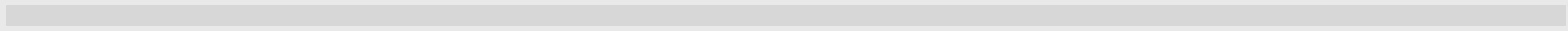
equi

Quarterly Outlook



Q4–2023

Dear Clients

In our previous quarterly outlook, we shared several leading economic indicators that led us to believe that a recession was imminent. Since then, several notable events have transpired, strengthening the confidence that we have in what was viewed as a contrarian position.

First, we sent a communication on July 25, 2023 stating that we believed the economy to be at a local peak, characteristic of the period leading up to a recession. Since then, it appears that the S&P 500 has undergone a steady decline which we expect to continue through the end of the year. The broad stock indices, like the Russell 2000 and Dow Jones, have seen Q3 2023 gains wiped out, entering negative territory.

On August 1st, Fitch Ratings downgraded US debt from AAA to AA+, signaling its concerns regarding "expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance."

Employment data for 2023 has been on a downward trajectory, marked by recurring downward revisions in monthly figures.

Consumers continue to max out their credit cards and accrue debt as they attempt to maintain living standards amidst persistently high inflation.

Additionally, we have entered a period of global instability with the ongoing Russia-Ukraine conflict and the recent terrorist attacks against Israel by Hamas.

We are living in particularly turbulent times, and our team is paying increased attention to the many variables that can potentially put our investors at risk. We believe that Equi's mission of providing stability during times of market uncertainty is particularly relevant now, and we continue to be grateful for the trust that you place in us.

Itay Vinik

Chief Investment Officer

Tip of the Iceberg

Last quarter, we witnessed stubbornly high consumer spending despite indicators of an upcoming recession. However, business owners expressed negative sentiment in the form of drastically reduced inventory in anticipation of reduced spending by customers.

We are beginning to see consumers express financial strain in the face of high inflation as more households take on credit card debt and move towards renting rather than purchasing new homes. We believe that these are just early signs of the coming recession.

We anticipate a significant strain on consumers and households in Q4 of 2023 driven by the following factors:

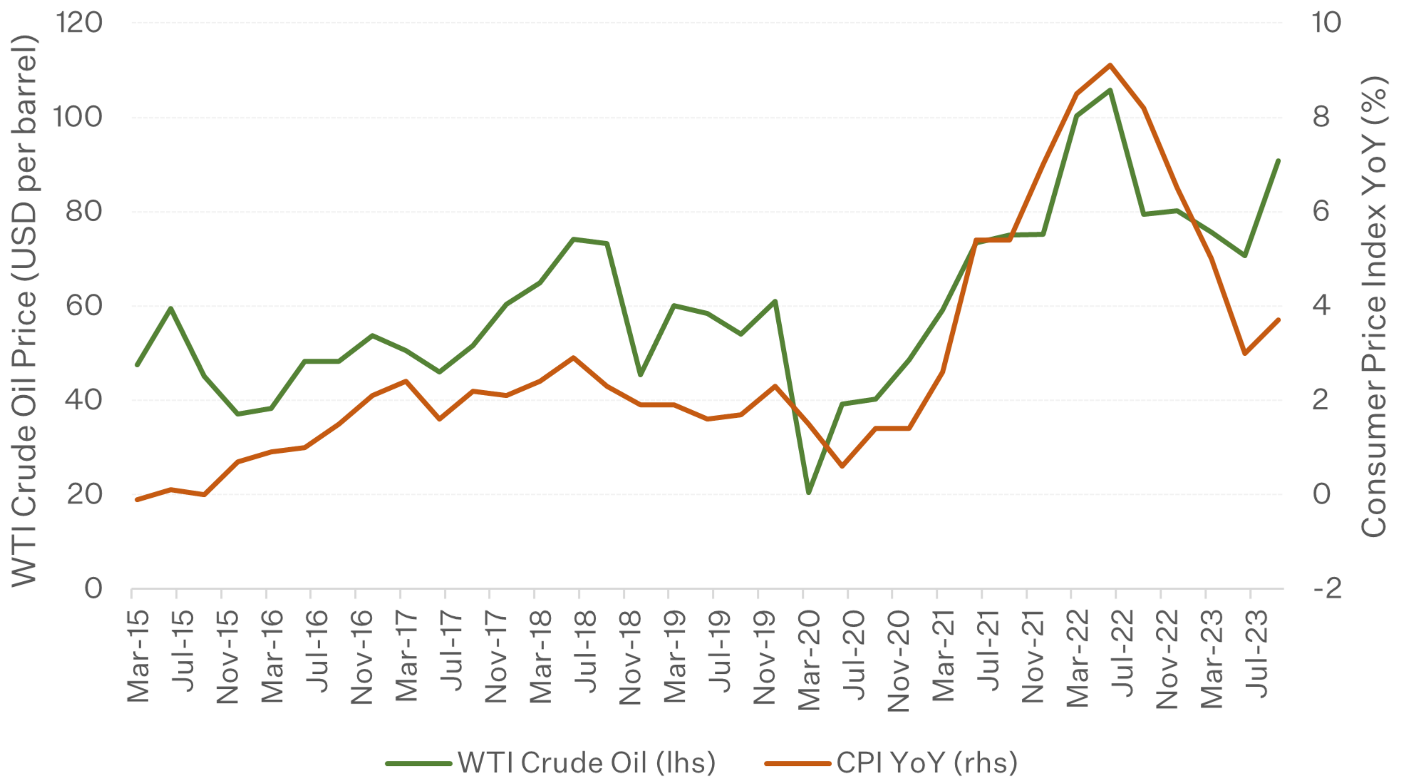
1. High inflation, exacerbated by high oil prices
2. Turbulence in the housing market
3. Depletion of household savings and surge in interest payments

