Quarterly Economic and Market Comments
June 30, 2023

As 2021 came to a close, most stock indices were at or near record highs. This included quality large U.S. technology stocks that had led markets higher over the previous decade, such as Apple that was flirting with a record $3 trillion market capitalization, but also highly speculative stuff, represented by Bitcoin, trading at $69,000 up from $10,000 in just over a year. True, there was a ton of speculation. True, valuations were, in many cases, extremely stretched. True, the world had taken on a lot of debt, including central banks who had bulked up their balance sheets to unprecedented levels. True, economic growth remained very lackluster. However, all of these factors had been in play to a greater or lesser extent for years without derailing the generally upward trend of equity markets as the lowest interest rates in history overwhelmed any and all investor misgivings. The fact that consumer prices post-Covid were rising rapidly was a new, niggling concern, but the world's central bankers were unanimous that it was a 'transitory" problem. Until they decided it wasn't, and embarked upon an unprecedented series of interest rate increases. Suddenly, equities were faced with a new reality to which they adapted by falling sharply. Bitcoin, for example, fell by more than 75% to $15,500 and the so-called "Magnificent Seven" (Nvidia, Meta, Tesla, Apple, Amazon, Microsoft, and Alphabet) fell between 25% and 65%. On the one hand, the discounted current value of future earnings, the lifeblood of stocks like the Magnificent Seven, are worth a lot less when 10-year U.S. Treasuries are yielding 4% than when they are yielding 2%; on the other hand, investors were assuming that monetary tightening would probably lead to a recession and lower corporate profits.

Surreptitiously, last October, amid pervasive caution about the economic and investment outlook, the U.S. dollar index topped out at 114.75 (currently 102.59), 10-year Treasury yields peaked at 4.33% (currently 3.81%), and a whole host of assets associated with a "risk-on" environment bottomed out and started to advance. A rise that, generally speaking, continued through the second quarter: the Canadian dollar (bottomed at 71.55, currently 75.57), the Australian dollar (bottomed at 61.70, currently 66.74), an index of International Junk bonds (bottomed at 31.37, currently 47.05), American Junk bonds (bottomed at 82.57, currently 92.03), Bitcoin (bottomed at $15,481, currently $30,619), a host of equity indices, and, inversely, the VIX volatility index, or fear gauge, (peaked at 34.88, currently 13.59). The rise in the closely watched U.S. S&P 500 Index has exceeded 20%, leading many to proclaim that a new bull market is underway. The public gets most of its news about the markets and the economy from Wall Street and the government - both of whom have a vested interest in putting a positive spin on events - and from an underfunded and subservient media that typically has neither the ability nor the inclination to question the spin. Still, the notion that a new cycle has begun because the S&P 500 has risen by more than 20% from its October low really takes the cake. First, why 20% as opposed to 25%? Secondly, rallies of 20% or more are not uncommon during the biggest bear markets. There were 6 such rallies in the Nasdaq 100 during the 83% plunge that followed the dot.com bubble and there were 5 rallies of more than 25% during the 89% drop in the Dow Jones Industrial Average between 1929 and 1932. Thirdly, any arbitrary number ignores critical context. Only hindsight will tell us whether the rise in equity prices since last October is part of a new cycle. However, if it is, we should expect to see most of the following: new highs in the indices, an uptrend that lasts a couple of years, a change in market leadership, and, last, but not least, no recession. The one cycle since WWII that superficially resembles the current cycle was the market decline from February to October 1966, which morphed into a new bull market that lasted for two years. Although it atypically did not go to a new high, there was no recession and there was a complete change in leadership. Like today, the market decline of 1966 was sparked by monetary tightening that led short-term interest rates to trade above longer-term rates (yield curve inversion) for five months, but the Federal Reserve stopped raising rates when the curve became inverted. So far in this cycle, the yield on 3-month T-bills has been higher than 10-year Treasuries for twice as long as in 1966. The inversion has been four times as steep and there is no sign yet that the Fed is through raising rates. So, avoiding a recession seems far less likely than in 1966 looking only at monetary policy.

