What Does The Rest Of 2023 Hold?

Let us start with some ancient history

We started the year with a number of strong views

- **US 2-Year yields** were going to move to new highs in the trend well **above 5%**
- **Fed Funds terminal p**ricing would go as high as **5.75% to 6.0%**
- The **US 2's 5's curve** (Our financial bible) would invert to **minus 73 to minus 78 basis points**

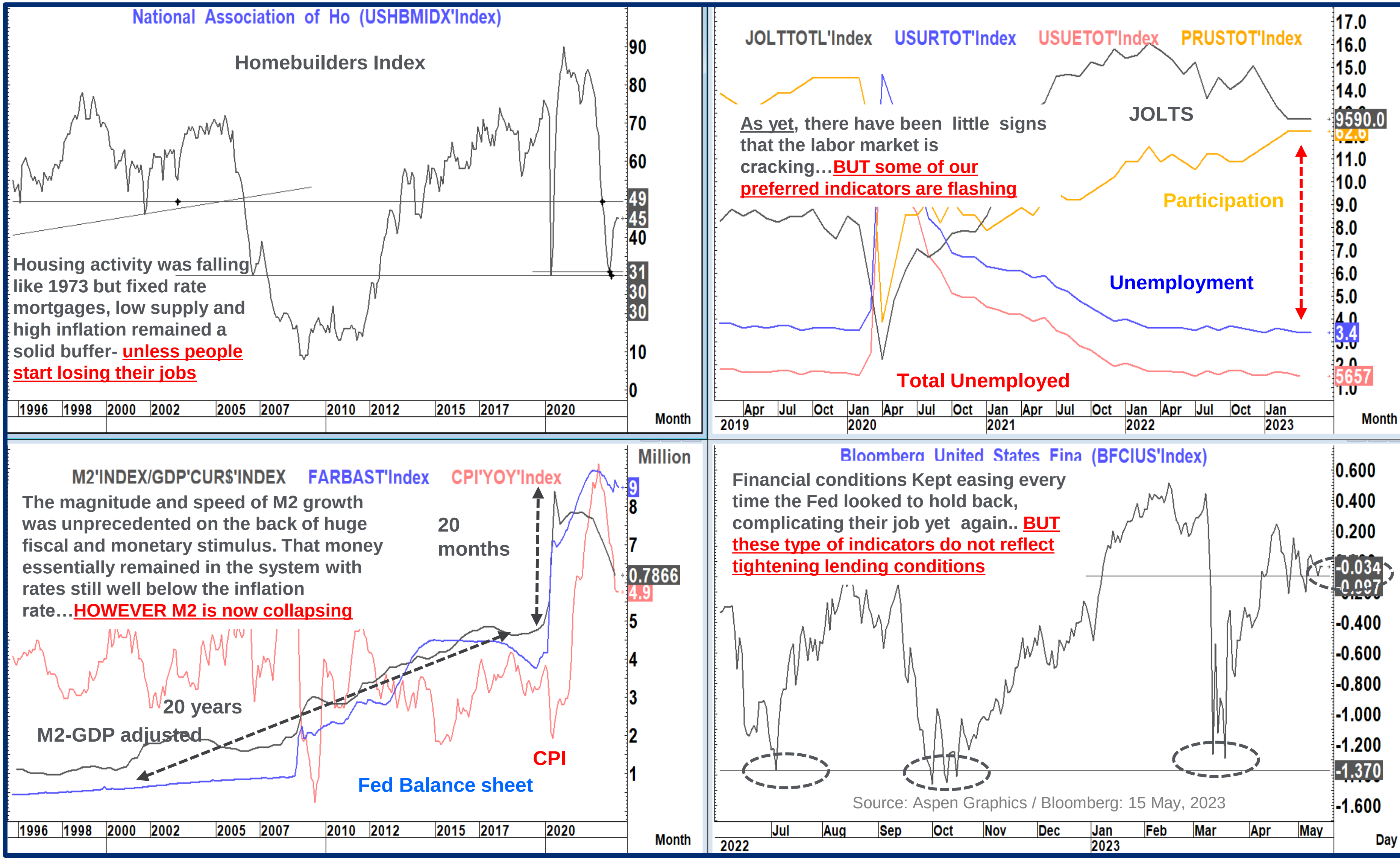
We also stressed that while we expected pricing of the terminal rate to go towards **5.75-6.0%** we only expected that rate from the Fed to materialize **IF** nothing broke

In addition, we noted that the underlying economy and inflation were likely resilient to these rate hikes.

What did we mean by that?

Techamentals – The Fed still has challenges

More and quicker hikes looked to be needed as the Fed moves were having minimal impact

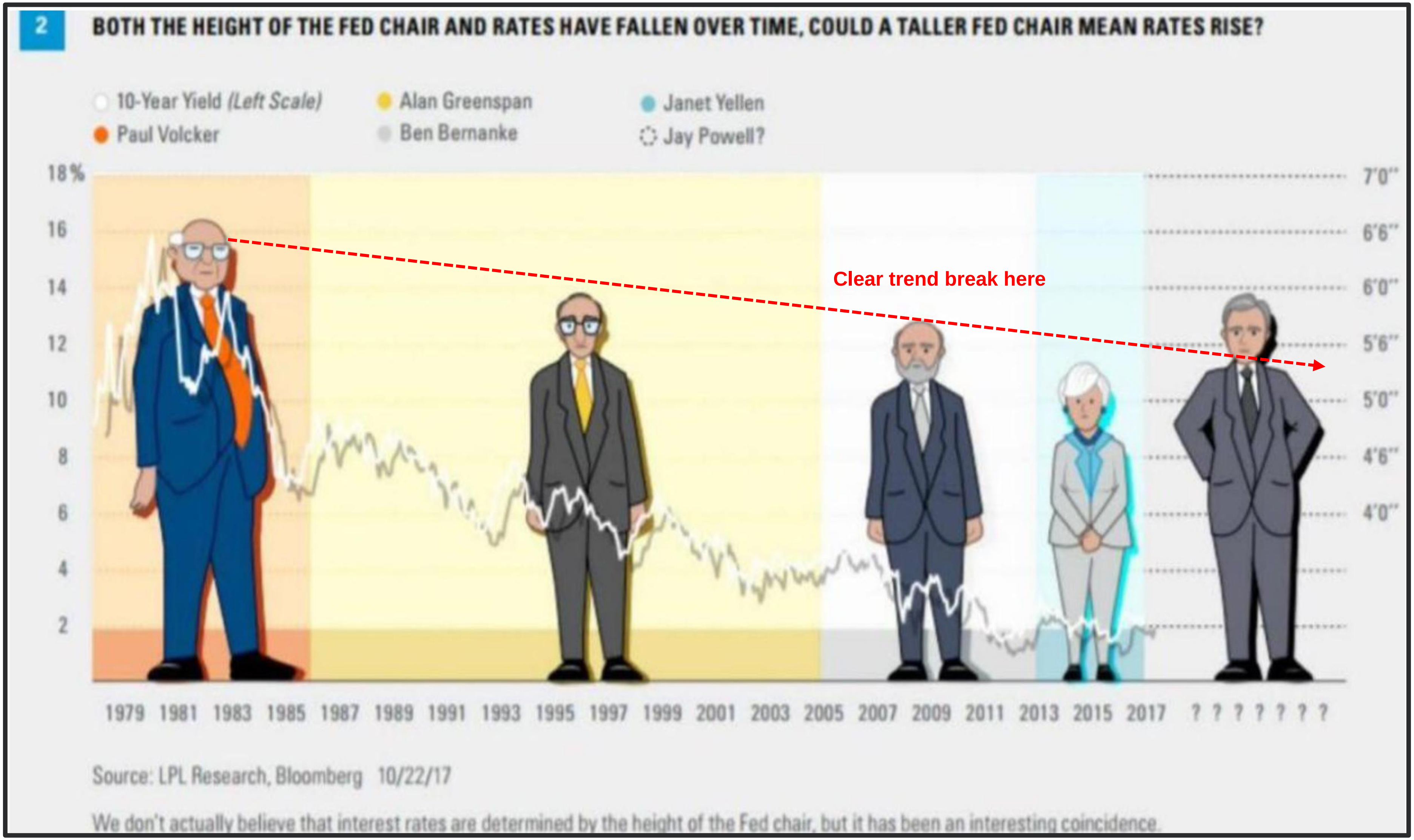


Techamentals do not help the Fed

Wage growth and Services inflation- Were elevated also

Rates Was this the most important trend break ? ☺

We’ve talked the Volcker talk. Are we going to walk the Volcker walk? I don’t think so



