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RESEARCH | MACRO

Macro Thoughts

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Thought to ponder…

"A moral position is not a slogan, or wishful thinking. It doesn't come from outside or above. It begins inside the heart of a character and grows from there.

Bird by Bird
Anne Lamott

The View from 30,000 feet

Last week's economic data continued to point to an uneven economy, where interest rate sensitive sectors struggle in the face of higher rates, goods and manufacturing sectors are experiencing downward demand and price pressure as the consumer eases back from their cash-infused pandemic buying binge, and service sectors slowly creeps ahead as spending patterns rotate away from goods. It's against this backdrop that investors gauge each economic data release and every speech by Fed officials. As the week started jitters about weak manufacturing data stoked growth concerns, while data indicating stronger services demand fanned inflation worries. As the days progressed, interpretation of Fed speeches drove optimism that the terminal Fed Funds Rate may stay near current expectations providing buoyancy.

- Atlanta Fed President Bostic outlines landmarks needed to reverse course of monetary policy
- A review of key arguments of the bull case for equities – better PMIs, strong employment, sector rotation and technical trends
- The potential problems in the residential real estate sector look manageable compared to commercial real estate
- The most *Frequently Asked Question* from client's this week: How's that ***Three-Leg Stool*** of yours holding up?

Atlanta Fed President Bostic outlines landmarks needed to reverse course of monetary policy

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- "…history teaches that if we ease up on inflation before it is thoroughly subdued, it can flare anew. That happened with disastrous results in the 1970s. After the FOMC loosened policy prematurely, it took about 15 years to bring inflation under control, and then only after the federal funds rate hit 20 percent. We don't want a repeat, so we must defeat inflation now."

- Bostic's outline for landmarks to shift policy (color denotes signs of progress):
  - A narrowing of the gap between labor supply and demand
    - The estimated over demand of workers in excess of supply is 4m, which needs to ease to pandemic trend of about 1m for the Fed to feel the job is done.
  - Higher interest rates more decisively affecting aggregate demand
    - Durable Goods Orders are above where they were a year ago, the most recent Personal Consumption Expenditures were trending higher and GDP projections are beating the Fed's estimates. There are limited signs that interest rate policy is slowing aggregate demand.
  - Ongoing recovery in aggregate supply
    - Progress has been made on this front, with supply chain disruptions related COVID having eased significantly.
  - Reduction in the breadth of inflation
    - More than 75% of the goods used to calculate CPI Index showed inflation rates of 6% or more, which compares to pre-pandemic levels of 10%. This means there a still a lot of work to do.
  - Stable inflation expectations
    - Inflation expectations surveys are showing that psychology around persistent inflation is easing but has not returned to pre-pandemic trends.