Importantly, unlike the 1966-68 cycle, there has been no change in leadership. U.S. equities have gone to new highs relative to U.S. Treasuries as has been the case since 2009. Similarly, U.S. equities have outperformed their foreign counterparts as they have for the past decade. Eurozone equities, for example, are cheaper relative to U.S. stocks than at any time in the past 35 years. Finally, large capitalization technology companies, primarily the Magnificent Seven, have led the way again in the wake of their 2022 sell-off. The Nasdaq Composite experienced its third best first half ever, a year after having its second worst first half on record in 2022. The biggest 15 companies in the S&P 500 are up by more than a third while the median company is essentially flat. The Technology, Communication Services, and Consumer Discretionary sectors, which house the Magnificent Seven, put in record or near record first half performances, while the Energy, Utilities, Health Care, and Consumer Staples sectors were all in negative territory. Rarely has value been as out of favour relative to growth as is the case today. Buying the "Dogs of the Dow", the 10 Dow Jones stocks with the highest yields, a strategy with an enviable long-term track record, produced a negative return in the first half. The "deep value" segment of the S&P 500 has been this cheap less than 1% of the time since 1970. Meanwhile, the so-called PEG (price-to-growth) ratio of the S&P 500 Technology sector has risen to levels only seen at the peak of the dot.com bubble and the ratio of the aggregate price to free cash flow has risen to nosebleed levels even as the revenues of the Magnificent Seven are, in aggregate, growing at single-digit rates. With Apple breaking decisively through the $3 trillion market capitalization level, the five largest companies saw their combined weight in the S&P 500 reach the highest level (almost 25% and more than 50% of the Nasdaq 100) since the infamous "Nifty Fifty" era in 1972. There was a certain plausibility to buying these stocks when short-term interest rates were zero, but now that they are 5%, that rationale is off the table. In 2022, as interest rates rose and markets sold off, investors looked for new leadership to emerge in commodities, or value stocks, or smaller capitalization stocks, or emerging markets, or other areas that had underperformed over the previous decade and looked like good value. So far, it has not happened and the market advance since last October looks more like a continuation of the old bull market than the beginning of the new one. If it is a new bull market, it is the weakest advance for the unweighted S&P 500 in at least the past 50 years.

One factor that is not at play in the rising market since October is higher earnings. To take one egregious example, semiconductor stocks have risen strongly even as semiconductor sales have fallen by 20% and the P/E ratio on the Nasdaq of 31 is virtually back to where it was at the peak in 2021. Nonetheless, a number of factors have come together to allow equity markets to rise. First, there was a good deal of pessimism last Fall. Too many people on one side of the boat. It needed to be worked off and it has been. Secondly, monetary tightening has taken two forms - central banks raising rates and selling off some of the bonds they had bought so massively since 2009, otherwise known as quantitative tightening. The rapid rise in interest rates led to a crisis in the government bond (gilt) market in the U.K. in October and in the regional bank sector in the U.S. in March. Together, they caused the Fed to pull back on their quantitative tightening even as they continued raising interest rates. Some believe this is the critical factor behind the better performance of "risk on" assets over the past 8 months; namely, the belief that central bankers will flinch at the first sign their monetary tightening is putting financial conditions seriously at risk. A third important factor has been the lack of a recession. Economists have been talking about a recession in the U.S for months, yet it just hasn't happened. This has led many to conclude that it isn't going to happen or, if it does, it will be sufficiently mild so as not to greatly affect corporate profits.

