September 2022

From the front page of this weekend's WSJ:

Markets Wrap Up A Rough Quarter In Retreat

BY KAREN LANGLEY

The rout in markets deepened Friday to end a dismal third quarter in which hope faded that monetary tightening would soon ease, sending bond yields soaring and leaving U.S. stocks on track for their worst year since the 2008 financial crisis.

The intensifying declines alarmed investors who entered the quarter enjoying a summer rally that more than halved the S& P 500's 2022 losses before fizzling. As the months progressed, hair-raising moves dashed any remaining sense of safety, with major stock indexes enduring their deepest one-day retreats since 2020 and government bond yields interrupting their ascent to notch their biggest daily pullbacks in years. U.S. stocks fell Friday, cementing their quarterly losses. ...

The mounting losses and hazy outlook weighed on investors' spirits, with surveys showing individual investors were the most pessimistic in years and fund managers holding unusually high levels of cash.

Growing certainty that the Federal Reserve would persist in raising interest rates to fight inflation despite the risk of economic pain reverberated throughout markets. The yield on the 10-year U.S. Treasury note climbed above 4% for the first time in more than a decade, while the dollar strengthened to a decadeslong high against other currencies.

Fed Vice Chairwoman Lael Brainard said Friday that while the central bank was monitoring financial tremors that could result from its rate-rising campaign, it wasn't going to halt it prematurely. Underscoring the challenge facing the Fed and other central banks, data releases Friday in the U.S. and Europe showed no signs of price increases abating.

Consumer spending in the U.S. rose in August as did the Fed's preferred measure of inflation. In the eurozone, the annual rate of inflation in September hit 10%, the highest level since records began in 1997.

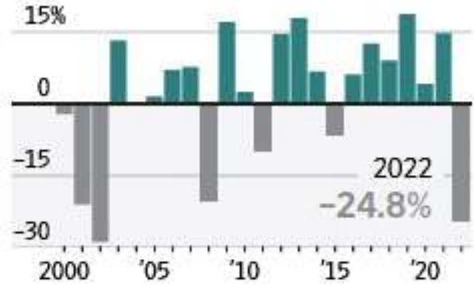
The persistence of inflation and the moves by central banks around the world to lift rates have slammed overseas markets. Meanwhile, Russia's war in Ukraine and China's Covid-19 lockdowns have further threatened the global economy. An MSCI index of worldwide stocks outside the U.S. declined 11% during the quarter, bringing its year-to-date losses to 28%.

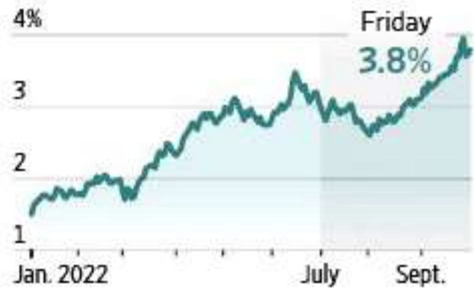
Debt markets are under stress: The Bank of England this week launched an emergency intervention to restore order in bond markets after a government tax-cut plan sparked wild swings on both sides of the Atlantic.

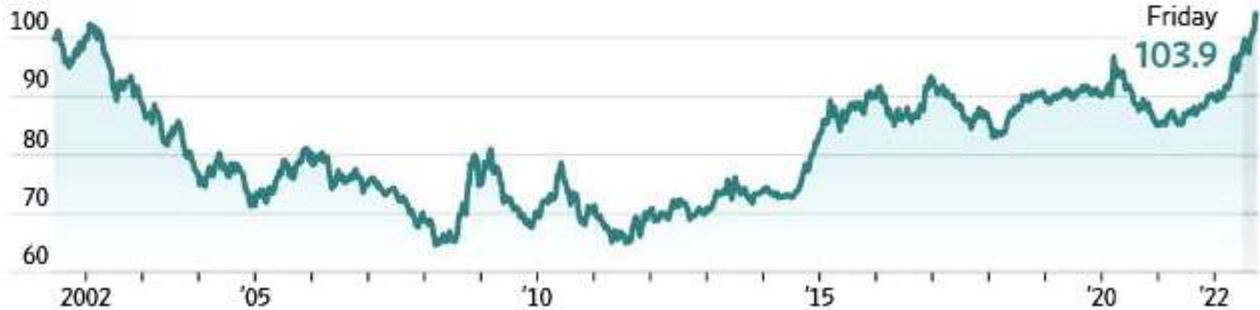
Recent days brought disheartening milestones for U.S. stocks: The S&P 500 answered the months-old question of whether its June low would hold by closing lower still, while the Dow Jones Industrial Average fell into a bear market, down more than 20% from its high.

After reversing its gains from July and the first half of August, the S&P 500 closed out the quarter down 3.8%, bringing its year-to-date decline to 24%. It most recently ended a year with a larger loss in 2008, when markets shuddered during the global financial crisis. ...

One







Sources: FactSet (Index and ETF performance); Dow Jones Market Data (Performance through September, Treasurys, WSJ Dollar Index)

particularly disorienting twist of 2022: Bonds have fallen alongside stocks, giving investors few places to hide. Shares of the iShares Core U.S. Aggregate Bond exchange-traded fund, which tracks investment- grade bonds, lost 5.3% during the quarter and are down 16% in 2022, on pace for their worst year in data going back to 2004.

Markets have responded harshly to signs that a weakening economy could cut into profits. FedEx Corp. shares slumped 21% in mid-September in their biggest one-day drop on record after the delivery company warned of a sharp drop in package deliveries. The stock was one of the S&P 500's worst performers in the third quarter.

And it has become clear that the central bank isn't done. Stocks tumbled in August when Fed Chairman Jerome Powell vowed during a speech in Jackson Hole, Wyo., to fight inflation even at the expense of economic growth. More recently, major indexes recorded their worst day in more than two years after hotter-than-expected inflation data bolstered expectations for future rate increases. ...

Professional investors broadly are shying away from risk. Bank of America's September global fund manager survey found that average cash balances jumped to the highest level since October 2001, in the aftermath of the 9/11 terrorist attacks.

Individual investors are feeling particularly glum. Bearish sentiment, or expectations that stock prices will fall over the next six months, rose to its highest level since March 2009 in a recent poll from the American Association of Individual Investors. ...

From Friday's Global Investment Strategy:

Fourth Quarter 2022 Strategy Outlook: A Three-Act Play

I. Macroeconomic Outlook

Back in February 2019, we speculated on what could cause the next recession. We wrote "When the next recession rolls around, it will probably be sparked by a surge in inflation, which forces the Fed to raise interest rates much more rapidly than it has so far."

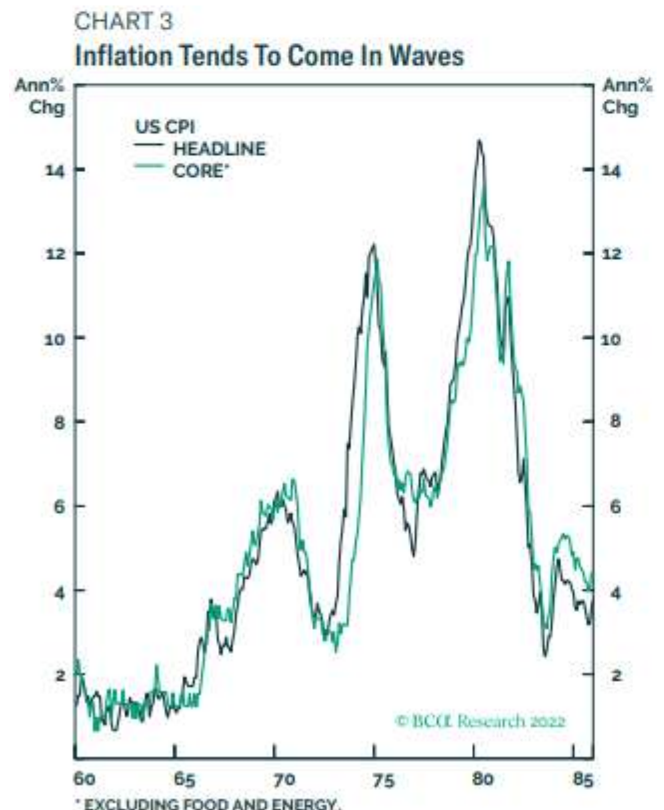
The idea that soaring inflation could lead to a recession seemed far-fetched at the time. There had not been any major inflationary episodes in the developed world for over three decades. ...

When the unemployment rate is well above its full employment level, a decline in joblessness does little to push up wages and prices. There are still enough people around eager to find work. Only when labor market slack is fully absorbed can inflation finally take off.

This was precisely what happened in the second half of the 1960s. And this was what happened late last year.

A Three-Act Play

Where do we go from here? If we had to describe the economic outlook between now and the end of 2024, it would be as a play in three acts of roughly nine months each:

