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By the Way

Monthly commentary from Jack Way

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"inflation is still too high for the market to break out… but growth is too resilient for the market to breakdown."

The S&P 500 continued to trade in a range around the 4,000 level until last week when Congress passed the debt ceiling deal, the FED seemed prepared to not raise rates at the June meeting, and the May jobs report beat expectations by a wide margin. I remain sceptical of the durability of the breakout given several headwinds facing the market going forward, but remain mindful that fighting the tape is often an expensive exercise. Market breadth has been awful. Bull markets feature wide-spread strength across many sectors, but 2023 has displayed just the opposite. The S&P 500 is up 11.2%, but an equally weighted 500 is only 1.5% higher. Over 100% of this year's gains came from the top ten weighted stocks in the Index, and less than half of the S&P constituents are trading above their 200-day moving average. Such narrow leadership has historically led to lower prices. There is also likely to be a withdrawal of liquidity in the economy. Excess liquidity has been the fuel for many of the strong markets over the last decade plus. The U.S. debt ceiling was actually reached in January of this year, which meant the Treasury Department has not had the ability to issue bonds since then and has been paying its bills out of the General Account to the tune of $400+ billion. Actually the U.S. could have continued to cover the costs of Social Security, Medicare, defense and interest payments from cash flow even when technically in default. Not pretty, in fact ugly, but doable. Now that the debt ceiling deal has been signed, Treasury will begin to issue debt again to refill the coffers, which will compete for the capital in the system available for stocks. This is not to forget the many other negative factors such as a possible recession, FED tightening, high valuations, bank stresses etc. Until we have more clarity on the economy, more consolidation seems appropriate to me. I agree with the guy who recently wrote; "inflation is still too high for the market to break out… but growth is too resilient for the market to breakdown." However, at least in the short term, it is important to remember "the stock market is not the economy". (There, I've covered all the bases.)

You can pick your poison as mixed releases come out, depending on your preferred outlook. The New Orders survey of the PMI dropped to 42 indicating a contracting economy, but new jobs last month came in at 339,000 much higher than the 180,000 consensus estimate. Leading economic indicators continue to decline, but 2nd quarter GDP estimates are back over 2% and the China reopening, which was hoped to spur global growth has proved disappointing. U.S. inflation as measured by the CPI has declined from over 9% to 5% in the last 10 months, but it is nowhere close to allowing the FED to reverse its efforts to slow the economy. Speeches from FED members indicate a divided board on the direction of future actions. It's difficult enough for we layman (layperson?) to predict policy but much worse when there is little agreement within the FED itself. Current debate on Wall Street centers around whether the June meeting will produce a "pause" in the rate increases; or will it be merely a "skip" with an increase in July.

The smart economists at Strategas (not an oxymoron in this case) have given us something else to worry about. They point out that the FED consistently tells us it is "data dependent". The problem is that economic data is prone to error, misinterpretation, and revision. They cited as an example, U.S. 1st quarter unit labor costs which were revised sharply lower sometime after the original release. As an integral part of everyone's concern about so-called "sticky inflation", it changed the outlook dramatically. If the FED was to act on data that was unclear, or even not correct at an important juncture, it could prove painful.

Despite the debt ceiling deal including decreases in some U.S. government expenditures, I don't see a future with meaningful reductions in the levels of outstanding debt and deficits. Given the debt ceiling deal included suspending the ceiling until after the 2024 election, there is little to discourage more spending. Politicians get into office by spending for their constituents and

they will continue to do so. We haven't talked about Modern Monetary Theory in quite awhile. If you remember it is based on the belief that a country can print all the money needed to grow without fear of deficits or debt until an increase in inflation causes a change in behaviour. The Progressive wing of the Democratic party was particularly vociferous in support of the theory during the spending part but has gone quiet now that inflation has arrived, and austerity should be policy. (I'm not waiting for Republicans to lead the charge either.)

Two months ago, I added a paragraph to this letter about the significance of artificial intelligence (AI). To be honest it was more of an effort to fill up space, although totally sincere. It has turned out to have been perfect, if accidental timing. Nothing has captured the news and imagination in the last two months like AI. As an illustration, NVIDIA, the world's most valuable producer of chips and AI platforms, recently updated its revenue guidance for the quarter ending July to a staggering $11B versus Wall Street consensus of $7.2B.

The Economist magazine had an interesting article about migration into developed countries and its potential impact: Last year 1.2 million people moved to Britain; 1.4 million (net) to the U.S., a third more than pre-pandemic; Canada was at 2x the previous record. How will these countries deal with a foreign-born population rising faster than at any time in history? Jason Trennert wrote that New York City, which is losing residents and tax revenue at a rapid rate, has taken over a closed 1,000 room hotel in mid-town Manhattan and will pay $200 per room per night for an "asylum seeker arrival center". It's hard to argue with the altruism, but it's still an economic concern.

Finally, like my short mention in March on artificial intelligence, here is another uncertainty that bothers me. For years people have been questioning the supremacy of the U.S. dollar as the world's reserve currency. I have always dismissed that theory, but not as much anymore. More and more countries are concerned about U.S. support politically, economically, and even militarily and are prepared to seek relationships with other countries particularly China, including making use of the Yuan in trade.

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