core personal consumption expenditures price index (PCE) is the value of the goods and services purchased by, or on the behalf of “persons” who reside in the United States.
- With Friday’s market decline, the S&P 500 had its worst week since December 9th of last year, while the Dow finished its fourth straight weekly decline.
- If inflation persists, the Federal Reserve is unlikely to be able to lower inflation without having to continue its rate hike agenda, and in turn, increasing the likelihood of a recession.

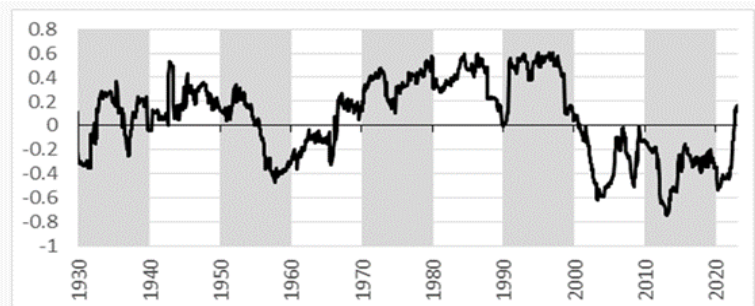
Macro View – Russia’s Invasion a Year Later

Last Friday marked the one-year anniversary of Russia’s invasion of Ukraine. U.S. equity markets had already begun their bear market decline ahead of Russia’s February 24th invasion. In 2022, markets were faced with significant inflationary pressures. The invasion may not have been the root cause of the inflationary surge in the U.S. that sparked the Federal Reserve to take swift action in order to combat inflation, but a surge in crude prices and other commodities didn’t help. Fast forward one year since the invasion, as of the time of this writing, the S&P 500 Index (TR) is down about 5.86% while the Dow Jones Industrial Average (TR) is up 1.32%. The war between Russia and Ukraine continues on and progress towards a peace deals appears doubtful. And even if



Fixed Income – Change in Correlations

Historically, stocks and bonds have had a negative correlation to one another. When stock prices appreciate, bond prices depreciate, and vice versa. However, in 2022, the chart below shows the trailing three-year correlation between stocks and bonds turned positive and is something that has not happened since November of 2000. So, what could have caused this dramatic spike? One could say the increase in correlation between stocks and bonds could have resulted from inflation, to where the Federal Reserve was forced to take swift action by raising interest rates. This dramatic increase in interest rates triggered a bond market sell-off and repriced growth stocks, whose valuations are dependent on low discount rates. As inflation persists, it would not be unreasonable to believe that correlations between the stocks and bonds will remain high for the foreseeable future.



Source: SBBI Ibbotson US Large Stocks and US LT Govt until 1989. Bloomberg thereafter.

Taking Stock – Can’t Catch a Break

Boeing (BA) has certainly had its struggles over the last decade. Last Thursday, those struggles continued as the aviation company suffered another hit when they were forced to temporarily halt delivery of their 787 Dreamliner planes resulting from fuselage issues. News of the halt drove the company’s stock down by more than 3% in after-hours trading and is just the latest issue the Dreamliner saga, which are often used for long-haul international routes. Back in 2021, Boeing was also forced to halt deliveries for the second time in less than a year due to issues determined by the FAA. And like before, Boeing will not be able to resume deliveries until they are able to demonstrate to the FAA that it has resolved the issue. As issues continue to pile up, one could question if there needs to be a change at the management level in order to get the company back on the



Technical – Falling Wedge Formation

Last week, Bloomberg Television’s Markets Correspondent Abigail Doolittle mentioned that there is a possible bull wedge formation on the S&P 500. As you can see are the chart below, the index bounced off of the 200 Daily Moving Average (DMA) on Friday and is starting to form what appears to be a Falling (Bullish) Wedge pattern. This pattern would suggest, if the index were able to hold the 200 DMA support level, then markets could be poised for a trend change to the upside and might test the early February highs. However, if the support level were not to hold, one could suggest there could possibly be a pullback that should be contained around the 3800 to 3900 level.