Charting Bostic's landmarks – there is a lot more work to do

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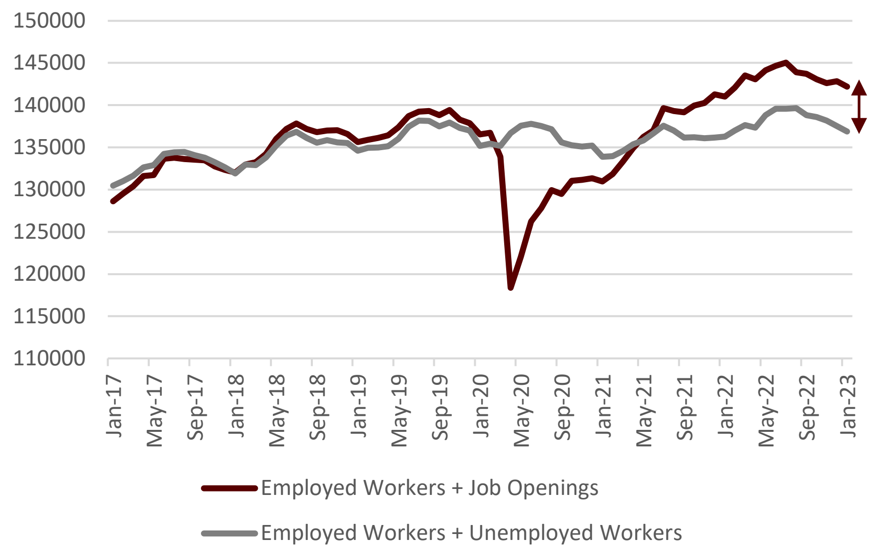
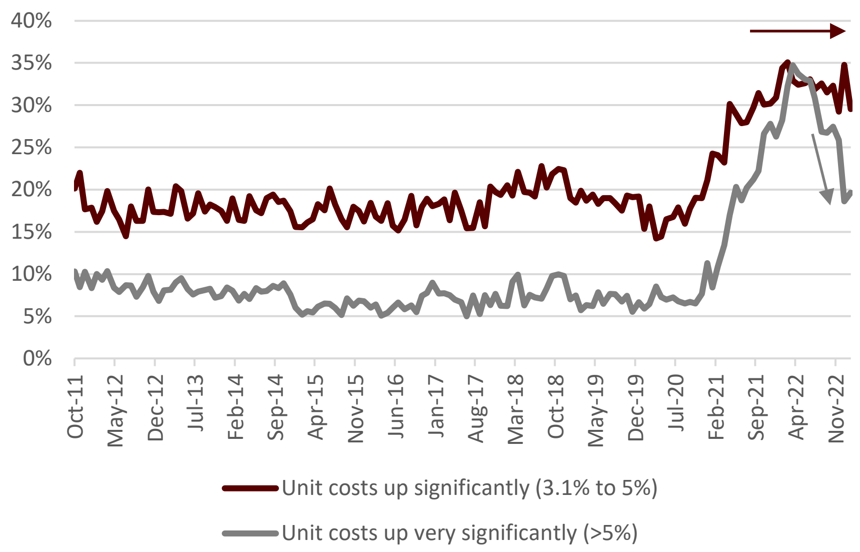
BOSTIC'S FORMULA FOR EMPLOYMENT GAP DEMAND FOR WORKERS OVER 4M VS PRE-PANDEMIC OF 1M



Source: Bureau of Labor Statistics

ATLANTA FED BUSINESS INFLATION EXPECTATIONS SURVEY PROGRESS, BUT PSYCHOLOGY STILL TROUBLING



Source: Federal Reserve Bank of Atlanta

A review of key arguments of the bull case for equities – PMIs, sector rotation and technical trends

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- The bullish case for equities goes something like this:
  - Coming into 2023, the markets were deeply oversold with expectations of dramatically lower earnings and a signs of a recession beginning to materialize in Q1. That didn't happen, instead the economy began showing signs of increased positive momentum.
  - Jobless claims came in below 200k for the seventh straight week, a new record. Employment market is showing few signs of weakness.
  - Global PMIs are trending positively (S&P produces PMI data for 30 countries for Manufacturing and 13 countries for Services)
    - February 2023
      - Manufacturing percent of countries in expansion: 53.3% (average PMI 50.1)
      - Services percent of countries in expansion: 92.3% (average PMI 53.6)
    - September 2022
      - Manufacturing percent of countries in expansion: 43.3% (average PMI 49.6)
      - Services percent of countries in expansion: 53.9% (average PMI 50.6)
- The technical picture provides legs to the buoyancy story:
  - The ratio of Consumer Staples to Consumer Discretionary had hit highs consistent with extreme pessimism at the end of December but has since reverted to pre-pandemic trend, signaling that investors have become less defensive.
  - Brent Donnelly from Spectra Market produced and interest analysis last week that showed that over the last 14 periods where the S&P500 traded below the 200-day moving average, and subsequently then broke out above it, 80% of time the bear market was over. His conclusion was there might be a 317 reasons why the markets should persist lower, but the fact is that it's not moving lower, so don't get sucked into cognitive desistance. Although I agree he has a point the market is buoyant, I however land on concern for the 317 points of data signaling caution and a ceiling secured by valuations, so being patient still seems like the prudent move to me.