Thinking about whether the U.S. and global economy will slip into recession is not just a matter of pedantry. Over the past 150 years, the median drop in U.S. corporate profits during recessions has been 18% and the median decline in stock prices has been 35%. In the five recessions since 1980, corporate earnings fell on average by 25% and, importantly, stock prices did not bottom until after the recession had begun. Unfortunately, notwithstanding rising stock prices over the past eight months, the economic data continues to suggest that a recession in the U.S. and elsewhere is highly likely. The venerable ISM manufacturing index in the U.S. has shown contraction for eight consecutive months, which last happened from December 2008 to July 2009 during the Global Financial Crisis. The current level of 46 is below where 9 of 12 recessions since WWII began. Only 22% of industries are growing compared to 83% a year ago and new orders have fallen for ten straight months. The Chicago Purchasing Managers' Index contracted for the tenth straight month in June and the current level is below where it was at the start of 6 of the 7 recessions that have occurred since its inception. Gross Domestic Income (GDI) in the U.S., the flip side of GDP, is down 0.8% year-over-year. Since World War II, a 12-month negative reading in the GDI has only happened during a recession. Three years ago, the median existing home price in the U.S. was $284,000 and the 30-year mortgage rate was 3.12%. Today, the median home price is $396,000 and the mortgage rate is 6.67%. The result is a $22,000 increase for a 20% downpayment and an increase in the monthly payment from $973 to $2,037, putting the Housing Affordability Index back to where it was in the Reagan era. Not surprisingly, the price of existing homes has fallen on a year-over-year basis for the first time in over a decade while the number of pending sales is down 20%. Shipments of cardboard boxes, a great bellwether of economic conditions, have fallen at a pace only seen twice before over the past 30 years. Customer traffic into restaurants fell in April to a level not seen since February 2021. The Federal Reserve Bank of Dallas reported that lending guidelines have tightened the most on record over the past two months. Then there are the two major forward-looking indicators. First, the Conference Board's Index of Leading Indicators fell in May for the 14th straight month. This has only happened twice before - from April 2007 to May 2008 (the recession began in December 2007) and from June 1973 to July 1974 (the recession began in November 1973). Those two recessions were among the deepest of the post-war era, it should be added. Secondly, there is the yield curve which a study for the Federal Reserve Bank of New York concluded, "significantly outperforms other indicators in predicting recessions two to six quarters ahead." That bank's yield curve model puts the odds of recession in the U.S. at 99%. Others reach similar conclusions. Ned Davis Research notes that 91% of U.S. yield curves are inverted, well above the 55% level that indicates that a recession is likely. Real Investment Advice states, "100% of the 10 economically sensitive yield curves we track are inverted. A recession is imminent when 50% of the yield curves tracked enter inversion." Finally, Research Affiliates observes that "the magnitude of the current yield curve inversion far surpasses previous inversions".

Nor is the dismal economic outlook restricted to the U.S. China, which was supposed to energize the world economy as it emerged from its brutal Covid lockdowns, is stumbling. Despite a big decline in mortgage rates, housing loans are contracting for the first time ever and the manufacturing sector has been contracting for the past three months. Manufacturing is declining in three nearby economic powerhouses - Taiwan, South Korea, and Singapore. Plunging monetary growth and rising interest rates have led Eurozone data points to keep surprising on the downside. The air seems to be coming out of the balloon in Canada as the Bank of Canada has raised interest rates to a 22-year high. The leading indicators in Canada, as in the U.S., are pointing towards recession and the Bank of Canada Business Outlook Survey shows sales expectations down for the past six quarters. The fact that the

Bloomberg Commodity Spot Index has racked up five straight losing quarters, its longest such streak since 1998, probably says a lot about the state of the world economy.

