February 2023

With the 10-year Treasury yield back above 4%, this from Bloomberg's Evening Briefing last night:

After January's party and February's let-down, the focus now is back on how much higher interest rates might go in the US and Europe. Swaps markets are pricing a peak Fed policy rate of 5.5% in September while some traders are betting the benchmark interest rate could rise to 6%. Relentless data showing a historically tight American job market may have job seekers smiling, but Wall Street is gritting its teeth.

From last night's Global Investment Strategy:

Hot Or Not?

Global Growth Surprising on the Upside

Going into 2023, the prevailing view was that Europe was already in recession, the US was on the cusp of one, and that China would struggle to manage its reopening campaign.

In the end, all three fears proved to be overblown.

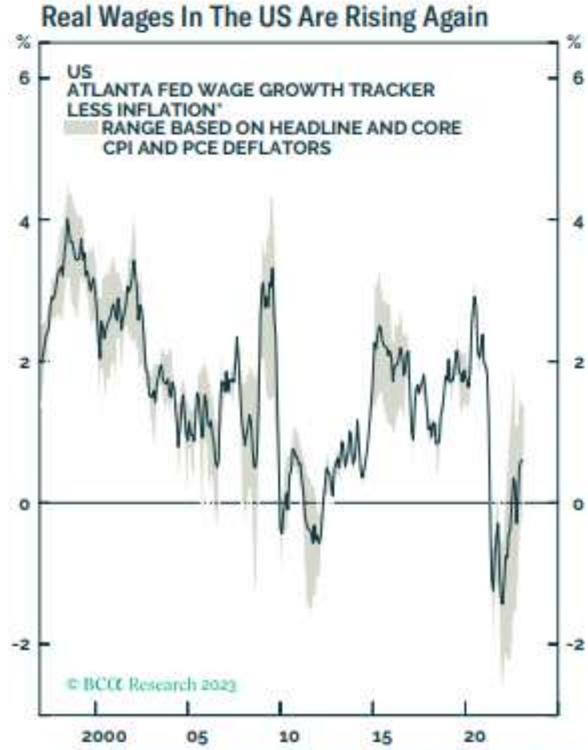
Europe: Economy Thawing

Not only did Europe apparently avoid a recession, but the latest data suggest that growth is accelerating, thanks in part to falling gas prices and close to €800 billion in fiscal support for the private sector. Notably, the European PMIs are recovering, as is business sentiment. Consensus GDP estimates are edging higher.

The European labor market is holding up well. The euro area-wide unemployment rate has fallen by 0.2 percentage points over the past 12 months and now stands at 6.7% – about a percentage point below its pre-pandemic level. In the UK, the unemployment rate remains near a cycle low of 3.7%. Wage growth across Europe is accelerating.

CHART 4

Real Wages In The US Are Rising Again



* BASED ON WAGE GROWTH MINUS THE AVERAGE OF HEADLINE CPI, CORE CPI, HEADLINE PCE, AND CORE PCE INFLATION.
SOURCE: FEDERAL RESERVE BANK OF ATLANTA, BUREAU OF LABOR STATISTICS, AND BUREAU OF ECONOMIC ANALYSIS.

US: Still No Recession in Sight

Despite pockets of weakness in some of the regional Fed manufacturing surveys, a renewed drop in mortgage applications, and an unexpected decline in consumer confidence in February, on the whole, US growth appears to be on a firmer footing than most had expected late last year. The Atlanta Fed's GDPNow model is tracking real private final domestic demand growth of 3.3% in Q1, up from an initial estimate of 1.1% produced in late-January.

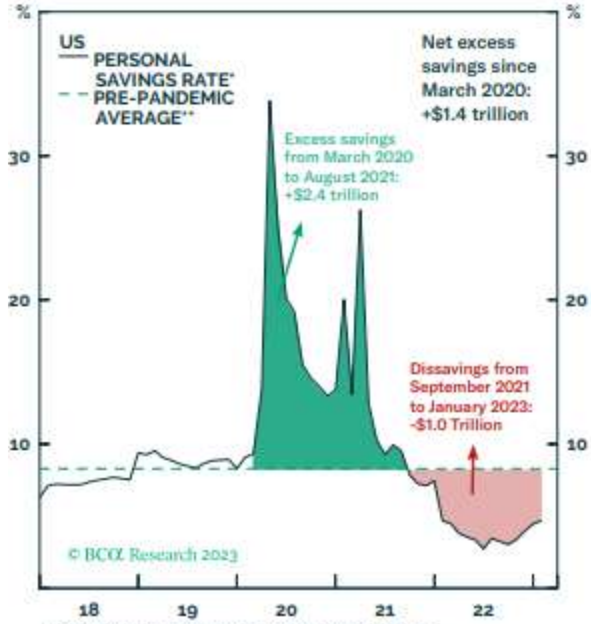
As in Europe, the unseasonably warm winter has flattered the US data. That said, there are more fundamental forces at work. Real wage growth has turned positive (**Chart 4**). Adjusted for inflation, US disposable income began to recover in the second half of 2022. It then rose at a sizzling annualized pace of 18% in January, fueled by strong employment growth, lower tax receipts, and an 8.7% increase in social security payments – the highest cost-of-living adjustment in 40 years. Rising real incomes usually translate into increased spending.

