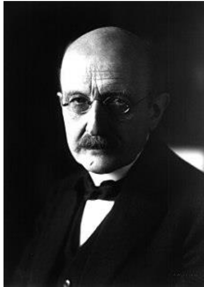
Knightsbridge
WEALTH MANAGEMENT

October 11th, 2022

Fall Quarterly Commentary



"A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it."

Max Planck (1858-1947)
Physicist, Nobel Laureate

The stock market showed signs of life early in the third quarter, as interest rates eased and investors anticipated signs of slowing inflation. This soon gave way to economic reports which continued to run inflationary. You learn in Macroeconomics 101 that when inflation is high, central banks must hike interest rates. As summer gave way to fall, rates resumed their uptrend and both stocks and bonds swooned in response. The quarter ended with the S&P 500 Index down 24% for the year, and the benchmark U.S. Aggregate bond index down 15% over the same period. Even our Managed Income strategy, which emphasizes downside protection, is down, although its single digit year-to-date loss outshines most other investment returns.

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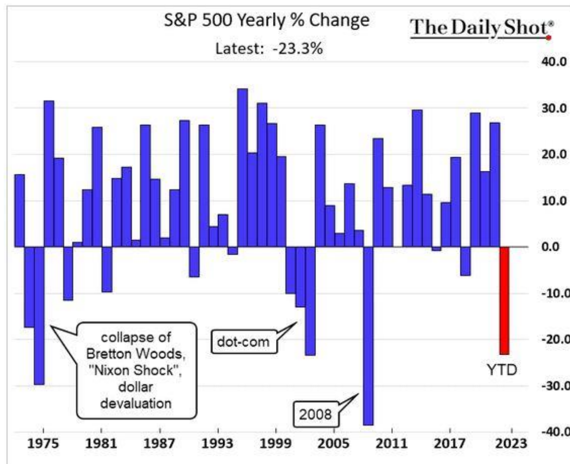
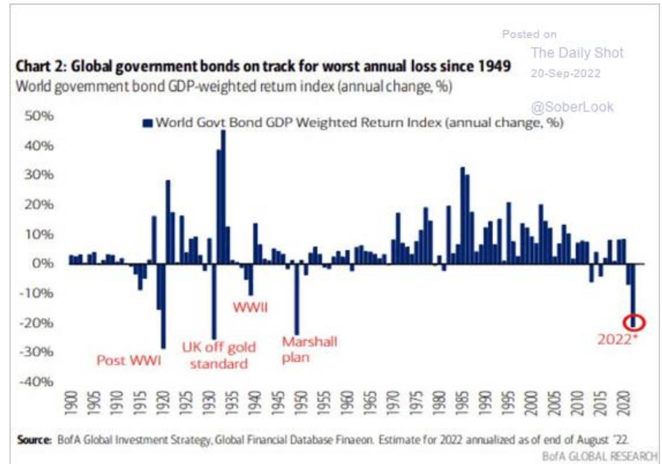
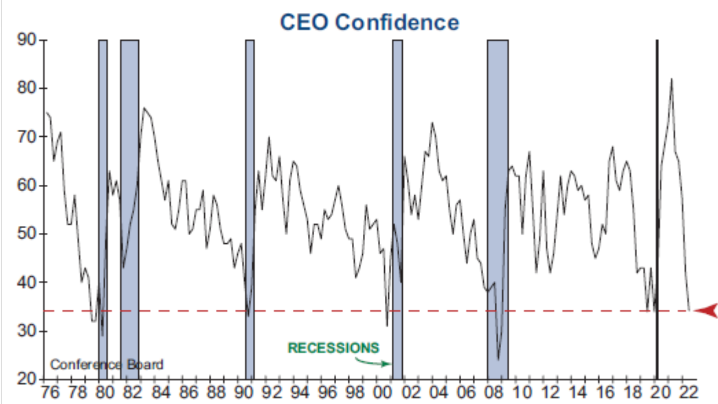
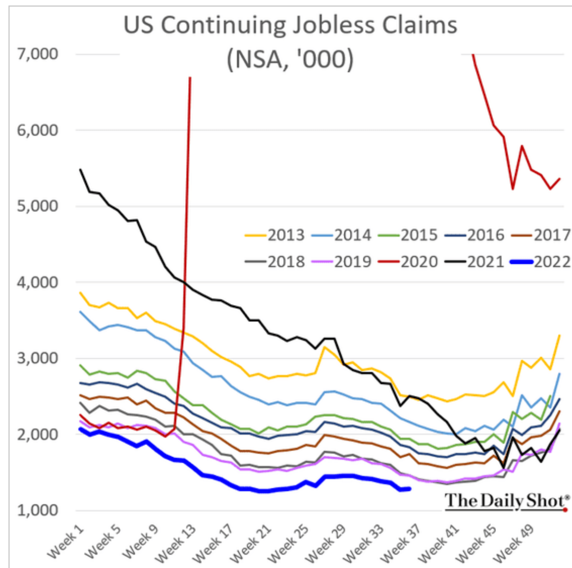