The Future of Office Space – Part I

Clint Pekrul, CFA

“Commuting to office work is obsolete. It is now infinitely easier, cheaper and faster to do what the nineteenth century could not do: move information, and with it office work, to where the people are. The tools to do so are already here: the telephone, two-way video, electronic mail, the fax machine, the personal computer, and so on.” — Peter F. Drucker, 1989

The above quote was taken from a working paper entitled *Work From Home and the Office Real Estate Apocalypse* from the National Bureau of Economic Research (Arpit Gupta, Vrinda Mittal and Stijn Van Nieuwerburgh, 2022). The 1989 quote from Peter Drucker, who was a business consultant and author, seems quite visionary today considering the fundamental shift in the way we view work in the post-covid world.

A generation ago, it was not the internet or social media that connected people, but antiquated technology like the land-line telephone, fax machine and the personal computer that moved information. With the advances in technology, the need for many white-collar office workers to physically commute to their jobs was not fundamental to productivity. Many workers could technically, to some degree, fulfill their work obligations remotely.

Obviously, technology has advanced exponentially since 1989. The covid pandemic and subsequent economic shut down just reinforced what Peter Drucker lamented thirty-four years ago. In retrospect, the pandemic gave workers the upper hand in terms of working conditions.

Back in 1989, while there was technology available for remote work, employers by-and-large were not likely to let employees dictate their work environment. After all, companies make considerable investments in office space, such as leases and furnishings. Employers created a favorable work environment, but their employees had to commute to the office.

Furthermore, there was the notion that if workers were allowed to do their jobs remotely, there would be a loss of productivity. So, for the next several decades workers commuted and participated in the office experience. But then came 2020 and the pandemic. Suddenly, workers were required to do their jobs remotely.

In the years that followed, there has not been a collapse in productivity. Workers became accustomed to the flexibility that technology afforded them to work remotely and, to some degree, according to their own schedules. We're three years removed from the pandemic and many workers have not gone back to the office. Furthermore, they are likely to never return to the office.

Companies have responded by embracing the new work-from-home trend and allowing their employees to continue

remote work or requiring their employees to be in the office only a few days a week. Furthermore, in some cases, businesses have not renewed office leases or are not anticipating renewing their leases as they expire. This begs the question: what is going to happen to millions of square feet of unused office space?

Empty Buildings

According to the NBER paper, which used New York City as the sample, there was a roughly 45% decline in office values in 2020 and a 39% decline in the long-run, with an estimated value of roughly \$453 billion. These figures are not insignificant. Furthermore, according to the paper, physical office occupancy in the major office markets of the U.S. fell from 95% at the end of February 2020 to 10% at the end of March 2020, and has remained depressed ever since, only gradually creeping back to 47% by mid-September 2022.

According to Fortune, office vacancy will increase by 55% by the end of the decade as hybrid and remote work push real estate to an 'inflection point'. While higher-end office space might be more insulated, the prospects for mid- to low-level offices is less certain.

The NBER paper also highlights an important fact: because office assets are often financed with debt which resides on banks' balance sheets and in CMBS portfolios, large declines in value would have consequences for institutional investors and for financial stability. This is a concern especially if some office properties become a stranded asset.

There is considerable lag time in the industry as office leases tend to be long-term (e.g., 10 years or more). So the issues we are addressing today will likely play out over the next five to ten years as leases gradually roll over. What is uncertain is how businesses in general will renew their offices leases, if at all.

It is likely that in many cases, new leases will be negotiated on a smaller space or on more favorable terms. At any rate, the cash flows that are generated from office buildings could be adversely impacted in the years to come, which in turn could permanently diminish the value of the office space stock.

It is highly unlikely that we will return to pre-covid vacancy rates, considering that the work-from-home trend is unlikely to reverse. So, what happens to the millions of square feet of unused office space, and who ultimately pays the price for working from home?

Next month we will explore possible solutions for the beleaguered industry and what likely outcomes will mean for the broader economy.

Q: What do you believe is the range for the markets for the rest of 2023?