US households still hold $1.4 trillion (5.4% of GDP) in pandemic savings (**Chart 6**). Relative to disposable income, household bank deposits are 15 percentage points above where they were on the eve of the pandemic (**Chart 7**).

Granted, much of those savings are held by relatively well-to-do families. Nevertheless, it is worth remembering that while rich households spend less of their income than poor households, they also have more income to spend. In the US, the top 20% of income earners account for nearly 40% of consumption compared to 9% for the bottom 20%.

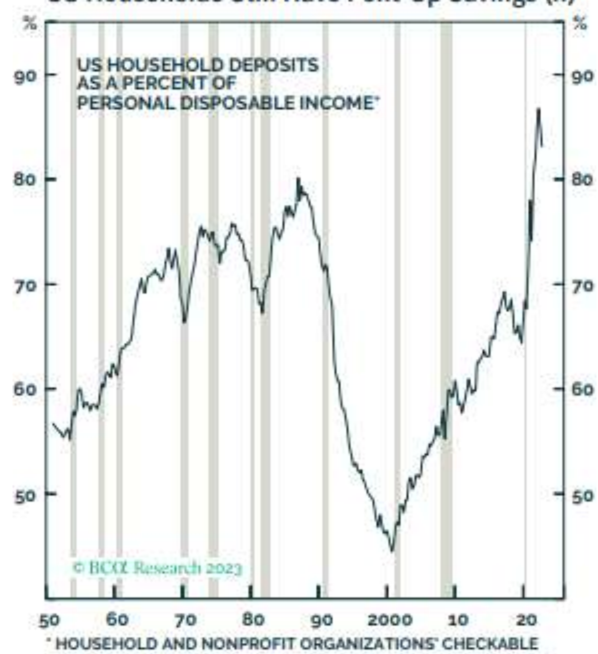
For households with insufficient savings, credit still remains available. Credit card debt has soared in recent months. Even home equity line of credit (HELOC) originations have spiked. Critically, however, consumer borrowing does not look exceptionally stretched as a share of disposable income. This suggests that credit can continue to expand during the remainder of the year.

CHART 6
US Households Still Have Pent-Up Savings (I)



* SHOWN AS A PERCENT OF DISPOSABLE INCOME.
** AVERAGE SAVINGS RATE FROM THE BEGINNING OF 2018 UNTIL THE START OF THE PANDEMIC.
NOTE: THE CALCULATION OF EXCESS SAVINGS ASSUMES A PRE-PANDEMIC BASELINE WITH 4% DISPOSABLE INCOME GROWTH AND 8.3% SAVINGS RATE.

CHART 7
US Households Still Have Pent-Up Savings (II)



* HOUSEHOLD AND NONPROFIT ORGANIZATIONS' CHECKABLE DEPOSITS, CURRENCY, AND TIME AND SAVINGS DEPOSITS AS A PERCENT OF PERSONAL DISPOSABLE INCOME.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

China's Economy on the Mend

China's economy appears to have weathered the huge surge in Covid cases better than many had anticipated. Mobility metrics have bounced. The PMIs are on the upswing.

Even the beleaguered housing market is showing signs of life. For the first time since 2021, more than half of Chinese cities reported an uptick in home prices in January. New home sales rose in February, marking the first year-over-year increase in 19 months.

As in most countries, Chinese households have accumulated a significant amount of savings over the course of the pandemic. Bank deposits stand at 101% of GDP, up from 84% in February 2020. Given the penchant of Chinese families to plough their excess savings into real estate, another upturn in the housing market cannot be excluded.

