PCM
PEAK CAPITAL MANAGEMENT

Can we climb a Wall of Worry?

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One of the oldest "truisms" of the markets is that stocks climb a wall of worry. At its core, the statement confirms what we see with fear and greed; historically it is a good time to buy when fear is high and a good time to sell when greed is high. Some of the issues facing investors and the economy are potentially more dangerous than whether or not companies achieve their earnings estimates.

At the top of the 'worry list' is that we have entered a prolonged period of "Slugflation". This is represented by sluggish economic growth with persistently high inflation. Increasingly, this period is being compared to the stagflation of the 1970's when the oil embargo led to the worst recession since 1929 and stocks shed 50% of their value. As we have witnessed lately, even during prolonged bear markets there are multiple sharp rallies such as what happened in March when stocks gained 10% over a 3-week period after falling nearly 13% year-to-date (even more pronounced with the Nasdaq). I would not be surprised if, with the benefit of hindsight, we peaked in late December 2021 and remain in a bear market into 2023 and possibly beyond.

The loss of globalization is another primary concern for investors. There are many ways to define globalization and countries acting in their own best interest should be celebrated by their citizens. The concern is more about the loss of global economic cooperation and costly disruptions to supply chains that are exacerbating inflationary pressures. Conflicts like what is happening in Ukraine are a part of this but so are changes caused by economic sanctions and economic conflict. Shortages of components and high energy prices are very likely to squeeze corporate margins and could lead to an earnings recession in the ensuing quarters.

We are also in the early stages of accounting for the increased cost of servicing debt due to higher yields. Public and private debt are at astronomical levels and higher servicing costs mean less discretionary income for consumers and less flexible fiscal policy for governments. Reduced consumer spending from higher interest rates has likely not been factored in to forward GDP estimates when 70% of GDP is represented by consumer spending. The Fed, in my opinion, made a massive error in judgment leaving rates near zero and keeping liquidity spigots wide open for so long making "behind the curve" an understatement of the year candidate. It is just as likely they err in the opposite direction and crush growth leading to a sharp recession as monetary policy becomes restrictive.

The last concern I will mention (among the dozen that could be discussed) is China. Few people outside of Asia understand how bad things have gotten in China. First, the latest strain of COVID is wreaking havoc economically and politically, especially in Shanghai where the majority of opposition to Xi Jinping exists. Shanghai claims to have managed the early stages of the pandemic well, but is now in widespread lockdowns that will impact supply chains and the global economy most than most analysts realize. Beijing's likely hard stance towards Shanghai will continue as CCP elections are approaching. Expect prolonged supply chain issues leading to continued above trend inflation as a result of COVID lockdowns in China. The banking system in China has not remotely repaired itself following the seeming collapse of major real estate developers. The CCP's pivot from growth-centric to populism suggests government bailouts are not forthcoming and credit will become even more tight in China. It is hard to argue that growth in China brought the global economy out of the last recession, but it increasingly looks like they may lead the world into the next global recession.

Instead of discussing the potential for a global food shortage, recession in Europe, collapsing housing market, market breadth, or a broken Congress, I will look at the proverbial other side of the coin. Today, as if often the case, the glass can be viewed as half full or empty. Banks are the first to report earnings each quarter and frankly they are surprisingly upbeat on the prospects for both consumer and corporate spending. ISM Services data as well as recent ADP payroll reports do not suggest a contraction in the economy is imminent. Wages are rising (not as fast as inflation) and if you want a job, you can get a job. As Stephanie Link, Chief Equity Strategist for Hightower, recently said to me, "I worry when there is no worry." Maybe stocks can in fact climb a wall of worry and finish higher but I would not bet my retirement on it.

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Peak Margin

Source: Advisor Perspectives

Margin levels in brokerage accounts speak to the confidence investors have about future market moves. When margin levels are rising, investors are increasingly confident in higher stock prices to justify borrowing funds to take or hold equity positions. Buying stocks on margin increases overall rate of return as long as stocks move higher but have the ability to compound losses when stocks correct. Historically, market peaks have been identified (with the benefit of hindsight) when margin debt rolls over and declines for a period of time. Astute investors reduce margin exposure before bear markets which often lead to margin calls and forced selling exacerbating a market decline. Sharp drops in margin balances, such as the recent decline, should be viewed as a cautionary red flag for investors.

- Each of the last 3 recessions were forecasted by a sharp decline in margin debt which typically occur within 3-6 months of a market top using data that goes back to 1982.
- Since 1995, there have only been 3 occasions where margin debt grew 60% or more on a year-over-year basis, those are 1999 (before dot.com crash), 2007 (before financial collapse) and 2021.
- Short positions, also require the use of margin as investors "borrow" stock to sell at today's prices with the obligation to replace the stock in the future, can impact margin balances.