Inflation Likely to Persist in the Midst of Oil Shock

In September 2023, the OPEC+ alliance, comprising 23 oil-exporting nations dictating global crude oil supply, stood firm in their commitment to curtail oil production until 2024. This unwavering stance triggered a surge in crude prices, soaring from July's $70 per barrel to a noteworthy $90 per barrel in September.

The prevailing geopolitical tensions, exemplified by the protracted Russia-Ukraine war and the Israel-Palestine conflict, are poised to sustain the heightened oil prices over an extended duration.

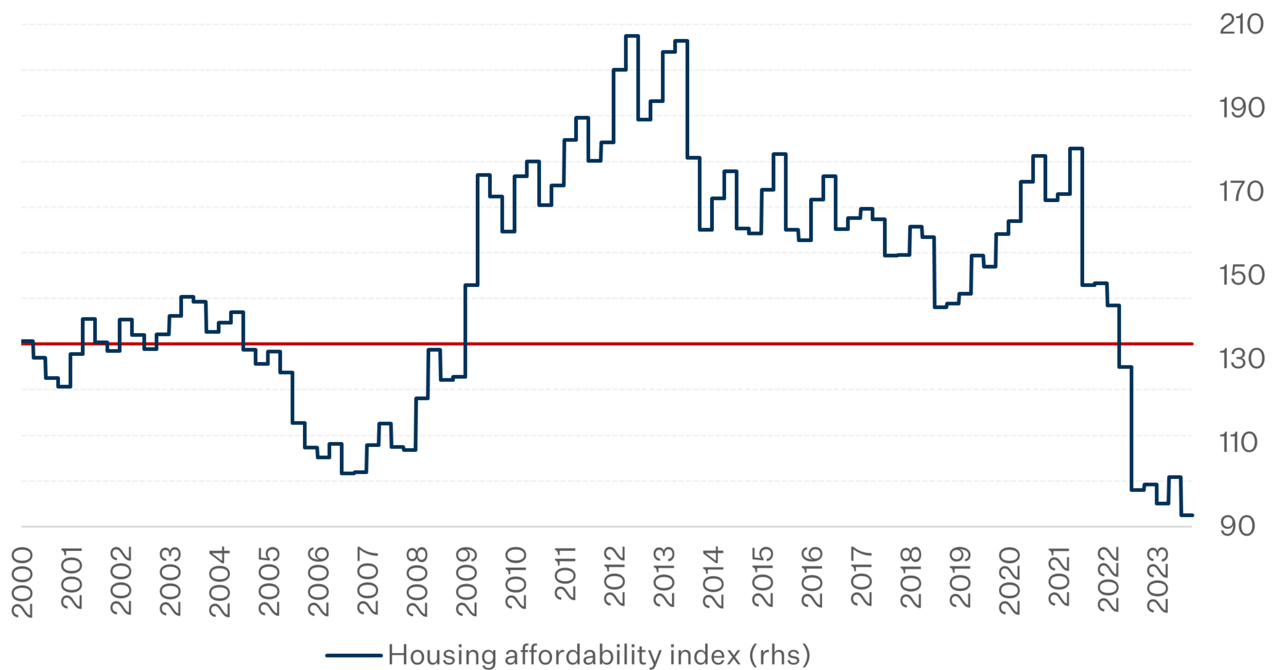
Given the pivotal role of oil prices as a key driver of inflation, our projections indicate that the US inflation is unlikely to decrease before the end of the year.



Turbulence in the Housing Market

Due to homebuyers seizing historically low mortgage rates amid the Covid-19 pandemic and subsequently holding onto their properties, the US housing market is grappling with a severe shortage of inventory, propelling home prices to unprecedented highs. This phenomenon is reflected in the housing affordability index, which has plummeted to its lowest point in history, surpassing even the levels observed prior to the housing bubble in 2006.

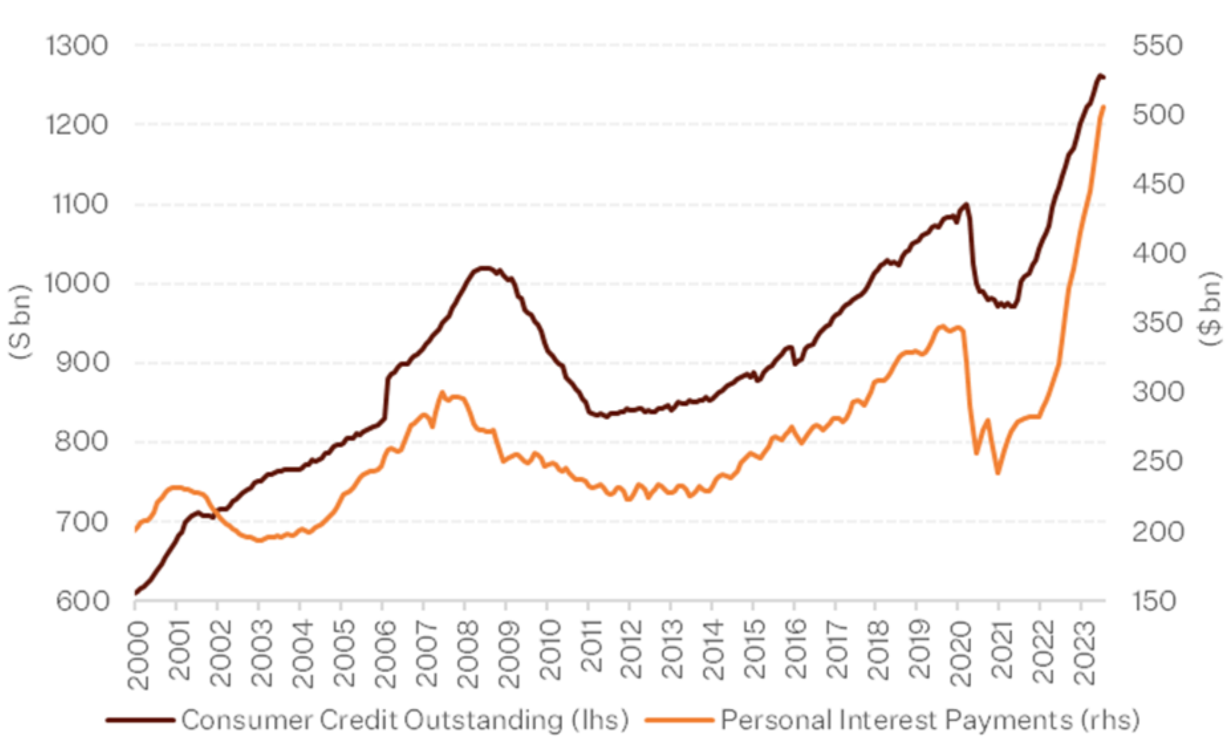
The combination of soaring home prices and prevailing high-interest rates has also triggered a substantial surge in rental costs as individuals turn to renting instead. The exorbitant expense associated with securing shelter contributes significantly to the upward pressure on inflation, making it resistant to a downward trend as the year draws to a close.



Depletion of Savings

With inflation remaining stubbornly above 3%, driven by surging energy and shelter costs, consumers are resorting to maxing out loans and credit cards to navigate the financial strain. As the Fed raises interest rates in an effort to rein in inflation, this decision concurrently triggers a surge in interest payments, placing additional strain on consumers' disposable incomes.

The once plentiful savings amassed from government-issued checks have dwindled, depleted to cover essential daily expenses. This has resulted in a negative cumulative excess savings (which measures the disparity between actual personal savings and the 48-month implied trend).

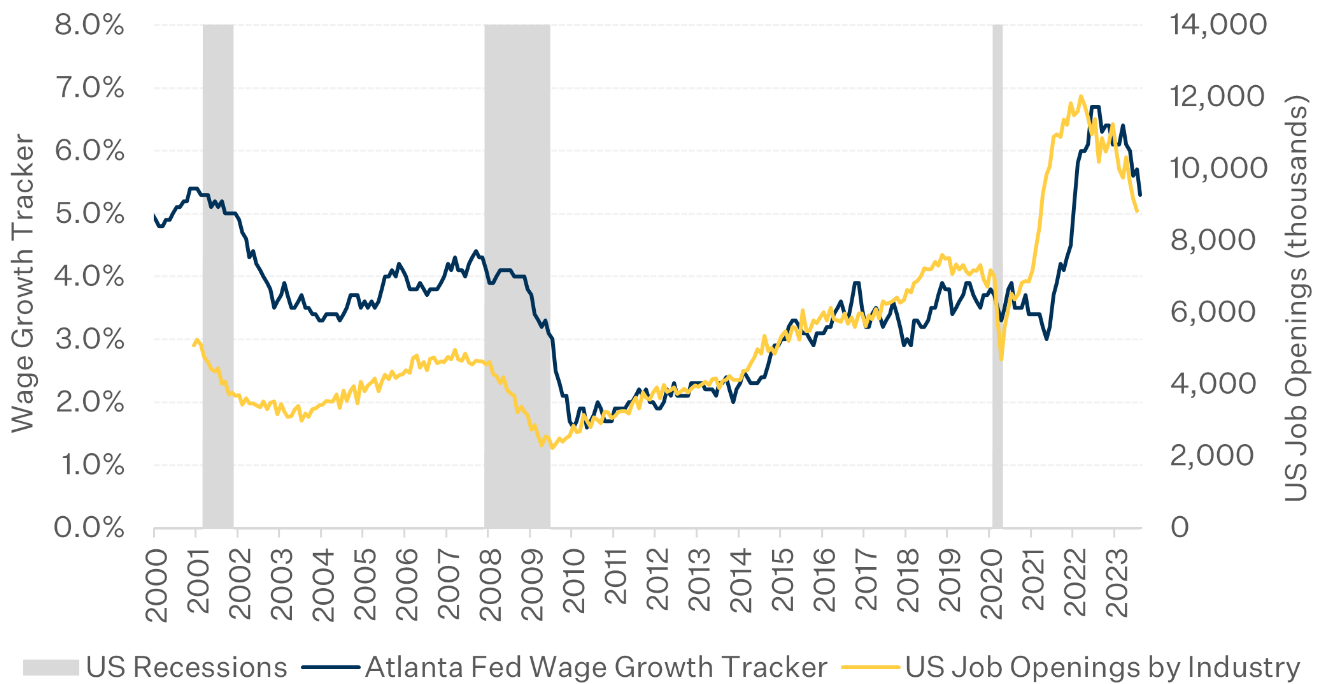


With disposable incomes constrained by the high cost of living, we anticipate consumers to cut back on spending, particularly in non-essential categories like leisure and travel. This overall decline in spending is likely to prompt businesses to reduce inventory stockpiling and expansion efforts, contributing to a more widespread slowdown in economic growth.

The Job Market Deteriorates

Beyond the challenges posed by the escalating cost of living, consumers are contending with a labor market undergoing a noticeable downturn. Job openings have seen a sharp decline, plummeting from the 2022 peak of 12 million to the current figure of 9 million. Simultaneously, the unemployment rate is inching upward, progressing from its initial low of 3.5% earlier this year to the current trajectory approaching 4%.

The most recent non-farm payrolls report, a metric gauging changes in employment excluding the farming sector, reveals a noteworthy shift in the labor landscape. There is discernible reshuffling from high-paying full-time positions to lower-paying part-time jobs. The deteriorating job market is anticipated to impact spending for goods and services in the months ahead, potentially contracting overall business activities.

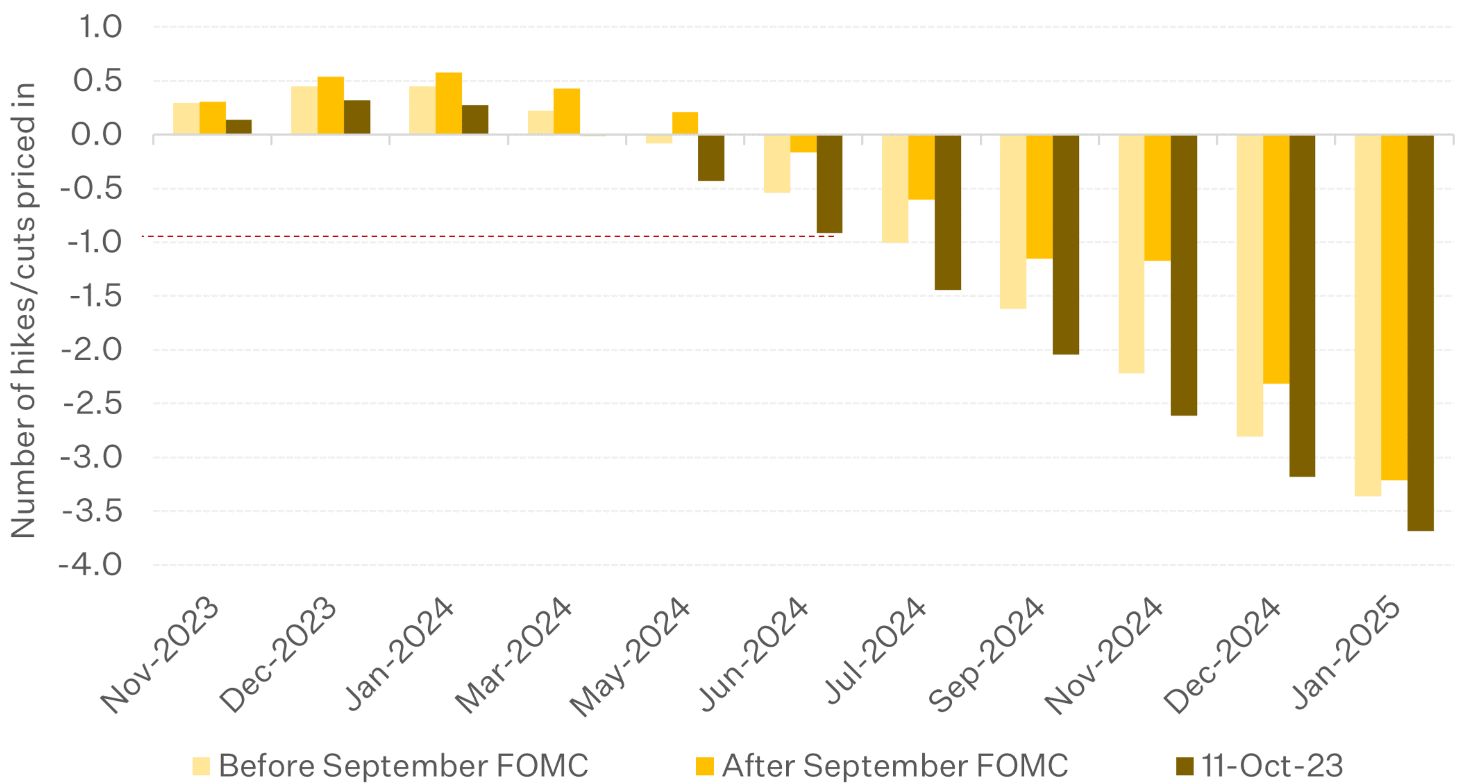


Furthermore, historical data reveals a pattern where significant drops in job openings and wage growth trackers coincide with recessions, as evidenced during the dot-com bubble ('00 – '01), the housing crisis ('08 – '09), and the Covid-19 pandemic ('20). Indeed, in the face of sluggish or negative business growth, crucial cost-saving measures such as wage cuts, layoffs, and restricted job openings become imperative to sustain businesses through challenging economic downturns.

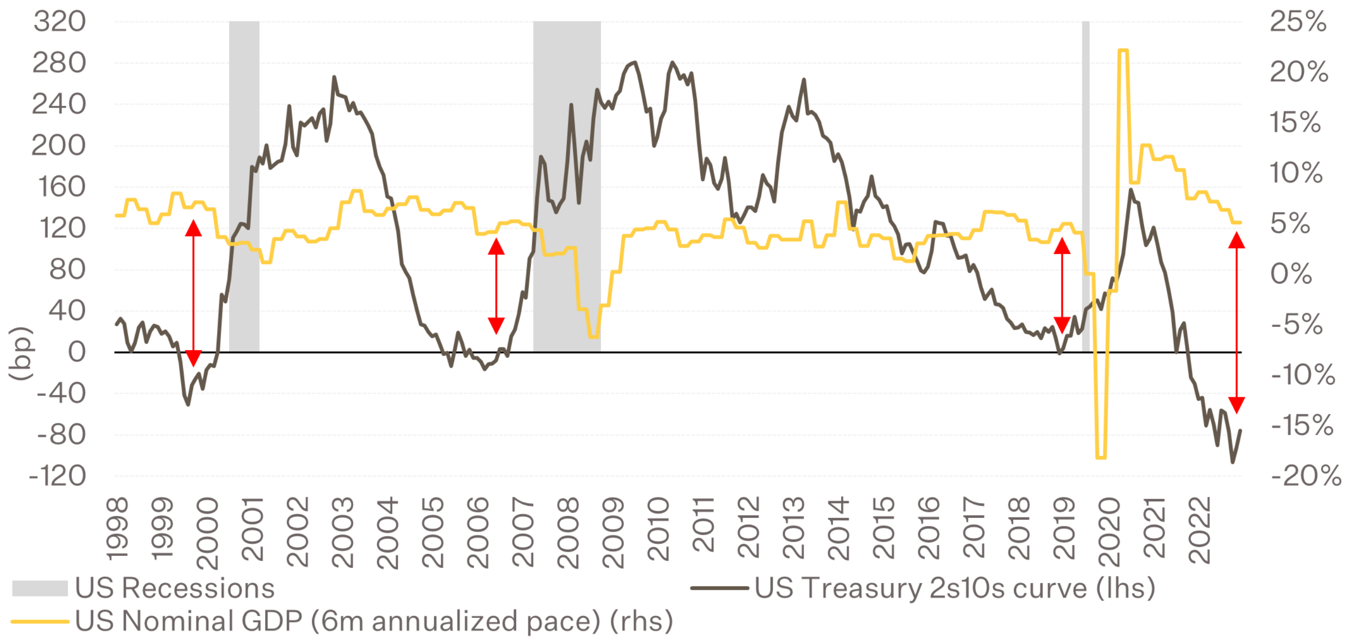
Overall, anticipating constrained consumer budgets, we foresee a decline in retail sales during the last quarter of 2023. Additionally, as interest rates rise, the credit and loan support vital for businesses is set to tighten, intensifying the decline in business investments and hampering expansion efforts. This, in turn, is expected to contribute to a broader economic contraction towards the end of this year and the early months of the next.