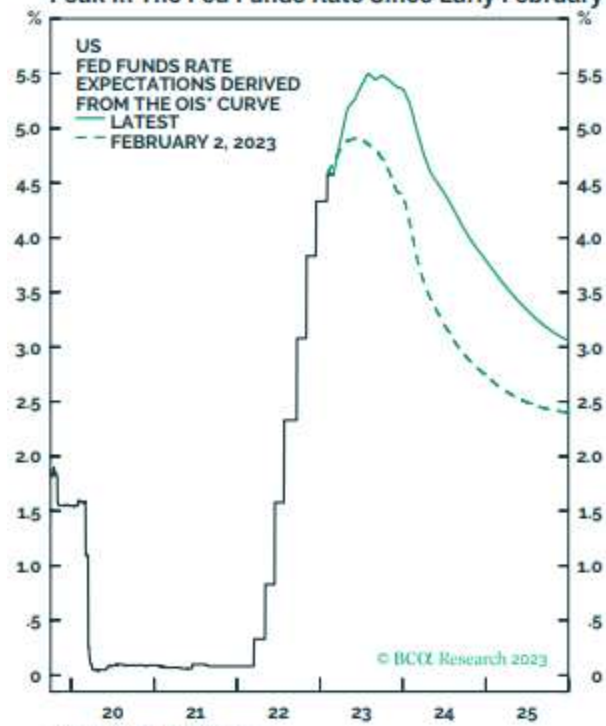
From Ice to Fire?

The upturn in the global economy is displacing fears that growth will be too weak with fears that it will be too strong, which could force central banks to hike rates more than was previously thought necessary in order to tame inflation.

Nowhere is this fear more apparent than in the US. The core PCE deflator rose by 0.6% in January against expectations of a 0.4% increase. The prior month's reading was revised up from 0.3% to 0.4%. Both median and trimmed-mean PCE inflation have reaccelerated. The prices paid component of the ISM manufacturing index jumped to 51.3 from 44.5 last month.

CHART 13

The Market Has Revised Up Its Estimate Of The Peak In The Fed Funds Rate Since Early February



* OVERNIGHT INDEX SWAPS.

Since the start of February, the market's estimate of the peak in the Fed funds rate has risen by 60 basis points to 5.50% (**Chart 13**). The 10-year Treasury yield has climbed from 3.40% to 4.07%. The DXY has strengthened by 2.7%, albeit this is somewhat more than what one would have expected based on the widening in real interest rate differentials.

As we discussed two weeks ago in a report entitled "Rising Risk Of A Second Inflation Wave," the possibility that the US economy will fail to cool down without significantly more monetary restraint is a risk that investors ought not ignore – and, indeed, it is a bigger risk for 2023 in our minds than a recession.

Why Disinflation Is Still Probable

That said, there are still two reasons why inflation may come down without the Fed needing to raise rates much more than what is currently discounted.

The first reason is that there is still a lot of disinflation in the pipeline. A simple regression of shelter inflation on the New Tenant Repeat Rent index, which the Bureau of Labor Statistics has recently begun publishing, indicates that shelter inflation is close to peaking and will decline by three percentage points by mid-year. Shelter accounts for 43% of core CPI and 17% of core PCE.

Contrary to the Fed's expectations, we think that goods inflation can remain subdued over the coming few quarters. Admittedly, used car prices have rebounded so far this year. However, this largely reflects a drop in Chinese microchip production (which has since corrected) and a shortage of rental vehicles making their way onto the used car market. ...

Wage Growth Moderating

A further surge in non-shelter services inflation cannot be excluded of course, but for that to occur, wage growth would need to reaccelerate. So far, that does not seem to be happening. The growth in average hourly earnings has dropped from around 8% in 2021 to about 5% at present. The 3-month change in average hourly earnings in the leisure and hospitality sector – the sector where labor shortages were most acute following reopening – has swooned to only 0.7% from a high of 27%.

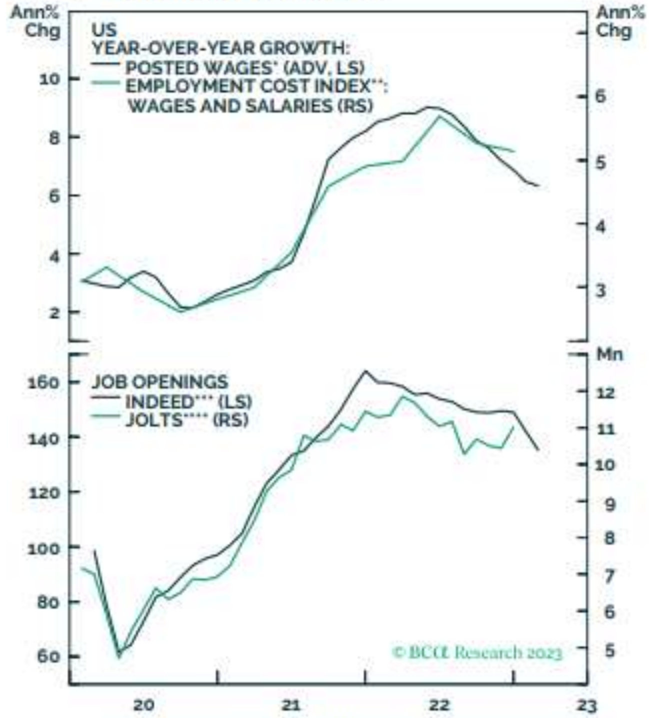
The Employment Cost Index (ECI) has also cooled. Given that posted wage growth on job sites such as Indeed leads the ECI, this trend may have further to run (**Chart 18**).