So amid all the gloomy economic portents, why have stock prices been rising and why has the world economy and the U.S. economy in particular been muddling through - U.S. housing starts stronger than expected; consumer confidence in the U.S. at a 17 month high and global consumer sentiment in the “extreme optimism” zone; growth in nominal U.S. personal consumption expenditures as high in the first quarter as at any time in the past 20 years; the most positive economic surprises in the U.S. since 2021; a U.S. unemployment rate below 4%. Each of these data points has a backstory that makes them less positive than they appear. Nevertheless, they collectively cause many to question the inevitability of a recession and to justify a less risk averse investment position than would be suggested by the leading economic indicators, yield curves, and the stated willingness of central bankers to keep interest rates “higher for longer”. There are no doubt numerous reasons for the relative resilience of the U.S. and world economy. One is labor hoarding. The National Federation of Independent Business in its most recent survey found that 60% of small businesses were searching for workers and 43% said they had no qualified applicants. As a result, companies are more reluctant to let go of existing workers than would normally be the case. In all likelihood, however, the biggest factor relates to the timing of the impact of rising interest rates. Monetary policy always operates with long and unpredictable lead times. This is probably truer today than ever before. In 1950, roughly one-third of all jobs in the U.S. were in manufacturing. Today, it’s about 8%. In 1950, residential investment represented 8% of real GDP. Today, it’s less than 3%. These two sectors are particularly sensitive to the cost of credit. The fact that services, and particularly government, represent a much larger share of the economy probably means we have a historically weaker transmission mechanism of monetary policy. Also, during Covid, when interest rates dropped to record lows, many corporations refinanced their fixed-rate debt. As a result, in aggregate, they have the lowest interest expense to cash flow in decades and will not feel the full brunt of higher interest rates for some years. Similarly, homeowners in the U.S. typically locked in low interest rates on their mortgages such that, while the conventional mortgage rate in the U.S in the first quarter was 6.3%, the effective rate on mortgage debt outstanding was 3.5%. This is the main reason the number of existing homes for sale has fallen to a record low as homeowners are “prisoners” of their ultra-low interest rate homes. Canada doesn’t have a 30-year mortgage regime, but the same principle applies. The real hurt from higher rates for people who took out cheapie mortgages in 2020 and 2021 will not be felt until 2025 and 2026. Then, too, during Covid, the U.S. government - and some other governments, including Canada’s - engaged in the biggest combined monetary and fiscal stimulus experiment in American history. This led to a sharp rise in consumer price inflation which the central bank is now trying to rein in. Nevertheless, the shock waves of that stimulus are still being felt. Between September 2019 and April 2022, the balance sheet of the Federal Reserve ballooned by $5.2 Trillion or at a 42% rate of growth. Only once before, between October 2017 and September 2019, has the Fed attempted to shrink its balance sheet, a policy that was quickly abandoned then and the prospects for which are uncertain today. While there has been an unprecedented decline in the money supply over the past year, there is still an excess of money left over from the Covid stimulus. On the U.S. fiscal front, trillions of dollars were paid out leading to excess savings in the order of $2.0 - $2.5 Trillion. Those excess savings have been gradually spent over the past two years and it is estimated they will be gone sometime in the next 12 months. At the end of 2022, it was estimated excess savings in the U.S., Canada, the U.K. and the Eurozone were above $3 Trillion. Given the rapid and large increases in interest rates that have taken place over the past year and their impact on the yield curve, a recession in the U.S. and elsewhere later this year would not come as a surprise. On the other hand, the lingering effects of the Covid stimulus, not to mention the ongoing large government budget deficits in the U.S., Canada, and elsewhere could push a recession into 2024. Incredibly, the Canadian government is borrowing money to send people cheques at the same time they are raising interest rates to lower the rate of inflation. No doubt this is a bad idea from a long-term perspective, but it does serve to keep the economy stronger in the short run than would otherwise be the case. The fiscal situation in the U.S. is even worse. Even after the “deal” that Republicans secured in order to raise the debt ceiling, the Congressional Budget Office forecasts a federal budget deficit equal to 6% of GDP in 2024 rising to 7.3% in 2033 under the rosiest of economic scenarios. This is completely unsustainable in the long run, but represents a lot of economic stimulus in the short run. A critical variable will be the actions of central bankers. Further increases in interest rates will obviously increase the likelihood of recession sooner rather than later.