PCM
PEAK CAPITAL MANAGEMENT

Up, Up and Away

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Fed Chair Powell's speech at the Jackson Hole gathering could have been titled the hit song from 1967 by the Fifth Dimension, Up, Up and Away. The new mantra from Powell and the voting members of the FOMC seems to be "higher for longer" as the inflation hawks retain firm control over monetary policy. Powell stated that policy would remain restrictive, and the Fed's focus would be on managing risks, i.e., reemergence of inflation. Most market observers took this to mean additional rate hikes and the likelihood of a rate hike at the next Fed meeting climbed to 65%. The implied terminal rate for Fed Funds now stands at 5.49% giving the Fed plenty of flexibility based on market expectations.

Last month we discussed how the individual data points on the Leading Economic Indicators were declining with the exception of stock prices. August has seen a continuation of deteriorating fundamentals, especially among consumers. Delinquency rates on consumer debt is rising and with depleted savings, the consumer appears to be running out of steam. Higher mortgage rates may also be starting to impact housing and homebuilder confidence which saw a steep decline in August. Long-term yields that determine mortgage rates climbed in August with the 10-year UST rising 55 basis points. Inflation has stabilized and would only be responsible for 11 basis points, so the rising 10-year bond appears to be driven by other factors. Presumably, part of the reason for rising real yields is new issuance which is slated to top $1 trillion this quarter alone. Another factor is the Fed's quantitative tightening as they sell bonds to reduce their balance sheet. With limited demand from overseas, upward pressure on yields will likely continue to draw capital away from the equity markets and into what is considered secure.

Powell and his allies continue to fight the inflation dragon, but signs are appearing suggesting economic growth has peaked and is likely to reverse the current trend. The data out of China suggest something beyond just a slowing economy as their debt bubble created by rising real estate prices appears to be in the process of deflating. Many analysts are comparing China with what happened in the US back in 2008 and 2009 when debt defaults skyrocketed, and confidence plummeted. It used to be said that when the US sneezed, the world caught a cold. Responsibility for global economic growth has shifted to China in recent years as demonstrated by IMF projections for 2023. The IMF predicts China will be responsible for 23% of global growth while the US contribution is only 11%. If China goes into a long-term slowdown from a deflationary debt cycle, the risk of a global economic recession rises significantly.

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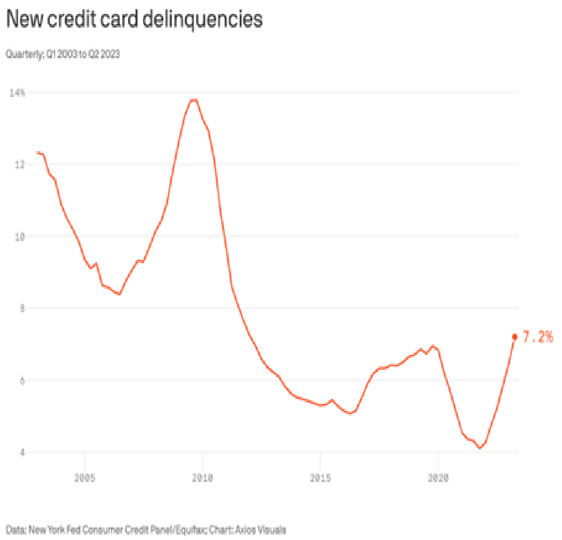
We are two months into the 3rd quarter and GDP appears to be surging towards peak growth potential even as many see the fundamentals of the economy and consumer deteriorating. While puzzling to many, the strong growth likely means the Fed will be in no hurry to start cutting rates as the market has hoped. One factor causing GDP to spike is the rise in productivity the last couple of quarters. Productivity waned around 1.1% annual increases over the last decade after increasing at an annual 2.5% the prior decade. In the 2nd quarter productivity rose 3.7%, the highest gain since late 2020. Manufacturing productivity gained 4% in Q2, nearly equaling the highest gains in a decade. The labor markets remain relatively tight and small businesses continue to list difficulty hiring qualified employees as one of their biggest challenges according to the NFIB.