The Bond Market is Anticipating a Recession

Although the FOMC members – the group of policy makers in charge of the US monetary policy - reiterated in their September meeting that the Federal Reserve Bank would commit to holding rates at this elevated levels for an extended period of time to curb inflation, which reduces the amount of cuts the market thinks the fed would do in 2024, the bond market has since then reversed its course and now is bracing for a much more gloomy picture with the first rate cut in projected to take place in June 2024.



Additionally, the 2s10s Treasury curve is exhibiting a bear steepening pattern, in which the 10-year yield is increasing more rapidly than the 2-year yield. This trend often precedes economic recessions. Furthermore, GDP growth, a key indicator of economic health, is also on a downward trajectory. Nominal GDP growth has been reverting to pre-pandemic levels at around 4% to 5% a year. Notably, the post-pandemic decline in GDP growth has been more pronounced than historical trends, and the 2s10s curve has also hit the most inverted levels in history.
We believe that the conjunction of a steeper UST curve and sluggish growth may be indicators of an impending economic recession in 2024.

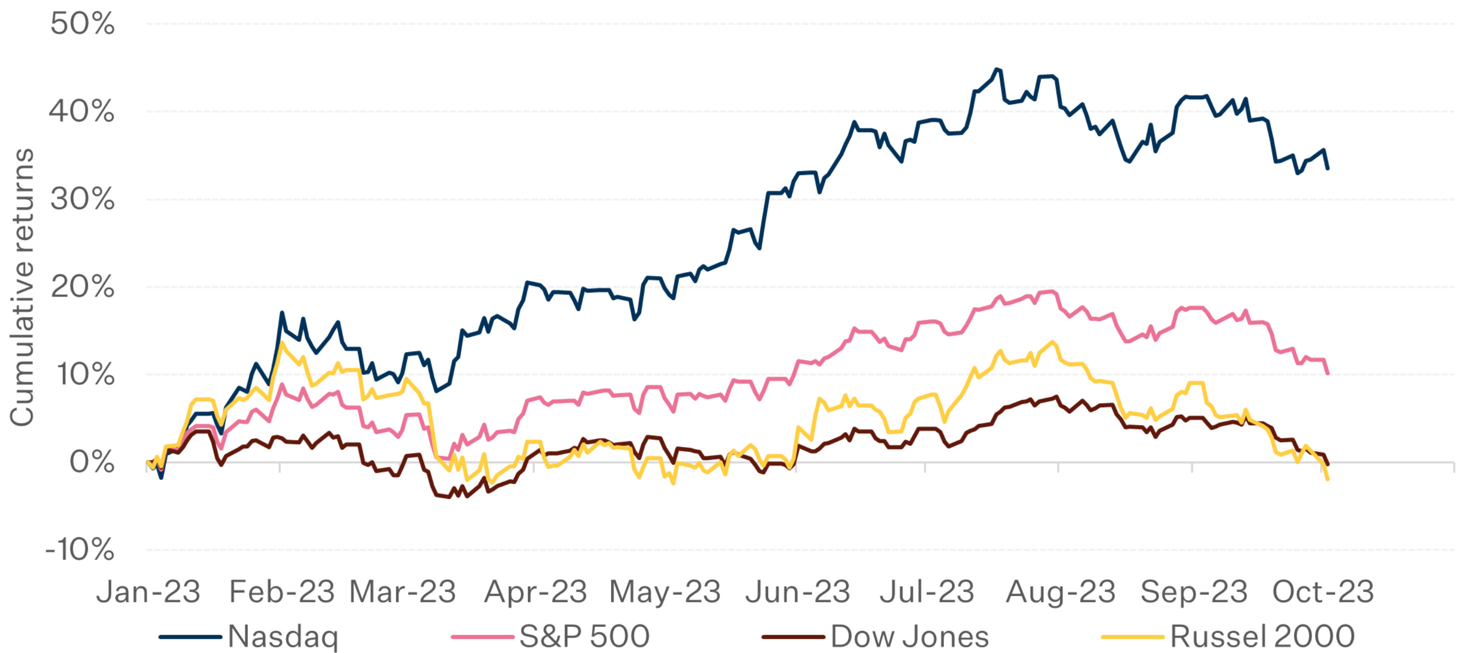


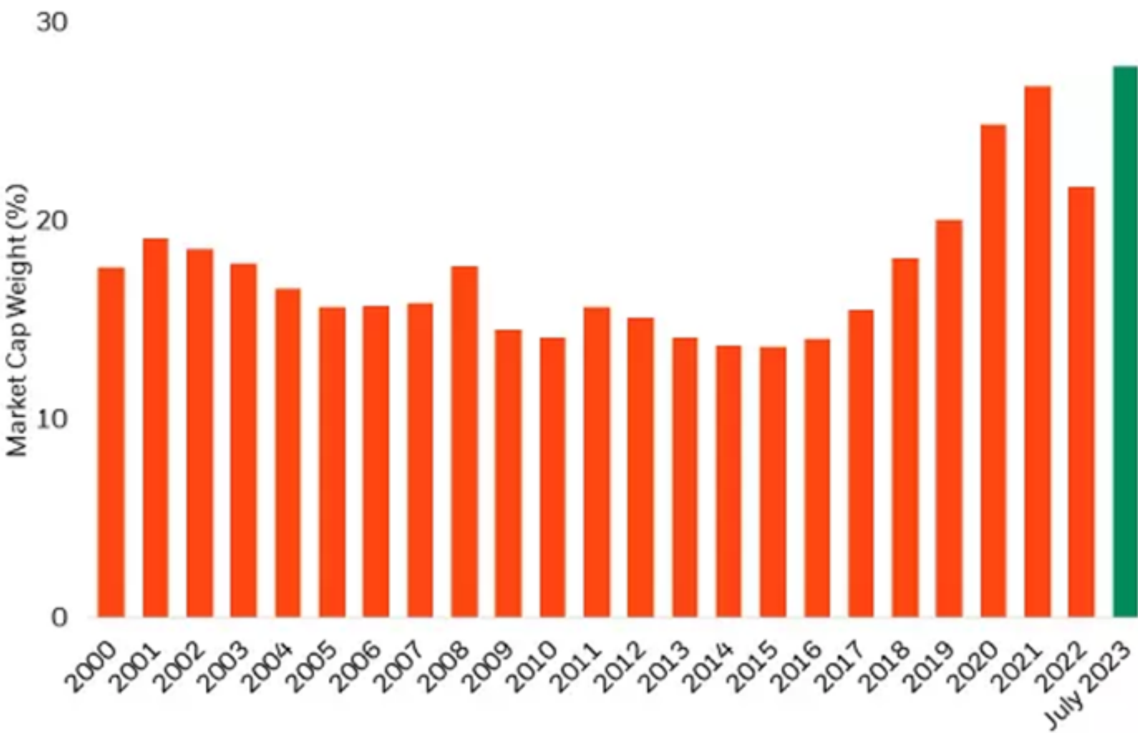
Artificial Intelligence Driving Artificial Valuations

Stock Markets Poised for Price Correction by End of 2023