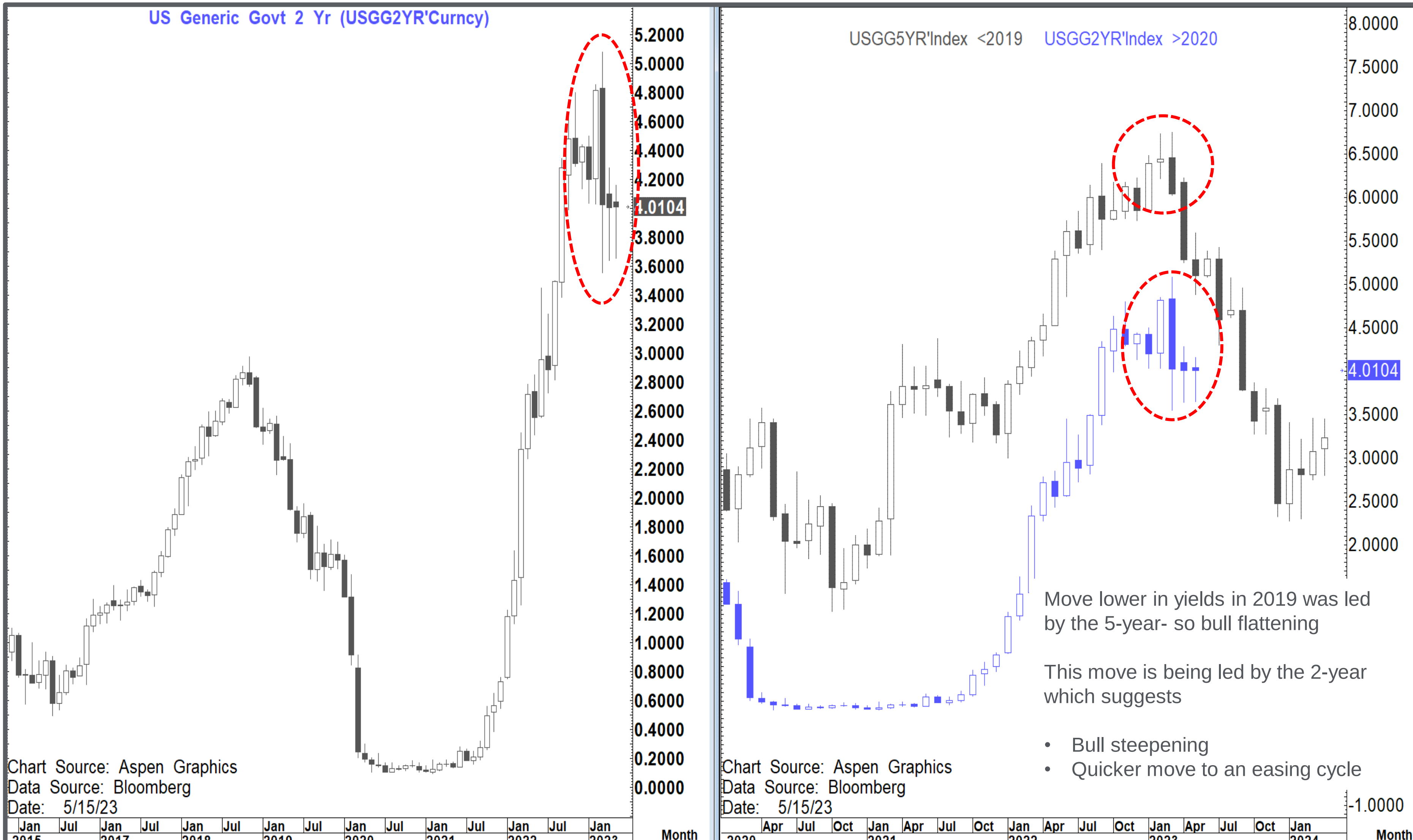
Then something broke

Long before Covid and Ukraine we had penciled in 2023 for a potentially strong recession

- **It fit with the long-term cycle of the last 50+years in the US.**
- **1972-1974:** Inflation becomes unhinged, Fed raises rates sharply, Equity market falls sharply (S&P fell 17% in 1973 and NASDAQ 31%), housing activity falls sharply, and economy falls into a deep recession from the first quarter of 1974…then **17 years later**
- **1989-1991:** Savings and loan/housing crisis… then **17 years later**
- **2006-2008:** GFC**1**.. then **17 years later**
- **2023-2025: ???...**But recessions do not come just because of a timeline.
- **What would be the catalyst?**
- **Often recessions begin with the domino of asset/credit markets that feed into the real economy.**
- That is now looking like a clear danger here.
- **So, what are we looking at here to guide us?**

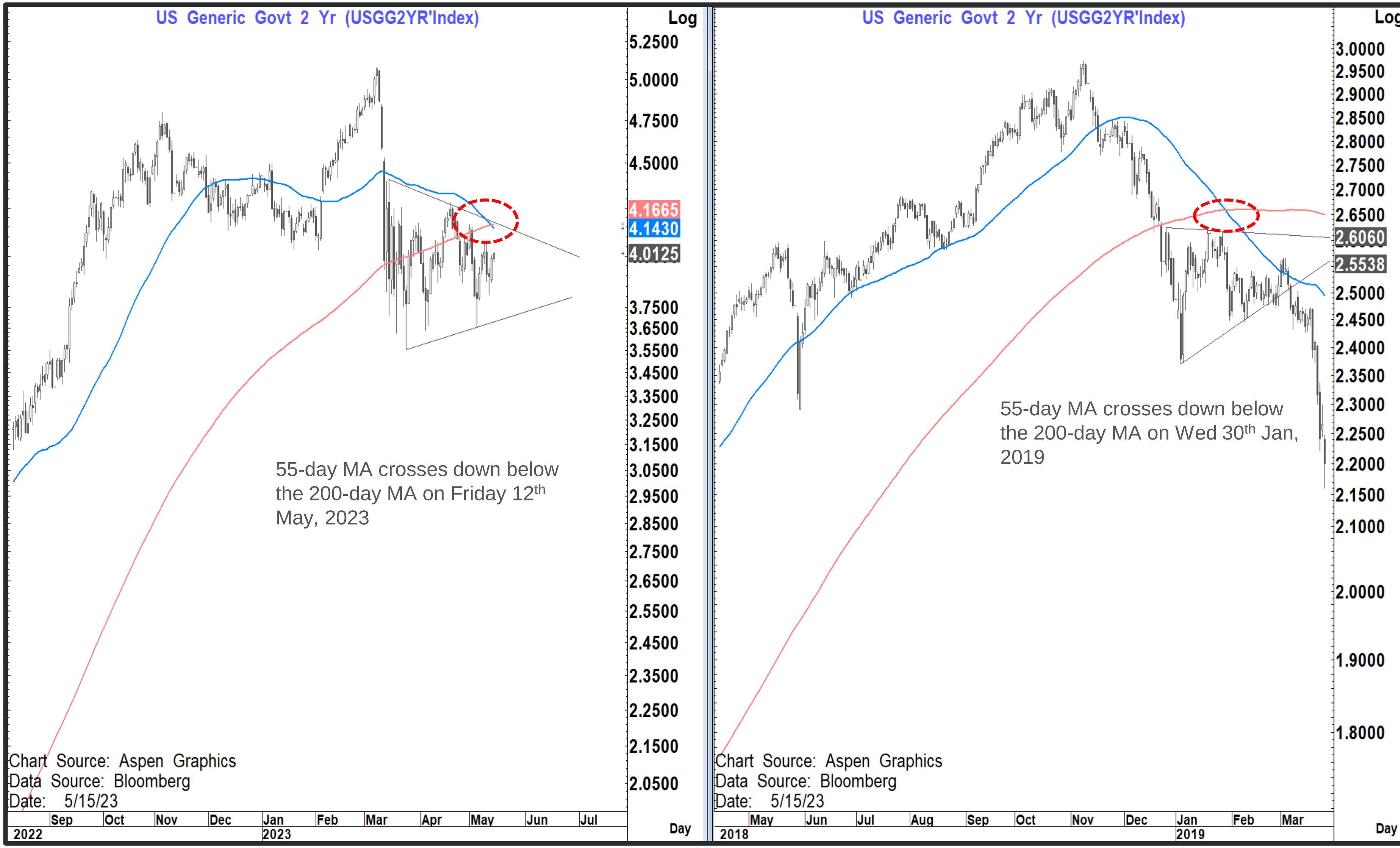
Yields: US 2-year yield- Outside month at the high