Not surprisingly, these terrible markets have been accompanied by extremely negative economic sentiment. CEO confidence levels are consistent with past recessions and amazingly, consumers feel worse than when the entire economy was shut down during COVID and during the depths of the Great Recession.

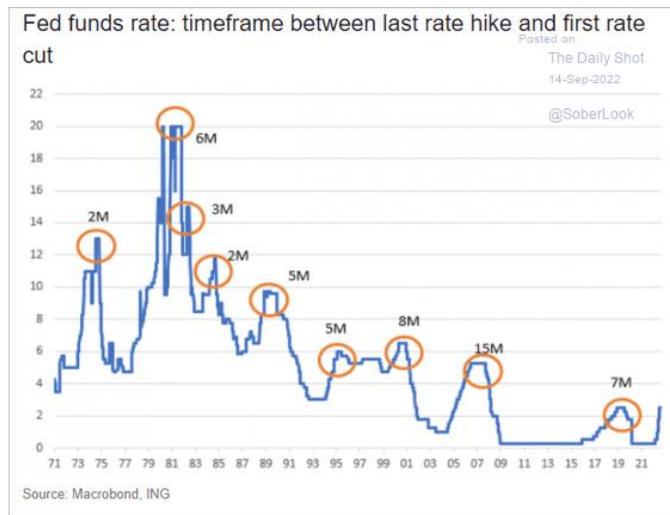


This is particularly striking because by some measures the economy is quite strong. Continuing jobless claims (unemployed people) are at decade lows and the unemployment rate just *dropped* to match a half-century low at 3.5%. People have money to spend and most who want jobs can find them.



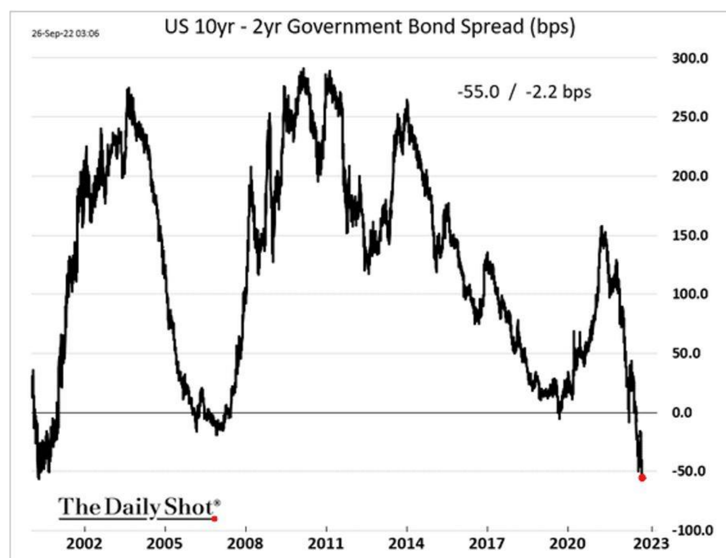
It's no secret why people feel so dreary about the economy: inflation. It's also no secret why markets are so dreary: the Fed's reaction to said inflation. The Federal Reserve is likely to raise rates[1] past the point of tipping us into a recession. Theoretically, this doesn't have to be the case; supposedly the Fed could hike interest rates fast enough and high enough to stop inflation, but not so fast or high that it causes a recession. However, there are a few reasons to doubt that the Fed's interest rate hiking program will please Goldilocks on the first try.