Bullish arguments related to technicals and positioning

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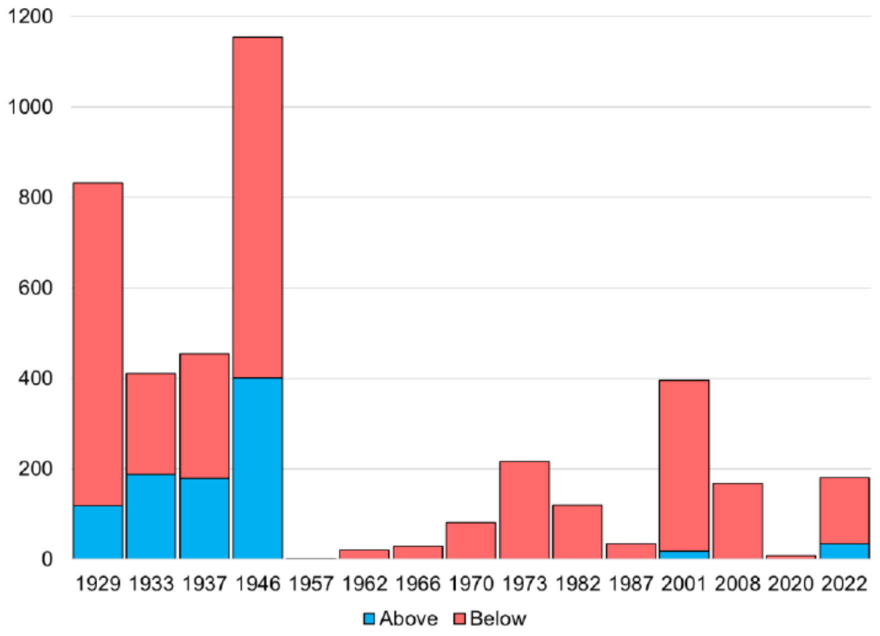
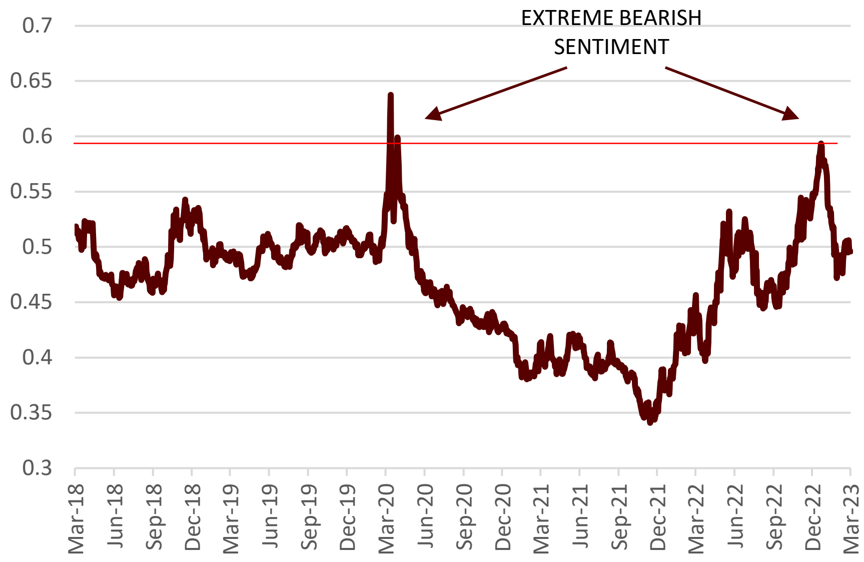
TIME S&P500 SPENDS BELOW 200-DMA OVER DROPPING 20% POST 1962 – VERY UNUSUAL FOR IT TO REVISIT SUB-200-DMA