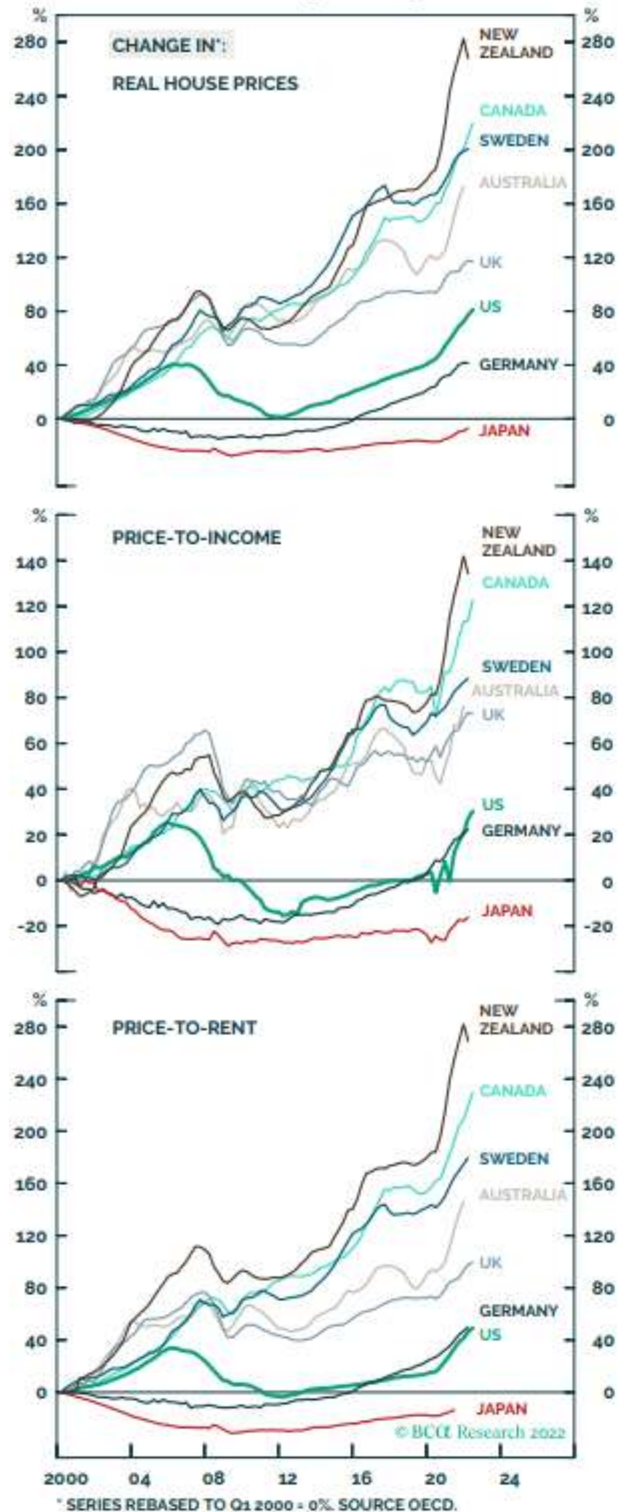


Act 1 - Goldilocks (October 2022 to June 2023): ... any increase in aggregate demand will simply push up inflation because the economy does not have enough spare capacity to produce more than what it is already producing. As demand drops in response to tighter financial conditions ... Inflation will fall with little loss in output. ... And while growth is weaker abroad, that should change as Europe experiences a V-shaped recovery following its energy crisis and China loosens its zero-Covid policy.

Act 2 - The Second Wave (July 2023 to March 2024): Everyone is sick of hearing about the latest Covid wave. Well, get ready to hear about the next inflation wave. During past inflationary environments, inflation came in waves (**Chart 3**). This time will be no different. As inflation comes down over the coming months, real wage growth – which is still negative – will turn positive. Real disposable income will rise. Consumer sentiment will

recover. Aggregate demand will increase, pushing us back up the steep side of the aggregate supply curve. And with global growth on the upswing, commodity prices will recover, further supercharging inflation.

Act 3 - Recession (April 2024 to at least December 2024): The second inflation wave will catch investors and policymakers off guard. Most of them are assuming that the nominal neutral rate of interest is quite low. The second inflation wave will shake that belief. After pausing its interest rate tightening campaign early next year, the Fed will start hiking again in the second half of 2023, bringing the Fed funds rate to 6% by the end of that year. By that point, US mortgage rates will be over 8%, high enough to sink the housing market and the rest of the economy. Housing markets abroad, which are in an even more perilous shape, will tumble (**Chart 4**).



US Economic Resilience

Within BCA, there is a raging debate between the "recession later" and "recession imminent" camps. I am firmly on Team Later. This reflects my out-of-consensus view that the neutral rate of interest is quite high, implying that it may take more monetary tightening than widely anticipated to induce a recession. The market has been moving briskly to price in a higher neutral rate, but there is still further to go.

The fact that the US economy has not already succumbed to recession, as so many were expecting in the spring, provides some preliminary support for the view that the "choke point" for interest rates is quite high.

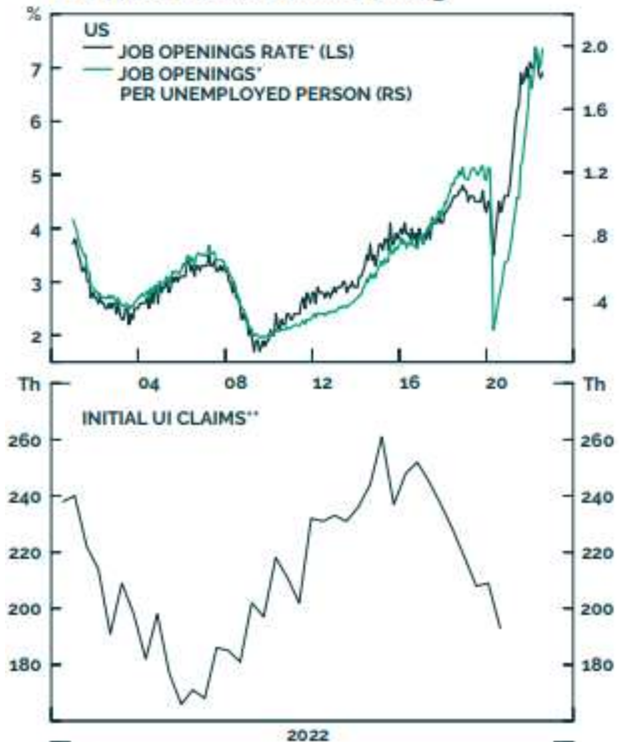
Notably, the labor market remains very strong (**Chart 5**). There are nearly two job openings for every unemployed worker. For the foreseeable future, most workers who lose their job will have little difficulty finding new ones.

After having risen earlier this summer, initial unemployment claims have dipped again. Claims are one of the best leading indicators of the labor market. ...

There is plenty of pent-up demand across the economy. Bank deposits are still $2.7 trillion (10.7% of GDP) above their pre-pandemic trend. Admittedly, most of these savings are skewed towards middle- and upper-income households who tend to spend less out of every dollar of income than the poor.

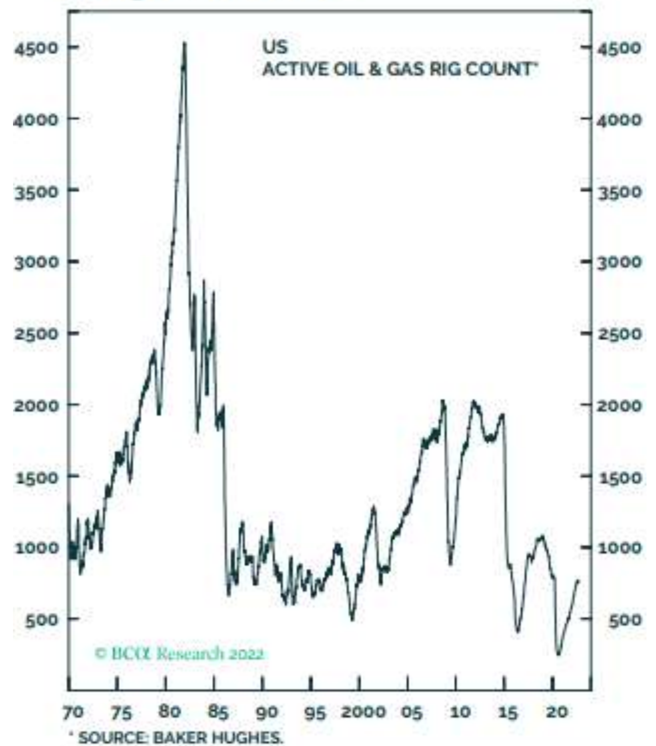
Nevertheless, even the top 10% of income earners spend about 80% of their income. This suggests that most of these excess savings will be deployed, supporting consumption in the process.

Some commentators have argued that high inventories will restrain production, even if consumer spending remains buoyant. We doubt that will happen. While retail inventories have risen of late, the retail inventory-to-sales ratio is still below pre-pandemic levels. This is true even if one excludes the auto sector, where inventories are extremely low. Moreover, real retail sales have almost returned to their pre-pandemic trend.



There is also significant pent-up demand for capital equipment. Following the dotcom boom, core capital goods orders moved sideways for two decades. Manufacturing capacity flatlined. The average age of the nonresidential capital stock rose by over two years. Excluding investment in intellectual property, business capex as a share of GDP is barely higher now than it was during the Great Recession.

Not only is there a dire need to replenish the existing capital stock, but there is a pressing need to increase domestic manufacturing capacity, especially in the energy sector. Despite soaring energy profits, the US rig count is still 62% below its 2014 peak (**Chart 14**). Refining capacity remains stretched.

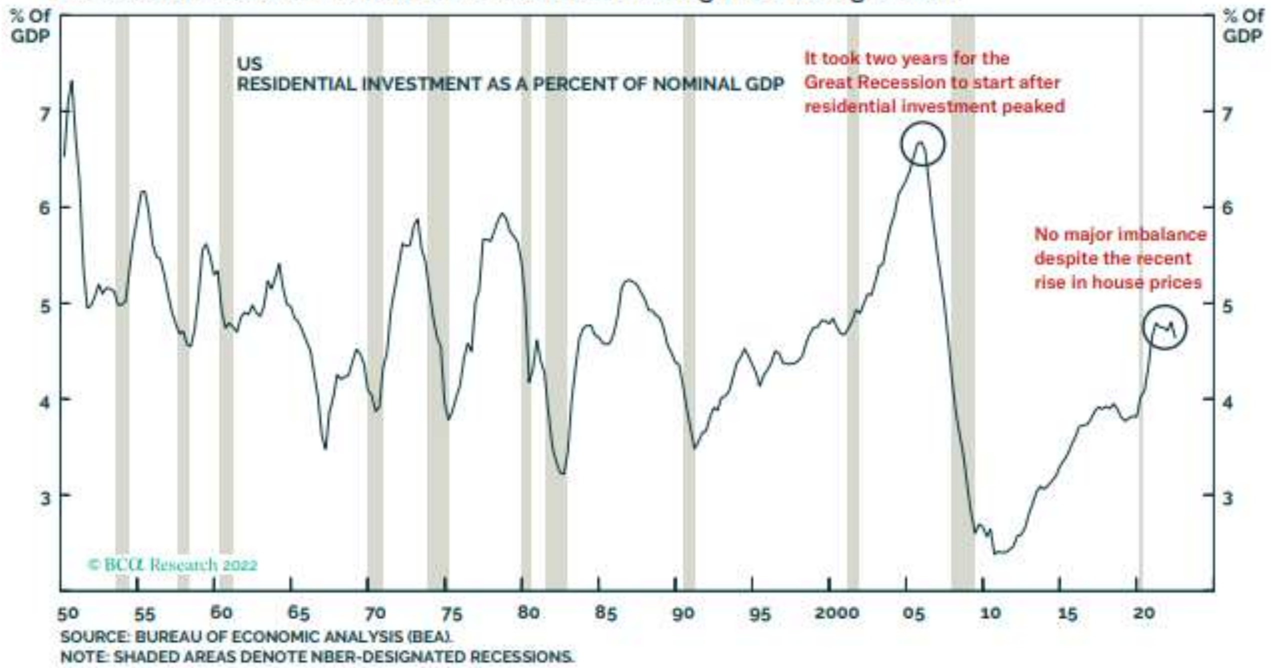


Housing Won't Sink the Economy Just Yet

Housing remains the weak spot in the US economy. This is not surprising. Housing is the most interest rate sensitive sector of the economy. Mortgage rates have risen from as low as 2.65% last year to 6.7% today.

