April 28, 2023

"One of these things is not like the others,
One of these things just doesn't belong,
Can you tell which thing is not like the others
By the time I finish my song?"

– Sesame Street

Dear Client,

While the equity market rally begun in October of last year persists, other asset classes continue to tell a story of economic slowdown, lower corporate profits, and ongoing credit concerns. In fact, below the surface (i.e. other than the top twenty mega-capitalization names), the equity market itself is less healthy. We discuss these financial market crosscurrents below and our interpretation of what is signal and what is noise. First, a review of Q1 performance for "primary" assets.[1]

Risky assets were a mixed bag in the first quarter. US equities were up 7.9% during the three-month period, followed closely by global equities which produced a 7.4% return. Commodities lost 2.2% during the quarter, more explicitly corroborating the ongoing economic slowdown.

Indicating the narrowness of the equity rally, the USA MSCI Equal Weighted Index returned 4.2%. In fact, twenty stocks accounted for almost 90 percent of the S&P 500's first quarter gain. Without the mega-capitalization growth stocks, the S&P 500 returned 1.4%.[2]

[1] We refer to US equities, long-dated US Treasury bonds, gold, and commodities as "primary" asset classes borrowing the language of HCWE & Company. The idea is that these four assets best capture two variables that explain a significant amount of asset price movement: global growth (explained by investor risk sentiment) and inflation. This framework is the basis for a permanent portfolio, an "all-season" portfolio, risk-parity, etc. US equities and commodities are "risk" assets, while US Treasury bonds and gold are "haven" assets. The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, ACWI for the MSCI All-Country World Index, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.
[2] https://www.ft.com/content/b01c0a46-1162-4893-8b92-d42fbf4424a0

Safe-haven assets, on the other hand, were uniformly up, signaling a risk-averse attitude. After leading the way in the fourth quarter of 2022, gold put in another strong quarter, up 7.1%. Long-dated US Treasury bonds returned 5.4%.

Consistent with the defensive posture we have held for the past year-plus, the Grey Owl All-Season[3] strategy was essentially flat for the period (down 0.4%). (If the framework we discuss below is directionally correct, the comparison with an equity-heavy benchmark would be towards the top of a bear-market bounce.)

Bear Markets in Context

Given the ongoing rally in equity markets, it is worth reproducing a chart we included in our last letter. The chart below juxtaposes the current bear market that began at the end of 2021 with the 2000-3 and 2007-9 bear markets. All bear markets have significant rallies during the overall downward trend. A high-teens percentage rally alone, does not mean the bear market is over.