Unlike the erratic and lagging JOLTS series, the number of job openings posted on Indeed has continued to fall, with the pace of the decline accelerating since the start of the year. LinkUp, which tracks openings on corporate websites, has observed a similar trend.

Surveys of business compensation plans point to a further moderation in wage growth. Twenty-two percent of firms in the most recent NFIB small business survey planned to raise compensation over the next three months. While this is above the long-term average of 16%, it is well below the high of 32% registered in October 2022. A recent report by Goldman Sachs revealed that, among Russell 3000 companies, the share of management teams citing labor shortages dropped from a peak of 16.5% in Q3 2021 to 4.9% in Q4 2022.

CHART 18

Wage Growth Is Slowing (II)



* SHOWN ADVANCED BY 2 MONTHS AND AS A 3-MONTH MOVING AVERAGE. SOURCE: INDEED.

** ALL WORKERS IN PRIVATE INDUSTRY. SOURCE: BUREAU OF LABOR STATISTICS (BLS).

*** SERIES REBASED TO FEB. 2020 = 100. SOURCE: INDEED.

**** SOURCE: BUREAU OF LABOR STATISTICS (BLS).

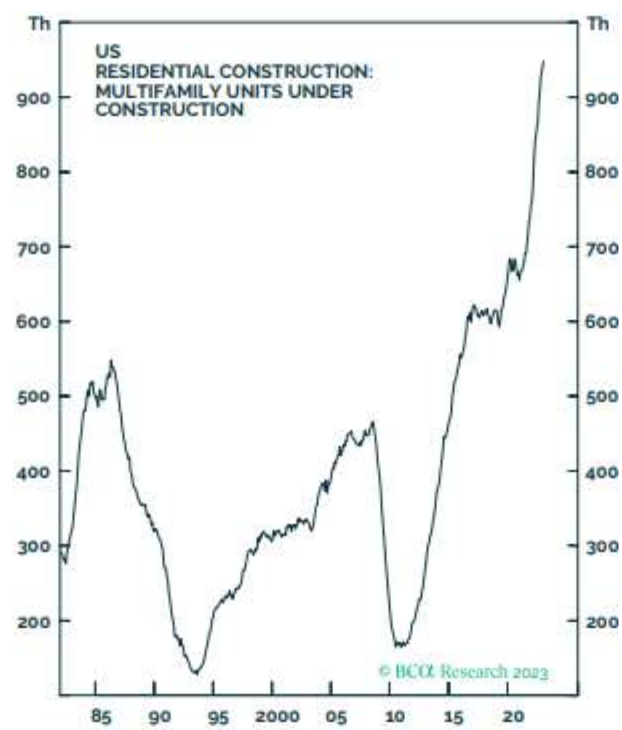
Lags Lags Lags

The second reason to expect the US economy to cool down is that the full effects of monetary tightening have yet to be felt.

Consider apartment building. Although the number of multi-family housing starts has begun to fall, units under construction continue to rise. The number of units under construction has increased by 24% since the start of 2022 and is more than double what it was at the peak of the housing bubble (**Chart 20**).

CHART 20

Apartment Building Has Surged In The US



It takes an average of about 12 months to finish a multi-family construction project, a span of time that increased during the pandemic due to widespread shortages of labor and construction materials. Thus, even though rental growth has cooled, we may not see a meaningful decline in multi-family construction until the end of this year or 2024.

By the same token, it will take a while for home prices to fall by enough to produce a sizable negative wealth effect. And given that almost all mortgages in the US are of the fixed-rate variety, it will also take a while for discretionary spending to decline meaningfully in response to higher mortgage rates. In the housing downturn preceding the GFC, 20 months elapsed between when home prices peaked and when the recession ensued. The lag between the top in construction activity and the recession was two years.

The lag between tighter lending standards and slower credit growth runs at around 12-to-15 months. This implies that the recent surge in credit growth will reverse, but again, probably not until next year.

Investment Conclusions

Our base case is that the US economy will succumb to recession in mid-2024. This is a year later than the current consensus view. Over the past seven cycles, stocks have peaked, on average, six months before the onset of a recession (**Table 1**). This provides a limited runway for equities to gain altitude during the remainder of the year.

If the US avoids a recession in 2023, earnings estimates should stabilize, at least temporarily. There is a reasonably strong correlation between earnings revisions and the economic surprise indices. The latter have moved into positive territory over the past six weeks.

Excluding energy, S&P 500 EPS was down 7.1% in Q4 2022 relative to a year earlier. Against the backdrop of 5.0% sales growth, profit margins have fallen back to mid-2019 levels.

Earnings guidance was cautious in Q4 – arguably too cautious. According to The Conference Board, 93% of CEOs expect a recession over the next 12-to-18 months. Very conservative guidance from companies such as Walmart and Home Depot reflects this apprehension.

Institutional investors were more than two standard deviations underweight equities in the most recent BofA Global Fund Manager Survey (**Chart 24**). Any news that inflation is cooling could put a fire under the stock market.

That said, we would not want to push our luck too far. As we have argued in the past, achieving a soft landing is a lot less difficult than maintaining one. One look at the US unemployment rate reveals that once it gets to low levels, it does not move sideways for years on end (**Chart 25**).

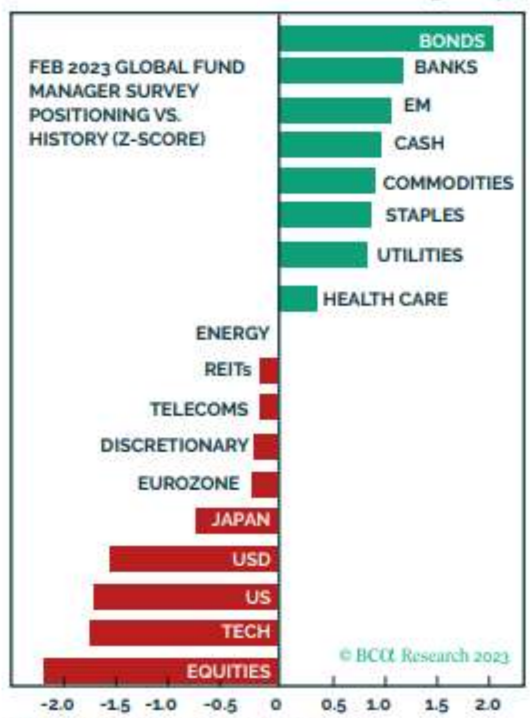
There is also the risk that inflation falls for a while but then moves higher, something that routinely happened in the 1970s (**Chart 26**). We would assign a 20% probability to such an outcome. With all that mind, a vigilant disposition is appropriate at the current juncture. We moved to a neutral allocation on

TABLE 1
On Average, Stocks Have Peaked Six Months Before The Onset Of A Recession

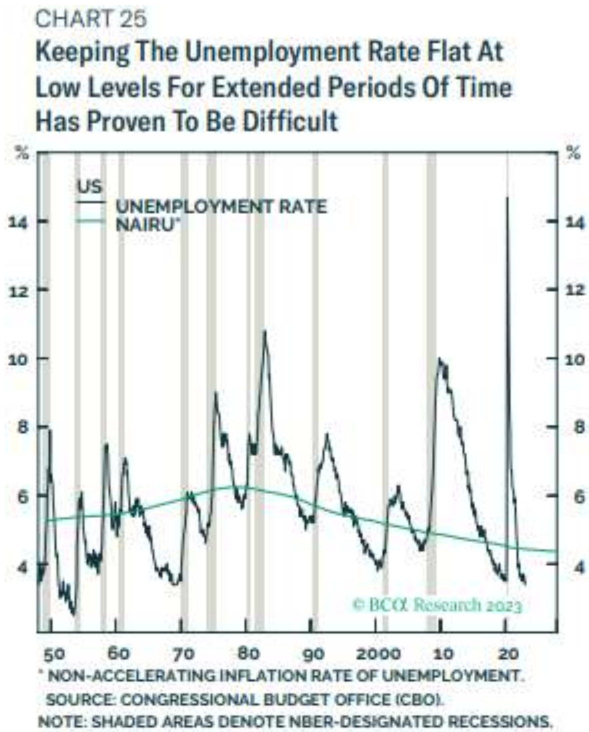
RECESSIONS	S&P 500 PEAK* (MONTHS)	S&P 500 TROUGH* (MONTHS)	PEAK-TO-TROUGH DECLINE (%)
DEC '69 - NOV '70	-13	+6	-36%
NOV '73 - MAR '75	-11	+10	-48%
JAN '80 - JUL '80	0	+2	-17%
JUL '81 - NOV '82	-8	+12	-27%
JUL'90 - MAR '91	-2	+3	-20%
MAR '01 - NOV '01	-7	+18	-49%
DEC '07 - JUN '09	-2	+14	-57%
AVERAGE	-6	+10	-36%

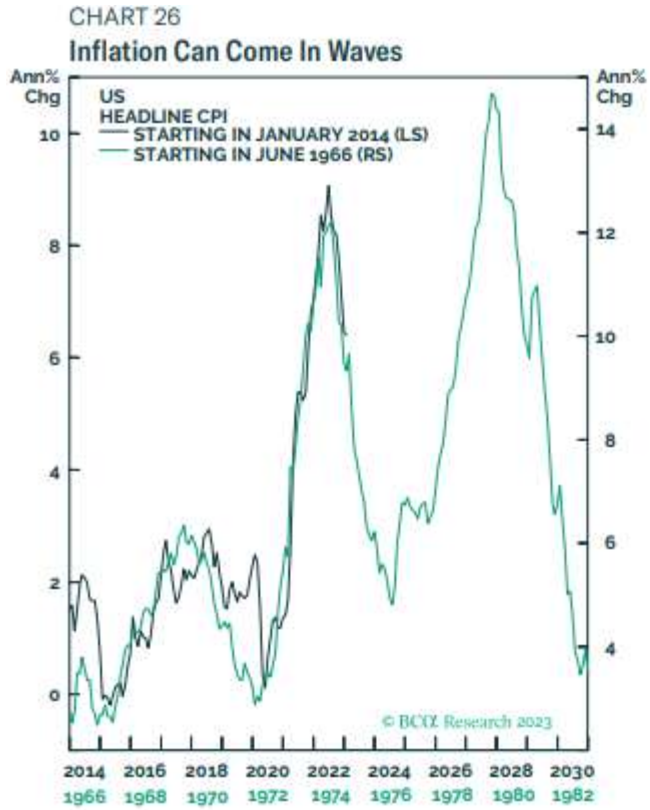
* RELATIVE TO THE START OF NBER-DESIGNATED RECESSIONS.

CHART 24
Institutional Investors Are Underweight Equities



SOURCE: BOFA GLOBAL FUND MANAGER SURVEY.





stocks over a 12-month horizon during last summer's rally, and would not hesitate to cut our tactical overweight either if the risks of a recession this year increase or the odds of a second wave of inflation rise. ...

From Morningstar:

Are Hedge Funds Now Worth Considering?

In 2022, they delivered on their promises.

John Rekenthaler
Feb 13, 2023

Out of Favor

In "Hedge Fund Performance: End of an Era?" (Nicolas Bollen, Juha Joenväärä, Mikko Kauppila), the authors found that from 1997 through 2007 an equally weighted index of hedge funds gained an annualized 11%, as opposed to 8% for U.S. stocks, slightly more for their foreign counterparts (it's hard to believe these days, but sometimes it helps to diversify internationally), and 6.5% for domestic bonds. As a group, hedge funds were also less volatile than equities.

That, obviously, was a winning combination. So winning, in fact, that investors expected ongoing miracles from hedge funds. In 2008, the investable composite index of hedge funds, computed by Hedge Fund Research, dropped by an average of 18%, with equity hedge funds losing 25%. While disappointing, that result easily bettered the global stock market, which fell by more than 35%. But investor expectations for hedge funds had become so inflated that their losses came as a shock. ...

The Culprits

The industry's decline owed to two factors. First, hedge fund assets grew almost 20-fold in a decade, from just over $100 billion in 1997 to almost $2 trillion entering the global financial crisis. This expansion both diluted the industry's managerial talent and—happily for financial markets' efficiency but distressingly for hedge fund shareholders—shrunk its investment opportunities. Far more money chased the same deals, thus shrinking arbitrage spreads and each transaction's profits.

Second, the easy trade disappeared. Entering the New Millennium, technology-company prices had reached levels not seen before or since (even at their recent peaks, such stocks were 30% cheaper than in December 1999). Sensing danger, hedge funds almost completely dodged the ensuing technology-stock collapse. That single, huge decision greatly boosted their relative performance.

Unfortunately for shareholders, hedge funds have subsequently enjoyed few similar circumstances. To be sure, the stock market has periodically crashed, but as a group hedge funds cannot time the overall market. Rather, the industry thrives when its managers can exploit differences in *relative* value—that is, when they can find times when some stocks rise, while others fall. Such did not occur in 2008, nor often since then. The stock market's tides have mostly moved in unison.

The 2022 Rebound

According to HFR, its investable equity-fund index dropped 12% in 2022, as opposed to a 19% decline for U.S. equities. That result may not entirely satisfy hedge fund skeptics, as the group still suffered a double-digit loss. However, in a year when stocks and bonds across the globe were rocked, the 3% loss sustained by HFR's composite index, which includes all flavors of hedge funds, surely deserves praise. The industry once again earned its keep.

Unfortunately, that result still leaves hedge funds behind the better public funds. HFR's investable composite index began operations in January 2005. Since that time, it has gained an annualized 4.9%, which is considerably lower than the gains for two Vanguard funds that are hedge fund rivals, Vanguard Balanced Index VBINX and Vanguard STAR VGSTX. As with HFR's index, those Vanguard funds hold a broad mix of securities, including both stocks and bonds. But their annual returns have been 200 basis points higher.

In defense of hedge funds, HFR's index has performed very steadily. Combining nearly 500 funds, as HFR's benchmark does, greatly reduces volatility. Over that period, the standard deviation of HFR's index has been barely above that of Vanguard's Intermediate-Term Investment-Grade VFICX bond fund. Individual hedge funds are notoriously dangerous, but when collected by the hundreds, and diversified among investment strategies, they are remarkably stable.

Looking Forward

Regrettably, I do not believe that hedge funds' recovery is sustainable. While the industry last year profited by shunning growth stocks and long-term bonds that had become overpriced (at least in hindsight), those relative gains have already been booked. And it seems unlikely that strategy will remain fruitful. At 26, the price/earnings ratio on the Vanguard Growth Index VIGRX is not much above its historic norm, and the yield on Treasury notes is near its 10-year high.

Also, despite my gibes, the money is back. After languishing for several years following the global financial crisis, as disappointed investors redeemed their shares, hedge fund assets have recently boomed. Hedge funds currently possess almost $5 trillion, more than triple what they held a decade ago. Consequently, they once again are keeping the markets efficient, while squeezing their own profits. It's hard to see how hedge funds can prosper without finding another big trade.

Of course, one need not buy the averages. My analysis therefore is moot for those who, despite the paucity of research data, can find 1) abnormally good funds that 2) have not yet been discovered and 3) are open to new investors, while 4) avoiding the industry's occasional bombs. Good luck with that.

Outdated Regulations

Currently, hedge funds are only available to "accredited" investors who meet either income or wealth requirements (or who qualify in other ways, such as owning a securities license). That the investment minimums have not changed since 1982 bears witness to how little lawmakers care about these rules. They realize that the accredited-investor mandate is a dusty vestige. When anybody with a debit card can buy cybercurrencies backed by absolutely nothing that are hawked on television, why prevent them from buying hedge funds?

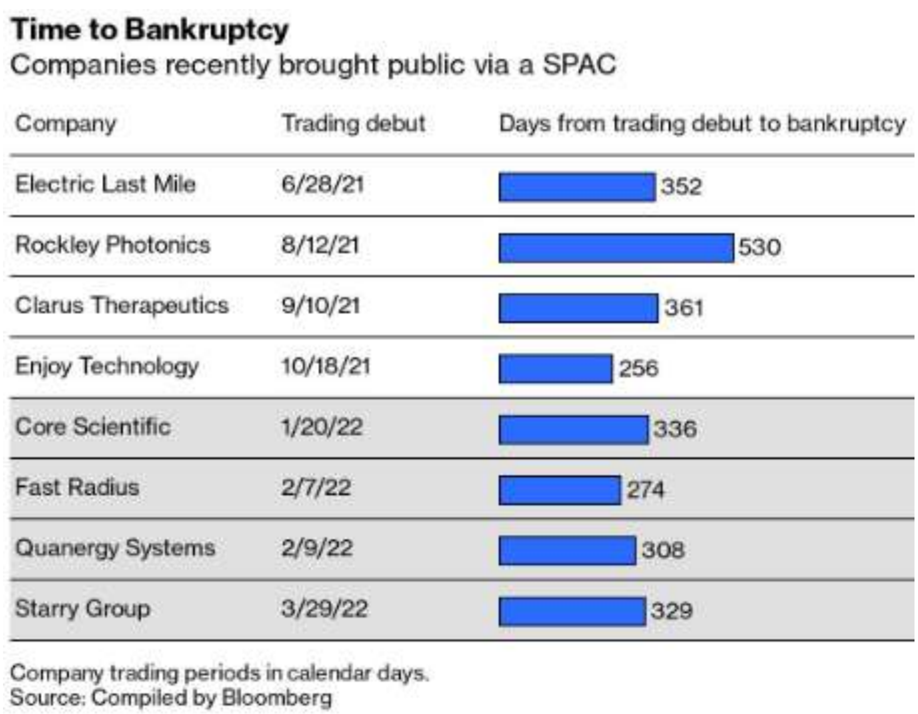
House Republicans are currently proposing to amend the accredited-investor rules. Although I distrust their motives, as their statements appear to have been ghostwritten by Wall Street marketers, I share their conclusion: "A person's economic status may demonstrate an ability to withstand losses, but it certainly does not demonstrate financial sophistication." True that. Let the people choose.