We believe that the technology companies that have been keeping the S&P 500 afloat face heightened vulnerability in the wake of rising interest rates. Furthermore, the significant concentration of technology stocks poses a risk, potentially dragging down these indices as stocks of the "Magnificent 7" - Amazon, Apple, Google (Alphabet), Meta, Microsoft, Nvidia and Tesla - decline. Notably, these “Magnificent 7” companies are also exhibiting unrealistic P/E ratios, hovering around 43 years, compared to that of 33 years for the Nasdaq and 20 years for the S&P 500. These elevated P/E ratios raise concerns about overvaluations, fueled by the excessive enthusiasm surrounding the introduction of generative AI, and set the stage for a potential significant price correction in the coming months.

The broad stock indices, like the Russell 2000 and Dow Jones, have seen Q3 2023 gains wiped out, entering negative territory. The Nasdaq index, known for its tech focus, mirrors this trend, and the S&P 500 appears to have reached its peak.





Market capitalization weight of the seven largest companies in the S&P 500 index

Domestic and Global Instability Likely to Disrupt the U.S. Economy

The end of September witnessed a strained impasse in funding negotiations between the Republican and Democrat parties. The core issues centered on military aid for Ukraine and funding for fortifying the border wall. Despite Congress reaching a consensus on a stopgap bill, providing short-term funding until November 17, the looming possibility of a government shutdown still casts a substantial shadow.

Furthermore, there have been numerous worker strikes affecting major industries in the U.S. To date, over 230,000 workers have participated in strikes, influencing critical industries such as auto, healthcare, and education. The frequent occurrence of strikes, if protracted, has the potential to significantly impede economic growth.

2023	Union	Participants
April	Los Angeles teachers strike	35,000
	Rutgers University strike	9,000
May	Oakland teachers strike	3,000
	Writers Guild of America strike	11,500
June	Starbucks strike	3,000
July	SAG-AFTRA (Actors union) strike	160,000
	Unite Here local 11 (Hotel workers) strike	1,750
August	Robert Wood Johnson University Hospital nurses strike	1,700
September	United Auto Workers strike	13,000
	Total (up to date)	**237,950**

Moreover, the protracted conflict between Ukraine and Russia, heightened tensions between Israel and Palestine, and growing unrest across the Middle East collectively elevate international geopolitical risks. Consequently, these factors pose significant challenges to both price and economic stability in the United States. We anticipate that ongoing domestic uncertainties and escalating international conflicts will persistently exert a detrimental impact on the general performance of the U.S. stock market and the economy as a whole.

1970s On Repeat?

	1970s	2020s
Inflation	**High inflation** Inflation reached **12%** in 1974 and again jumped to **13.5%** in 1979	**High inflation** Inflation reached **9%** in 2022 and is showing signs of increasing again.
Oil & Energy	**Energy crisis:** • **OPEC** oil embargo • Oil prices **quadrupled** from $3 to $12/barrel	**Energy crisis:** • **OPEC+** production cut • Russia bans diesel and gas exports indefinitely • Oil prices **doubled** from %60 (in 2019) to $120/barrel in 2022 and is on path to reach $100/barrel soon
Stocks	**Volatile price actions:** • Dropped **26%** in 1970 • Collapsed by **48%** from 1973 to the end of 1974 • Decreased by **19%** in 1977	**Expected volatile market reactions:** • Dropped **34%** in 2020 • Steadily declined by **25%** in 2022 • We expect some bearish actions forthcoming in 2024
Worker Strikes	**Frequent worker strikes affecting key industries:** • 1970 **Postal** Workers Strike • 1970 United **Farm** Workers Strike • 1973-1974 **Oil** Crisis and Longshoremen's Strike • 1977 United **Steel** Workers Strike • 1979-1980 **Air Traffic** Controllers Strike	**Frequent worker strikes affecting key industries:** • 2020 **Teachers** Strike • 2020–2021 **Healthcare** Worker Strike • 2023 **Actors** Union Strikes • 2023 United **Auto** Workers Strike

The 2020s could experience a recession akin to the that of the 1970s, given the similarities between the two periods:

- Persistently high inflation, aggravated by an energy shortage and expensive cost of shelter, as well as heightened tensions with unions frequently resorting to strikes, has the potential to amplify domestic economic vulnerabilities and constitute a deep recession.
- The ongoing expansion of government borrowing, and the already substantial size of the Fed's balance sheet could limit options for mitigating an economic downturn, potentially prolonging the recession.
- Moreover, international political tensions, particularly conflicts like the Ukraine-Russia dispute, and increased tensions between the U.S. and international organizations (OPEC+, BRICS) and sovereigns (China, Russia, Saudi Arabia) may impede the ability of the U.S. to recover swiftly in the event of an economic downturn.

Learn from the past, look to the future, but live in the present

Although the outlook can be intimidating for many investors, we firmly believe that our understanding of the past, our preparedness for the future, and our keen ability to navigate the present circumstances will allow us to weather the storm.

Disclosures

Towards Equilibrium Inc. (“Equi”) and Equilibrium Ventures, LLC. (“EquiV”) communications are intended solely for informational purposes. They should not be construed as investment, legal, tax, or trading advice and are not meant to be a solicitation or recommendation to buy, sell, or hold any securities including funds mentioned. Any such offer or solicitation can only be made by means of the delivery of a Confidential Private Placement Memorandum to qualified eligible investors.

EquiV is registered as an investment adviser with the Texas Securities Board Investment Advisers Act of 1940. Registration of an investment adviser does not imply any specific level of skill or training and does not constitute an endorsement of the entity by the Securities Exchange Commission.

Predictions, opinions, and other information on this website are subject to change continually and without notice of any kind and may no longer be true after the date indicated.

Past performance is not indicative of future results and an investment in an investment fund involves the risk of loss. The investment fund is speculative and involves a high degree of risk.

Asset allocation does not guarantee a profit or protection from losses in a declining market. Investments, when sold, may be worth more or less than the original purchase price.

S&P 500 performance obtained from Bloomberg. References to S&P 500 are included for illustrative purposes only. It is not expected that funds will make investments in S&P 500 companies. Funds are expected to invest with a strategy that is different from a strategy of making equity investments across an index. Accordingly, investors should not expect that an investment would provide exposure that is similar to an index investment in S&P 500 companies or any other specific benchmark.

Investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.