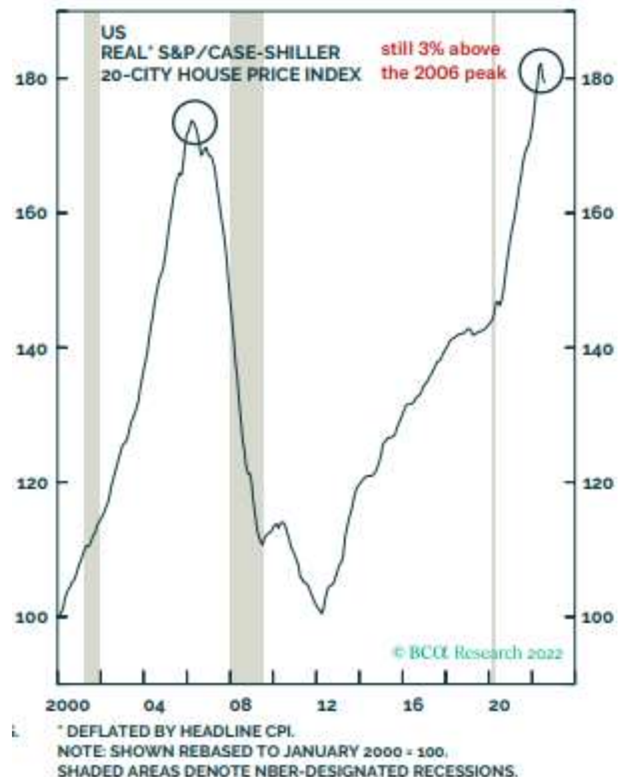
Could the downturn in the housing market push the economy into recession? The answer is yes, but probably not in the next 12 months. During the housing bubble, residential investment hit a high of 6.7% of GDP in Q4 of 2005. However, the Great Recession did not start until two years later, in December 2007, when residential investment had already receded to 4.2% of GDP. The S&P 500 peaked just two months earlier.

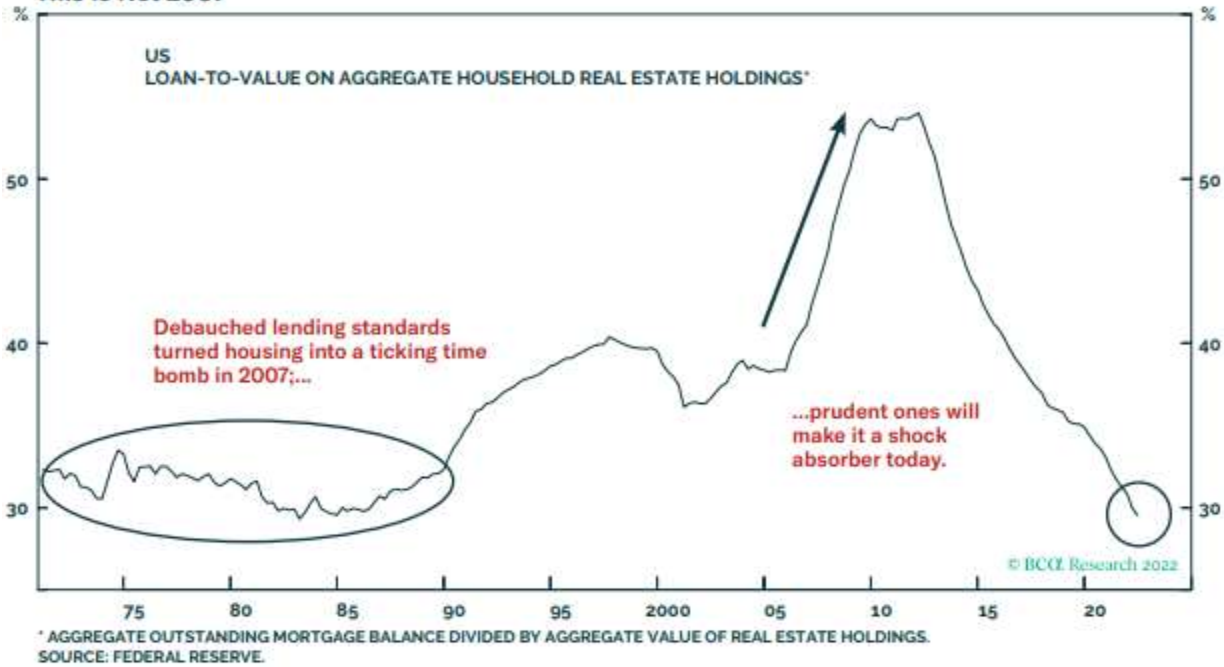
Unlike in the mid-2000s, there is no glut of homes in the US today: Residential investment reached 4.8% of GDP last year, about where it was during the late 1990s (**Chart 17**). The construction of new homes has failed to keep up with household formation for the past 15 years. As a result, the homeowner vacancy rate stands at 0.8%, the lowest on record (**Chart 19**).



While new home inventories have risen, this mainly reflects an increase in the number of homes under construction. The inventory of finished homes is still 40% below pre-pandemic levels. The inventory of existing homes available for sale is also quite low.

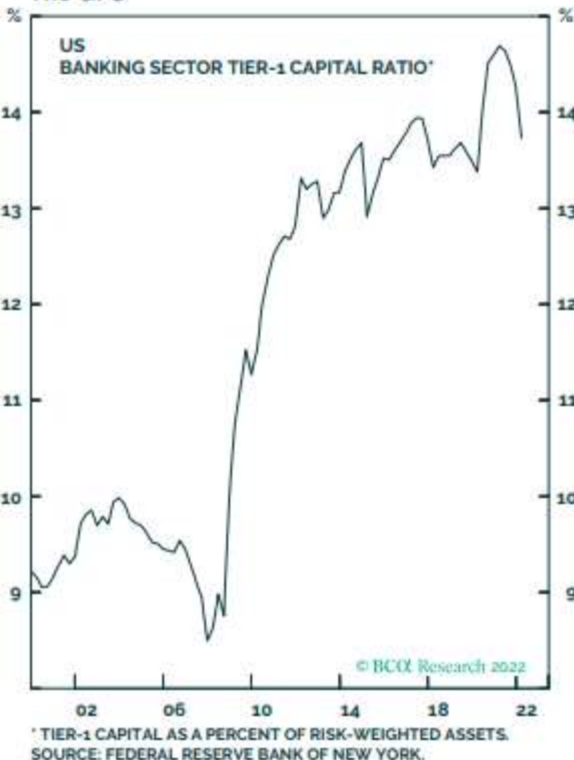
Admittedly, home prices are very high (**Chart 21**). Across much of the country, prices will almost certainly decline in real terms, and possibly in nominal terms, over the next few years. That said, home prices tend to fall fairly slowly. It took six years for prices to bottom following the housing bubble, and this was in the context of a severe recession and a wave of foreclosures and fire sales.

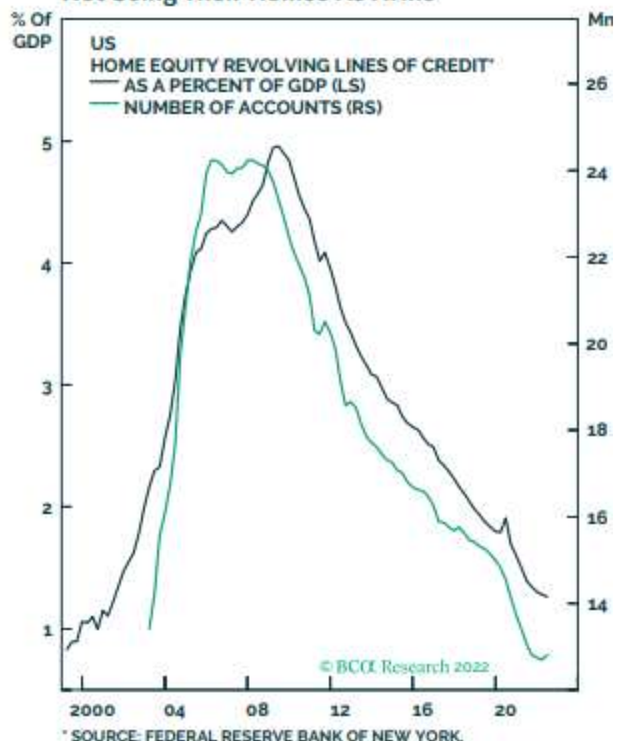




Judging by FICO scores, lenders have been quite prudent since the subprime crisis. The aggregate loan-to-value ratio for US household real estate holdings stands near a low of 30%, down from 45% in the lead-up to the GFC (**Chart 23**). Banks are also much better capitalized than they were in the past (**Chart 24**).

Whereas homeowners used the equity in their homes to finance a major spending boom during the housing bubble, they have been squirrelling away their savings over the past decade. Outstanding balances on home equity lines of credit sank to a 21-year low of 1.3% of GDP in Q2 2022, down from almost 5% of GDP in 2009 (**Chart 25**). And while higher mortgage payments will reduce discretionary spending, this only applies to new





homeowners. Fixed-rate mortgages, which account for 96% of all mortgages in the US, are insulated from rate increases.

All this suggests that the coming decline in home prices will not suppress consumption by enough to induce a recession until 2024 at the earliest.

Europe: Get Ready For a V-Shaped Recovery

The latest data suggest that Europe has sunk into recession. Judging from the performance of European currencies and stocks, most investors do not expect the growth outlook to improve anytime soon.

We are more optimistic. Despite a near cut-off of Russian natural gas imports, EU natural gas inventories have reached 88% of capacity – roughly in line with past years and above the EU's November 1st target of 80%.

While decreased gas usage by industrial firms has helped beef up inventories, Europe has also had success in displacing Russian energy with alternative sources. Imports of liquified natural gas have doubled over the past 12 months. In less than one year, Europe has become America's biggest overseas market for LNG.

A new gas pipeline linking Spain with the rest of Europe should be operational by next spring. In the meantime, Germany is building two "floating" LNG terminals. It has also postponed plans to mothball its nuclear power plants and has restarted its coal-fired power plants, a decision that even the German Green Party has supported.

France is aiming to raise nuclear energy production, which had fallen below 50% of capacity earlier this summer. Électricité de France has pledged to nearly double daily output by December. For its part, the Dutch government has suggested it will raise production from the massive Groningen natural gas field if the energy crisis intensifies.

