FRIDAY, JANUARY 27, 2023

Well, hello and welcome to the Dividend Cafe and forgive me for the casual attire, but I am jumping on an airplane here. It has been a absolutely phenomenal week in New York City I assure you very long suit and tie days, but nevertheless, very productive. Some wonderful meetings and now I'm really looking forward to getting back to California with my family and back in the Newport Beach office all of next week. Today's Dividend Cafe is going to explore this issue about recession. I've written Dividend Cafe is about recession before. One of the things I've had, and I wrote one that was well trafficked last year about the dreaded R word, one of the themes I've had is still very important to me although it's not really where we're going with today, which is the unpredictability of how to apply a portfolio or market call to recessionary dynamics that in other words, if someone did know, and I'm about to make the case that no one most certainly does, if someone did know what exactly was about to take place with the economy. I do not believe that there are portfolio managers and I most certainly do not believe there are regular investors that could take that data and perfectly apply it. That the challenge would still be there as to knowing what has been priced in and knowing certain timing issues, knowing the depths and severities that could be at stake and all of that type of stuff. And just in terms of market response at general, there's a confounding element to markets that applies to currency, to fixed income, to the rate markets, to commodities, to equity prices, to valuations to real estate. So knowing what the macro circumstances are, which is impossible and applying in a portfolio are two different things.

But what I want to talk about is the setup of the market right now, the setup of the kind of sentiment realities and point out that this first month, the first month of 2023, again, we still as I'm recording, have two or three, about two and a half market days left in the month. But so far it's been a positive month and pretty darn good one. There's been a lot of ups and downs, but no, it's been a solid month for risk assets, but who knows where things go. But my point is not so much what markets have done this month to talk about contrasting 2023 so far to 2022. It's not about a market outcome. It is true that after 26 days markets are up and last year markets are down. That's actually my not my point though. My point is that the conversation is not right now about really was driving market pricing last year. Last year the obsession was what's the Fed going to do? How tight are they going to go? Are they going to go tighter? When are they going to stop? And then of course that led to a big evaluation in terms of the inputs that would affect Fed decision making. But right now I believe it's almost universally accepted within a certain bandwidth where the Fed is. Now it is, someone could disagree if a quarter point of the next meeting and then a half a point after that or a quarter point at the next meeting and then done. Quarter point at the next meeting and a quarter point at the meeting after that seems to be futures pricing expectation right now. So that's the most baked in. So you're at 4.25 right now on the Fed Funds Rate and there's outcomes between 4.50 and 5.00 as a terminal, the most prevalent is about 4.75.

Who cares? I mean that the point is people see the Feds stopping in months and there is a group that still says, oh no, they're going to go to six seven. They keep on going, that's fine, but that's not, that's a pretty fringe view. It's not within the consensus, it's not within pricing, it's not within various outcomes in the rate market, the yield curve, Fed funds, futures. So yeah, markets could end up being really, really wrong, but the focus is regardless of the specifics the Fed's about to deposits and therefore it now I get to start Dividend Cafe today. If we're not talking about the specifics of what's going to happen with interest rates in the Fed, then what we're talking about is the outcome from what the Fed has done. In other words, will there be a recession, will there be a soft landing?

How hard of a recession will there be and so forth. And the notion of a economic slowdown perhaps not being as severe as people feared is becoming a growing expectation. I was on stage yesterday at an event in New York with Jason Tr, who's the CEO of Stratus Research and a macro economist I know and think highly of. And he said he put 50% odds on a pretty normal recession 40% on a soft landing and 10% on no recession at all. So that's 50 50 essentially between the kind of better camp and the worst camp that so that I don't want to put odds on it. I just want to show you right now fundamentally why I believe there are pretty darn compelling arguments for recession coming and pretty arguments for why one not, may not come or there's a sort of mitigation against a recession.

The first and foremost argument by the way is not causative. It's not because this has happened. It's going to create a recession. It is predictive and that is the yield curve and we've been talking about forever. The two year and tenure have been inverted. Now for let's see, I believe we're looking at over six months and rather substantially inverted. Right now we're sitting in between 65 and 70 basis points let's call it roughly 4.20 on the two year and roughly 3.50 on the 10 year we've been there for a little bit and that curve has stayed 65 to 70 sloped even if an inverted slope, even if the total rates went from four 50 and three 80 respectively down. So the spread between the two has stayed at that 65 to 70 basis point level, that's significant. That's been a long time of it. And there was a yield curve inversion in 2006 before the '08 recession. There was yield curve inversion 2000 before the '02 recession, but there have been rarely, but nevertheless, there have been yield curves that inverted that did not lead to recession and there have been yield curves that didn't invert and there ended up being recession what we would call both a false positive factor and a false negative factor. So this one I think is screaming that there's a policy error at the Fed and that there's an expectation for a recession coming and I point out again, it is predictive, not causative, and yet other aspects in the Fed market could become PR causative, but they're not there, which would be blowing out credit spreads, widening credit spreads that then because of that illiquidity capital removed from the system widening spread that it means higher borrowing costs for some aspect of leverage finance and the corporate sector or in real estate or what have you. And those things can become recessionary, but they just simply haven't happened yet.