Source: Spectra Markets

RATIO OF CONSUMER STAPLES TO CONSUMER DISCR SECTOR ROTATION OUT OF STAPLES INTO DISCRETIONARY



Source: Bloomberg

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Residential real estate sector look manageable compared to commercial real estate

- Residential Markets
  - The S&P CoreLogic 20 City Index underwhelmed last week, with a month-over-month decrease of -0.51%, below consensus estimates of -0.40%.
  - This barely begins to describe the stress, given that annual deprecation in major metro areas has set in, according to Case-Shiller y-o-y:
    - San Francisco: -16.0% (according to California Association of Realtors San Francisco is down -35% from the peak)
    - Seattle: -15.1%
  - Adjustable-rate mortgages make up less than 10% of all outstanding residential mortgage debt.
  - There are about 80m homeowners in the U.S. Of those, nearly 18m refinanced 30-year fixed rates at record low rates in 2020 and 2021.
- Commercial Markets
  - Kastle maintains keycard and fobs for over 2,600 buildings representing 41,000 businesses in the U.S. The Kastle Back to Work Barometer exceeded 50% for only the second time since the pandemic began last week. Within that number there is a wide variance by days of the week, with the lowest attendance day being 32.4% and the highest being 57.2%.
  - High profiled debt defaults have begun to hit the wire with Pimco's Columbia Property Trust and Brookfield both defaulting on mortgages in the last month.
  - In the U.S., there is approximately $92b of nonbank office debt that will mature in 2023, and $58b in 2024.
  - About 48% of all debt on commercial office buildings is at variable rates.
  - As an example of how severe profitability will be impacted, according to Bloomberg, Blackstone's Willis Tower in Chicago had $1.3b of debt that was just refinanced. The new rate increased debt servicing costs by over 300%.
  - Over supply: Cushman & Wakefield reports that by 2030 the U.S. will have in excess of 330m sq ft of office space.
  - According to MSCI Real Assets, commercial real estate transactions have now fallen to their lowest level since 2010.
  - CoStar data indicates that the New York commercial real estate vacancy rates have hit a record 12.7%.
  - The Green Street Commercial Property Index has fall 14% from its March 2022 peak.
  - Globally, Bloomberg estimates that there is more than $175b of distressed commercial real estate debt.

Both private equity and banks facing increased exposure to commercial real estate defaults

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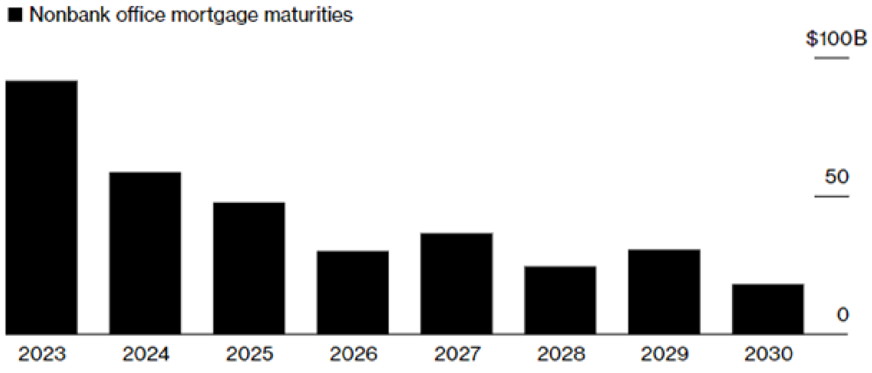
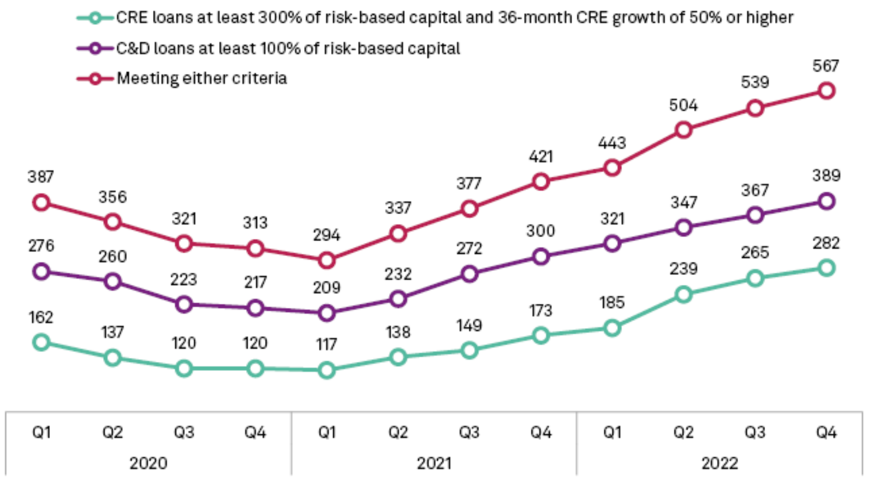
NONBANK OFFICE DEBT REFI ESTIMATES
IN 2023, $92B WALL OF PRIVATE DEBT SET TO REFI



