JOPPA MILL ADVISORS LTD.

Grist from the Mill

Investment Fog

April 2023

Have you ever been lost in the fog? It can be rather disconcerting as all sense of direction is impaired and one can't see beyond the end of their fingers. Things are not at all what they seem. Indeed, fog has been a major factor in numerous deaths, John F. Kennedy Jr's ill-fated flight to Martha's Vineyard in July 1999 being a prime example. Fog develops when there is a differential between the air temperature and the dew point – the water vapor condenses to form droplets that are suspended in the air.[i]

The S&P 500 Index remained range-bound during April, trading between 4109 and 4170, closing the month essentially at the upper end of the range[ii]. 10-year U.S. Treasury note yields declined 22 basis points to 3.43% at month-end[iii]. Headline inflation continues to trend down, as the extraordinarily elevated levels of 2022 roll off the trailing 12-month calculation. The anxiety provoked by the failures of several regional banks seems to have abated for the time being after the sector was bludgeoned in the wake of these events. Regrettably, the narrative has been crafted to fit the outcome rather than being grounded in the reality of these institutions risk management practices. With private and public markets eschewing further investment in their start-up firms, banking clients withdrew demand deposits to fund business operations. This forced Silicon Valley Bank and First Republic, who had lent heavily against non-marketable assets, to draw on their capital, which had been invested in longer-term U.S. Treasury-backed bonds while those yields were in the sub-2.0% range. With yields now in the 3.5% range, the market value of these securities resulted in significant capital losses, such that the banks' liquidity and viability were threatened[iv]. These episodes were neither a credit nor a banking crisis; just idiosyncratic poor risk management.

While the S&P 500 has gained some 7+% year-to-date ("YTD" defined here as 12/31/2022 – 4/28/2023), the headline masks some concerning activity below the surface. Six "technology" stocks (AAPL, MSFT, AMZN, NVDA, GOOG and META) constitute approximately 24% of the S&P 500 Index. On a YTD basis, GOOG and AMZN are the laggards among this crowd, posting gains in the mid-20% range, while NVDA and META define the upper boundary with gains on the order of 95%![v] Indeed, Artificial Intelligence has captured the attention of investors! These stocks are the primary drivers of the Index return thus far. Such narrow leadership suggests that all is not well with the broader market. Indeed, 60% of stocks are trading <u>below</u> their 200-day moving average. The Financial sector remains under pressure with investors fearing some form of credit crisis as lending standards are tightened. This could be a potential risk to commercial real estate as loans come due and borrowers must refinance their projects at considerably higher rates. Recessionary fears and a slow to emerge recovery in China have driven the Energy sector down nearly -9.5%, despite production cuts from Saudi Arabia.[vi] Traditional "defensive" sectors, such as Healthcare and Utilities are each down -2.5% YTD.[vii] Homebuilders, whom one would expect to be under pressure with rising mortgage rates and the anticipation of a recession, have returned nearly 18% YTD as a shortage of housing continues and existing homeowners are reluctant to sell and give up sub 4% mortgages![viii]

Industrial Production and Capacity Utilization suggest the economy continues to make some headway, while Purchasing Manager surveys point to some slowing, with the Services sector continuing to benefit from the post-Covid rebound for the time being. The flies in the ointment continue to be related to the employment/labor situation. Wages continue to rise due to the inability to find new workers. The unemployment rate ticked down in March to 3.5%, as did the number of job openings.[ix] The Federal Reserve's traditional *modus operandi* is to raise interest rates to slow the economy, forcing employers to trim payrolls, thus quashing aggregate demand and driving the rate of price acceleration (inflation) down.

As we have noted, in large part, the recent surge in inflation stemmed from product shortages related to supply chain interruptions during Covid lockdown. This was aggravated by the fiscal stimulus afforded by the Treasury and fundamental changes in the labor force. Ongoing efforts to drain money from the system, shrinking the Federal Reserve's balance sheet, will eventually have the desired effect on inflation; however, it is not at all clear that the traditional metrics, such as wage growth and unemployment are the appropriate mileposts to gauge effectiveness in a post-Covid world. (*See "In Like a Lion, Out Like a Lamb", our March edition of "Grist from the Mill").*

The present uncertainty weighing on the market is the impending approach of the U.S. debt ceiling is the moisture in today's atmosphere. Without the ability to continue to issue serial debt, there is a risk that the U.S. Treasury may not have sufficient funds on hand to meet maturing obligations. The mere prospect of this becoming a reality is an unmitigated disaster. The U.S. dollar is considered the world's reserve currency (i.e., used for trade globally). Consequently, governments hold excess reserves in U.S Treasury obligations. Any worries that the U.S., may not honor their obligations would create chaos in the global capital markets. <u>Every financial market professional knows this</u>. 2011 provides a helpful illustration as Congress confronted the debt ceiling obstacle. Political wrangling over spending cuts lasted until the 11th hour before the ceiling was raised. That event resulted in the U.S. losing its coveted AAA credit rating.[x] Moreover, running out of money would lead to sequestration – freezing government payments, shutting down non-essential government operations and pulling a huge amount of spending by the government out of the economy. Such an outcome is unlikely given the ramifications it would have. Nevertheless, this is a significant weight hanging over the markets.

To further my analogy, there seems to be a temperature differential obscuring the horizon -the U.S debt ceiling. While challenging to be surrounded by the current "fog" of ambiguity, as long-term investors our focus remains on secular growth trends. Last month, we outlined a number of the advantages the U.S. will leverage going forward; however, until some of the fog lifts, it will be difficult to sustain any momentum. Summarizing briefly:

- The commercial advent of Artificial Intelligence has been likened to the introduction of the iPhone. (While ubiquitous today, the concept was brand new in 2007!)
- Changing demographics will force industry to improve productivity. We are parsing more data in our pursuit of efficiency and will have fewer workers as baby boomers exit the workforce.
    - Deere is a leading technology company, refining the planting, fertilizing and harvesting of crops to improve yields and reduce labor with autonomous machinery. Food never goes out of fashion!

- The evolution to renewable energy is inevitable and the U.S. continues to be a leader in the development of such resources.
    - As Europe discovered rather abruptly when Russia suspended natural gas shipments, the renewable/sustainable energy infrastructure is nowhere near ready to meet the political demands and timetable set forth. Fossil fuel remains a critical element of energy production.
    - The "Green" movement has discouraged incremental capital spending to develop additional capacity in the oil and gas industry
- Infrastructure spending is necessary, both to prepare for the broader application of renewable energy, but also to repair the deteriorated state of existing infrastructure.

Now, if we could just separate the politics from the economic realities, we might find the fog lifting….

All the best,

Jim

James W. Graves
Managing Director

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[i] https://en.wikipedia.org/wiki/Fog#:~:text=Fog%20forms%20when%20the%20difference,are%20suspended%20in%20the%20air.
[ii] Source: TD Ameritrade
[iii] Source: Bloomberg
[iv] Yield data source: Federal Reserve of St. Louis Economic Data
[v] Return data source: Barchart.com
[vi] ibid
[vii] ibid
[viii] ibid
[ix] Source: First Trust "Monday Morning Outlook" 5/1/2023
[x] https://www.reuters.com/article/us-usa-debt-downgrade/united-states-loses-prized-aaa-credit-rating-from-sp-idUSTRE7746VF20110806