Whether these measures end up being enough to prevent gas rationing this winter may hinge on the weather. Natural gas accounts for over 40% of EU residential heating use once electricity and heat generated in gas-fired plants are included. Although Europe experienced a cold spell over the past week, long-term meteorological forecasts are pointing to a milder-than-normal winter.

European spot natural gas prices have fallen from over €300/Mwh in late August to €186/Mwh. Despite the sabotage of the NordStream 1 pipeline, the futures market is still discounting a further decline in prices over the next two years ...

A drop in natural gas prices would lower Europe's spiraling energy import bill, which has pushed the trade balance into deficit this year (Chart 30). That would be good news for European currencies.

On the policy front, European governments are taking steps to buttress household balance sheets during the energy crisis. Nearly €600 billion in support measures have been announced so far. These measures should help prevent a situation where energy prices fall next year, but the region remains mired in recession as households seek to rebuild their savings.

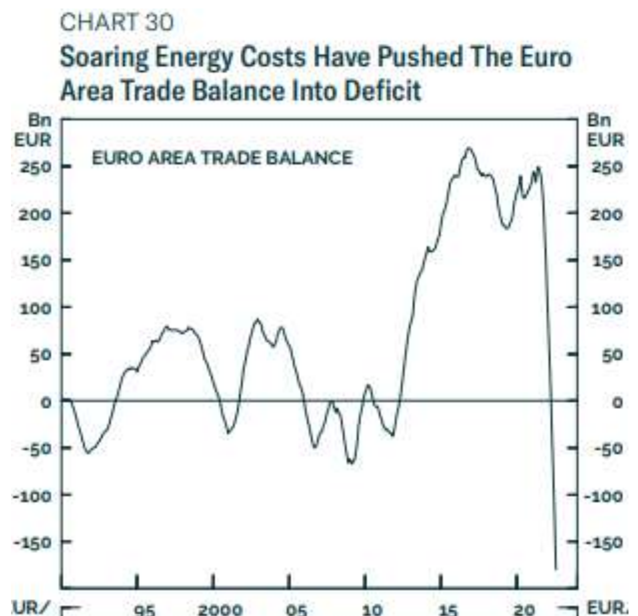
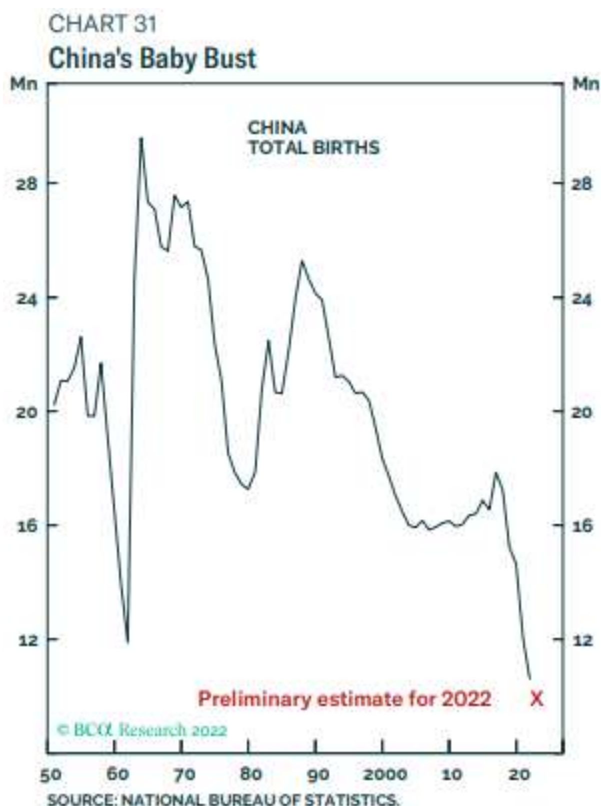


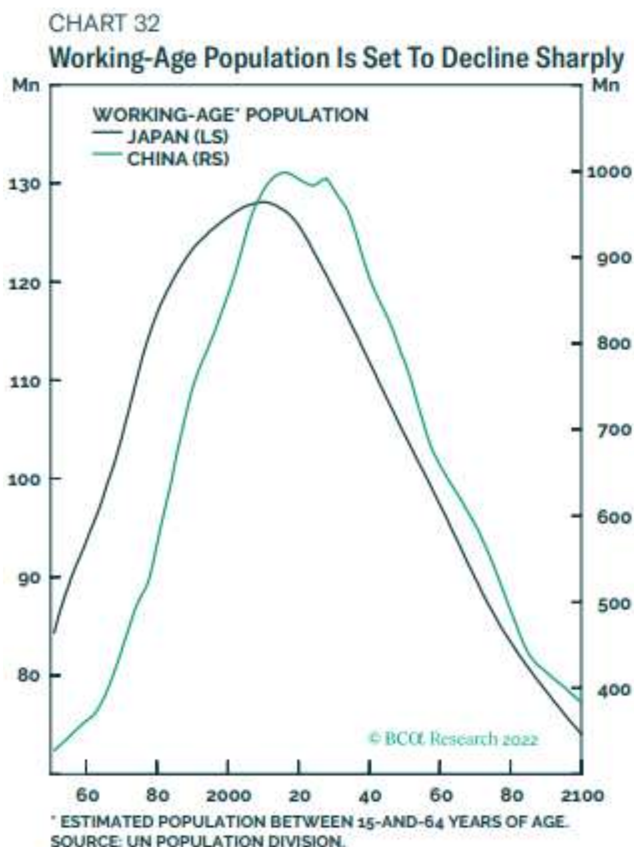
CHART 30
Soaring Energy Costs Have Pushed The Euro Area Trade Balance Into Deficit

China: The End to Lockdowns?

While other countries have been lifting Covid restrictions this year, China has persevered with its zero-Covid policy. According to Goldman Sachs, this policy is suppressing the level of China's GDP by 4-to-5 percentage points.

In addition to the economic costs, the zeroCovid policy is also taking a social toll on the country. Approximately 15 million children were born in China in 2019. Preliminary estimates suggest that only 10 million will be born in 2022 (**Chart 31**). For a country set to lose 600 million (or 60%) of its working-age population by the end of the century, that is a huge problem (**Chart 32**).





It is highly unlikely that China will abandon its zero-Covid policy in one fell swoop. That said, some easing in lockdown measures is likely by early next year, which is sooner than most investors expect.

China is ramping up production of Paxlovid, Pfizer's highly popular anti-viral drug. It is also aiming to launch an Omicron-specific booster shot built on mRNA technology.

Reopening the economy will not eliminate all of China's problems, of course. Most notably, China's real estate market faces a bleak future. Chinese home prices are among the highest in the world. According to BCA's China strategists, 12% of apartments are sitting empty. Partly due to the adverse demographic trends discussed above, demand for housing will shrink over the coming decades, sending prices lower.

In the short term, the authorities will try to soften the blow from a sagging housing market by providing financial support to struggling property developers and easing credit policy. This should put a floor under construction activity in 2023, but at the cost of aggravating the oversupply problem down the road.

The Path to a Global Recession

In the past, the US unemployment rate has gone through a bottoming phase lasting slightly less than two years in the lead-up to recessions (**Table 2**). The unemployment rate fell to 3.6% in March and has fluctuated in a narrow range of 3.5%-to-3.7% since then. If history is any guide, the unemployment rate should remain near current levels for another 15-to-18 months, placing the beginning of the next recession in early 2024.

TABLE 2

In Past Cycles, The Unemployment Rate Moved Sideways For Nearly Two Years Before A Recession Began

US UNEMPLOYMENT RATE PRIOR TO RECESSIONS				
	MINIMUM (%)	MAXIMUM (%)	DIFFERENCE (%)	DURATION (MONTHS)
APR 1978 TO DEC 1979	5.6	6.2	0.6	21
SEP 1988 TO JUN 1990	5	5.4	0.4	22
MAR 1999 TO JAN 2001	3.8	4.3	0.5	23
JAN 2006 TO NOV 2007	4.4	4.8	0.4	23
MAY 2018 TO FEB 2020	3.5	4	0.5	Bottoming phase would have lasted longer had it not been for the pandemic 22
SINCE MARCH 2022	3.5	3.7	0.2	6

What will cause this recession? Our guess is that the principal cause will be a second wave of inflation emanating from the US.

Despite August's hotter-than-expected CPI and PCE reports, a variety of indicators suggest that inflation will temporarily decline over the coming months. Gasoline prices are falling. Food inflation should dip on the back of recent declines in agricultural prices. Used car prices appear to have rolled over. Shipping costs are plummeting, as are other measures of supply-chain bottlenecks. Even private sector measures of rental inflation have cooled.

The problem is that the coming decline in inflation could sow the seeds of its own demise. Today, we have an odd situation where nominal wage growth is at multi-decade highs, but real wages are still falling because of high inflation. As inflation comes down, real wage growth will turn positive, lifting real disposable incomes, confidence, and spending. The economy will overheat again, causing inflation to move back up.

The rebound in real wages will occur alongside a diminution of the fiscal drag stemming from the end of various pandemic-related support programs. ...

Commodity prices are also likely to rise on the back of stronger global growth. This will contribute to higher inflation. In addition, a decrease in the value of the dollar will push up import prices, further fueling the second inflation wave.

As inflation starts to reaccelerate in the second half of 2023, the Fed will have no choice but to raise rates, ultimately bringing the Fed funds rate to 6% by the end of that year.

The Fed Will Blink Early Next Year

The consensus view these days is that the Fed is so obsessed with inflation that it will keep tightening until the economy falls into recession. Strategically, the Fed has a strong incentive to talk hawkishly. After having been burned by the whole “transitory” narrative, the FOMC needs to cement its anti-inflation credentials in order to keep long-term inflation expectations from rising. However, it is one thing to bang the drum about inflation when unemployment is near a half-century low.

It is quite another to do it when unemployment is rising. In its latest Summary of Economic Projections released on September 21st, the Fed changed almost all of its dots but for one notable exception: The “longer-term” dot for the Fed funds rate remained stuck at 2.5%. To the extent that one can think of the longer-term dot as the Fed’s estimate of the neutral rate, lifting policy rates all the way to 4.6% would imply very tight monetary policy from the Fed’s perspective – and hence not consistent with the Fed’s stated intention of raising the unemployment rate by less than one percentage point.

If the August inflation reports prove to be outliers, as many of the real-time drivers of inflation listed above suggest is the case, the Fed will no longer feel the need to ratchet up market interest rate expectations any further. This could potentially open up a 6- to-9-month period for stocks to rally.