Shades of November 2018 but with important differences



Yields: US 2-year yield- Daily "Death cross"

The first since 30th January, 2019 after the final rate hike of the cycle

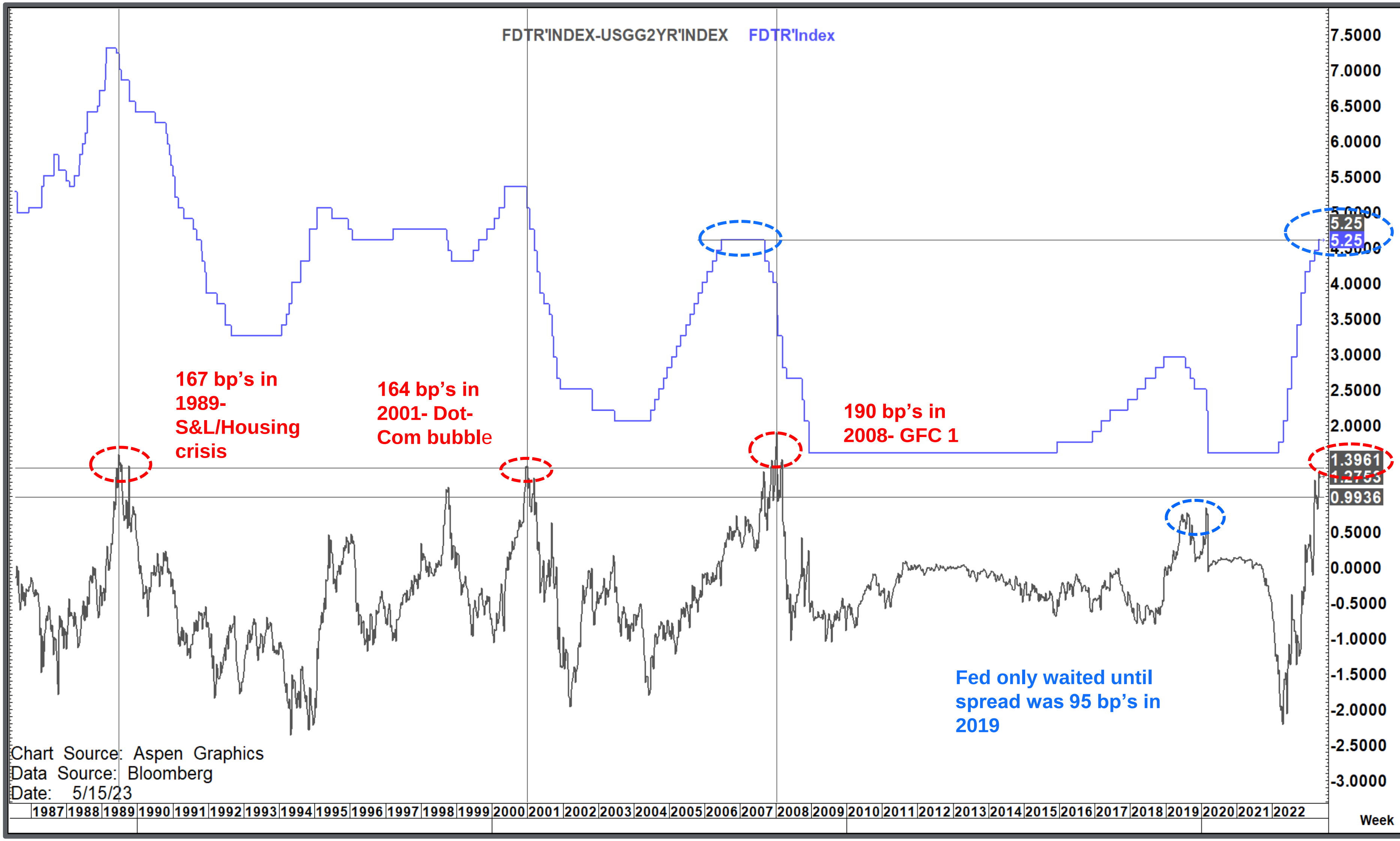


Yields: Major pivot on the 2-year yield

55-200 week MA setup is one of our favourite indicators

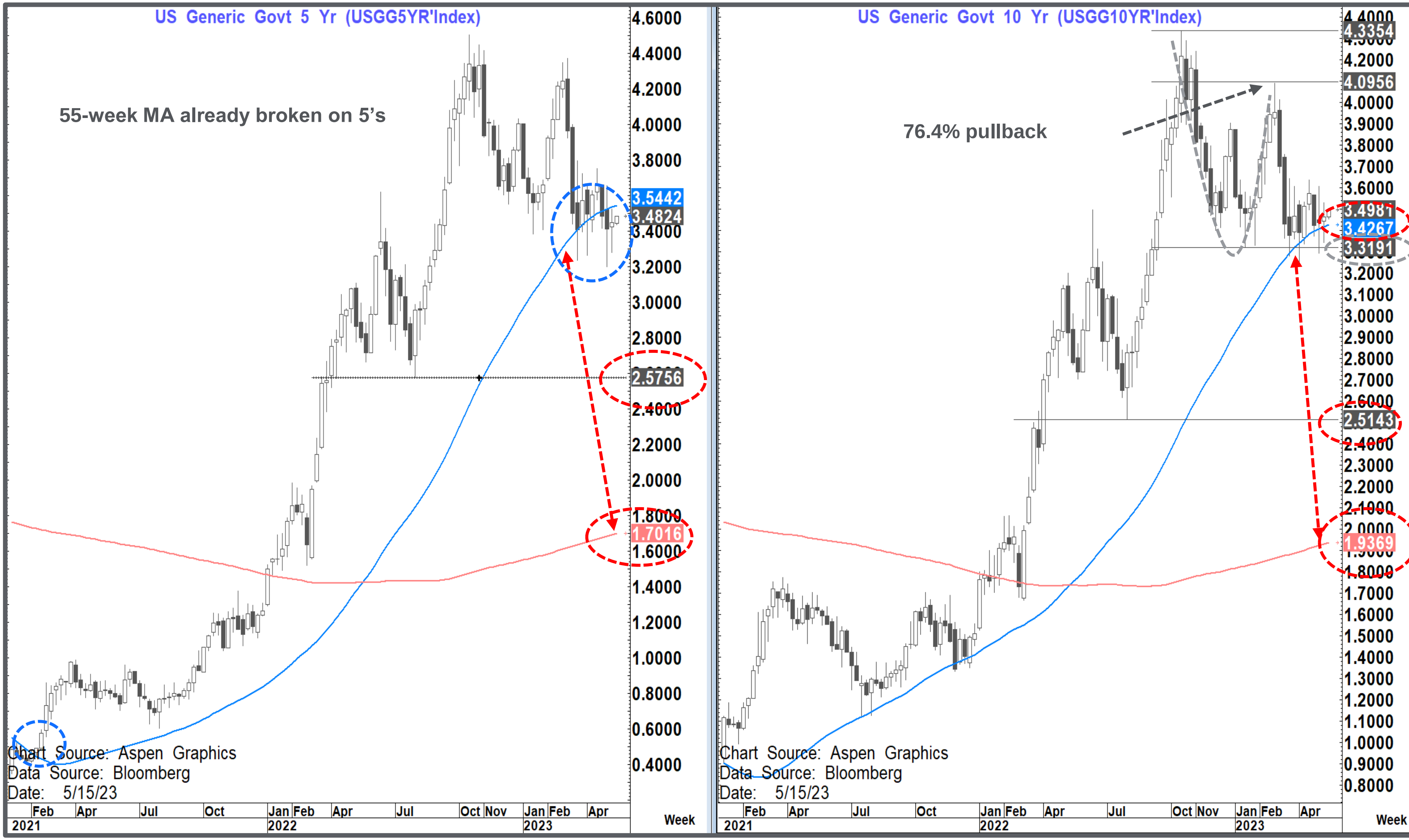
US 2-year yield and the Fed Funds rate in last 30+ years

Reaching a very pivotal point- Spread over 140 bp's rings alarm bells



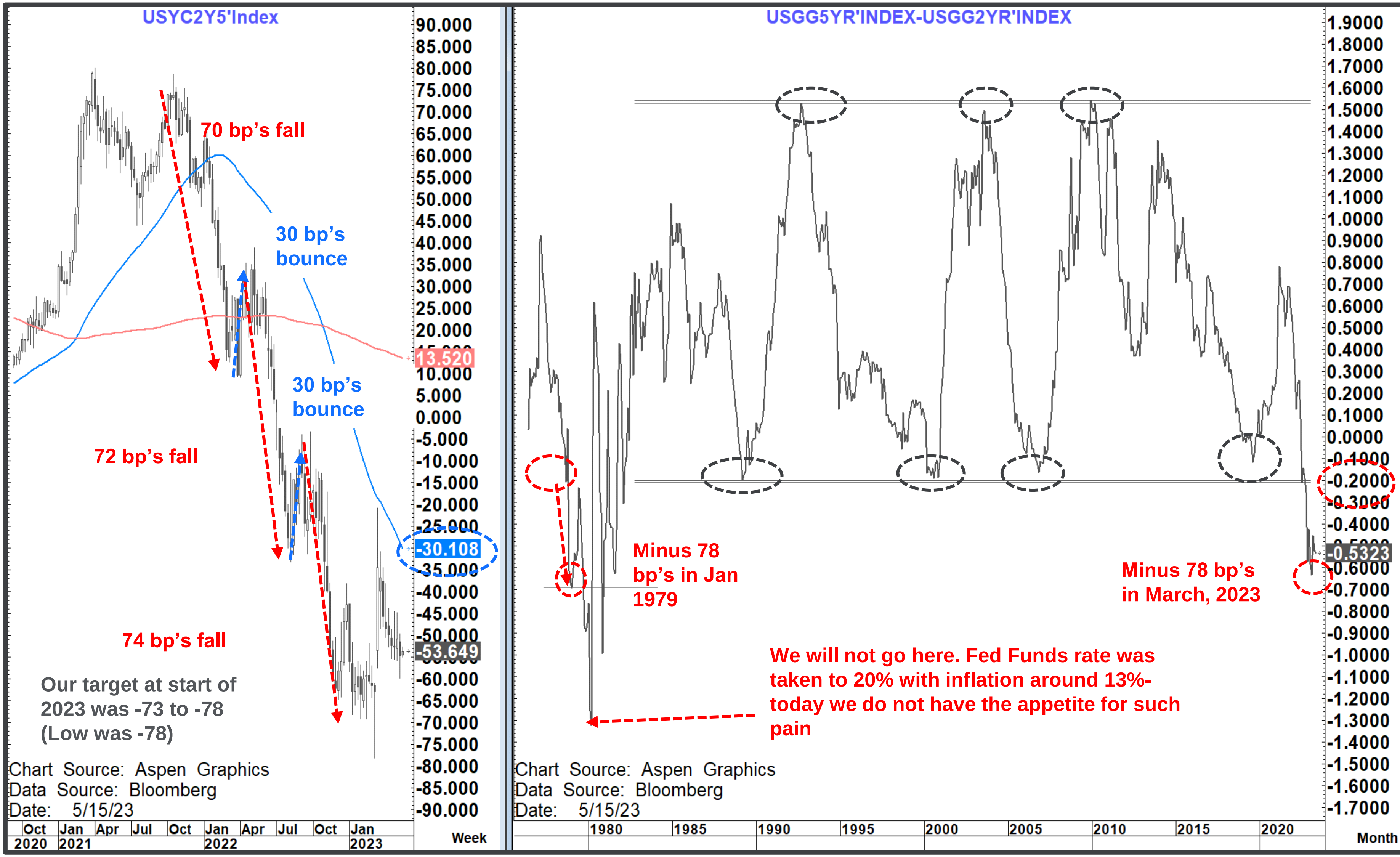
Yields: 5's and 10's also looking shaky

5's have already broken the 55-week MA/ 10's under pressure



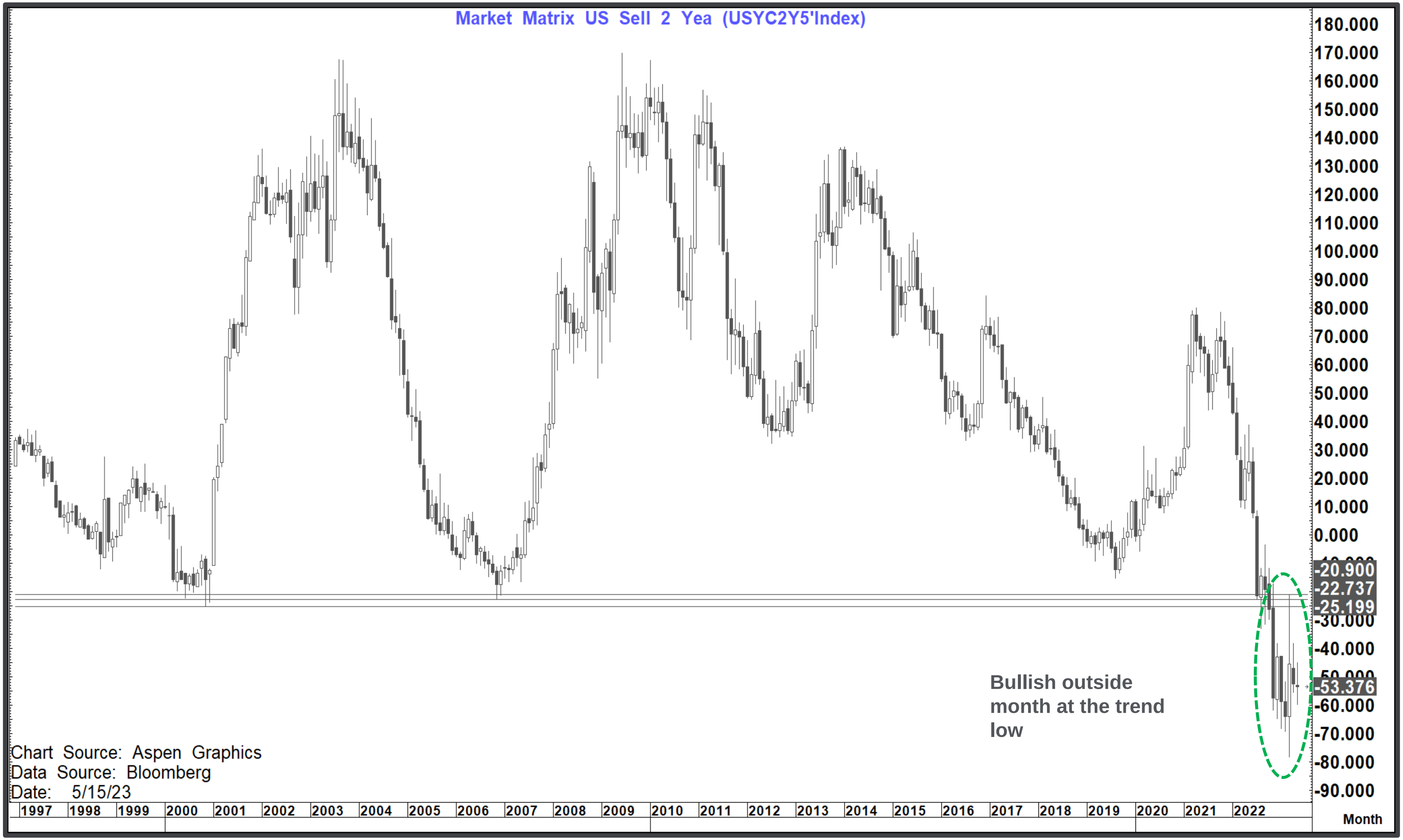
Yields: US 2's 5's curve- Our financial bible

What is it telling us?