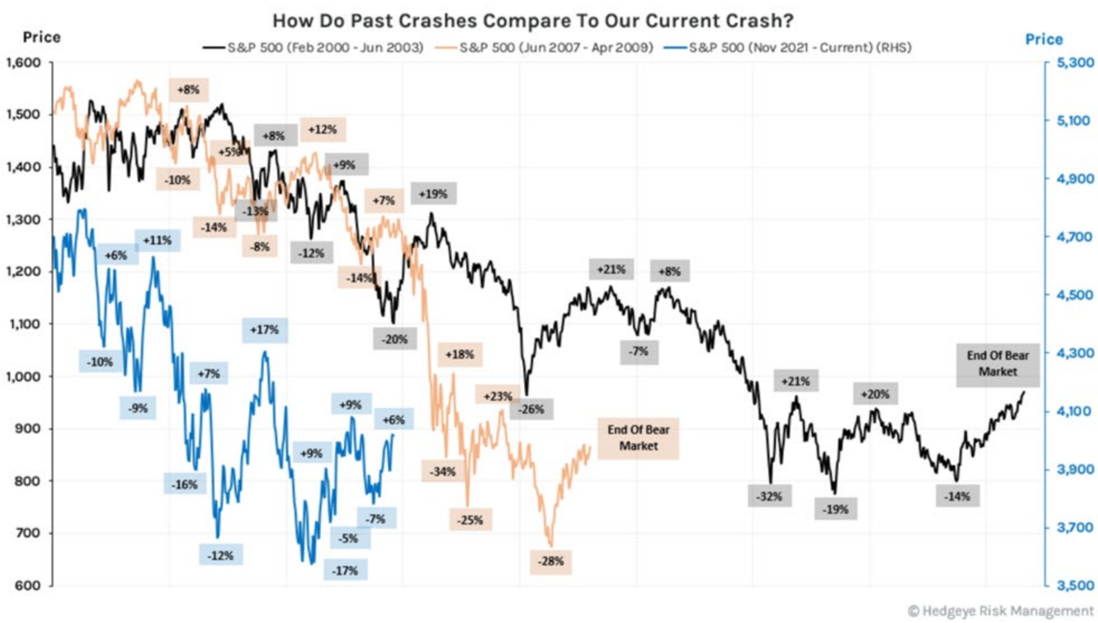

Figure 1 - Current & Past Bear Markets; Hedgeye.com

[3] Despite the generic and frequent use of the term, we renamed our strategy Grey Owl All-Season after Bridgewater Associates requested we do so claiming it conflicted with a strategy they call All-Weather.

Economic Growth

Growth continued to not just decelerate, but contract, during the first quarter. The chart below should look familiar to consistent readers. We have shared an updated version each of the last few quarters.

The US ISM Manufacturing Purchasing Manager Index (PMI) summarizes in a single datapoint the state of the US economy. The PMI is a "diffusion index" which aggregates survey data from decision makers throughout the manufacturing economy. The questions are around the managers' expectations (e.g. "do you plan to acquire more or less inventory next month compared to this month) and are thus a leading indicator of economic activity.

For over a year now, we have noted the deceleration in the PMI. All the while, expressing our belief that it was likely this indicator would enter contractionary territory (i.e. below 50). It dropped below 50 in November 2022 and has continued lower since to a low of 46.30 in March 2023.

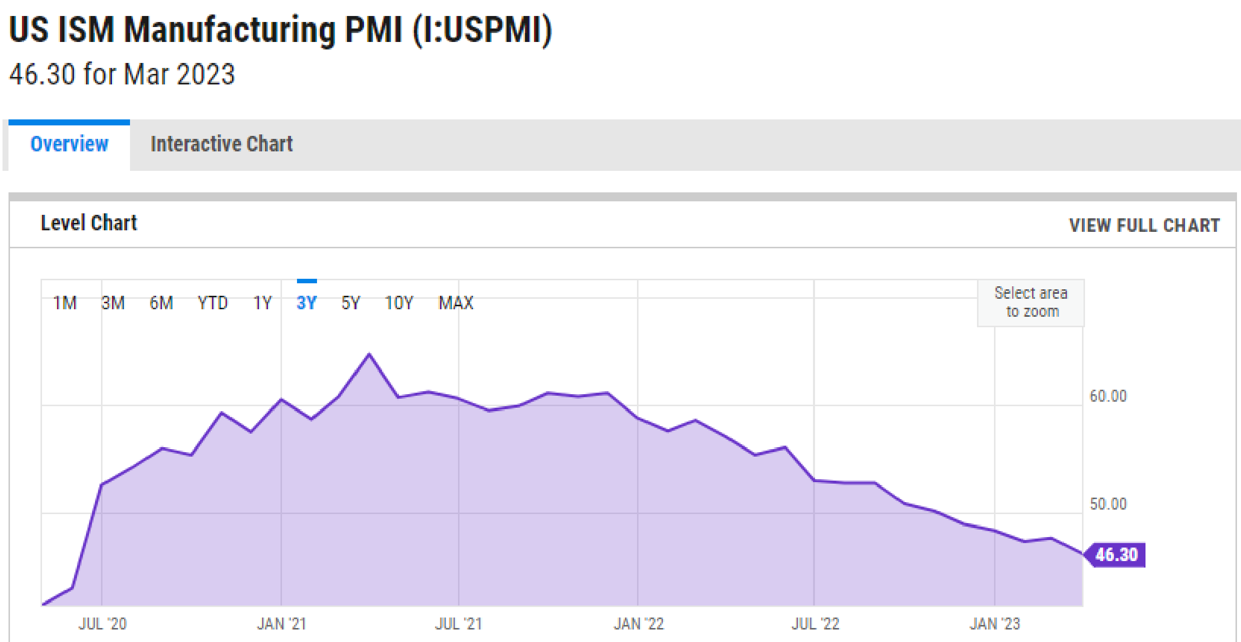

Figure 2 – US ISM Manufacturing PMI monthly[4]