II. Financial Markets

A. Global Asset Allocation

... Consistent with our “Three-Act Play” scenario, we see the S&P 500 and other global bourses recovering into the second quarter of next year as US inflation temporarily comes down, Europe experiences a V-shaped recovery, and China loosens its zero-Covid policy (Act 1). Stocks will peak in mid-2023 and then begin to weaken, first as the Fed hikes rates in response to a second wave of inflation (Act 2), and then as the US and the rest of the world fall into recession in 2024 (Act 3).

Bond yields will move sideways during Act 1, reflecting the crosscurrents of better-than-expected growth on the one hand, and falling inflation on the other hand. Yields will rise during Act 2 but then fall during Act 3.

The dollar will weaken during Act 1 as the Fed breathes a sigh of relief, only to strengthen again in Act 2 as the Fed embarks on another round of rate hikes. To the extent that the Fed will have more scope to cut rates in 2024 than most other central banks, the dollar will probably weaken during Act 3, although the greenback’s defensive nature will blunt some of the downward pressure.

Obviously, the scenario described above should be seen more as a loose guide for where markets are going rather than a quarter-to-quarter point forecast of what will actually unfold.

How investors should position their portfolios at the current juncture depends a lot on their time horizon. Investors with a short-term tactical horizon should consider bringing equity exposure above benchmark to take advantage of a possible Goldilocks environment lasting for the next few quarters where inflation falls and global growth surprises on the upside. Longer-term investors, wary of the risks of another wave of inflation and an eventual recession, should adopt a more defensive posture. ...

One “Ironic” Risk to the View

There are many risks to the views expressed above that one could mention, including the possibility that US inflation does not fall fast enough to allow the Fed to relax a bit early next year; that Europe suffers an unseasonably cold winter; that China is slow to remove Covid restrictions; not to mention a myriad of geopolitical risks that the global economy faces.

There is an additional, somewhat ironic, risk that is worth mentioning – a risk that has escalated of late: If markets were to fully adopt our view that the neutral rate is quite high, then rate expectations and bond yields would likely continue to rise and stocks would continue to fall. Rather than a three-act play, we would move straight to the third act: a recession. Considering how rapidly the markets have shifted towards our view of the neutral rate in recent weeks, this is a risk that we are monitoring closely.

B. Equities

Not as Cheap as They Seem

After trading at 19.6-times forward earnings at the start of the year, global stocks now trade at 14.4-times forward earnings (**Chart 42**). The forward P/E ratio in the US stands at 16.2, down from 22.3. Outside the US, the forward P/E ratio has fallen from 15.0 to 11.1.

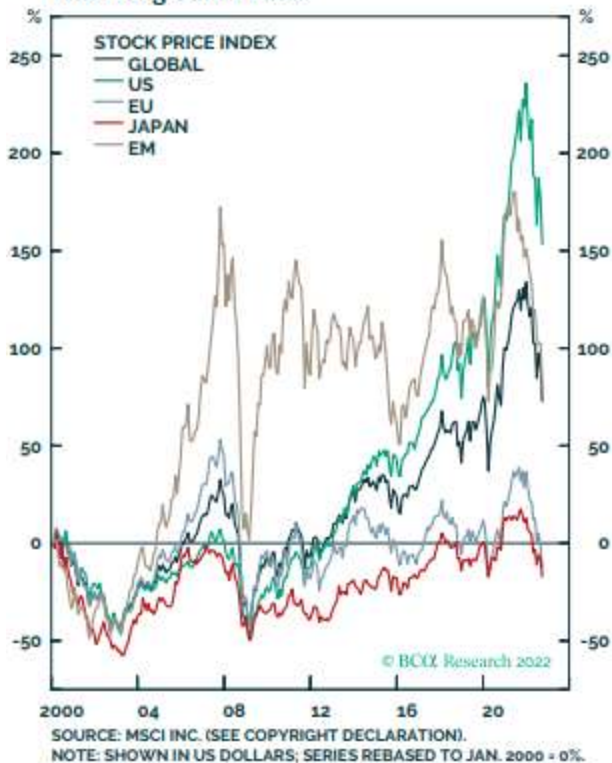
Although global stocks have definitely cheapened ... the forward earnings estimates cited above do not discount a recession, at least not a moderate-to-deep one. While US earnings estimates for 2022 and 2023, once the high-flying energy sector is excluded, have fallen by 5.9% and 6.5%, respectively, they will almost certainly fall further if the economy succumbs to a major downturn. While a recession in 2022 and 2023 is not our base case, it is a possibility that cannot be excluded either. ...

The surge in inflation has made owning bonds riskier than before. Starting in the late 1990s, bonds were one of the few assets whose prices rose when the economy turned down, and the value of other assets such as stocks and real estate declined. This year, in contrast, bond prices plummeted as stocks swooned and the risk of recession intensified. Bonds did not insulate investors like they once did.

That said, the absolute riskiness of stocks has probably also increased over the past nine months, given heightened economic and geopolitical risks. If stagflationary worries recede over the coming months, it is quite probable that the equity risk premium will decline, allowing stocks to rise. Looking out beyond mid-2023, however, structurally higher real bond yields imply structurally lower P/E multiples.

US Equity Outperformance: How Long Can It Last?

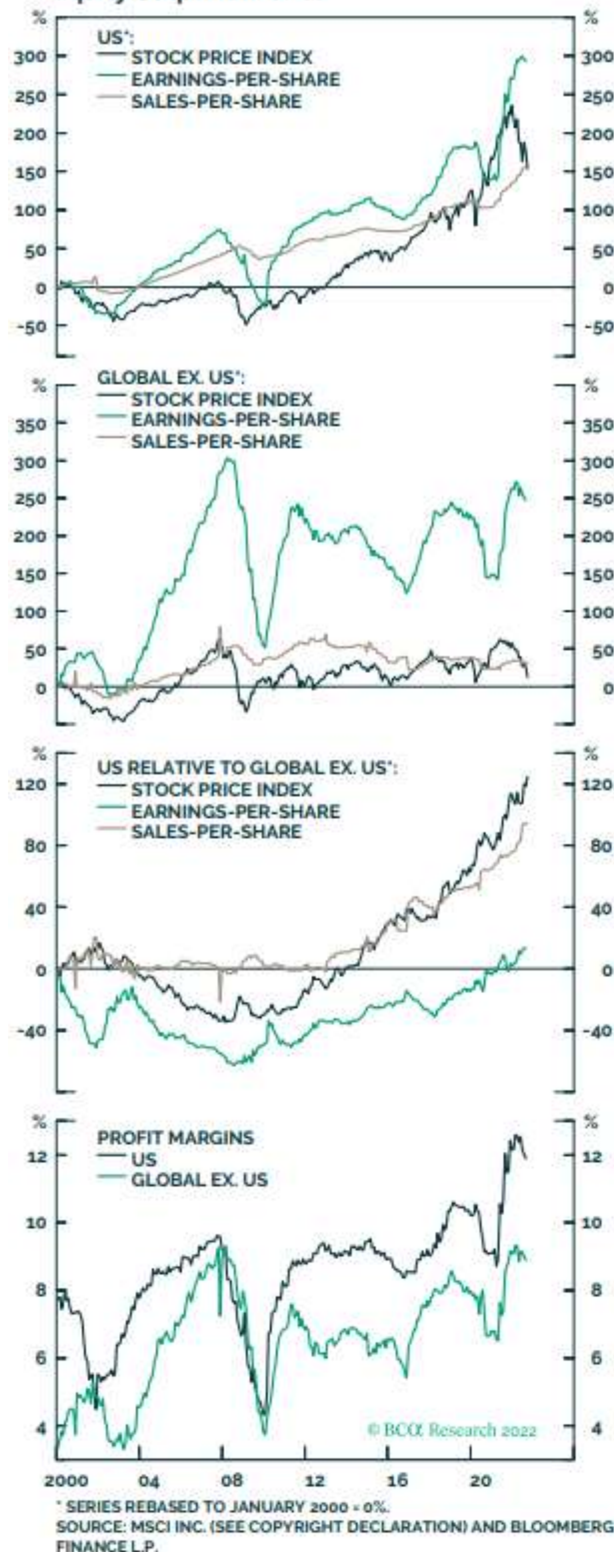
After underperforming every major market between 2000 and 2008, US stocks have blown away the competition in the post GFC era (**Chart 45**). Faster sales growth in the US, supported by an expansion in profit margins, powered US outperformance (**Chart 46**).



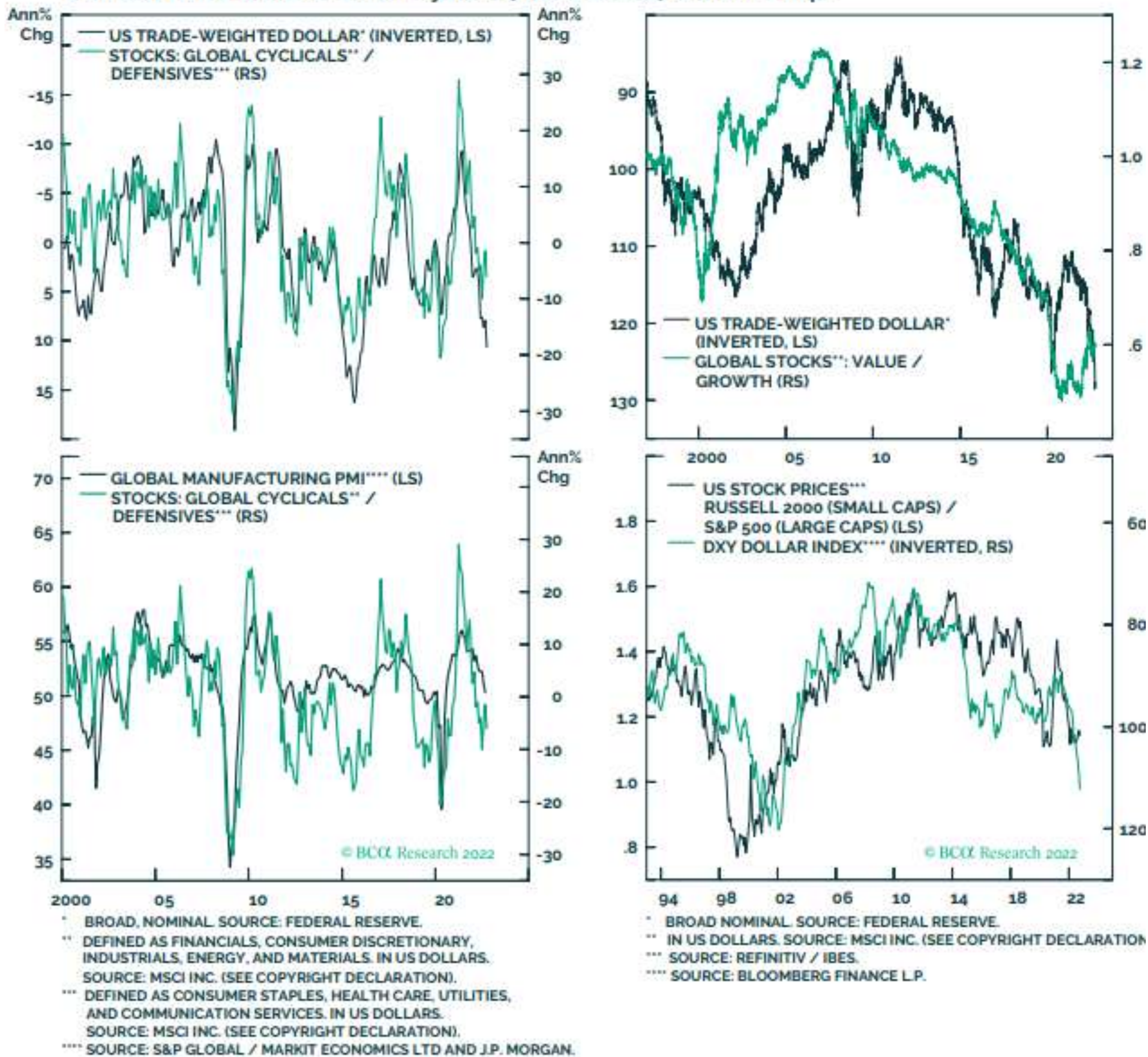
Differences in sector composition – most notably, the larger weight of fast-growing sectors such as tech and health care in US indices – explain about a fifth of US outperformance since 2008. The rest is explained by superior US returns within sectors.