Yields: US 2's 5's curve- Is the low in?

Posted a bullish outside month (Lower low than prior month/Higher high/ Close above prior month high)



Yields: it's a liability problem

Contrast the difference to the asset problem of the GFC. This is more like the S&L crisis- Valuation, not quality but on both Asset and Liability side stresses emerge

Yields: Higher for longer has a bad track record

The last 50+ years paints an interesting picture on policy turns from cycle peaks

- 1971- 1 month (cycle peak)
- 1973- 1 month (interim peak)
- **1974**- 2 months (Cycle peak)- **Deep recession 1973-1975- 1 year 4 months**
- 1979- 2 months (interim peak)
- March 1980- 1 month (cycle peak) **Mild recession 1980- 6 months**
- Nov 1980- 2 months (interim peak)
- 1981- 1 month (Structural cycle peak) **Recession 1981-1982- 1 year and 4 months**
- 1982- 3 months (cycle peak)
- 1984- 2 months (cycle peak)
- **1989**- 4 months (cycle peak) **Deep recession- 8 months in 1990-1991**
- 1995- 5 months (cycle peak)
- 2000-2001- **8 months** (cycle peak) **Dot Com crash- mild recession – 8 months**
- **2006-2007**- **15 months**- **GFC1**
- **2018-2019**- **7 months.** Covid downturn in 2020.

So, only on 3 occasions over nearly 50 years was the terminal rate sustained at its peak for more than 5 months. Coincidentally or not these instances led into

- **The Dot Com bubble burst; GFC1; The Covid Pandemic (outlier)**

Not exactly a confidence building record that everything will end well.

On 8 occasions the turn happened inside 1-2 months.

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What supports this market dynamic?

The unemployment rate is a lagging indicator

<u>Unemployment</u> is low yes at 3.4%- but that is a lagging indicator

In Sept 2019 (Just ahead of Covid) unemployment was also low at 3.5% yet the Fed started easing because markets and the backdrop were warning that things were deteriorating.

In May 2007 (GFC) unemployment was at a cycle low of 4.5%- how did that work out?

In April 2000 (Dotcom bubble) unemployment was at a cycle low of 3.8%- all good?

In March 1989 (Housing and S&L crisis) unemployment was at a cycle low of 5%- Nothing to see here?

In May 1979 (Oil crisis and Paul Volcker) unemployment was at a cycle low of 5.6%. By June of 1980 it was at 7.8% on the way to an ultimate peak of 10.8% in 1982

<u>JOLTS</u>

Job openings remain high at 9.6mm and the ratio of openings to unemployed is about 1.6:1 **BUT**

- That ratio has fallen from above 2 in the middle of 2022
- JOLTS are over 2.4mm (20%) from the highs in March 2022 and down 1.6mm in Q1- <u>That is the largest quarterly fall **EVER**</u>
- Job openings may even be lower still as often interviews continue (Info on competition/market environment/compensation picture etc.) but companies do not pull the trigger as hiring freezes and/or RIF's take place

NFP

- Levels have been steadily dropping since Feb last year moving back into the 2010-2020 range
- At turning points, the number is likely suspect- particularly due to the "Wallpaper chart"

<u>Initial Claims</u>

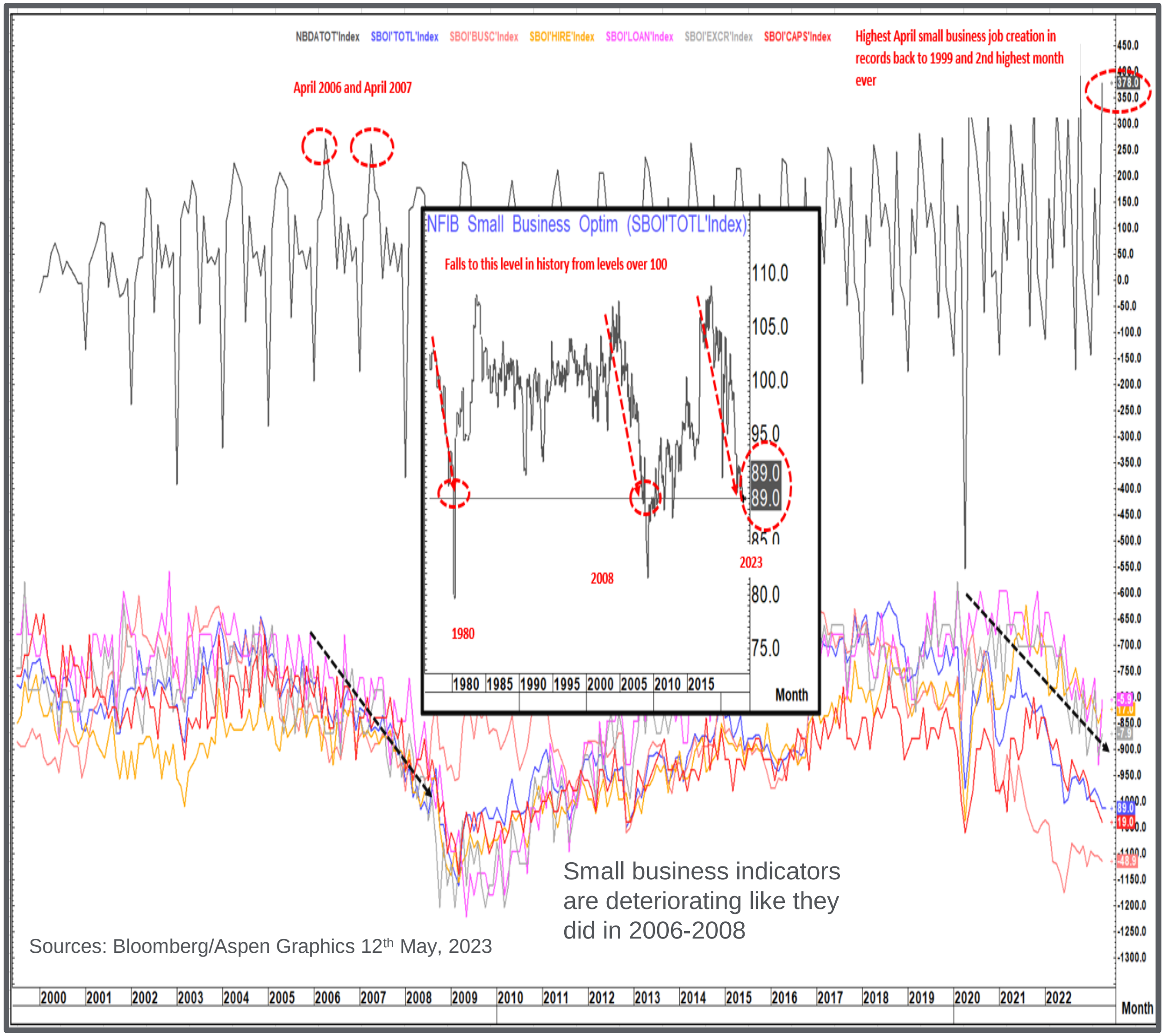
- Initial claims are up at levels not seen (outside of Covid) since 2017

<u>The quits rate (voluntary job separations initiated by the employee)</u>

- Is falling and at 2.5% is just 1/10th above the 2019 peak and 2/10ths above the 2005 peak having fallen from 3% in April last year.

Techamentals: Employment- The wallpaper chart

That is what we call the “Birth Death Ratio”



CES Net Birth-Death Model (This looks like a death that is under exaggerated)

*Currently, the CES sample includes about 122,000 businesses and government agencies drawn from a sampling frame of Unemployment Insurance tax accounts which cover approximately 666,000 individual worksites. The active CES sample includes approximately one-third of all nonfarm payroll workers. **The sample-based estimates are adjusted each month by a statistical model designed to reduce a primary source of non-sampling error which is the inability of the sample to capture, on a timely basis, employment growth generated by new business formations.***

The April adjustment was **+378 K** which is both the highest April ever reported in this series and the 2nd highest monthly total ever

As we have recently said

Small Business is the backbone of the US economy

Small banks are the backbone of small businesses

The backbone is broken as these small banks come under stress, lending conditions tighten, capital investment slows etc.

Techamentals: Inflation

Inflation is too high, there is more work to do…BUT

Inflation is clearly too high , but what is the path? The Fed's mandate is headline inflation.

Headline CPI hit a peak (YOY) at 9.1% last June. Since then, it has fallen yoy in every month since the peak.

When inflation peaked in June last year the Fed Funds rate (Upper bound) was 1.75%. It is hard to argue therefore that the Fed Funds rate was the primary driver for it starting to turn. Inflation has almost halved since and we have seen the Fed Funds rate continue to rise to 5.25%

The 3-month run rate on headline CPI is **3.6%** and the 6-month run rate is **3.4%**

Headline PCE inflation is at **4.2%** from a peak of **7.0%** in June last year without one uptick along the way (March YOY fell from 5.1% to 4.2%)

There was clearly a one off aberration with the 2.0% monthly number in January in headline PCE- but the 2 prior numbers were 0 and .2 and the 2 subsequent numbers were .10 and ZERO

If you (selectively) leave out that aberration and take the 3 numbers prior and 3 numbers after the 6 months annualised rate is actually 2.4%

Core CPI

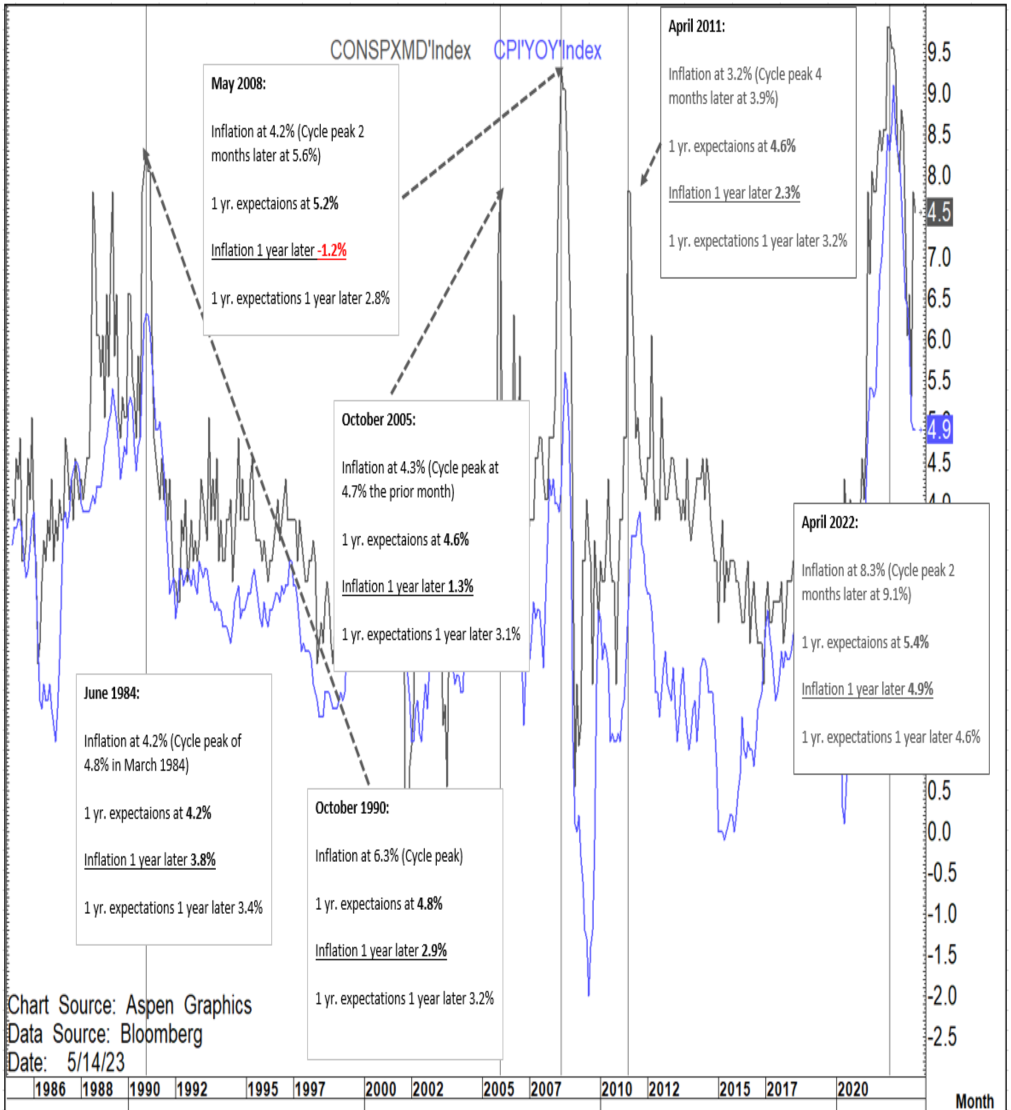
Core CPI stands at **5.5%** but again peaked last June at **6.6%** and has not had one annualised uptick since then.

Core PCE actually peaked in Feb 2022 at **5.4%** and is now **4.6%**

However, because the Fed is so focused on not making the same mistake again (which probably means they will) they now delve into the various sub-components to validate this continued inflation fight.

IF there was still no trade off then I would understand. Now they appear to be looking for reasons to hold the course as they did when the course was "transitory inflation".

But what about Michigan inflation expectations?
Comparison of peaks in 1 year Inflation expectations and where inflation was exactly 1 year later



Forget for a moment that it was the "reliance" on inflation expectations on the other side that got us in this miss.

As inflation went higher and higher ,we got comment after comment that this was all transitory because inflation expectations were well anchored.

"Please sir I would like to buy a car and can you please price it at inflation expectations rather than inflation"

This survey for the initial release **targets** about 420 cases for the preliminary reading, but the exact number fluctuates depending on interview schedules. If we stop for a moment and think of the likely accuracy of a random group of about **420 people in a country of 332 million** accurately forecasting where inflation will be in 1 years' time and that influencing monetary policy- **it could hardly be described as remotely credible.**

And full disclosure- I am not sure whether **targets** means ,they keep going until that number is hit, or they just reach out to that number.

IF the latter then the number of respondents is even lower.

Furthermore, when we look at the chart below spanning the last almost 40 years we see

- The predictive value of this indicator has been very poor with actual number 1 year later being lower than expectations every time (including this year)
- The misses have ranged from 0.5 percentage points up to 6.4% points
- The 1 year inflation expectation has been much closer to the actual inflation, at the time of prediction or the then cycle peak being formed, than to the actual rate 1 year later

The reasoning is very simple- Human nature is to project forward on the basis of how you are feeling today . Thereby, inflation expectations amongst consumers will be much more a factor of what you are seeing today than what you are necessarily expecting tomorrow.

Techamentals: Inflation

But what about Michigan inflation expectations? (Contd.)
That comparison also holds on the downside

April 1983	Inflation	1 year inflation expectations	Infl. 1 year later	1 year exp 1 year later
March 1983	3.6% (Cycle low of 2.5% in July 1983)	1.8%	4.8%	3.4%
March 1986	2.3% (Cycle low of 1.1% in Dec 1986)	2.3%	3.0%	3.0%
March 1992	3.2% (Cycle low of 2.6% in Jan 1992	2.6%	3.1%	3.1%
Nov 1998	1.5% (Cycle low)	2.3%	2.6%	2.9%
Nov 2001	1.98%	0.4%	2.2%	2.4%
Dec 2008	0.1% (Cycle low of **minus 2.0%** in July 2009)	1.7%	2.7%	2.5%
April 2020	0.3% (Cycle low of 0.1% in May 2020)	2.1%	4.2%	3.4%

Sources: Bloomberg12th May, 2023

Yet again a 100% track record of being more related to what had happened than what was going to happen.

