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By the Way

Monthly commentary from Jack Way

"The worst loans are made in the best of times"

After three months of corrective action in August, September and October that saw the S&P 500 decline by 10%, the Index needed only one week of November to recoup over half of that loss. High interest rates and concerns about economic and earnings growth gave the bearish narrative the upper hand for those ninety-odd days, but as rates fell and third quarter earnings were solid, stocks have resumed an upward trajectory. The so-called "Magnificent 7" continue to have an outsized influence on the overall market. Just as a reminder that's Apple, Microsoft, Amazon, Tesla, Alphabet (Google), Meta (Facebook) and NVIDIA. The top 5 represent over 25% of the market weight of the S&P 500, with Microsoft and Apple together exceeding 14½%. New statistics continue to amaze me. Individually those two stocks on their own are larger than the Russell 2000 Index of US Equities, and each of the country Indexes of the United Kingdom (FTSE 100), France (CAC) and Germany (DAX). Such a concentration in so few stocks is great for those that own them in the good times, but as someone who has been around a long time and witnessed the rise and fall of the "Nifty Fifty" of the early 70's; Exxon and big-cap oils of the early 80's and many other examples of the "madness of crowds", I remain concerned. In defense of the "7", while their valuations aren't necessarily cheap, third quarter earnings for the group did beat estimates, and consensus earnings expectations for 2024 are at (+)12% while the rest of the 500 is at (-)4%. Market internals improved dramatically during the recent rally, and seasonal strength will be with us into February, and as such are two more short-term pluses.

No one really knows what the "lag" is between FED policy implementation and its impact on the economy, but it seems fair to say that we are finally experiencing the beginning of the slowdown in U.S. growth resulting from last year's tightening efforts. Payrolls in October rose 150,000, well below expectations and down from 297,000 in September; the ISM survey of Purchasing Managers reported manufacturing at 46.7, again below the consensus forecast of 49 and solidly in contraction territory; and the unemployment rate continues to creep higher at 3.9% up from the low of 3.4% we saw in April. That increase of 0.5% has got people talking about the "Sahm Rule" which attempts to recognize recessions early on and has been extremely accurate. Named after Claudia Sahm, a former economist at the FED (and now at Bloomberg); it states that we are in a recession, even if it hasn't been reported as such, when the 3-month average of the unemployment rate rises by 0.5%. So, we have the simple number but not the 3-month average. Even she has said that given how different the economy is today, acting on historic observations is no sure thing. We certainly aren't in recession yet given U.S. GDP grew at a surprising 4.9% in the third quarter. I say surprising since only 3 months ago the consensus of economists was that third-quarter GDP would rise by only 0.5%; wrong by factor of 10. As baseball announcer, Bob Uecker would say "Just a little outside". Comparisons have been made with the third quarter of 2007 that also rose by 4.9%, but in my mind only serves as another reason not to depend too much on reported numbers. As one analyst pointed out, the 2007 quarter's first estimate was 3.9%; that was revised to the 4.9% number; and went finally into the records at 2.3%. At any rate FED policies appear to be having the desired effect, and a broad consensus is making the assumption that rate increases are a thing of the past. The FED is being helped in its fight against inflation by generally tight financial conditions that experts say have had the same effect as a 0.75% rate increase by the FED. The elephant in the room is whether the restrictive policies have gone too far, the weakening economy can't be controlled, and we fall into a recession. I've always liked Hemingway's quote in "The Sun Also Rises" when a character is asked how he went bankrupt; "Two ways. Gradually, then suddenly." I sense we might be saying the same thing next year, only about a U.S. recession.

Since the U.S. 10-year Treasury Bond touched a yield of 5%, the rate has as the English like to say, "come off the boil" and dropped into the 4½% range. Nevertheless, there is a very real danger to those individuals, corporations, institutions, and governments that borrowed money at close to zero rates of interest and must now pay it back or refinance at today's much higher rates. For many the problem is in the not-too-distant future. It was relatively easy to make a profit when money was basically free for the taking, but we may soon find out, as the tide goes out, who is swimming without a bathing suit. We have already had two glaring examples in 2023 – Silicon Valley Bank and Sam Bankman Fried (oddly both recognized by just their initials; SVB and SBF). More to come I should imagine. Howard Marks says, "The worst loans are made in the best of times".

The biggest player on the financing stage is the U.S. government itself. The Department of the Treasury will next year need to raise $2.8 trillion to refinance current debt and another $2.4 trillion in new debt. With a Republican controlled House of Representatives and a Democratic controlled Senate and being an election year, we should expect what Strategas has labelled "Budget Warfare" and that the estimate is very likely low. Speaking of the U.S. election, a New York Times poll indicated President Biden was in big trouble for reelection because of his age, which caused great hysteria and debate on the Sunday morning political talk shows many suggesting he should step aside. However, only 2 days later results showed Democrats winning almost every meaningful election (there weren't that many but there was no denying a rejection of the more extreme and inflexible positions of hard-right Republicans on matters such as abortion.) Two things to ponder; polls aren't that reliable, and probably the real answer is that a majority of voters don't want either Biden or Trump.

On a final personal note, the protests against Israel, but more specifically individual Jews, reek of antisemitism and are especially sickening taking place at our so-called institutions of higher learning. Secondly it takes a strong dose of amnesia to forget the carpet bombing of Dresden and the deaths at Hiroshima and Nagasaki that helped win World War II and then take the high road about civilian deaths in Gaza.

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