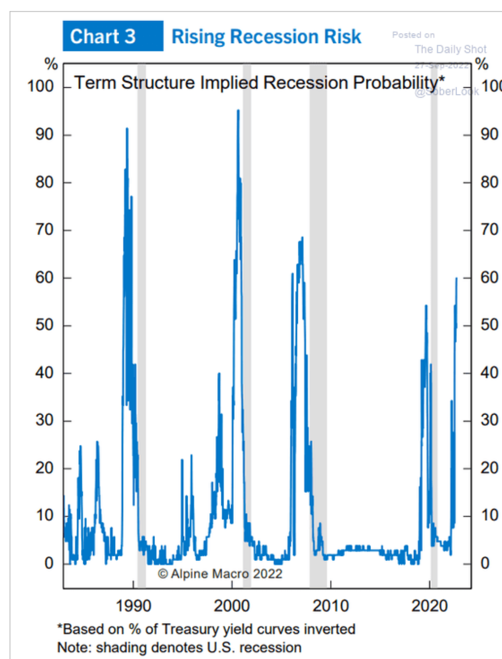
As you can see from the below graph, the history of the Federal Reserve finding the perfect rate and then leaving it there isn't great. Usually, they overdo it and are forced to quickly lower rates to clean up the mess they created.



[1] Readers should be reminded that the Federal Reserve isn't just raising rates. It's doing reverse money printing (money vaporization?) by selling bonds to the tune of up to $95 billion dollars a month.

The stock market is a leading indicator and its decline points toward recession. The yield curve is also inverted, with 2-year Treasuries yielding more than 10-year Treasuries, an unusual condition which often augurs recession.





It seems the Fed is virtually certain to hike us into a recession given two things:

1. U.S. economic growth has already come to a halt and monetary policy works with a one-year lag. If rates are raised today, those higher rates will still be working their economy-slowing magic a year from now.

2. Shelter inflation, which makes up about one-third of the Consumer Price Index (CPI), shows up in official reports with a one-and-a-half-year lag[2]. Remember in late 2020 and 2021 how housing prices soared but inflation remained subdued? The jump in home prices didn't start hitting broader CPI until 2021-22. That means even if inflation (including housing inflation) completely stopped today[3], CPI would continue showing large increases for some time due to the lag[4].

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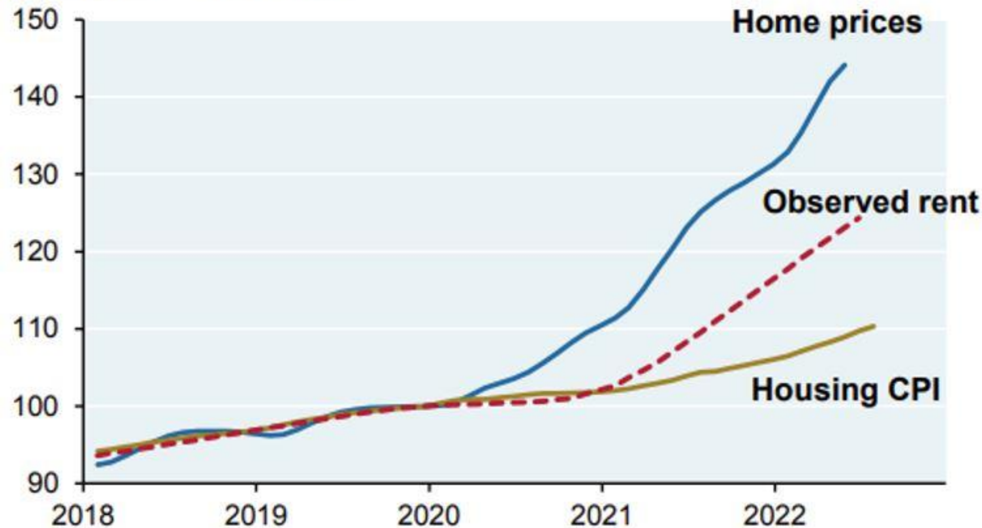
[2] According to a recent paper by the Dallas Fed. https://www.dallasfed.org/research/economics/2022/0816

[3] Real estate company CoStar recently reported that asking rents fell 0.1% nationally in August. If these declines were to continue, it would be a year and a half before they are fully reflected in CPI.

[4] CPI lags conditions on the ground for a few reasons. Firstly, when rent starts going up, most people don't pay more until their previous lease expires. CPI



Taking these two facts together and putting it another way, if the Fed wanted to avoid hiking interest rates too high, it would need to stop hiking *before* the inflation rate receded.

Unfortunately, the Federal Reserve is unlikely to stop raising interest rates until actually seeing inflation coming down. Right or wrong, the Federal Reserve has indicated it sees the risk of not hiking enough as much greater than hiking too much. This means it won't stop until seeing substantial progress, by which point it will likely already be too late.

In fact, despite nearly every leading indicator now showing inflation is set to decline (see charts below), the futures market is pricing in a greater than 90% chance the Fed raises rates 0.75% in November, its fourth straight increase of that magnitude. This is despite nearly every leading indicator now showing inflation is going to decline.