Techamentals and markets. What leads

We look at 2 Year Yields; JOLTS; 2's 5's Bible and Initial Claims- And the winner is? Initial Claims

US Unemployment Rate Moves off Bottom	Lag / Lead Time Between X vs. US Unemployment Rate	2yr Yield Major Peaks
Jun-79	Lagged by 28 months	Aug-81
Apr-89	Led by 1 months	Mar-89
Apr-00	Lagged by 1 months	May-00
Jun-07	Led by 12 months	Jun-06
Mar-20	Led by 16 months	Nov-18
?	Leading by 1 month and counting	Mar-23
		Timing has been inconsistent

US Unemployment Rate Moves off Bottom	Lag / Lead Time Between X vs. US Unemployment Rate	JOLTS Major Peaks
Apr-00	Lagged by 9 months**	Jan-01
Jun-07	Led by 3 months	Mar-07
Mar-20	Led by 16 months	Nov-18
?	Leading by 13 months and counting	Mar-22
	** JOLTS only started in Dec 2000	2001 an abberation. Otherwise lead has averaged about 10 months

US Unemployment Rate Moves off Bottom	Lag / Lead Time Between X vs. US Unemployment Rate	2s5s Bottom (Financial Bible) Major Bottoms
Apr-00	Lagged by 7 months	Nov-00
Jun-07	Led by 7 months	Nov-06
Mar-20	Led by 7 months	Aug-19
?	Leading by 1 month and counting	Mar-23
		Ignoring 2000 lead has been 7 months

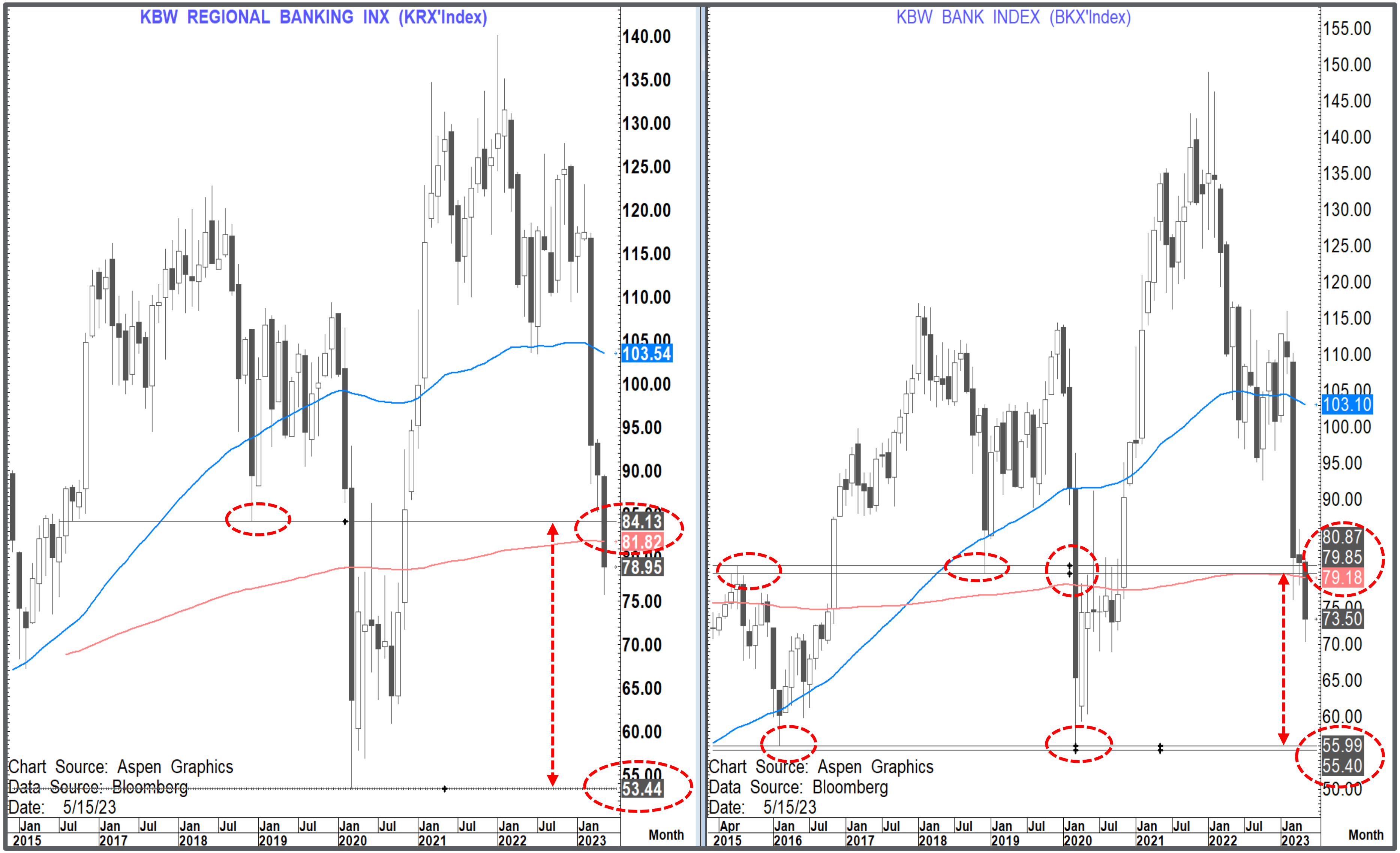
US Unemployment Rate Moves off Bottom	Lag / Lead Time Between X vs. US Unemployment Rate	Initial Jobless Claims Major Bottoms
Jun-69	Led by 7 months	Nov-68
Nov-73	Led by 10 months	Jan-73
Jun-79	Led by 7 months	Nov-78
Apr-89	Led by 3 months	Jan-89
Apr-00	Led by 0 months	Apr-00
Jun-07	Led by 17 months	Jan-06
Mar-20	Led by 6 months	Sep-19
?	Leading by 7 months and counting	Sep-22
		Average lead of about 7 months-led every time
		Right where we are now with April number

Sources: Bloomberg12th May, 2023

Regional Banks are Contained

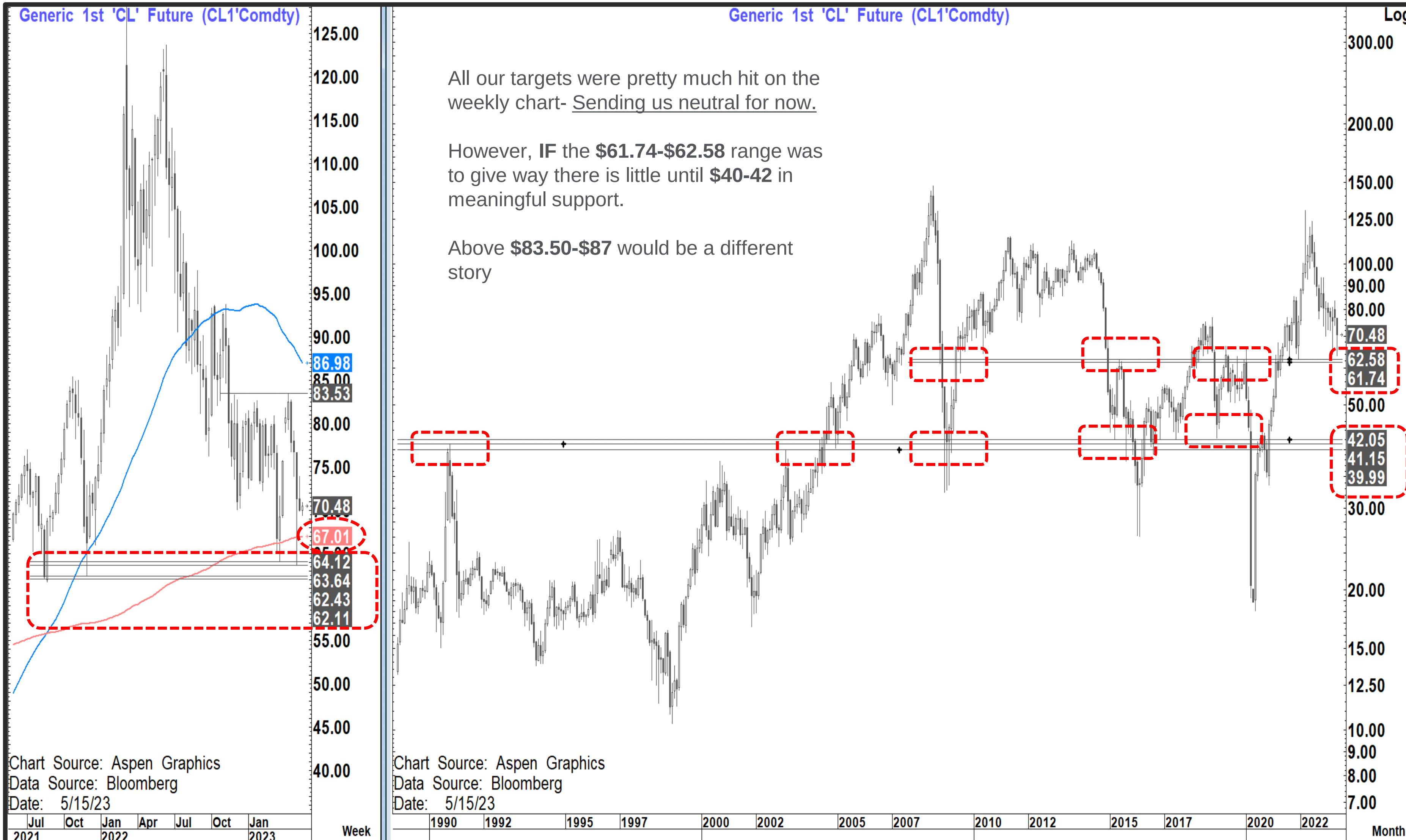
“Subprime Is Contained” Ben Bernanke , March 2007

2006-2008 is however not the roadmap- the 1980-’s S&L crisis is



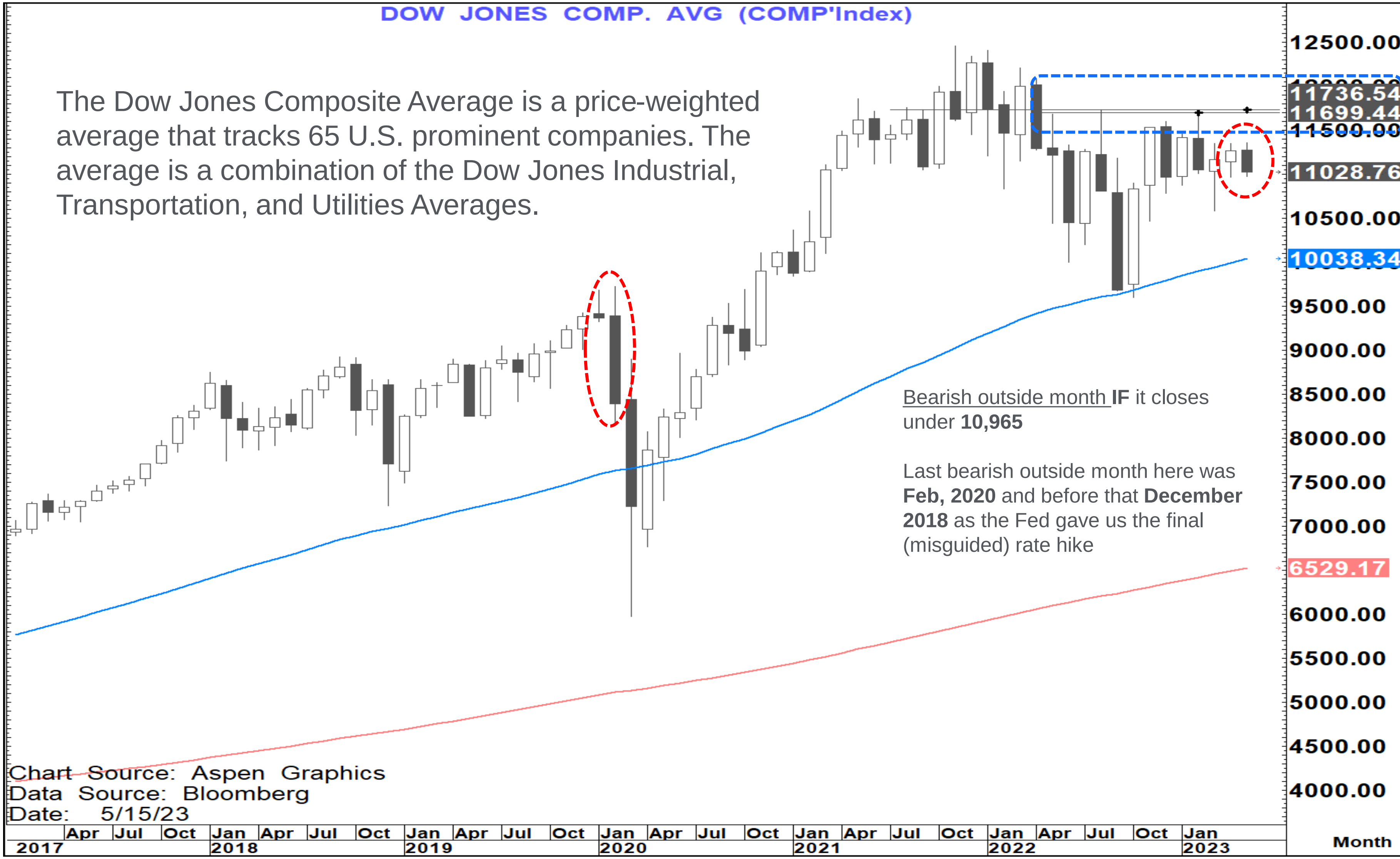
Oil: Mind the Gap

Battle of Economic/banking concerns and OPEC+/ SPR replenishment



Equities: Equity markets – When confused go to the COMP

While the NADAQ has traded well other indices give a mixed picture



USD-Index

A battle of two indicators?

Does the 55-200 week MA setup send it to 98.06?

(Full disclosure- It was not above the 55-week MA for the preferred 2-year period – was just 17 months)

Or, is it a double bottom with a neckline at 105.88 that could signal back towards the 111 area?

If the World is just fine but the US is lagging, and the problems are really US based- then a weaker USD is the likely outcome

BUT…that is not our view of the World.

We think the US may be already headed into recession but when the US catches a cold the rest of the World catches a fever.

IF this picture becomes more of a “risk off “ World expect the USD-Index (Heavy European weighting) to catch a bid

Also, right now, market view seems uniformly bearish the USD and despite everything the DXY is actually only down less than 1% on the year.

Chart Source: Aspen Graphics
Data Source: Bloomberg
Date: 5/15/23

So where are the risks?

We have a huge amount of moving parts

Rates
- Fed struggling in its battle against inflation (1970's).
- Economic/employment/housing, savings and fiscal buffers have made their job challenging but that could be changing
- Fixed income bear market (1970's)

Economy
- Cyclical recession 1972-74+17=1989-1991+17=2006-2008+17= **2023-2025+17?**
- Are markets and the economy going to do what the Fed could not?
- Huge debt to GDP ratio over 120% requires high nominal growth
- Starting to look like S&L crisis of 1980's

Geopolitics
- Russia/Ukraine ongoing maintains some supply inflation issues (1970's)
- Turmoil in Iran? (1970's)
- Netanyahu back in power in Israel? Danger of conflict? (1970's)
- China/Russia alliance (1937)
- Sanctions on China (Semi conductor chips)- like Oil restrictions on Japan in 1941. Taiwan dangers?

Housing
- Sharp fall in activity in high inflation environment (1973-1975)- **but this is not 2006**
- Only a stress for borrowers **IF unemployment** rises sharply.

Oil
- All of the above retains danger of another Oil price shock (1974 and 1978) further down the line but for now the economic backdrop may be a greater driver

Did anybody say STAGFLATION?

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