Now number two I think is the purchasing manager's index, the PMI that we refer to either in manufacturing or in services, and they both now for some time have been pointing to declining business activity and the manufacturing side was there longer. The services side is catching up to the downside and that negative push in the PMI is often fundamentally foreshadowed a recession. The third is industrial production. And again, I talk about PMI and IP, the Industrial Production because I think it is far more significant than consumer and retail activity for reasons I've talked about a lot. You don't need to worry about American's appetite to shop. They love spending money you have to worry about their capacity to do so, meaning access to credit and income. And the fact of the matter is that industrial production, which is a index looking at more production oriented and less consumption oriented activities for manufacturing to mining the utilities that it had a significant drop in December and it had been trending up post covid in reversed. It hasn't been a long drop and there's a chart of this at dividendcafe.com. I think it's significant. And so I would encourage you to look at those three things, yield curve, ISM and industrial production as pretty compelling cases for a recession to come.

But then the other side of this, and you go, okay, well hold on, what are you doing here? Harry Truman's economist because he's tired of hearing on one hand. And on the other hand, I do this as intellectual honesty. I do this because objective presentation of data is the burden of a financially serious person. You do not ignore data because it goes against the narrative of other data. And I will tell you that the employment data remains a real challenge for those that are headstrong. Sure of a recession coming, I totally understand it could change, but a three and a half percent unemployment rate, a 10 and a half million unfilled job level, there are 10 and a half. Another way of saying it is 10 and a half million job openings and wages that have increased, not decreased weekly initial jobless claims that have come down over the last several months. They're not only at a high level, they're lower level as the Feds been tightening there, even in the face of a lot of announced high profile technology layoffs, the labor data doesn't support a recession thesis yet. It can change obviously, but right now that has to be taken into account. One data point that you say, okay, maybe there's a crack in the armor here is hours worked. Average hourly average hours worked have come down a tiny bit in the last two months. That could be foreshadowing de mors coming. It hasn't moved much and it's been more recent, but that's something we'll keep an eye on. Number two though, I think is the household debt levels. We were at 115% of household debt to disposable income as a ratio going in the financial crisis recession, it's down to about 90% now. I'd rather it be at 60 or 70. I still think it's high for a macroeconomic read, but it has. It's a lot lower 25% reduction from one 15 to 90. It gives more buffer to the ability of households to withstand certain recessionary or contractionary conditions.

The third is that housing has often been associated with recession activities, both the recession in 1990 and obviously the great financial crisis of 2008 and a lot of people relying on extracting equity from their homes and that dried up and a lot of people that then took a hit to their ability in the economy because they adjustable rate mortgages. And so as rates went higher, it impacted their monthly disposable income. However, we were at something like 35% of people in 2008 with our adjustable rate mortgages and we're at 6% in the last couple years. And so there's a much lower risk level of people that are already owners of homes all of a sudden having effectively a pay cut as a home payment rises. Now for new home buyers rates are higher and therefore they're going to buy at this level. They're going to have a bigger chunk of monthly income go to the payment.

But of course that through time gets mitigated by lower prices as I wrote about and talked about in my housing issue last week. But the adjustable rate reality, the household debt reality and the job dynamic are all compelling arguments either for a very soft type situation or no recession at all. Corporate debt by the way, is in this kind of none of the above category because on one hand the amount of debt service as a percentage of operating income is still very low. And a lot of those, because companies did obtain very favorable rates. And so even though rates have gone up, they were already locked into a better rate scenario and the denominator operating income has gone up a lot. Now look, operating income can start coming down if you get weakening economic conditions and the cost of debt service can go up if some of those rates do start to reset, there is certainly a lot of floating rate out there but for now, you still have a favorable debt ratio in the corporate sector, but there is high levels of corporate debt. Absolute dollar levels of debt are very high. So I just see that as sort of in kind of no man's land, a sort of purgatory input to our recession evaluation. So this is how I'm going to conclude with a conclusion, what I'm calling the perfect call. The perfect call is that nobody knows and you say, come on, I've listened to this for that, but let me elaborate.

It is very destructive for someone to tell you that there will be one in the face of the three counterpoints, and it's very destructive to say there will not be one in the face of the three arguments that I made earlier. And if one has all six facts on the table, they can then go to an inkling and I have an inkling that there will be a recession and I have anecdotal support that it will be a mild one, but there is no way I'm going to present that to people that I have a fiduciary duty to as actionable. The various compelling tug of war of economic data right now is real. And I have no agenda for there to be one or not be one. There's political agendas that are out there. There are business model agendas I've written before about these permanent bear people. This is just simply not where you want to be getting advice from.

I am all four people looking objectively at all the data and leaning heavier for one side over the other as long as it's done with that type of intellectual honesty that I'm trying to present. But the perfect call here is that I don't know and neither does anybody else, and that your portfolio should not care. It should not matter that if there is a financial objective one has in their life and there ends up being a recession or not being a recession, one's portfolio should not have something happen to it. That disarms the financial objective, that undermines and threatens the financial goal. So a portfolio that is bullet proof in terms of goal achievement from the way this plays out in recession is the way someone has to be. And a lot of people are not aligned that way. We work tirelessly to do that, and that's what we're going to continue to do. And I believe that's the perfect call around the 2023 ambiguity of a recession. I'm going to leave it there. I would encourage you to look at the charts at dividendcafe.com. I'd encourage you to reach out with any questions you may have, and we look forward to coming back to you again next week with a really wonderful DC Today on Monday. Thank you for listening to watching and reading the Dividend Cafe.