Cracks in the Housing Market

The recent run up in interest rates could ultimately become a headwind for the housing market. According to the Mortgage Bankers Association (MBA), the rate on a 30-year fixed mortgage has accelerated higher to roughly 5%. What is a hot housing market has effectively become more expensive for first-time buyers. Thanks to easy monetary policy in the wake of the global financial crisis, borrowing costs were quite manageable. The result was a decade-long boom in housing. But now the story has changed as the Fed has turned hawkish. With incredible speed, the ratio of monthly mortgage payments to income has accelerated higher, as illustrated in the chart. If the Fed does indeed aggressively hike, it is anyone's guess how high the ratio could go.

- While the deterioration in affordability might not immediately impact the overall housing market, it could prove to be a headwind in the long run as a new wave of potential buyers get priced out. Ultimately, higher financing cost could materially reduce demand if incomes don't rise in lockstep.
- Supply chain issues remain a problem for the industry. Higher rates mean higher financing costs for homebuilders, which in turn could make the supply shortage issues we're experiencing now even worse in the long run.

Rise of the U.S. Dollar

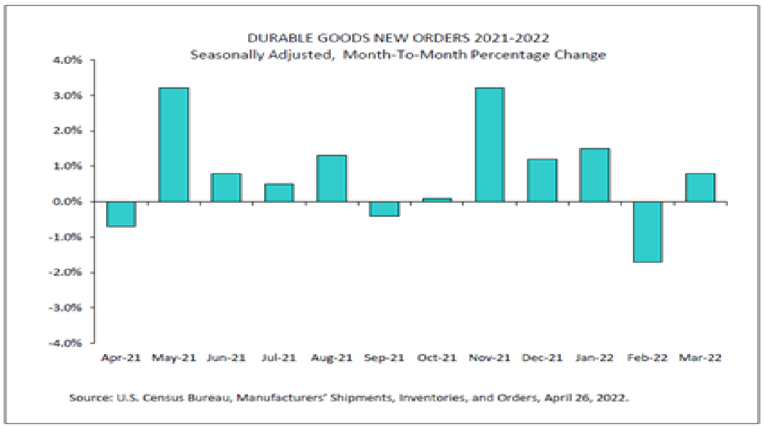

Source: Reuters

On Friday April 22nd, the U.S. Dollar Index (DXY) rose to 101.25, a level not seen since March 2020 which reached as high as 102.992. The following week, the U.S. Dollar Index continued its rally rising another 1.73% to 103. The rise of the U.S. dollar is largely attributed to expectations that the Federal Reserve is set to undergo a more aggressive stance on tightening monetary policy in order to combat inflationary pressures. Federal Reserve Chair Jerome Powell all but confirmed a 50 basis point increase in the Fed Funds rate during the May 3rd-4th policy meeting when speaking as part of an International Monetary Fund panel last month.

- The U.S. Dollar Index (DXY) is a measure of the value of the U.S. Dollar relative to a basket of foreign currencies (the Euro, Swiss franc, Japanese yen, Canadian dollar, British pound, and Swedish krona). The DXY was established by the Federal Reserve in 1973 following the dissolution of the Bretton Woods Agreement.
- According to the U.S. Bureau of Labor Statistics, the annual inflation rate in the U.S. accelerated to 8.5% in March of 2022, the highest level since December of 1981 from 7.9% in February and compared with market forecasts of 8.4%.