While the Atlanta Fed's GDPNow forecast high risen to +5.8% for the current quarter, many retailers are sounding an alarm on falling consumer spending. Macy's, Home Depot, Lowe's, and Dick's all issued cautious outlooks on consumer spending and lowered their revenue and earnings expectations. Debt service as a percentage of disposable income is the highest in several years, which suggests a slowdown in consumption in the coming quarters.

The jump in yields on long-dated Treasuries is very likely a buying opportunity for investors with the stomach to handle interest rate volatility. A slowing China increases the likelihood of recession in the first half of 2024 and if the Fed remains committed to quashing inflation, long-term rates will fall much faster than the short end of the yield curve. It could be a bumpy next couple of quarters for equities while the bond market delivers equity type returns after a couple of years of horrendous returns. It has been said that bull markets in stocks end as soon as the last bear becomes bullish. The same may prove true with the bond market today.

Becoming a Delinquent



Consumers are starting to feel the pinch of higher interest rates on credit cards and other consumer debt as witnessed by the rise in delinquencies. The latest data from the NY Fed shows 7.2% of consumers are now delinquent on credit card payments, the highest since 2011 as the US was coming out of the Great Financial Crisis. One factor that has supported strong consumer spending has been the deferrals on Federal student loan payments during the COVID pandemic period. As student loan payments resume, disposable income will decline, and delinquency rates will likely climb higher. Missing credit card payments often cause a spiral effect as penalties and higher rates are imposed when delinquent. Any rise in delinquencies is likely to remain modest as long as the labor market remains strong.

- What is happening with credit cards, car loan delinquencies recently rose above pre-pandemic levels at 7.3% of loans according to Moody's data. Lenders are also tightening standards making obtaining loans more difficult.
- Mortgage delinquencies have remained very low for the time being as many people had locked in fixed rate mortgages before rates began to rise. The Mortgage Bankers Assoc shows delinquencies are at 3.3% down from 3.6% a year ago.
- Most alarming in the NY Fed report on Q2 consumer debt was the increase of $45 billion in credit card debt in the quarter. For the first time in the survey's history, consumer credit card debt stands at more than $1 trillion.

Growth vs. Value

In many ways 2023 has been a mirror image of 2022, when the S&P 500 Index declined roughly -18% and the NASDAQ tumbled by -33%. In general, value stocks, as measured by the Russell 1000 Value Total Return Index, outperformed growth stocks last year, as measured by the Russell 1000 Growth Total Return Index. In 2022 value stocks dipped roughly -7% but held up much better than growth stocks, which tumbled roughly -30% as interest rates surged. Year-to-date, however, growth stocks, on the back of the AI rally, have gained 27% compared to a gain of just 4% for value stocks.

- The forecasted price-to-earnings ratio for the Russell 1000 Growth Index is roughly 29x compared to 15x for the Russell 1000 Value Index. This indicates that investors are now paying roughly twice the multiple for growth stocks compared to value stocks. The long-run average price-to-earnings ratio for the S&P 500 is roughly 15x.
- The multiple gap – 14x for growth over value – remains elevated but investors seem to remain confident that future earnings will support current valuations. Until that changes expect multiple expansion to continue and for stocks to rise overall at least in the near term.

Back in Play

Earlier this week, the U.S. District of Columbia Court of Appeals ruled that the Securities and Exchange Commission (SEC) was wrong to reject an application from Greyscale Investments, a cryptocurrency asset manager, to list an exchange-traded fund that tracks the "spot" price of Bitcoin. Currently, in order for investors to access bitcoin or other cryptocurrencies through their brokerage accounts, they would have had to invest in vehicles such as GBTC, a mutual fund that tracks bitcoin futures. With the new ruling, investors may soon have the ability to gain exposure to bitcoin, without having to "own" it. On the wake of the decision, BTCUSD jumped almost 8% before finishing the day up a little more than 6%. The SEC now has 45 days to appeal the ruling, which, if granted, would send the case either to the U.S. Supreme Court or an en banc panel review.