John Rekenthaler (john.rekenthaler@morningstar.com) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Follow-ups

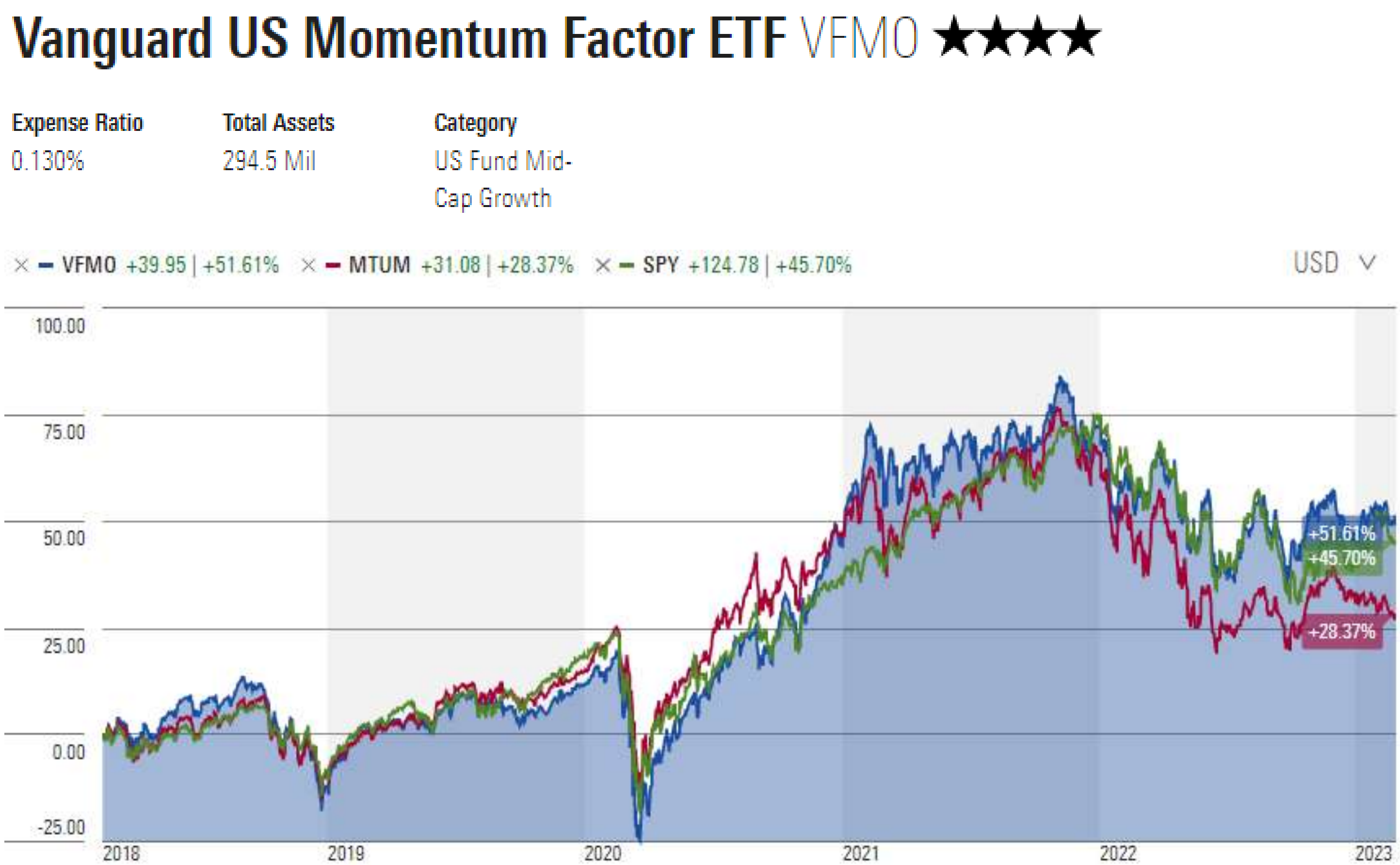
As we repeatedly warned, now this from Bloomberg on February 28th:

The SPAC, that early pandemic darling, may have run out its 15 minutes. Special purpose acquisition companies, for those who may have already forgotten, are publicly traded corporate shells with no business other than seeking out a merger with another company. Well, a growing number of ventures that went public this way have now gone bankrupt.



Positions

We had been waiting for an ETF that combined the Size and Momentum Factors. MTUM (Large Cap Growth, red line), and the S&P 500 (SPY, green line) have been added to Morningstar's chart since VFMO's inception for comparison:



While we now prefer VFMO for the Momentum Factor, MTUM has still outperformed the S&P 500 since its inception:

On 2/21 we added VFMO to a Funds only client @ 116.17.