Looking out over the next 6-to-9 months, US stocks will probably lag their foreign counterparts. If past history is any guide, a weaker dollar will also boost the relative performance of non-US stocks. Cyclical sectors, value stocks, and small caps should also benefit from stronger growth and a temporarily weaker dollar (**Chart 49**).

How US equities fare relative to their global peers over a long-term structural horizon is less clear. As my colleague Ritika Mankar discussed last week, US profit margins are exceptionally high and should come down as real wages start rising again. US sales growth will probably also slow as the tailwind from past globalization fades.



The catch is that there is no obvious reason to expect sales and earnings outside the US, which have been stagnant for over a decade, to accelerate noticeably. Thus, to the extent that non-US equity returns converge with the US, it may be because of lower US returns rather than higher overseas returns.



Follow-ups

We have shared Global Investment Strategy's view that we are not in a recession, nor do they expect one before 2024. Goldman Sachs concurs:

The Case for a Soft Landing: How High Inflation Could End Without Recession

Dissecting one firm's view on why inflation will fall to 2.5% without a big rise in unemployment

By *Greg Ip*

Sept. 7, 2022

Prominent economists including Larry Summers predict a recession is coming. Half of Americans think the U.S. is already in one, according to a Wall Street Journal poll. Federal Reserve Chairman Jerome Powell has stopped talking up a "soft landing," when the economy slows enough to bring down inflation but not push unemployment up much, and has begun warning of pain.

The gloom has felt justified. In March, I wrote that the odds don't favor a soft landing. Still, the chances aren't zero, and they might have improved with Friday's report that job growth continued in August while wage growth eased and the labor force expanded. Economists at Goldman Sachs have long been in the soft-landing camp, putting the probability of a recession in the coming 12 months at 33%. That is higher than normal but less than the nearly 50% average of economists surveyed by The Wall Street Journal. To understand the reasons Goldman expects a soft landing, I talked to its chief economist, Jan Hatzius.

History isn't a good guide to the present

The main obstacle to a soft landing is the historical record. In the three soft landings since World War II—1965, 1984 and 1994—the Fed wasn't trying to push inflation down; it was merely trying to keep it from going higher. At times like the present, when inflation was too high and the Fed set out to push it lower, a recession always occurred.

But Mr. Hatzius said that is a "small sample," largely confined to the 1970s and early 1980s, which shouldn't be extrapolated to today. First, he noted, the public expected much higher inflation back then, and it took high unemployment to change the public's wage- and price-setting behavior. Expectations today are much lower: The spread between regular and inflation-indexed bonds, for example, projects 2.4% inflation over the coming five years, and surveys by the University of Michigan and the Federal Reserve Bank of New York are in the same ballpark. So getting actual inflation back to 2% doesn't require stringent monetary tightening.

Second, today's economy is "too dislocated" by a pandemic, war and other disruptions to apply past relationships between growth, unemployment and inflation, Mr. Hatzius said. For example, he said demand for labor shows up as high vacancies and rapid wage growth rather than unemployment going continuously lower. Conversely, cooling labor demand should manifest itself as lower vacancies and wage growth, not necessarily higher unemployment. Goldman expects the unemployment rate in a year to be 3.8%, not much higher than its current 3.7%.

Similarly, in many goods markets, "You can see very large changes in inflation rates in response to relatively small changes in the supply-demand balance," Mr. Hatzius said, pointing to used cars, where "we've gone from sky- high inflation rates to modest deflation rates."

The soft landing has already begun

To achieve a soft landing, economic growth has to slow below its long-term trend of 1.75%—and it has, Mr. Hatzius noted. Growth was slightly negative in the first half of this year and will be around 1.25% in the coming 12 months, Goldman estimates.

Goldman also thinks the labor market has started to loosen up. The firm measures labor demand by adding total employment to job vacancies, and then compares that with the labor force. While demand still exceeds supply, the gap has started to close. The share of people quitting their jobs has trended steadily lower since December.

Goldman's wage tracker, which consolidates several different measures of pay, puts wage growth now at 5.5% a year. Mr. Hatzius said it has to fall to 4% to be compatible with 2% to 2.5% inflation, and he thinks that is happening. Hourly wage growth slowed in August, and corporate earnings calls and surveys by the National Federation of Independent Business and some Fed banks also show easing wage pressure.

Inflation doesn't have to fall to 2%

It is a long way from July's 8.5% increase in consumer prices to the Fed's inflation target of 2%. But that overstates how much work the Fed has to do. Its target is based on a different price index, which was up 6.3% in July, and that was buoyed by food and energy, whose prices were elevated by global disruptions and have begun dropping. Excluding those, "core" inflation was 4.6% in July. Easing of supply disruptions such as for used cars will further lower core inflation with no push from the Fed, Mr. Hatzius predicted.

Finally, Mr. Hatzius thinks inflation only needs to fall to 2.5%, not to 2%, for the Fed to stop tightening. The reason, he argues, is that the Fed wants inflation to average 2% over the business cycle, so it can tolerate 2.5% inflation during a strong economy to offset below-2% readings during recessions.

Private balance sheets are strong

Goldman economists were more pessimistic than the consensus in 2007, correctly anticipating the housing crash would do sustained economic damage. That was based on their analysis of financial balances: Private-sector spending significantly outstripped its income. That amplified the pullback in consumption and investment when the financial crisis hit.

Today, their analysis of financial balances leads to a different conclusion: Private borrowing is within historical ranges. This doesn't rule out recession. Indeed, it might mean the Fed, at the margin, must raise interest rates more to achieve the desired slowing in demand. But Mr. Hatzius said the sort of knock-on effects that transform a moderate downturn into something more severe are much less likely. The absence of such "tail risks" favors a soft landing, he said.

Goldman's upbeat outlook is swimming against the stream of economic history and recent market sentiment. But inflation news in July and job market news in August have made it more plausible than a few months ago.

Positions

BGSF - We purchased 2% positions in this Staffing IVA System Pick for 6 clients @ 12 on 9/14, and 11.91 on 9/15.

From The Insider's Forum of May 12th:

Company Overview:

BGSF, Inc. (BGSF) is a Plano, Texas based staffing concern, supplying temporary employees to commercial and multifamily properties, as well as IT, finance, accounting, consulting, legal, and HR professionals to multiple verticals. As of September 2021, the firm was the 79th largest workforce solutions concern in the U.S., providing temps to ~9,000 clients. BGSF was founded as LTN Staffing d/b/a BG Staffing in 2007 and went public on the OTC Bulletin Board in 2014, raising net proceeds of $8.4 million. It switched to the NYSE

American later that same year, eventually making its way to the NYSE in 2019. Shares of BGSF trade just below 13 bucks a share, translating to a market cap of approximately $135 million.

The firm operates on fiscal year (FY) that ends on the final Sunday of each calendar year.

Operating Segments

Since its founding, the firm has acquired twelve companies – primarily via balance sheet cash or debt – the most recent of which was its relatively tiny $3.8 million acquisition of IT consulting staffer Momentum Solutionz in February 2022. It has also grown two businesses organically and recently divested of one operating segment, leaving it with two: Real Estate and Professional.

Real Estate consists of front office personnel (~30% of the unit's revenue) and maintenance staff (~70%), who are provided to ~7,500 apartment complexes and commercial buildings in 35 states and Washington DC. All of these employees are recruited virtually. BGSF is the only publicly traded staffing company in real estate. This segment generated FY21 gross profit of $35.0 million on revenue of $92.0 million, rebounding 35% and 34% (respectively) from a pandemic impacted FY20.

The Professional unit is comprised of specialists in the aforementioned fields supplied to Fortune 500 companies, as well as small and medium-sized businesses with operations in ten states and clients in 43. Its IT staffing division is the 48th largest in the country and accounts for 22% of the segment's top line. Overall, Professional accounted for FY21 gross profit of $46.0 million on revenue of $147.0 million, representing growth of 14% and 6% over FY20 (respectively), as this sector was not as impacted by the pandemic. It was responsible for 62% of BGSF's total FY21 continuing operations top line.

The firm had a third segment that serviced the light industrial sector – its original raison d'etre – under the InStaff banner, which was sold to Jobsandtalent for a total cash consideration of $32.3 million in March 2022 so it could focus on its higher margin Real Estate and Professional segments. This division generated FY21 gross profit of $10.3 million and EBITDA of $4.7 million on revenue of $71.3 million, more or less consistent with results from its prior four years.

Staffing Market

Owing to the dislocations created by the shutdown of the country complemented by economic impact payments and enhanced unemployment benefits that incentivized would-be workers to stay home, the demand for temporary help has been robust, but only comprises about 2% of the total labor market. According to Statista, the U.S. staffing market reached $151.8 billion in 2021 and is expected to grow at a high-single-digit rate in 2022. The industry is highly fragmented with approximately 25,000 recruiting and staffing agencies operating ~49,000 offices throughout America. Allegis Group is the largest staffer, generating FY21 revenue of $9.2 billion for less than a 7% share.