- The Securities and Exchange Commission has communicated their concerns around a spot price Bitcoin ETF as they believe it is vulnerable to manipulation.
- In addition to Greyscale, there are eight other investment managers who have submitted applications to launch a spot bitcoin ETF, most notably Blackrock, Fidelity, and Invesco.
- Because both the futures-based product that the SEC previously approved and the spot price product are "like" products, the court ruled that "If you approve one, you have to also approve the other".

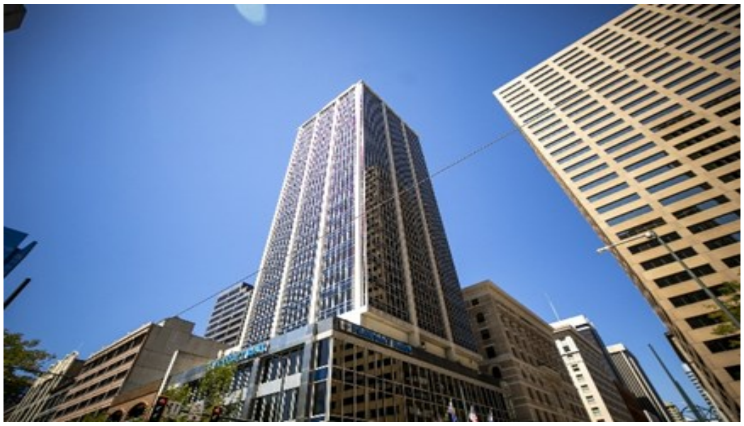
Quinn VandeKoppel

Macro View – Under Pressure

Earlier this week, ADP released their report showing that U.S. Job growth slowed sharply to 177,000 in August, a number that was less than expected by analysts. The less than expected jobs creation report might be a sign that the U.S. economy, which has been surprisingly resilient, is starting to slow due to the pressures of higher interest rates. The labor market, to the surprise of many, has been a key reason as to why the economy has grown faster than expected in 2023. With the Federal Reserve taking historic measures by hiking their Fed Funds Rate to the highest levels in over 22 years, all eyes will be on the Department of Labor's monthly jobs report as it may play a significant factor in the Fed's decision later this month whether or not to raise interest rates once again.

Taking Stock – Proposed Repurpose

Since the onset of the COVID pandemic, many employees have yet to return to the office at the same rate they were previously. With many of these office buildings being left vacant or underutilized, our team began to ask whether or not these vacant office buildings could/should be repurposed for housing. Last month, a study in Denver found that 16 office buildings are considered "good candidates" for conversion based on a list of criteria. The city noted that if the 16 buildings were converted for residential use, it could add over 5,000 units to the downtown neighborhood. With rents up more than 10% over the last year in Denver, converting these offices into housing could be a good option, especially for low-income households or to combat the city's rapid growing homeless issue.



Fixed Income – Attractive Risk/Return

It's no secret that fixed income has been under pressure over the last few years. However, with where yields are currently sitting, investors should be looking for opportunities to capitalize, especially in "risk-free" areas such as US Treasury Bills and Notes. As of today's writing, investors can earn an annualized yield of 5.565% on a 6-month Treasury Bill while also locking in around a 4.25% annualized return for a 5-year Treasury Note. JPMorgan's Global Market Strategist, Gabriela Santos, recently joined CNBC's "Squawk Box" and described what she believed was a very attractive opportunity for fixed income investors to possibly generate "equity-like" returns in an investment where they are not only benefiting from higher yields, but also price appreciation if yields were to decrease.

Technical – Double Top

Since the start of May, we have seen a significant rise in yields, specifically the 10-Year Note Yield. In the chart below, you can see that the yield increased from 3.40% in early May to 4.35% earlier this month before retreating back to below 4.20%. This increase equates to a whopping 28% change in just four months. However, you can also see that the chart also indicates a possible double top pattern. A double top pattern is a bearish technical reversal pattern that forms after an asset reaches a high price two consecutive times with a moderate decline between the two highs. While there is still much to play out before the double top is confirmed, this may be an indication for fixed income investors to begin to add duration within their portfolios.