Using the broad-based S&P 500, I believe the likely trading range for 2023 will be 3200-4200. As described in the Introduction of this report, the range is highly influenced by whether or not the Fed is able to navigate a soft landing for the economy. While not impossible, I think a soft landing is only a 20% probability given current data. I personally do not believe most analysts have accurately factored in the 'lag effect' of Fed policy. Whether the Fed is cutting or hiking rates, there is typically a 9-12 month lag on the Fed's actions full economic impact being known. Given that the Fed has raised rates at the fastest pace in history, the potential for an overshoot while trying to contain inflation they allowed to rise to alarming levels is high.

When the Fed maintained an ultra-accommodative interest rate policy as inflation grew, under the incorrect assumption it would be transitory, they created a problem that would not be easily fixed. This error was compounded by government fiscal policy of Covid-related subsidies whether extended unemployment, forgivable loans, employee retention credits, or other give aways from government largesse. We now have a budget deficit that will require the government to take more private capital to service debt while financing growth in the private sector is becoming cost prohibitive. I certainly see the risk of going below the low end of the range as greater than exceeding on the top end of the range.



It seems like we are in a tug-of-war between the bulls and the bears so far this year. The bulls came out roaring in January which sent the S&P 500 Index higher by roughly 6% for the month. However, it is difficult to tell if what we experienced in January was simply a sugar rush in the middle of a bear market or the formation of a support level for an extended rally. If you go back over the past year, we have experienced several head fakes on the notion that inflation will subside more quickly than anticipated and that the Fed will orchestrate a "soft landing" and ultimately lower interest rates. Such a scenario would be a boon for the tech-heavy growth stocks that were largely decimated in 2022.

But inflation is still running hot, and the Fed is likely to keep rates higher for longer. While I think volatility will be somewhat lower in 2023, it is hard to envision a scenario where the S&P 500 establishes a prolonged rally, given where we are in the economic cycle. Conversely, there are several positive headlines, such as strong consumer demand, that might prevent the S&P 500 from falling off a cliff. My take is a year with above average volatility and below-average performance.

Q: Is \$30 trillion of debt approaching a breaking point?



I am concerned it might be but Japan has shown that it is possible for deficits and debt to grow to levels people might have expected to be impossible. Japan today has debt to GDP above 220% that would have been unimaginable a decade ago. The U.S. debt to GDP of 98% (does not take into account off-balance sheet debt such as future entitlement spending) may be less than half of Japan's level but our debt is financed very different than in Japan. The ability for any country to issue government bonds when already highly indebted is about confidence and for now, few are worried the U.S. would be unable to repay current debt being issued.

It was the 1980's when the percentage of government spending to finance the debt was as high as it is today. The politics at that time were very different than today. Bill Clinton, a Democrat, was a champion of welfare reform which significantly cut discretionary spending and ultimately got the U.S. to a budget surplus. Today, there are large numbers of politicians who advocate for modern monetary theory (ability to spend unlimited amounts on government services) and outright Socialism. Taxing high income earners at 70% or higher is not only reasonable to these politicians, they view it as a moral mandate. Some combination of higher taxes and spending cuts will be needed, likely sooner rather than later which means more market disruption and political brawls.



The dollar figure is not really comprehensible. I think the more important figure is the amount of debt as a percentage of gross-domestic-product. Since roughly World War II through the Covid pandemic, the debt-to-GDP ratio had averaged roughly 65%, with a previous high of roughly 120% to finance the War and an all-time low of roughly 32% in the early 1980s. Baby-boomers were entering their prime working years and quarterly year-over-year real GDP in the US averaged roughly 3.2% from 1980 through 2000. We had a highly productive economy. Since the 2008 Global Financial Crisis, real GDP in the US has averaged just 1.8%, or approximately half of what it was a generation before.

Now, we have an aging population. The baby boomers are by and large no longer producing and saving for retirement. They are now retired and spending, which spurs demand and higher prices (i.e., inflation). To offset inflation the Fed has lifted interest rates off the zero bound, which makes financing government debt more expensive. There is a sense of foreboding that we simply will not have an economy that can produce sufficiently to support a much heavier debt burden over the years to come. Our current predicament is not all that surprising and has been a long time coming. Spending cuts are a way out, but are often political suicide.



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