BGSF Price and Operational Performance

After nearly reaching $30 a share in 2018 and early 2019, BGSF steadily declined before nosediving below $6 (briefly) during the pandemic selloff in April 2020. Because of its exposure to real estate, its performance was more profoundly impacted by the pandemic. With that said, even with its twelve acquisitions since 2010, the firm is not a fast grower with regards to its continuing operations. Since 2017, BGSF has accelerated its top line from continuing operations at a 4.8% CAGR while its Adj. EBITDA has fallen from $20.2 million in FY17 to $16.7 million in FY21, although the latter figure represents a 21% improvement over FY20. As such, the firm's

share price has only recovered to the low-double-digit to low-teens range, where it has remained since November 2020.

1QFY22 Earnings

Its recovery from the pandemic continued in 1QFY22, as BGSF reported non-GAAP earnings from continuing operations of $0.26 a share and Adj. EBITDA from continuing operations of $3.9 million on revenue of $68.5 million versus 1QFY21 non-GAAP earnings from continuing operations of $0.04 a share and Adj. EBITDA of $1.3 million on revenue of $49.8 million. The 38% improvement at the top line flowed to the gross profit line, which improved 44% to $23.4 million.

Real Estate revenue increased 39% to $25.9 million as billed hours rose 26% while the average bill rate increased 10%. Professional revenue surged 37% to $42.6 million as a 37% increase in billed hours (mostly in its IT Consulting unit) and a partial contribution from recently acquired Momentum Solutionz were almost entirely responsible for the improvement.

No specifics regarding the firm's outlook was provided, only that management was "optimistic in [its] outlook for 2022."

Although shares of BGSF rallied 10% to $12.93 in the subsequent (April 28, 2022) trading session, it was on paltry volume of 26,700 shares.

Balance Sheet & Analyst Commentary:

Concurrent to its earnings report, management announced a $0.15 a share quarterly dividend, a 25% sequential increase from the prior quarter (for a current yield of 4.7%) and its 30th consecutive. Although it is 50% below pre-pandemic levels, the dividend hike reflects management's otherwise undefined optimism for the firm's future. As of March 27, 2022, BGSF's balance sheet showed no cash as the firm used proceeds from its InStaff disposition and balance sheet cash to pay down a term loan, leaving it with liquidity of $20.9 million, representing the untapped portion of a $35 million revolving credit facility.

In a relatively unsexy business and with less than 11 million shares outstanding, it isn't surprising to see little Street support for BGSF. Only Roth Capital has made commentary in the past two years, maintaining a buy rating and a $21 price target back in November 2020. With that said, the firm is expected to earn $1.06 a share (non-GAAP) on revenue of $263.5 million in FY22, representing 8% and 10% increases over FY20, respectively; and $1.25 a share (non-GAAP) on revenue of $281.8 million in FY23, reflecting 18% and 7% improvements over FY22, respectively.

In addition to the c-suite's confidence concerning BGSF's prospects, directors Douglas Hailey and David Allen Jr's early-May stock purchases totaling 28,000 shares indicate that the firm's board shares the same sentiment.

Verdict:

In addition to the insider buying, another window into what management believes its company to be worth is through the sale of its InStaff segment. It sold for 7.5x Adj. TTM EBITDA and .45x FY21 sales. Admittedly, BGSF is shedding a lower margin and no growth business, but applying the same metrics to its continuing operations produces share prices of $10.34 and $11.97, both slightly below its current level. These prices represent an approximate floor for the firm's stock, especially considering one is being paid 4.7% to wait for continuing operations earnings to accelerate off a post-pandemic base, boosted by a focus on IT consulting.

Although the economy contracted by 1.4% in 1Q22, the labor market is still tight. As such, with an understanding of the somewhat illiquid nature of BGSF shares, the recommendation here is to follow the insiders and accumulate shares of BGSF.

Recommendation: Buy BGSF up to $14.00 a share.

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/04/2022	7	Hailey Douglas, Garvey Beth, H...		21,639
05/02/2022	1	Hailey Douglas		20,000

CRGY - We purchased 1% positions in this E&P for 6 clients @ 14.38 on 9/21.

From Z4 Energy Research on Sep. 7th:

We added to our position in CRGY at $14.56 average cost, down about 13% on the day. The shares are off on the announcement of a selling shareholder secondary ... and have now filled a gap from the solid 2Q22 report on a red day for the group. The company is also buying in a portion of the offering. We see this low valuation, low decline, decent yield (> 4% implied at present price) upstream consolidation story as well positioned to grow the dividend in 2023 and gain more exposure on the Street (only 1 analyst in print on this 140+ MBOEpd name). This add increases our position by 37% and our average cost to $14.13.

on Aug. 10th:

Crescent is a mid cap acquire and exploit E&P with a diverse portfolio that is off the radar for most.... The company should be moving from the 120 MBOEpd realm to > 150 MBOEpd this quarter with a Unita Basin acquisition that closed at the end of 1Q. Our sense is they can tighten guidance higher with this call (they report tonight, call in the morning) having a full quarter's production in the books from the new play. The company offers a 5% implied yield off a base only dividend. They are under-spending cash flow and have been adding

low decline rate properties to help them continue to do so (they're a KKR team and focused on returns). The balance sheet is not overly levered and should improve near term. The oil cut is close to 45% with solid realizations and they have about 60% of mid point guidance hedged as they protect the balance sheet. They are somewhat less hedged in 2023 and substantially less covered in 2024. CRGY trades at 3.5x our 2022 Base case and at a substantial discount (< 70%) to pro forma proved developed reserves. ...

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
08/16/2022	1	Kendall Brandi		500
08/15/2022	5	Rockecharlie David, Conner Ben...		26,616
08/12/2022	6	Simon Karen, Rockecharlie Davi...		58,550

PDM - We purchased 2% positions in this Office REIT for 4 clients @ 12.0164 on 9/14.

From September's Forbes Real Estate Investor:

A Strong Buy In The Office Sector

It should not be a surprise that the office sector has been one of the hardest hit property categories coming out of the pandemic due to many employees continuing to work from home. ...

Like most office REITs, the scenario of many employees working remotely has created an interesting conundrum in which investors have been trying to decide whether the sector has a moat (competitive advantage to protect profits and market share). Office REITs generated average returns of about 25% in 2021, and since then they have given back these returns, down 25% year-to-date in 2022.

The sector has become a cherry picking contest for value investors. You can't ignore the overall cheapness as viewed in the table to the right.

Office REITs Are Cheap

Sector	Dividend Yield	Current P/FFO
Farmland	1.9%	34.9
Cell Towers	2.0%	27.8
Single Family Rentals	2.1%	25.9
Self-Storage	3.1%	25.8
Industrial	2.5%	25.5
Manufactured Housing	2.8%	24.8
Apartments	2.8%	23.4
Data Center	1.8%	21.9
Gaming REITs	4.8%	17.0
Diversified	4.4%	16.7
Timber	2.8%	16.4
Net Lease	5.4%	15.5
Cannabis	9.5%	15.1
Billboards	5.3%	14.0
Shopping Center	3.9%	13.8
Office	5.7%	10.2
Healthcare	5.0%	9.9
Malls	4.1%	8.9
Commercial Mortgage	9.7%	8.4
Lodging	0.8%	-21.1

Source: iREIT

A Look At Piedmont Office Realty

Piedmont Office Realty (PDM) owns and manages office properties in seven major markets with 52 assets in Atlanta, Boston, Dallas, Minneapolis, New York, Orlando and Washington, D.C. with a combined footage of 16.1 million square feet. PDM's total leased occupancy of 87% and its average weighted lease term of 5.9 years is low compared to most other higher-rated and more expensive office REITs peers.

PDM does have low debt at 35% to gross assets and 5.8x net debt/Ebitda on a trailing 12-month basis, and it carries a solid investment-grade BBB rating. The company's portfolio contains an appealing mix of relatively unique mixed-use environments.

- Assets: 52
- Total Square Footage: 16. 1 million
- Percent Leased: 87%
- Weighted Average Lease Term: 5.9 Years
- Debt to Gross Assets: 35%
- Moody's/S&P Ratings: Baa2/BBB

Despite currently being significantly pressured and punished by the market—shares are down 35% year to date—PDM considers itself to be well-positioned for today's office environments, based on spaces that focus on wellness, asset flexibility, ceiling heights and windows that promote modern office designs. Most of the company's assets have easy access from major highways and airports as well as good parking options.

PDM has been working toward a portfolio that is more concentrated in the Sunbelt markets, selling properties in Chicago, New Jersey and Woburn, Massachusetts over the last few years.

Piedmont is disposing close to a billion in legacy markets, including in NYC, Cambridge and Houston. It already has some investment targets and recent M&As to point to, which exemplifies what the company is looking for when it redeploys capital.

PDM now only owns one property in New York. PDM has some fundamental upsides when it comes to its tenants. The company's average lease size has been steadily decreasing, down from 40,000 square feet to less than 15,000 square feet in first-quarter 2022. This means greater diversification, reduced potential impacts from expirations—which the company needs—and increased ability to renovate and capture benefits from those improvements.

Like most peers, Piedmont Office has been successfully pushing rents higher in its renegotiations. For first-quarter 2022,the company's change in cash rents was close to an increase of 5%—a nice bump but still

PDM's Ongoing Portfolio Transition

Disposition Dashboard ------- Redeployment Priorities ------ Redeployment Targets---- Year End 2023 Objective

- ✓ Elevate quality of portfolio
- ✓ Invest in high-growth markets
- ✓ Acquire differentiating assets
- ✓ Accelerate transition to Sunbelt
- ✓ Simplify the footprint
- ✓ Protect earnings trajectory

70%-75%
Annualized Rental Revenue Generated from Sunbelt Markets

Source: PDM corporate presentation

hampered by the effects of Covid. PDM can also point to a decade of consistent FFO (funds from operations) growth, which is a strong trend.

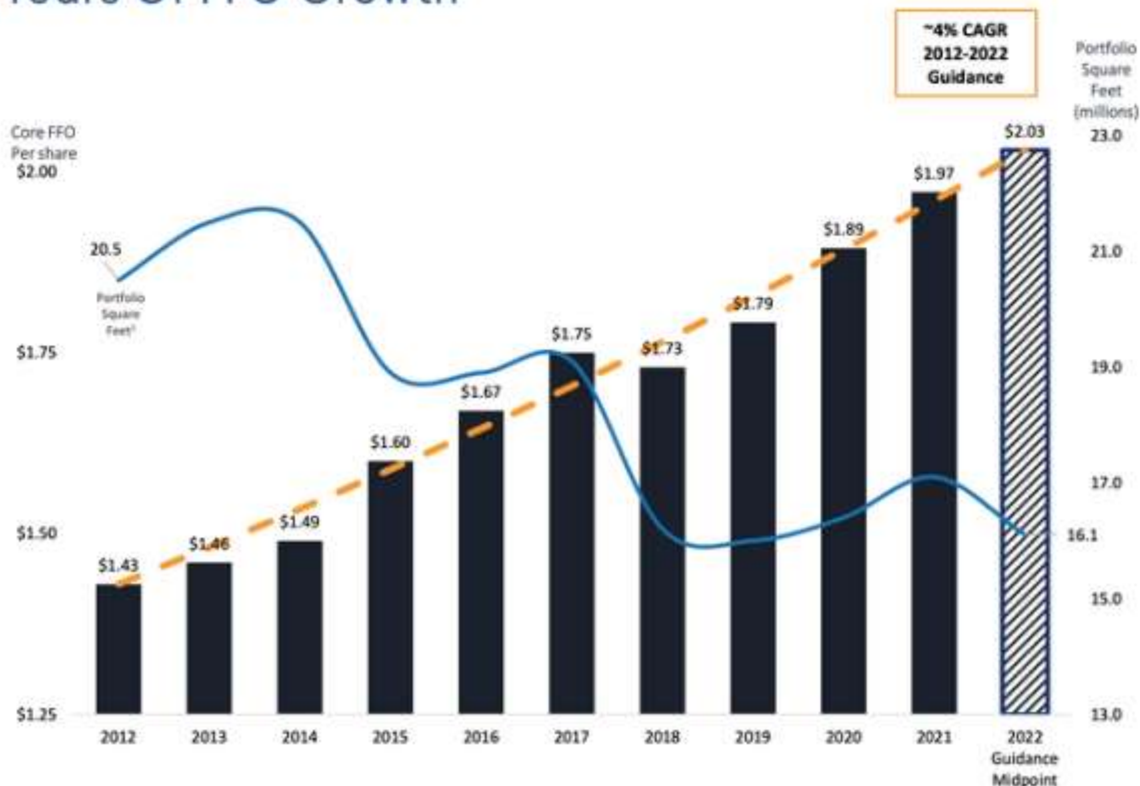
Where the company is showing strength and one reason I like the REIT is its new tenant leasing activity, which has been increasing. For the quarter ended June 2022 the company leased 233,000 square feet to new tenants, up from 201,000 in new leases at the end of 2021.

Around 70% of the existing company vacancy is in Sunbelt markets with 85% of the 2022 expirations in this market as well, but these should be relatively easy to replace.

Despite this, we're now at valuation levels for PDM that we have not seen in a long time. One hundred percent of the company's debt is unsecured and unencumbered, and the company has an above 50% investment-grade rating and is nationally recognized for its tenants. The maturity is a bit of an argument against the company in terms of risk—but the company's fundamentals are sound.

PDM maintains that it owns highly concentrated and attractive office properties in appealing submarkets and can offer clients good mixed-use square footage.

Management says it has a strong history of earnings growth. Like many other REITs, it recycles and lease-ups its assets, and its M&A and renovation strategy offers advantages for tenants. The arguments against Piedmont at a high valuation do hold some water. The combination of company disposals and the current environment calls for a very low rate of FFO and, consequently, a low rate of dividend growth going forward. I don't expect more than 5% FFO growth for the next few years, but don't rule out this REIT.



Piedmont Office Valuation

The valuation for this office REIT is less than 7x P/FFO, which despite the troubles I mentioned, has not been falling and is not expected to fall as we move forward.

Current FactSet forecasts call for a 2.9% FFO growth this year, followed by an estimate of about 2% per year until 2024. That's below inflation and below some of its peers, but most peers don't trade at the valuation we're seeing for Piedmont. At 11x P/FFO I am not a fan of this company given some of its question marks but at 6x-7x P/FFO, you're paying nickels for a BBB rated office REIT with an attractive set of properties that is set to remain stable for the next

FFO Peer Comparison

Company (ticker)	Dividend Yield	Current P/FFO
Empire State Realty (ESRT)	1.8%	10.6
Alexandria Real Estate (ARE)	2.8%	20.3
Kilroy Realty (KRC)	4.0%	13.0
Corporate Office Properties (OFC)	4.0%	11.6
Cousins Properties (CUZ)	4.2%	10.5
Boston Properties (BXP)	4.5%	12.7
Easterly Government Properties (DEA)	5.5%	14.1
Highwoods Properties (HIW)	5.8%	8.4
City Office REIT (CIO)	6.3%	9.1
Piedmont Office Realty (PDM)	6.4%	6.4
Vornado Realty (VNO)	7.2%	9.4
SL Green Realty (SLG)	7.6%	7.0
Brandywine Realty (BDN)	8.6%	6.1
Office Properties Income (OPI)	10.9%	3.9

Source: iREIT

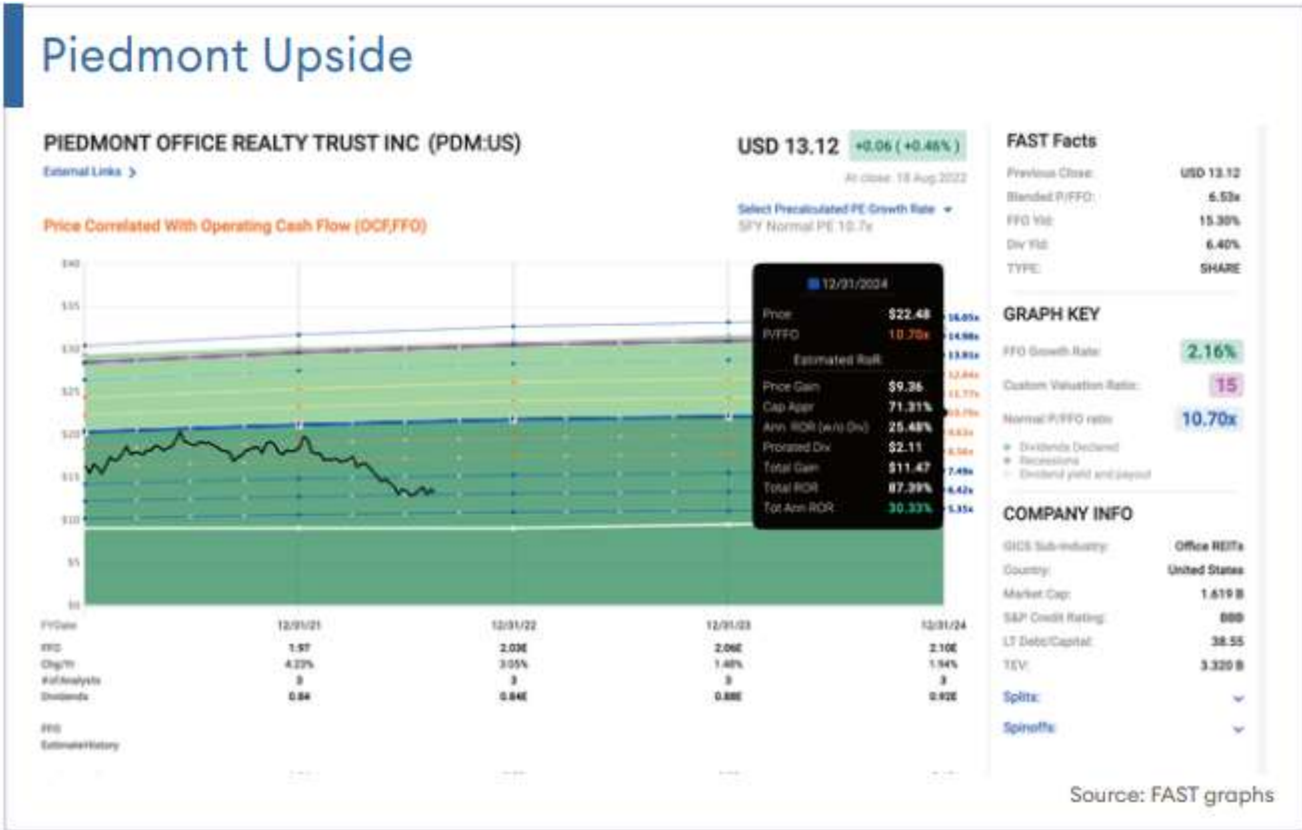
few years. I don't see this REIT dropping significantly.

Piedmont's biggest obstacle is lack of growth, which has been an issue for many years. The market seemed to have accepted this and allowed for PDM to trade at 10x-15x P/FFO for some time. This changed during Covid and the company has not yet fully recovered. It is now trading at what I view to be a significantly more fair valuation given what it offers. So, what should we pay for a sub-2.5% FFO growth rate with a yield of 6.4% (which is high given the context)? PDM could trade at these trough valuations and generate 13%-14% annual rate of return (RoR) on a 7.5x P/FFO. Given its better than 6% yield, I would consider this to be a very acceptable RoR, even in the environment we're currently in.

But the real kicker is if we see any sort of reversal to a double-digit multiple. In such a scenario, the potential returns could easily outpace 30% per year. Is this likely? I would argue that if the REIT's transformational journey and plans succeed and the company continues to deliver solid results, there could at some point come a trend reversal that could push this REIT back up toward the 9x-10x multiple ranges. Meanwhile, your invested capital is protected by cash flows that, over the past 10-15 years, have been very safe.

Another positive: In July PDM announced it had acquired 1180 Peachtree in Atlanta, located at 14th & Peachtree in the heart of midtown. This trophy asset is the second skyline-defining acquisition the company has made in the last 12 months, bringing the total footage to 1.3 million square feet. (The other property is 999 Peachtree.) The 41-story tower at 1180 Peachtree has anchor tenants that include King & Spalding, Roark Capital Group, Bain & Co. and Cushman Wakefield.

Let me emphasize this: valuations are important. A quality company is not a Buy at all prices. Piedmont is not the most diversified, the highest-rated or the highest-yielding REIT out there, but it is a solid company at a good valuation. ...



Like all investments, share price can go lower but I don't see that FFO is going to dry up or that the company is going to fail in its ambitions. There is (in investment vernacular) nothing speculative about Piedmont.

I rate PDM a Strong Buy with a margin of safety of up to 22.8% based on a conservative price target of $17 per share, implying an estimated multiple of 8.5x for 2022 and I am adding it to the SWAN portfolio. I consider this to be a lowball, fair-value level for the company, and one that is achievable in the medium to long term. This would imply an estimated three-year annual rate of return of 19.7% or 53% until the closing of fiscal 2024.

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
08/31/2022	2	Swope Jeffrey, McDowell Frank		47,000
08/04/2022	1	Cohen Glenn		3,000