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measures what most people are paying now, not what is happening with new leases. Secondly, the Bureau of Labor Statistics, which maintains the Consumer Price Index (CPI), only goes out and samples rents every six months. When they do find an increase, they don't reflect it immediately, but rather slowly phase it into their statistics over six months when they take their next measurement. Put these factors together and you get a substantial lag in the shelter inflation being reflected in CPI.

US 10yr Breakeven Rate
2.18% / -14.2 bps
The Daily Shot
US 5yr Breakeven Rate
2.23% / -17.6 bps
The Daily Shot

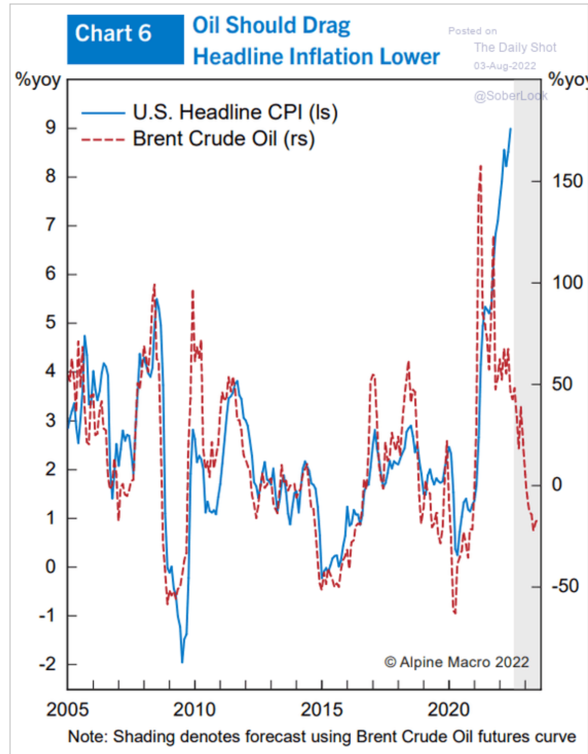
Chart 6
Oil Should Drag Headline Inflation Lower
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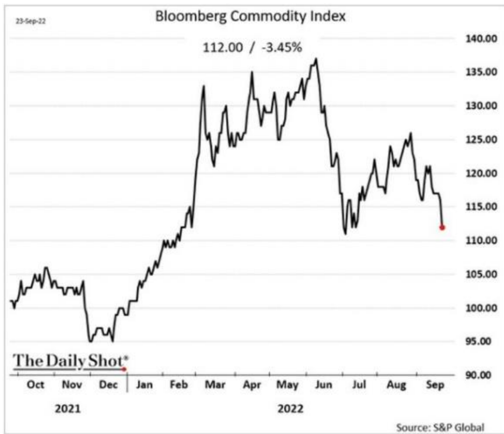
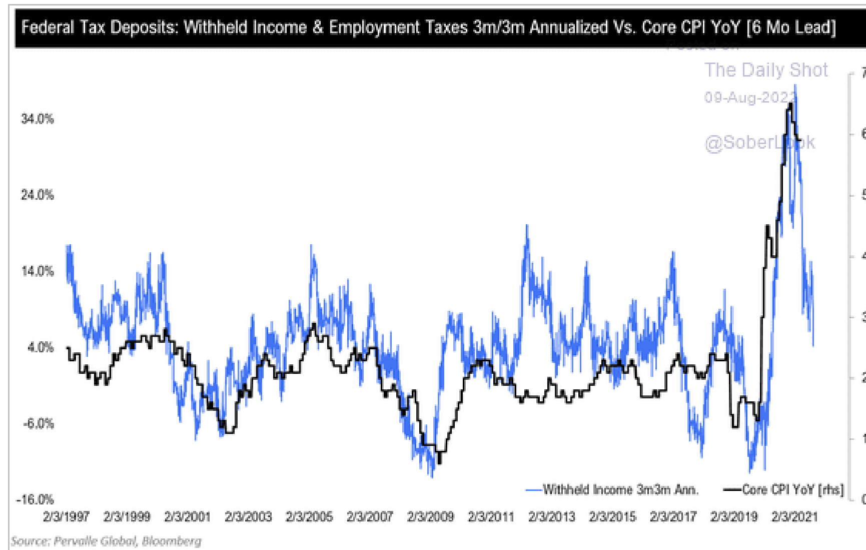
U.S. Headline CPI (ls)
Brent Crude Oil (rs)
© Alpine Macro 2022
Note: Shading denotes forecast using Brent Crude Oil futures curve

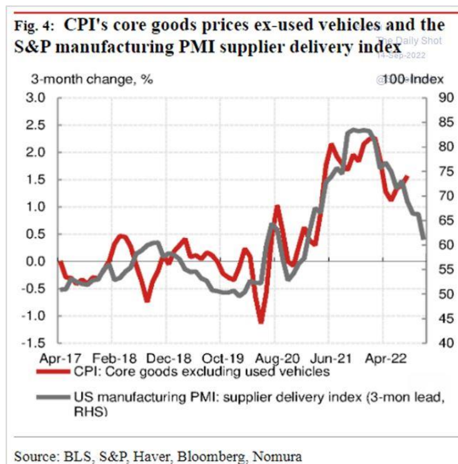

Bloomberg Commodity Index
112.00 / -3.45%
The Daily Shot
Source: S&P Global

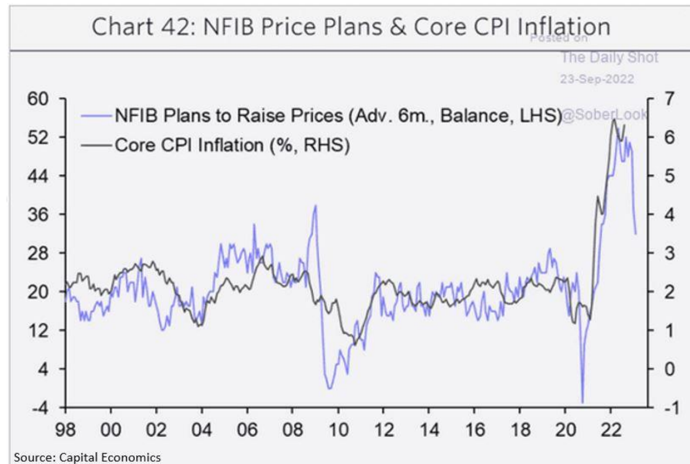
WCI Shanghai to Los Angeles Container Freight Benchmark Rate ($/40 ft Box)
Latest: 3,283.00
The Daily Shot

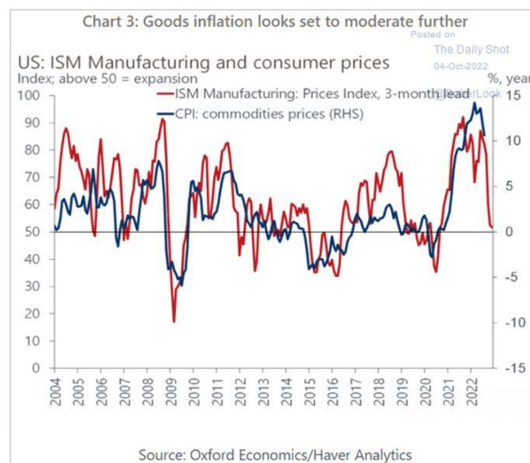

Federal Tax Deposits: Withheld Income & Employment Taxes 3m/3m Annualized Vs. Core CPI YoY [6 Mo Lead]
Withheld Income 3m3m Ann.
Core CPI YoY [rhs]
Source: Pervalle Global, Bloomberg

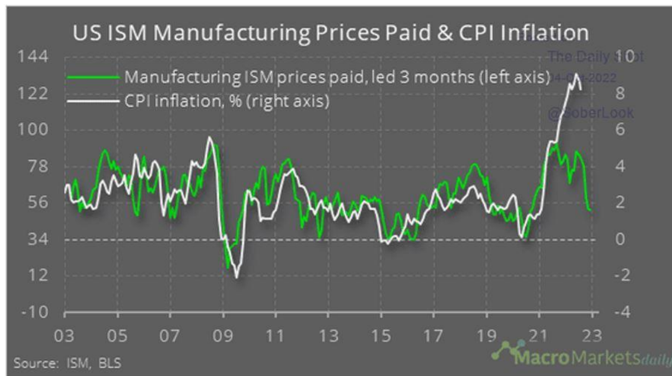
In addition to these measures, there is a bevy of declining survey data, all of which have a long history of leading inflation. They include:

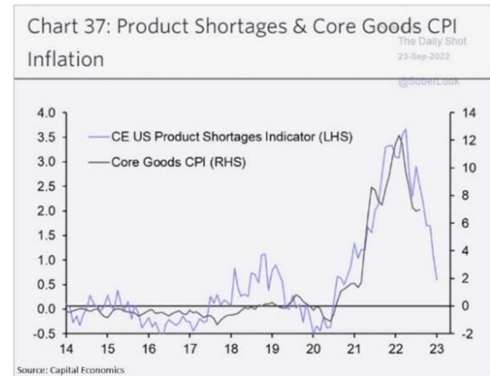
- S&P's Manufacturing Purchasing Manager Index (PMI) Supplier Delivery Index
- National Federation of Independent Businesses (NFIB) Plans to Raise Prices Index
- Institute for Supply Management (ISM) Manufacturing and Consumer Prices index
- ISM's Services and Consumer Prices Index
- ISM's Manufacturing Prices Paid Index
- Capital Economics US Product Shortages Indicator







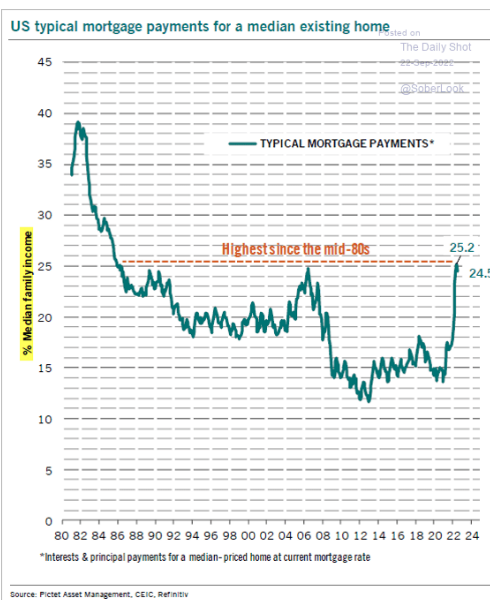




Suffice it to say, if the Fed is looking at where prices are, as opposed to where they're headed, it will over-tighten and cause a recession.

Prices in publicly traded markets, such as the stock market, react very quickly to what is expected to happen. Real estate, on the other hand, is a private market where prices move slower. We do not expect this asset class will be immune to higher interest rates, especially since real estate is almost always financed with debt.

Unfortunately for prospective home buyers, mortgage rates just hit 6.7%, the highest level since 2008. The result of these higher rates on already sky-high prices is that the typical mortgage payment represents the highest percentage of median family income since the mid-80s[5].

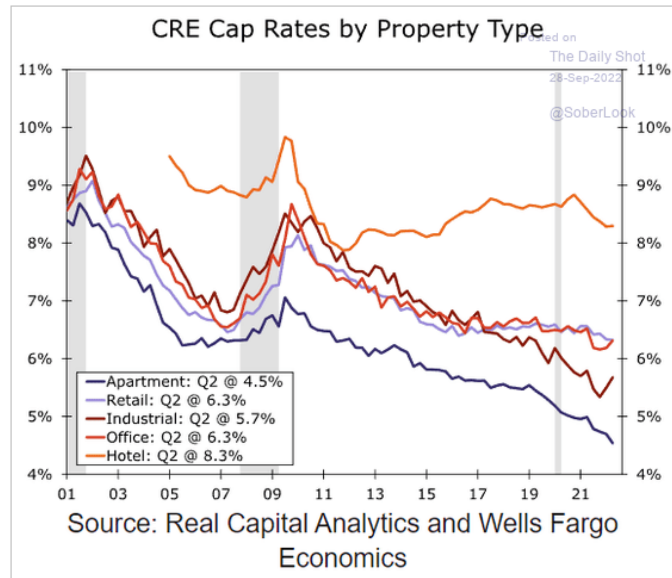


[5] The typical mortgage payment is arrived at by applying the current borrowing rate to the median U.S. home price.

The below chart of the national Case-Shiller Home Price Index and interest rates (shown upside down) implies a 12% reduction in national home prices. Perhaps this move has already begun. For the month of August, real estate company Zillow reported the first month on month decline in home values (-0.3%) in a decade.

Turning to commercial real estate, valuation is often expressed in cap rates, which is what a property earns (before the cost of debt service) divided by its purchase price. If a property earns four percent of its purchase price every year before debt service, it simply doesn't pencil out to buy that property with a mortgage that costs six percent.

In the previous decade, this calculus was moving in the opposite, beneficial direction. As debt became cheaper, real estate investors were able to pay more and more for the same property, pushing cap rates down (i.e. the price paid on a building per unit of earning moved higher and higher). Now that interest rates are rising, this process is reversing.



Because the world transacts in dollars, the financial damage from higher U.S. dollar interest rates won't be limited to our borders. Higher rates boost the value of the dollar, which wreaks havoc on anyone who needs to buy stuff in dollars (everyone) or who has dollar denominated debt (emerging market governments).

In general, when rates rise this quickly, and the dollar is this strong, things start to break.

Trillions of dollars of emerging market debt will need to be paid back in now more expensive dollars. We are seeing financial cracks which could fissure into an emerging market sovereign bond crisis. Interest rates on government bonds in Ghana and Pakistan recently hit 35% and 40% respectively. Four emerging market countries have defaulted on their debt so far this year. Ten others are classified as being in "severe stress" by S&P Global Ratings.

The Bank of England recently had to intervene in the U.K. debt market, buying long-term bonds to keep interest rates from skyrocketing and blowing up their massive pension funds. Nearly 30% of Chinese property developer loans aren't making their scheduled interest rate payments. Last week, it was rumored that major international bank Credit Suisse was teetering on the brink. While the last bit turned out to be just a rumor (for now), it is clear things are starting to break, and higher interest rates in the U.S. and abroad are the primary culprit.

After all this discussion on the destruction caused by interest rates, we feel compelled to take a moment to comment on monetary policy in general. Why is it central banks all do this raising rates thing again? Ah, yes, to fight inflation. Economics 101. It's what you do.

Readers of our last letter will recall that inflation is a rise in the ratio of an economy's spending compared to its capacity to produce. The Federal Reserve raises interest rates so that it is more expensive to buy things which are typically financed: houses and all things real estate, cars, and large projects like factories and roads. This brings down spending... in those industries.

Thus, the Federal Reserve seeks to balance spending across the entire economy on the backs of a few interest-rate sensitive industries. A little crazy, isn't it? Groceries are too expensive, and the solution is to put a bunch of construction workers out of a job.

The central bank playbook for the monetary cycle of high inflation → raise interest rates, and economic trouble / low inflation → lower interest rates, is so ingrained that while people constantly debate whether rates should be raised or lowered, seemingly no one ever stops to question whether this is the right approach in the first place. Doing anything else is simply unthinkable.

While a different approach might be unthinkable, it is not undoable. If the goal is to keep the spending / capacity to produce ratio stable, one can imagine much faster, more direct ways a central bank could influence spending than the very roundabout way of finessing some arcane interest rate up and down... an action which, by the way, results in substantial collateral damage such as bankrupting emerging market governments.

When economic output and inflation are low, could the government not increase spending by simply giving people money? How much faster, more equitable, and more targetable would that be? Conversely, the rational thing to do in a time of high inflation, like now, would be to reduce spending by removing money from the system[6]. Wouldn't that be a better, more direct way to reduce spending[7]?

The Federal Reserve didn't begin to operate until 1914 and the idea of fiddling with interest rates to manage the economy came even later. This practice has indeed helped tame the business boom-bust cycle somewhat. But this monetary policy technique was developed by humans, and anything

[6] You can imagine many schemes to accomplish this, with one being to apply a tax which flows directly to the Federal Reserve.

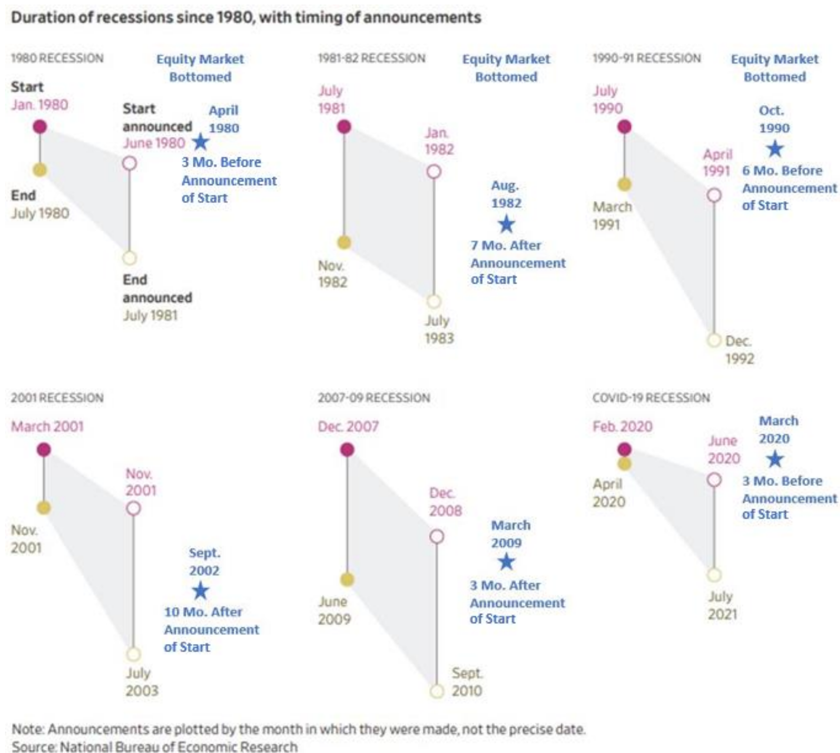
[7] One might question whether a government body could be responsible enough to use such a money-distributing-and-removing-policy responsibly, but the truth is they're already doing it. Central banks lower interest rates by buying short-term government debt instruments which yield more than the desired rate. They (usually) raise rates by taking the reverse action. In any case, whether a method works, and whether it can be responsibly handled, are two different things.

manmade can be improved upon. If we can go to the moon and put access to the sum total of all human knowledge in our pockets, then surely we can engineer better methods to manage inflation and tame the business cycle. But first we must question the dominant paradigm.

None of the above musings factor into our investment decision making; we must take the world as it is, not how we might wish it to be.

We've painted a pretty bleak picture of all the damage interest rates are doing to financial assets. Is all investment hope lost? Not so fast. There's a good case to be made for an improving investment landscape. In our estimation, it seems highly likely inflation will be whipped, one way or another. And when the Federal Reserve breaks things by raising rates too high, they'll end up lowering them again[8].

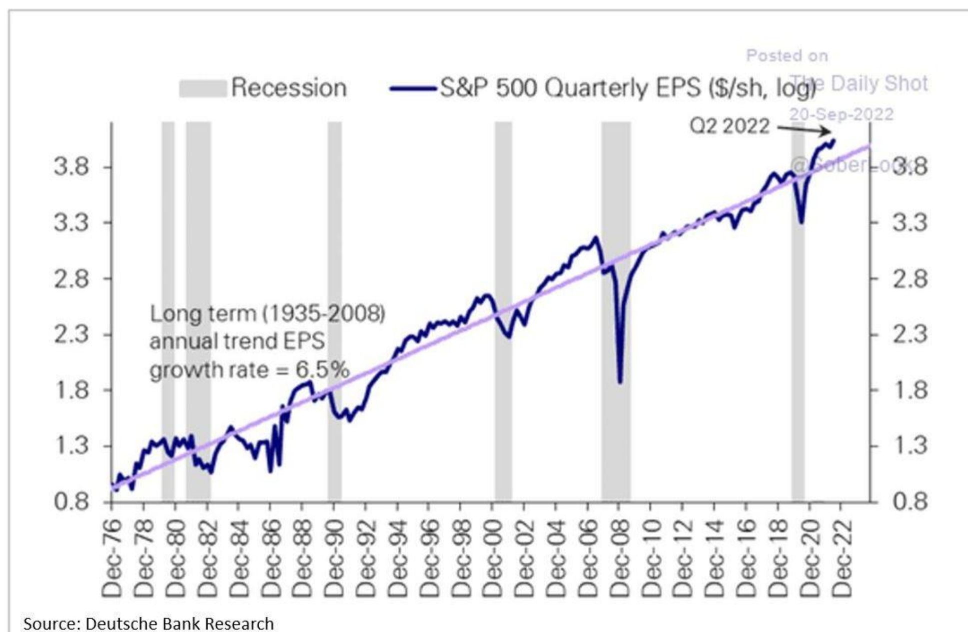
It is also important to keep in mind the fact that equity markets look ahead. This year's 24% decline and nine-month long bear market are already consistent with a moderate recession[9]. The following chart highlights the fact that the beginning and end of a recession are announced retrospectively, with the stock market often bottoming before the *start* of a recession is even announced.



[8] The Bank of England's recent intervention in its debt market, for example.

[9] There are a number of reasons to believe a recession would be a moderate one. Chief among these reasons would be that households and companies have a lot of cash on their balance sheets, banks are much more conservatively regulated, and rising home prices have left most homeowners with a lot of equity in their homes, making foreclosures less likely.

The current pullback may very well get worse before it gets better, but there is a reason the stock market has historically delivered solid returns over longer periods of time. That is because corporate earnings, which underpin the value of stocks, have climbed steadily higher. We see little to imperil that long established trend. It is in times like these that we must remember this long-term perspective.



Thank you for the continued trust you place in us as we endeavor to steward your assets alongside our own through these treacherous waters.

Sincerely,

John G. Prichard

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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