Source: Mortgage Bankers Association, Bloomberg

NUMBER OF US BANKS EXCEEDING CRE LOAN CONCENTRATION GUIDANCE



Data compiled Feb. 21, 2023.
CRE = commercial real estate; C&D = construction and development
Analysis includes operating and historical U.S. commercial banks, savings banks, and savings and loan associations.
Nondepository trusts and companies with a foreign banking organization charter are excluded.
Since the first quarter of 2020, regulators have recommended using Tier 1 capital plus the entire allowance for loan and lease losses as the denominator in credit concentration calculations because of many banks qualifying for and opting in to the community bank leverage ratio framework. Banks adopting the current expected credit loss model should use the portion of the credit losses attributed to loans and leases plus Tier 1 capital.
Companies that met both criteria are included in the totals for each criteria, causing overlap between the totals of each criteria.
Data based on regulatory filings.

Source: S&P Global

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FAQ: How's that *Three-Leg Stool* of yours holding up?

- For new readers to **Macro Thoughts**, we've been talking about the ***Three-Legged Stool*** metaphor for over a year now. We postulated that the economy would be held up in 2022 by three forces:
    - **Jobs** (supply/demand imbalance)
    - **Cash** (excess reserves on consumer and corporate Balance Sheets as a result of pandemic stimulus and cheap debt)
    - **Earnings** (a knock-on effect from all the extra liquidity floating around in the system)
- Our theory was that the economy would be resilient because these three forces would keep the economy floating even though the Fed would continually try and sink it… ***The Three-Legged Stool***
- These forces carried the economy through 2022, enabling us to avoid a recession. They also look set to continue to provide buoyancy to 2023.
- However, the legs are getting weak:
    - The Fed is specifically targeting the employment market and has stated they intent to raise rates and keep them high until the estimated imbalance of 4m workers come back inline with the pre-pandemic trend of a 1m gap. If the Fed gets its way and 2m workers move from employed to unemployed status, there will be major implications for the economy.
    - After peaking at an estimated $2.1 of excess cash reserves on consumer Balance Sheets, it's estimated that cash reserves are now under $1t, and the cushion will be completely gone by Q3 2023.
    - Calendar year earnings for the S&P500 is expected to be 2.1%, with Q1 and Q2, both projected to be negative. If negative earnings are the definition of an earnings recession, projections for Q1 and Q2 indicate that we have arrived.