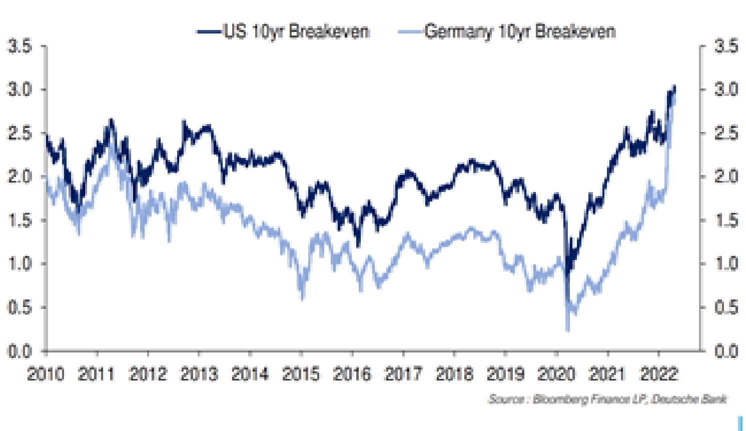
Macro View – Durable Goods

Durable goods orders, a broad-based monthly survey conducted by the U.S. Census Bureau that measures current industrial activity and is used as an economic indicator by investors, rose by 0.8% in March. March's increase followed a revised 1.7% percent decline in the month of February. The rise in orders, pointed toward sustained investment in business equipment and in turn, helping drive further economic growth at a steady pace. Jennifer Lee, senior economist at BMO capital markets noted that "the solid increase in core orders suggests that businesses remain in good shape and are still looking to bulk up machines and equipment to contribute to their bottom lines." However, with the war in Ukraine, and expected monetary policy tightening by the Federal Reserve, concerns of slowing demand are pointing towards further economic uncertainty going forward.



Fixed Income – Bunds or Bonds

The three most significant bond markets in the world are Treasuries, JGB's (Japanese government bonds), and Bunds issued from Germany. While the UST and Bunds tended to trade lock-step for decades, there was divergence going back to 2009 when breakeven yields (adjusted for inflation) were much higher for UST's than the comparable Bunds. On a nominal level, 10-year Bunds have traded at negative yields for most of 2019-2021 but recently have been on a tear towards higher yields. The chart reflects anticipated inflation in the US and Germany over the next 10 years so quite surprising to see breakeven yields on Bunds surpass the yield on Treasuries for the first time since 2009. The likely culprit for the sharp spike in Bund break-even's is energy prices. Losses in Bunds are likely to surpass losses in UST's until there is clarity on Russian sanctions.



Talking Stock – Netflix & Sell

On April 19th, Netflix Inc. (NFLX) reported Q1 2022 earnings and for the first time in 10 years, Netflix lost subscribers. After reporting earnings, shares closed out the following trading day down more than 35% and at the time of this writing, NFLX is down almost 59% over the last year. In a letter to shareholders, Netflix attributed its subscriber loss (~200,000) to a variety of factors including password sharing amongst households; increased competition in the streaming platform service space from the likes of HBO Max, Showtime, Disney+, and Paramount; and Russia's invasion of Ukraine which resulted in Netflix shutting down services in Russia for some 700,000 members. The once traditionally viewed technology name may now be evaluated as a streaming platform going forward but will likely continue to face challenges as competitors in the industry work to diversify their offering to subscribers.

Technical – Failing Breadth Analysis

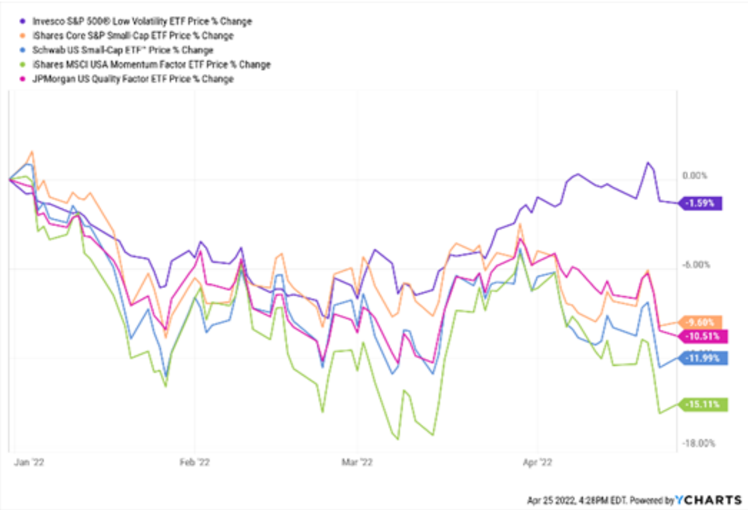
Technical signals that the bull market off the Covid-related lows of March 2000 is coming to a close are increasing by the day. The Nasdaq is the most clear at this point with more than 75% of the listed companies trading below their 200-day moving average. According to data from Yardeni, nearly 60% of the S&P 500 firms are trading below their 200-day moving average. While these are not yet at "extreme" levels, it should give investors pause for concern and suggest the markets may be entering a period similar to 2000 and 2007. Historically, bull markets end for the majority of stocks long before the indices turn lower by 20% or more. It is possible for a handful of stocks to surge higher late in bull markets but when those "favored" stocks run out of steam the market turns over and the bear market is in full swing.

Performance Update

Clint Pekrul, CFA

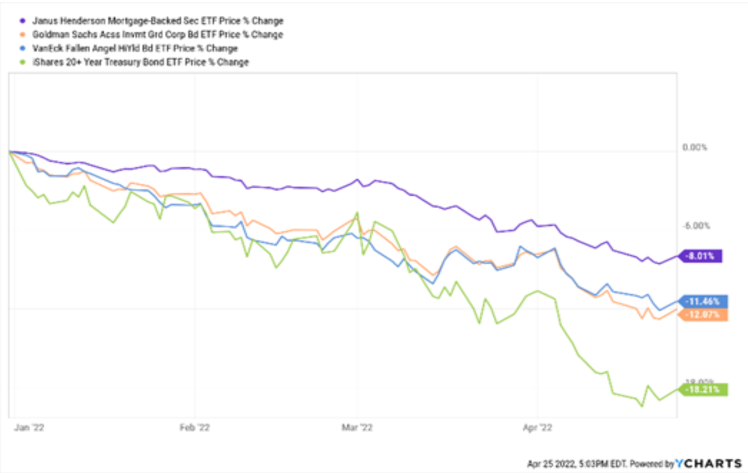
To say that 2022 has been a volatile year would be an understatement. With the Fed poised to raise interest rates substantially, asset prices have been essentially repriced across the board. The market seems to be pricing in at least a 50 basis point hike in May and then potentially another 200 basis points before the end of the year. These actions will influence return expectations for stocks, bonds and commodities. What follows is a summary of asset class returns year-to-date (as of April 25th) based on certain exchange-traded-funds (ETFs):

U.S. Equity Factors



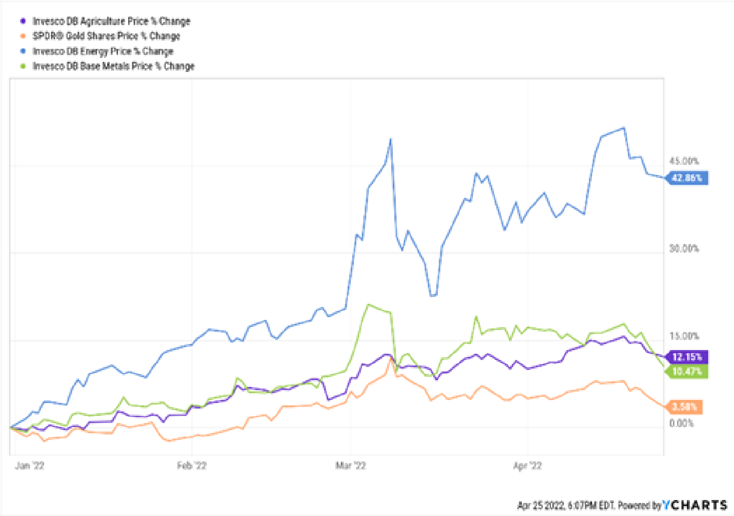
A cross section of factors reveals that low volatility stocks have held up reasonably well, while momentum stocks have experienced meaningful declines. Interestingly, this return pattern is basically the exact opposite of what we experienced two years ago with the onset of Covid. High flying momentum names have come back down to earth, while low volatility stocks have been proven to be quite defensive.

Bonds



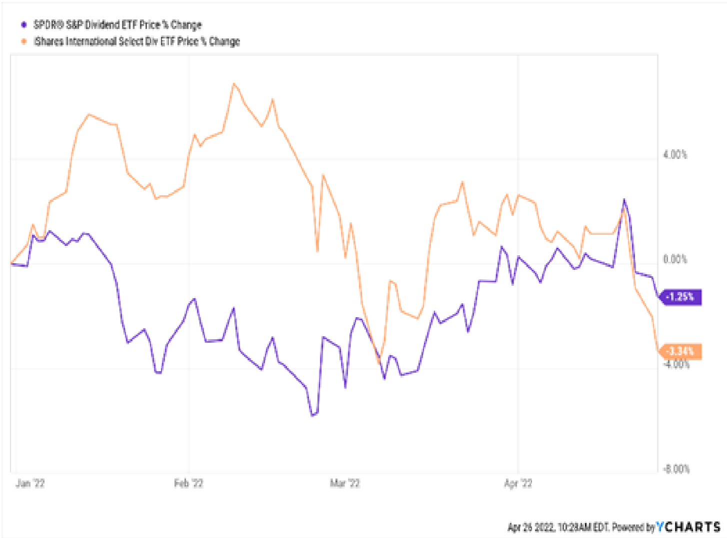
Not surprisingly, bonds have experienced meaningful declines this year as interest rates have risen. Longer-duration bonds have taken the brunt of the decline. Likewise, credit, both investment grade and high yield, have fallen. Mortgage-backed bonds, which typically have lower durations, have outperformed for the year on a relative basis.

Commodities



To little surprise, commodity prices have risen this year based on the inflation narrative. Energy prices have soared to heights not seen since before the global financial crisis of 2008. Likewise, base metal and agricultural prices are higher by double-digits.

Dividend Equity



Dividend paying stocks in general have outperformed the broad equity market on a relative basis. Both domestic and international dividend paying stocks are down only modestly for the year as investors turn to dividends as a potential way to combat inflation.

Q: Is the Fed About to Make a Policy Mistake?

A better way to phrase the question is probably, "Is the Fed about to make ANOTHER policy error?" The answer is very likely "yes". I do question if the Fed even left themselves a path to normalization given their inability to address rising inflation coming out the pandemic in 2020.

The Fed's view that rising inflation back in 2019 and 2020 was simply "transitory" and would revert back to sub-2% in the near term was one of the worst calls any Fed has ever made (and their track record for horrific calls is well documented). The lack of collaboration between fiscal and monetary policy has led to the predicament in which we find ourselves.

The Fed was focused on the labor market and attaining full employment while at the same time Congress was paying people increasingly high amounts to stay home and not work. The Fed clearly should have pivoted towards tightening before the end of 2020 but instead left rates near zero and kept pumping excess liquidity into the system. They likely have no choice but to squeeze the economy so severely as to cause a sharp recession as allowing inflation to run at 8-12% has its own devasting consequences. I see no way for the Fed to successfully navigate to a soft landing; it is going to be a bumpy ride fixing the policy errors of the last couple of years.

We'll only know in hindsight. I think the general consensus is that the Fed tends to get the timing wrong when they make substantial policy decisions. In this case the Fed is firmly committed to taming inflation.

Consequently, they will be raising their target interest rate perhaps by as much as 200 basis points before the end of the year. This would be the first meaningful lift off for the target rate since the global financial crisis. So far, the markets have not responded well because investors in general think the Fed will put the economy on the road to recession.

It is difficult for the Fed to tame inflation because its source is due largely to supply chain issues. The Fed can only address the demand side of the equation by raising interest rates. If the Fed raises too quickly, we run the risk of stagflation – a term coined from the 1970s that describes an economy experiencing both high inflation and sluggish economic growth.

If the Fed does indeed raise its target rate too much it will likely slow the economy to the point of a technical recession. Meanwhile, supply chain issues might persist despite the Fed's best efforts. This would be a worst-case scenario. If we fall into a stagnant economy, it will likely mean more market volatility and diminished return potential.

Q: What Should We Make of Elon Musk's Moves with Twitter?

Was a little bit surprised that the Twitter board caved in as quickly as they did. Musk is an interesting character with a proven track record of succeeding where many doubted he could succeed.

Elon likes to stir the pot and is often celebrated by people on both the left and the right and often despised by the same groups. He clearly likes the spotlight on him, and I believe he will use the Twitter platform accomplish a couple of things: (1) create a genuine platform for free speech and try to swing the pendulum of Big Tech back towards the center; (2) I think he will make changes that will make the platform far more valuable than the current value.

Twitter was often run as a company trying to facilitate an agenda as much as make a profit. I do think the path is going to be bumpy. Many Twitter employees are ideologues for causes mainly supported by the political left and will need "safe space" if Musk reactivated Trump's account as an example. It would not be surprising to see Musk make other acquisitions in the space in his attempt to plant a flag of free and open dialogue and issues and policy. Twitter's earnings may slip from current levels of the next few quarters, but I expect large increases 12-18 months out.

It seems like the world's richest man, according to Forbes, is set to acquire one of the world's largest social media platforms under the guise of protecting free speech. Elon has long been a Twitter critic claiming that the company does not sufficiently facilitate free speech. Somehow, by taking the company private, Elon will promote democracy and ensure that all voices are heard.

I think the larger issue surrounding Elon's takeover of Twitter is that if he is successful, one of the largest social media platforms in the world will be controlled by a single person. Such centralized control of a company that shapes public opinion doesn't seem too democratic. Shifting control of the social media platform used by millions to the world's richest man will have consequences. And billionaires, while publicly extolling the virtues of their actions, tend to have profit motives at the end of the day.

For example, how might Elon use his control of Twitter to boost Tesla's share price, or improve the bottom line for SpaceX and dominate the future of space travel? These motives don't necessarily promote free speech. There are also early indicators that Elon's commitment to the American conception of free speech may end up in conflict with the laws of other jurisdictions, most notably Europe, with its Digital Services Act that continues through the European legislative process.

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