Update on Commercial Real Estate

Clint Pekrul, CFA

Several months ago, we wrote about the challenges facing the commercial real estate market as the effects of work-from-home (WFH) become more permanent. According to the National Association of Realtors (NAR) in a July 2023 report, delinquency rates, while still below 1%, are expected to rise in the second half of the year. Meanwhile, there are risks in the banking sector, particularly for smaller regional and local banks, that could lead to a pullback in lending activity which largely drives commercial real estate development.

NAR's conclusion: As a result, most commercial real estate sectors continue to experience slower rent growth and higher vacancy rates compared to the previous year. In the office sector, there are more available spaces for lease than ever. Despite multiple efforts to repurpose unused office spaces, the slow return-to-office movement continues to hurt this sector. Source: https://www.nar.realtor/commercial-market-insights/july-2023-commercial-real-estate-market-insights

The question developers and investors alike must consider is what the office space sector will look like five to ten years from now. If the WFH trend slows or more workers ultimately head back to the office, will it be meaningful enough to send vacancy rates back to pre-COVID levels? Conversely, if the WFH trend intensifies, what will ultimately happen to all the vacant office buildings?

Some cities are tackling the issue by working with local developers to repurpose vacant office buildings. Case in point: the city of Denver recently conducted a study in conjunction with an architectural firm that concluded that roughly 4.7 million square feet of downtown office space could be repurposed into residential units across 16 different properties. Such a project would essentially convert the central business district into a central neighborhood district.

Denver is not the only city on the list to be considered for large-scale repurposing. San Francisco, Seattle and New York, among others, are exploring repurposing options as well.

However, repurposing is not necessarily a panacea. Real estate markets are highly regional and segmented and what works in one market might not work in another. In addition, some buildings are just not feasible for repurposing, leaving the prospect for empty buildings.

CRE Loan Demand

According to an August report from Market Insider, big commercial banks like JP Morgan, Goldman Sachs, Capital One and M&T Bank are trying to unload commercial real estate loans off their books as pressure mounts in the sector but are having trouble finding buyers.

Per the report: Experts have been warning of trouble for the commercial real estate sector after the slew of banking failures in early 2023 sparked a rapid tightening in credit conditions on top of higher interest rates spurred by the Fed's rate hike campaign. That poses trouble for the commercial real estate industry in particular, as there's around $1.5 trillion in CRE debt that's set to be refinanced over the next three years, much of which could run into trouble as rates stay elevated and property valuations decline. Source: https://markets.businessinsider.com/news/stocks/commercial-real-estate-debt-crisis-credit-crunch-bank-loans-default-2023-8

Essentially, the article suggests that the biggest banks foresee trouble on the horizon as a significant pool of CRE loans are set to roll over at a time when interest rates are significantly higher and vacancy rates are elevated.

This could lead to a perfect storm in which banks will have to take write downs on their loan portfolios. While banks are better capitalized today than during the mortgage crisis fifteen years ago, such a scenario would be quite disruptive for the financial sector.

Outlook

This isn't the first time there has been a glut of empty office space. In past recessions, as companies laid off workers, vacancy rates would rise. But today, we face a somewhat different scenario. Unemployment remains relatively low, and the cause of high vacancy rates – 12.9% according to NAR's report – isn't from economic distress but from the fundamental way in which many people work post COVID.

Some forecasts call for a gloom and doom scenario where downtowns across the country turn into ghost towns as empty office buildings remain vacant and restaurants and shops shutter. But this scenario seems extreme. The next couple of years will be critical as a mountain of debt is set to be refinanced.

More than likely, we think mixed used properties will become more common to bring more residential units into urban downtown areas while occupying downsized, or shared, office spaces. This would bring back lost foot traffic for shops and restaurants, etc., and boost property tax revenues. However, the process will occur gradually.

Q: Will the uber-cap AI rally stall?

When reading financial media it can appear that AI stocks are a relatively homogenous group that is getting a lot of traction in the markets. It is probably much easier to categorize AI stocks into different buckets in order to make any assumptions about their continued growth. The first grouping of stocks could be called ‘enablers’ as they provide the technology backbone for AI adoption. Companies like Nvidia have risen astronomically this year as has Marvel, a fellow chip maker. The gains posted by enablers are not sustainable in my view and will likely experience weakness when equities start to drift lower. The next group are the ‘scalers’ and are the companies most responsible for AI being implemented at the business to business (B2B) level. These tend to be large, established companies and AI is simply an avenue for growth in their business models. Think of Microsoft, Amazon, and Google whose stocks have performed well but not entirely dependent on AI spending. The last group are ‘empowered user’ that are primarily responsible for AI adoption by consumer and individuals. Companies like Meta, Salesforce, and Adobe could see high levels of volatility from current prices as investors are betting their earnings will grow from AI penetration. Investing in AI reminds me of the old adage about investing in the gold rush days. You were better off investing in picks and shovels than in miners, a reality likely to prove true with AI.

At the time of this writing, Facebook and Nvidia were higher for the year by 138% and 213%, respectively. Likewise, Microsoft is higher by 35%. The rally in stocks has been narrow based on the expected growth potential from artificial intelligence technology. The rally suggests that the industry could be dominated by a handful of mega-cap companies. Investors a paying a hefty premium today for the potential of outsized profits down the road. But as with any rally, at some point we must ask what will ultimately stall the advance. Given AI’s footprint in the broader S&P 500 Index, a pivot in the rally will have broad implications for equity returns.

There are two possible headwinds for the AI rally. The first is interest rates. Should the Federal Reserve raise its target rate in response to higher inflation, investors could pull money out of equities in favor of bonds. Given the level of profits on the table for the year, investors could be quick to reduce their overall AI exposure. The second possible headwind for the AI rally is an earnings disappointment, although this seems unlikely in the near term considering that Nvidia and Microsoft just beat consensus earnings estimates. As long as AI stocks continue to meet or exceed earnings expectations, it seems like the rally could be sustained and carry us through the rest of the year.

Q: Is China headed toward a financial crisis?

It certainly appears that way to me. As mentioned earlier, China has been responsible for nearly one-quarter of economic growth globally that is now at risk. China leveraged gains in productivity to become the world’s factory and grew their economy to rival that of the US. Following the recession in 2008, China pivoted away from being the low-cost manufacturer to a focus on real estate. For most Chinese nationals, real estate has been the primary savings vehicle for the last 15 years, driving prices higher. The availability of low-cost debt from state-sponsored lenders has resulted in ultra-high levels of leverage on real estate. Recently prices on real estate have begun to decline and the default rate on debt has been surging. I expect that China is in the early stages of what occurred in Japan in the 1990’s and in the US during 2008-2009. Private lenders will need government bailouts or be at risk of collapsing, creating further panic. The largest property developers in China have seen their share prices fall by 90% or more in recent months. Both Japan and the US emerged from their real estate debt crises and resumed growth after a couple of years. It remains unknown how the authoritarian policies of China will impact their recovery and how transparent the CCP will be in reporting the economic declines that will occur.

The news out of China certainly isn’t too encouraging. Investors have become accustomed to 8% GDP growth from the world’s second largest economy. But it seems like those days might be over, at least for now, as the country tries to reverse the deleterious effects of its COVID lockdown policies. China’s GDP grew at 3% in 2022 which was well off the policy target. And again, in 2023, China risks missing their GDP mark for a second consecutive year. Exports declined 14.5% in July on a year-over-year basis while imports disappointed. Meanwhile, China is grappling with over 20% unemployment among its youth and a property sector that is in meltdown. So, the picture out of China is fairly bleak and the Hang Sang Index reflects it, as it is lower by roughly -30% since 2021.

The overriding question is whether China’s government will pump enough stimulus to prop up its economy at least in the near term. Investors are looking for reassurances that the government will inject enough funding into the economy, particularly in the property sector, to stem the tide despite the longer-term consequences. During the financial crisis of 2008, Beijing was quick to stimulate the economy, but today the policy response has been slower. Hence the frustration. I wouldn’t necessarily declare a crisis because China has handled adversity before. But further inaction could perpetuate a negative feedback loop which sees investors flee and the economic data continue to weaken.

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