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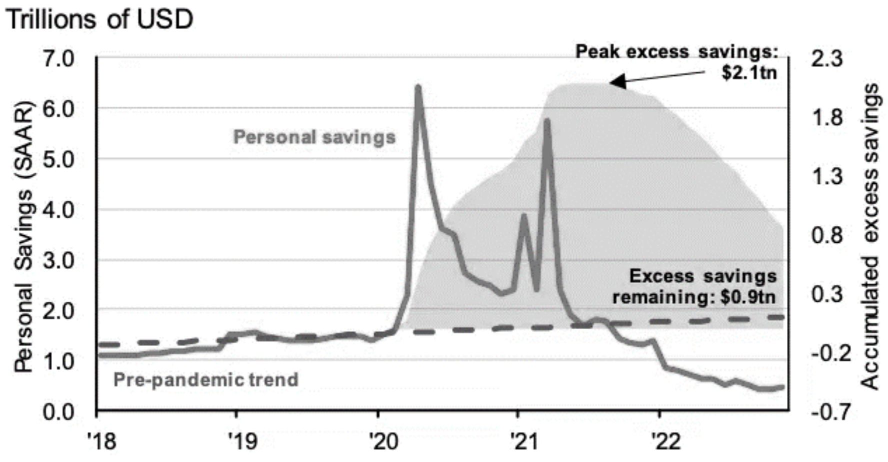
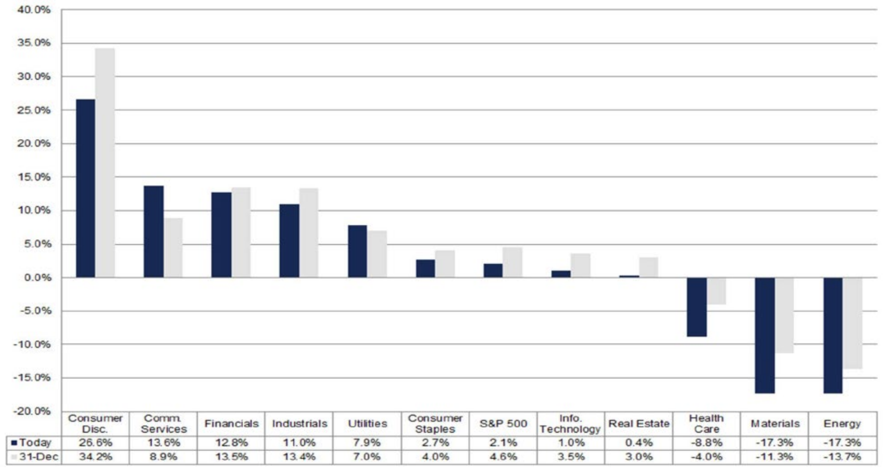
Two legs of the stool look weak – Excess cash evaporating, earnings projections deteriorating

CONSUMER EXCESS SAVINGS
$2.1T AT THE PEAK, DOWN TO $0.9T AT YEAR END



Source: JPMorgan

2023 S&P500 EARNINGS ESTIMATES BY SECTOR
ONLY SECTOR MOVING UP THIS YEAR IS COMM SERVICES



Source: Factset

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Putting it all together

- The financial markets are bracketed in a range. Bound at the top by a Fed that is intent on further restrictive measures based on strength in the labor markets and inflation, supported from the bottom by a string of better-than-expected economic data and consumers who continue to spend based on bloated cash reserves from the pandemic and relative certainty from rising wages and strong demand for workers from employers.

- As the Fed ever so slightly turns the screws on the markets, they hope to dampen employment demand and reduce aggregate demand for goods and services without creating a tail event somewhere.

- Suddenly in the mix is a new force we've not seen for over a decade, competitive interest on cash reserves. With the 6-month U.S. Treasury yielding over 5% and banks competing for cash reserves (Credit Suisse announced a saving account yielding 6.5% last week) as balances disappear into the Treasury and Money Markets, banks deposits are falling, and credit is tightening.

- The current market narrative is higher rates for longer. As we witnessed last week, we're likely to see bouts of market strength when this narrative weakens, and bouts of market weakness when this narrative is touted.

- All eyes have been fixed on the residential real estate market and the impact of rates, but distress may appear more quickly in commercial real estate because there are more variable rate mortgages, higher leverage and a lower demand story that is playing out as rates ratchet higher.

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