[4] https://ycharts.com/indicators/us_pmi

Yield Curve

The yield curve (i.e. the difference between the yield on the 10-year Treasury bond and the yield on the 2-year Treasury bond) agrees with the ISM Manufacturing PMI. The US economy is headed for a recession (if not already in one). Since 1950, every time the yield curve has inverted, a recession has followed within two years. 70% of the time it occurred within a year.[5] As the graph below shows, the yield curve first inverted in the middle of 2022. The inversion has become increasingly extreme as time has gone on.

Figure 3 - www.tradingview.com

[5] ChatGPT

Inflation

Like growth, inflation is subsiding (though it remains quite high relative to the last several decades). Commodity prices (typically the fastest goods to reprice) have been declining since the middle of last summer. While this chart is of historical prices, commodities do offer a forward look at measured inflation.

Figure 4 – www.tradingview.com

Notwithstanding the above, we are not forecasting a return to the low inflation of the past two decades. There are compelling arguments for both inflation and deflation going forward and the ultimate path is somewhat subject to political developments. As we move toward the back half of this year, comparisons to the previous year will become more difficult and it would not be surprising if inflation "sticks" at a level above the 2% Federal Reserve target. For now, the trend is lower, and we are positioned accordingly.

Corporate Profits

In the middle of 2022, expectations for S&P 500 full year 2022 operating EPS were $225. Final numbers came in at $197. That is a mere 5% decline from the all-time peak in S&P 500 earnings of $208. To put this in perspective, in the milder recession of the early 1990s, earnings declined over 15% from peak four-quarters to trough four-quarters. In 2001, again a mild recession, the similarly measured decline was over 30%.[6]

Today, expectations for the full year 2023 operating EPS are $218. In other words, the consensus expects corporate profits will grow again. Given pressure in central-business-district commercial office real estate, auto loans, and credit cards (to name just the most prominent areas of stress) we think 2023 EPS expectations will revise lower as the year progresses. Until that occurs, we expect continued pressure on equities and other risky financial assets.

The Debt Ceiling and US Sovereign Credit Default Swaps

If all that wasn't bearish enough, the US is approaching the date at which Congress will either need to raise the debt ceiling (the statutory limit on the amount of debt the US federal government can issue) or the Treasury will need to begin prioritizing payments. Current estimates for the deadline are sometime in June.

When this issue last climaxed between July 22, 2011 and August 8, 2011 the S&P 500 declined 17%.[7] Markets learn and investors do not get rich fighting the last battle, but markets also abhor uncertainty. In that context it is worth noting that it costs more to insure US Treasury bonds via credit default swaps today than it did leading into the last debt ceiling standoff in 2011. See the chart on the next page for a dramatic visual of the markets reaction to the debt ceiling debate.

[6] ChatGPT
[7] ChatGPT

Figure 5 - https://www.investing.com/rates-bonds/united-states-cds-1-year-usd

Positioned for Continued Economic Deceleration and Market Volatility

Since the end of 2021, we have positioned the Grey Owl All-Season portfolio for a risk-off environment. That action continues. Our “safe haven” positions, particularly our cash allocation, remain the largest they have ever been. Our biggest long positions are the US Dollar index (a typical safe-haven asset) and a basket of gold and precious metals securities (another safe-haven asset that works best when real rates are compressing). We have slowly been building a position in longer-dated US Treasuries as fears of inflation have subsided and the market appears ready to acknowledge a growth slowdown.

We are acutely aware that markets will shift toward growth and risk-taking long before that becomes obvious in the reported economic data. While equity markets have rallied from oversold levels in late 2022, this move has been very concentrated in the blue-ist of the current blue-chip names. The broad market is sanguine at best. Further, action in commodities, gold, and US Treasuries all point in the “risk-off” direction. One of these assets classes is not like the others. We believe the oddity is noise and the signal is the collection of asset prices pointed in the same safe-haven direction.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC