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Quarterly Outlook

Q1-2024

Dear Investors

Amidst distinctive economic data trends, heightened global tensions, and the impending U.S. election, we enter 2024 cautiously knowing that we will be required to navigate many uncertainties that will define the year ahead.

In 2023, we predicted that a hard landing was likely. While some voices contend that a hard landing was successfully averted, we believe that the probability of a recession remains high. Moreover, we anticipate that the severity of this downturn could be elevated, considering the heavy reliance on debt to maintain economic expansion.

Although headline job numbers have been celebrated as demonstrating resilience in our economy, the Bureau of Labor Statistics has had to revise 10 of the last 11 jobs reports numbers substantially lower. Unfortunately, this means that the Federal Reserve could be setting rates based on inaccurate data. We have also seen massive debt expansion over the last few years, partly driven by the pandemic, as well as an attempt to ease the pressure on those with student debt. According to the U.S. Government Accountability Office, the IRS and Treasury issued $931 billion in direct payments to individuals in 2020 and 2021 to provide relief during the pandemic. Additionally, the government has announced about $136.6 billion of student debt relief for more than 3.7 million borrowers over the last few years.

From a psychological perspective, Americans accumulated trillions of dollars in excess savings during the pandemic as relief funds were deployed but spending options were limited. Once pandemic restrictions eased, households depleted their savings at record rates, boosting retail sales through the end of 2023. A decades-long era of “easy money” and low interest rates, alongside the advent of Buy Now Pay Later, has fostered precarious consumerist behaviors that may put them in a difficult position if the jobs market falters.

Despite these worrying trends, we do see some bright spots in the economy as inflation seems to have come down significantly. Thus, we are positioning ourselves to be protected against a hard landing, while leaving ourselves the opportunity to take advantage of economic resilience that we may witness in the year ahead.

Itay Vinik

Chief Investment Officer

Introduction

In 2024, we'll be paying close attention to the following categories of data to determine when and how severely we may experience a potential recession.

- Government and household spending – we'll be paying close attention to the absolute amount of spending as well as the pace of spending in the public and private sectors
- Jobs market data - specifically the Job Openings and Labor Turnover Survey, or JOLTS
- The Leading Economic Index, or LEI, which we believe to be the most accurate leading indicator of recession
- Yield curves - especially the 10 Year-3 Month Treasury Yield Spread

The American Answer to Debt? More Debt.

Accumulating debt has been a part of American culture since the 1950s when the first modern-day credit card, the Diner's Club card, was created. The U.S. economy runs on borrowed money – from student loans, to mortgages, to daily credit card purchases. In fact, not relying on debt can actually hurt Americans who lack a credit history or credit score. However, the lax American attitude towards accumulating debt has placed the entire economy in a precarious situation.

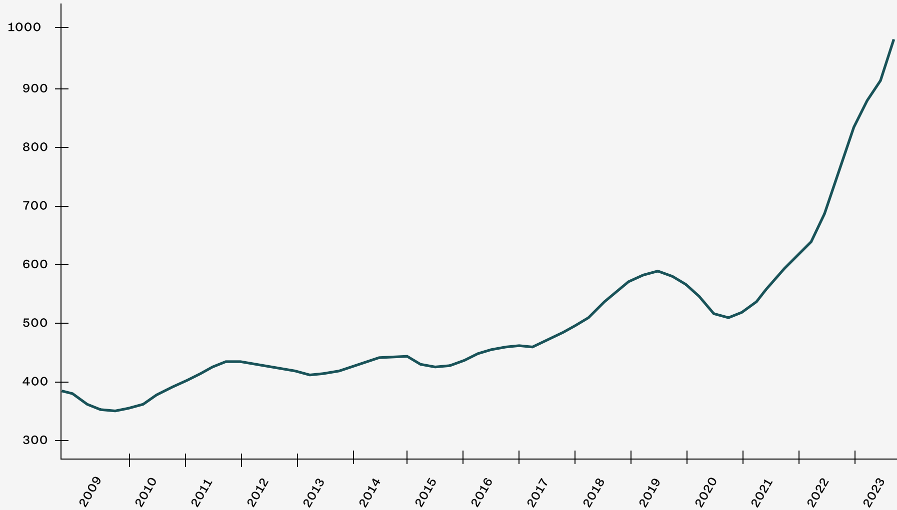
If the economy has been debt-driven since the 1950s, why is it problematic now? Accumulating debt is not necessarily a negative thing, especially if wages rise to support rising debt. However, the Federal Reserve has actively taken a hawkish stance to curb inflation, raising rates and tempering a rise in wages. It is the combination of rising debt and plateauing wages that puts Americans at risk.

> The national debt has reached $34 trillion, the equivalent of $100,000 of debt for every person in the United States.

Both the absolute amount of debt and the rate of acceleration is alarming. In 2020, the Congressional Budget Office predicted that gross federal debt would reach $34 trillion in fiscal year 2029. However, we hit that number by December 2023.

What does it mean for the economy?

If the government does not course correct in a meaningful way, the level of debt could jeopardize everything from national security to Medicare. In response to seemingly unchecked spending by the U.S. government, Fitch Ratings downgraded the United States' long term rating from AAA to AA. Foreign governments such as China, South Korea, and the United Kingdom have also massively reduced their holdings from 49% in 2011 to 30% in 2022.[1]

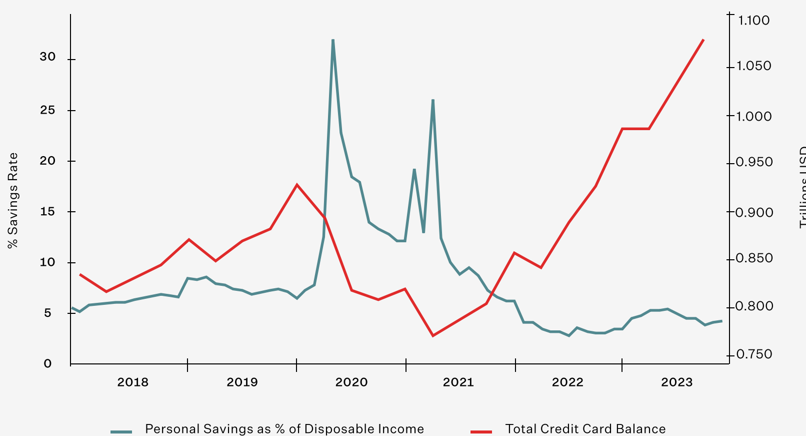


Currently, the U.S. is spending $120 billion more on interest payments than on national security. Annualized debt interest payments crossed $1 trillion in October 2023.

The combination of rising debt and rising interest rates could pose a serious challenge for the Federal Reserve. If the Fed cannot cut rates fast enough, or too late into a liquidity crunch, we could potentially face a prolonged recession.

Households on Thin Ice

The saving rate averaged 6.2 percent from 2016 through 2019[2], with an uptick starting at the end of 2018. However, households are now only saving about 4.1% of income, half of what it was in 2019[3].



Meanwhile, Americans accumulated $1.08 trillion in credit card debt as of Q3 of 2023.

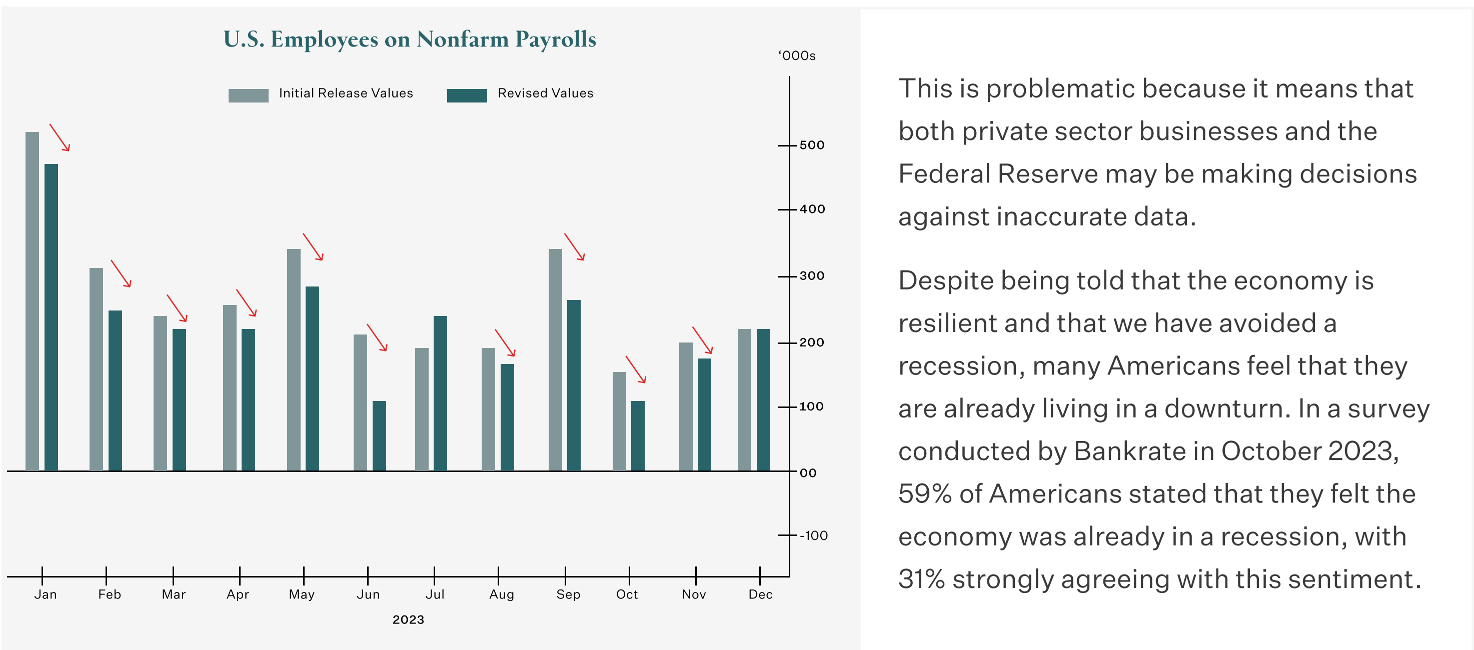
The combination of high inflation and higher cost of borrowing money has squeezed households from both sides, making it difficult to make ends meet. In order to cover increasing costs as well as less restrained spending habits, households have turned to credit cards and increasingly popular Buy Now Pay Later services. If unemployment begins to increase, many households will not have a safety net to fall back on.

1. *https://fortune.com/2024/01/02/us-national-debt-hits-record-34-trillion-congress-funding-fight/*
2. *Federal Reserve Bank of Boston*
3. *Bloomberg*

A Silent Recession

Throughout 2023, the Bureau of Labor Statistics has reported strong, and stronger than expected, jobs growth. The media painted an optimistic picture month after month.

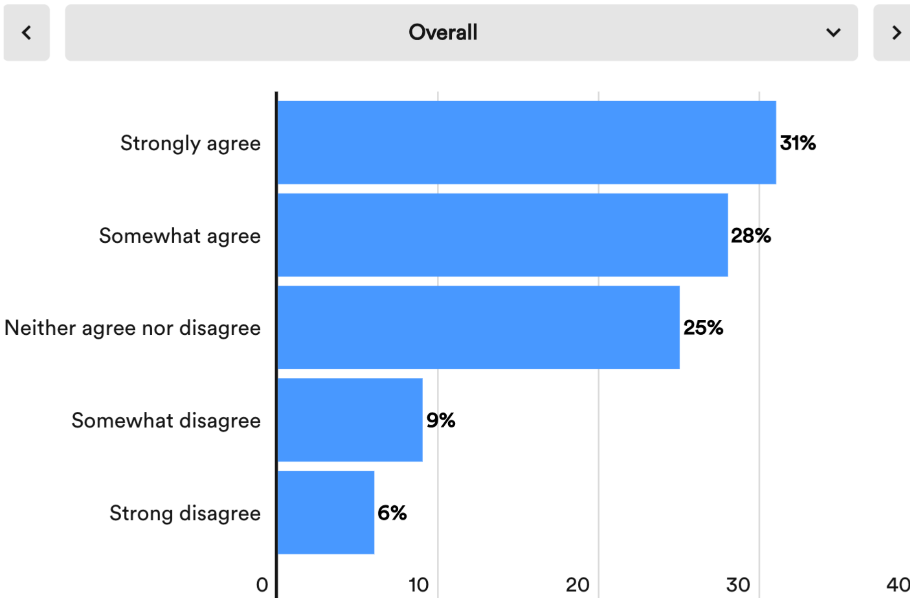
However, a closer look at the data shows that 10 out of the last 11 job reports have been revised substantially lower[4]. For example, September was revised down by 39,000 jobs; October was revised down by 45,000 jobs; November was revised down by 26,000 jobs, etc. Most worryingly, June 2023 was revised down by a whopping 80,000 jobs, which would have made it the weakest since December 2020[5].



This is problematic because it means that both private sector businesses and the Federal Reserve may be making decisions against inaccurate data.

Despite being told that the economy is resilient and that we have avoided a recession, many Americans feel that they are already living in a downturn. In a survey conducted by Bankrate in October 2023, 59% of Americans stated that they felt the economy was already in a recession, with 31% strongly agreeing with this sentiment.

4. *Bureau of Labor Statistics, Zerohedge*
5. *Bureau of Labor Statistics*



Note: Percentages may not total 100 due to rounding
Source: Bankrate survey, Oct. 26-30, 2023

Somewhat concerning is the fact that even those making at least $80,000 per year agree with this sentiment. 61% of those making $100,000 or more felt that we are already in a recession, and 65% of those making $80,000 to $99,000 felt that we are already in a recession.

On TikTok and Instagram, many are speaking up about the deception they feel about national numbers and media headlines and given it a name: “silent recession.”

Interviewees from the Bankrate survey such as Petra Gonzalez have stated that their businesses are not seeing the usual amount of customer traffic.

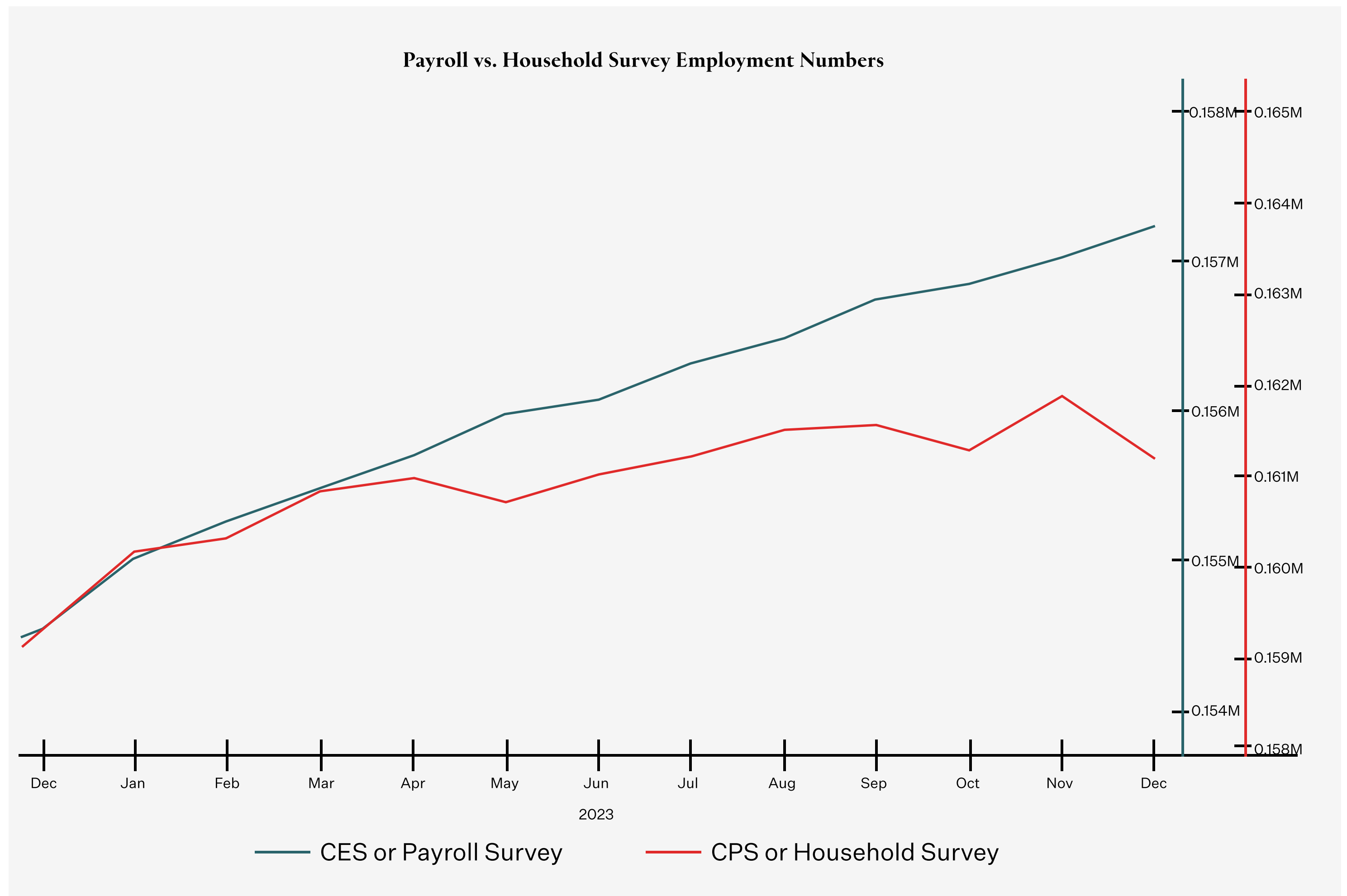
> “I call it a quiet recession because not many people are talking about it, but everyone is feeling it,” she says. “I interact with a lot of different people from different walks of life, and even people who are making $75,000 to $100,000 a year are saying, ‘Everything is going up. I want to do this, but I can’t because my money is going to my bills or paying back my credit cards.’ I feel like it doesn’t really matter the status of your financials. It’s just bad, and everyone is feeling it.”[6]

6. Bankrate

What's Happening in the Jobs Market

How can we determine what is actually happening in the jobs market?

First, let's take a look at the difference between the Current Employment Statistics (CES) survey, also known as the payroll or establishment survey, and the Current Population Survey (CPS), also known as the household survey. A moderate divergence between the two is fairly normal. However, in 2023, we saw a widening gap between these two numbers.



First, it's important to understand how these two numbers are defined. The Established Survey examines approximately 122,000 businesses and government agencies, representing about 666,000 individual worksites. It includes non-farm wage and salary jobs. The Household Survey examines a smaller sample of approximately 60,000 eligible households each month.

6. Bankrate

The most notable differences between the two surveys, as described by the Bureau of Labor Statistics, are[7]:

1. The household survey includes agricultural workers, self-employed workers, whose businesses are unincorporated, unpaid family workers, and private household workers among the employed. These groups are excluded from the establishment survey.
2. The household survey includes people on unpaid leave among the employed. The establishment survey does not.
3. The household survey is limited to workers 16 years of age and older. The establishment survey is not limited by age.
4. The household survey has no duplication of individuals, because individuals are counted only once, even if they hold more than one job. In the establishment survey, employees working at more than one job and thus appearing on more than one payroll are counted separately for each appearance.

It’s important to note that last difference. The Established Survey contains duplicate individuals while the Household Survey does not. This means that the numbers in the Established Survey are inflated because you can have many people who are working multiple jobs being represented. The Household Survey is a more accurate representation of, “How many individuals in the U.S. are gainfully employed?” You’ll notice that there has been a sharp drop recently. This trend may continue as many people may feel the pressure to take on multiple jobs in order to make ends meet.

Additionally, the quality of jobs has changed dramatically. In December 2023, the number of full time jobs plummeted by 1.5 million, which was the single biggest drop since the pandemic. However, the number of part time jobs increased by 762,000, which was the highest monthly increase since March 2018.

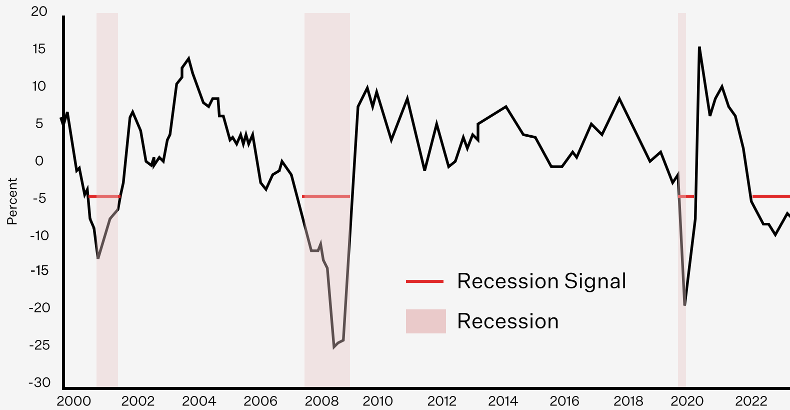
> Overall, the impact is that the number of net new full time jobs in the United States since February 2023 is zero.

Weak Consumers Mean Weak Businesses

Ultimately, if the jobs market does not improve or at least remain stable, businesses will start to suffer. The Leading Economic Index (LEI), conducted by the Conference Board, is what we believe to be one of the strongest leading indicators of a recession. It is a measure of several variables, including consumer sentiment and inventory orders by businesses.

On January 24, 2024, the Conference Board shared that the LEI continues to signal a recession. This was mainly driven by the interest rate spread, a significant drop in average consumer expectations for business conditions, and the decrease in new orders by manufacturers’ clients for new inventory.

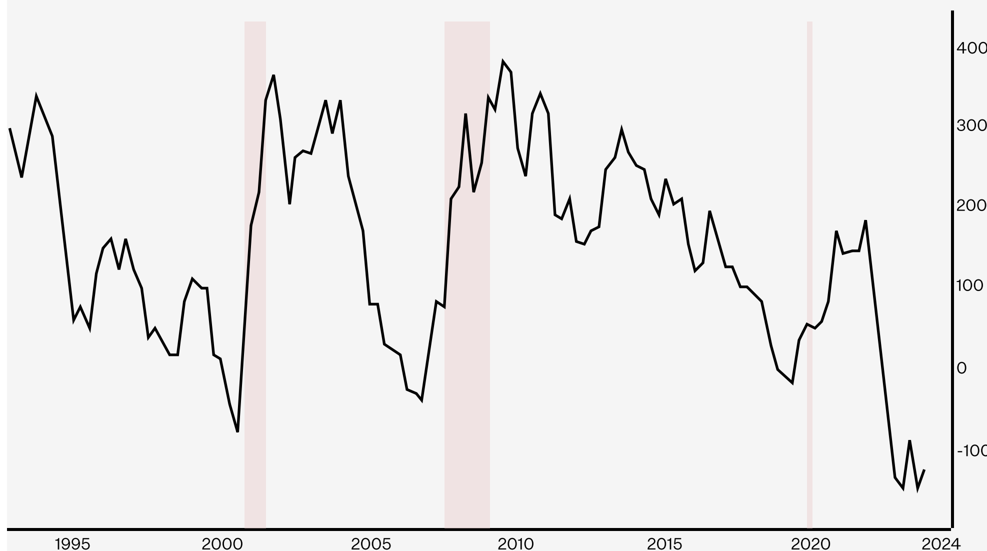
7. *Bureau of Labor Statistics*



We consider the LEI to be one of the strongest indicators of a recession because over the last 60 years, we have witnessed a notable decline in the LEI ahead of all recessions with the exception of two[8]. The average lag between the LEI index falling from its cycle peak to a recession has historically been about 14 months. Currently, we are in month 23, which would make this the longest lag time recorded, beating the record of 22 months ahead of the Financial Crisis of 2007-2009[9].

Yield Curve Predictions

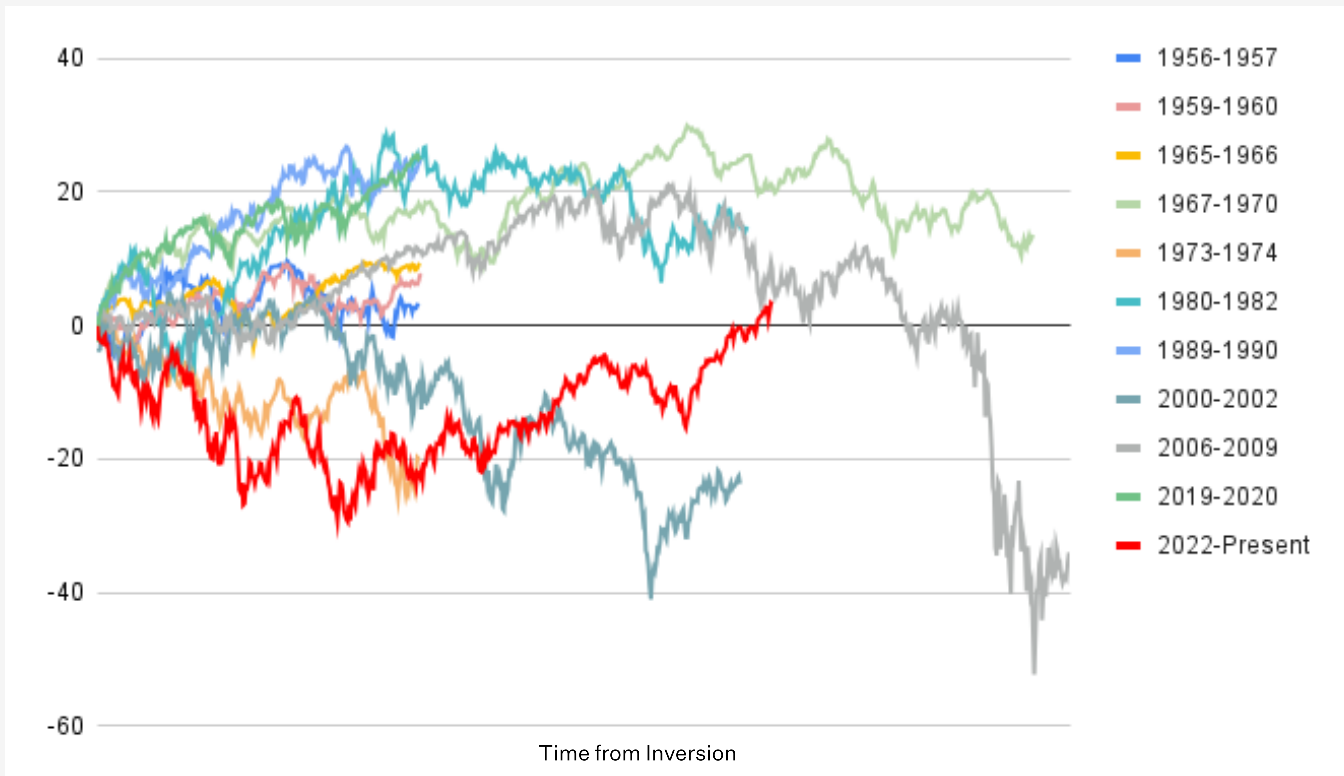
Another excellent leading indicator for recessions is the 10-year 3-month Treasury spread. Generally, an inverted yield curve indicates an upcoming recession. In late October 2022, the yield on the 3-month Treasury bill moved above that of the 10-year Treasury note. This inverted state persists to this day. As of January 26, 2024, the 3-month Treasury yield was 5.44%, while the 10-year Treasury yield was 4.15%.[10]



Typically, the curve dis-inverts as we enter a recession. We started to see the yield curve dis-invert in October of 2023, but it abruptly dipped back into its inverted state shortly after. We are again seeing a dis-inversion and continue to track the yield curve closely. A recession is usually confirmed when the yield curve makes its way back above the 0 line. This happens when the Fed starts cutting rates on the short end in response to a weakened economy.

8. *https://www.reuters.com/plus/lei-leading-edge-economic-indicators-fisher-investments*
9. *The Conference Board, EPB Research*
10. *U.S. Federal Reserve*

Equity Market Performance after a 10/1 Treasury Inversion



Federal Reserve, Bloomberg

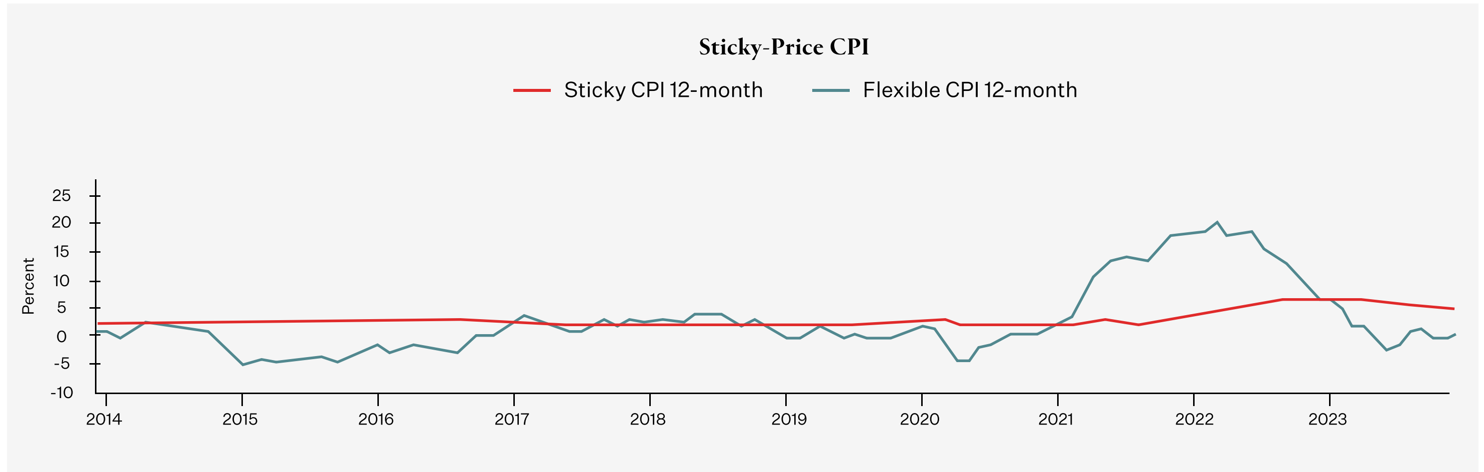
Notice above that the current equity market performance following a yield curve inversion is the biggest outlier over the last nearly seven decades. In the past nearly 70 years, there has never been a market rally following a yield curve inversion whose gains were not entirely wiped out in the subsequent bear market or downturn.

The Last Mile

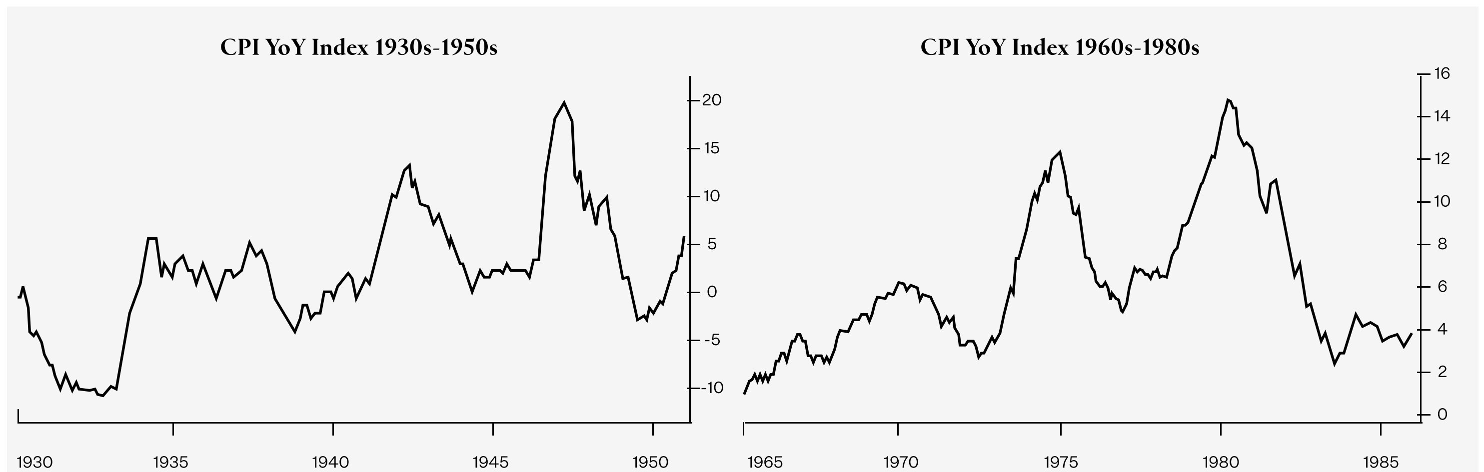
Although we are encouraged to see that inflation has come down significantly with the Federal Reserve's hawkish stance, we also believe that the most difficult challenge remains in the last mile.

> "The Fed has been pretty successful fighting the inflation bulge that saw the Consumer Price Index soar above 9% last summer. It's since shrunk back to just over 3%, but trimming down to 2% could be harder."
>
> Noah Yosif, National Association of Federall-Insured Credit Unions

Services inflation tends to be sticky and slow to respond to monetary policy. Although we have seen the flexible portion of the Consumer Price Index (CPI) come down 0.3% on a 12-month basis as of November 2023, the sticky portion -- mainly driven by services inflation -- has remained 4.7% higher compared to a year ago.[11] Thus, inflation could easily creep back up if the Fed decides to cut rates.



It is also quite rare that inflation hits with a single wave. We notice throughout history that inflation generally comes in three distinct waves over the course of one or two decades. It would be highly unusual for inflation to be stabilized in the long-run at this point in time. If history serves as an example, we should expect inflation to creep back up a few more times over the next decade or so before stabilizing.



11. *Forbes*

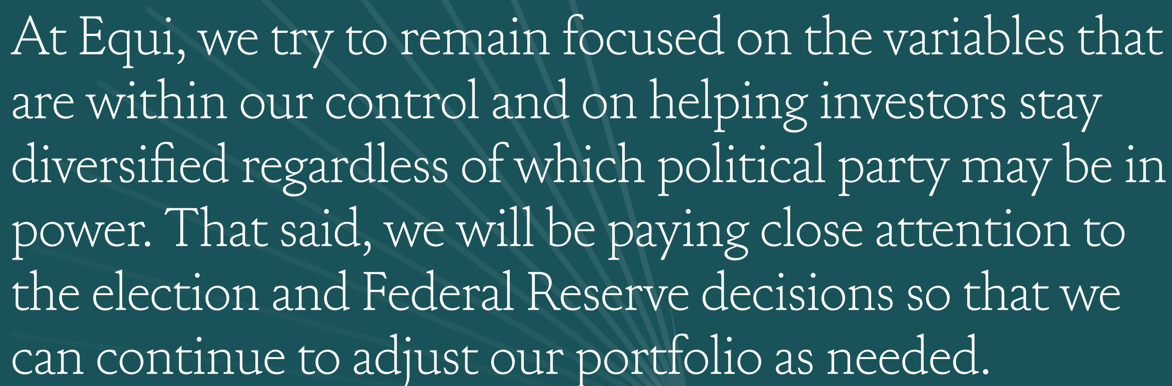
The Election

The fact that 2024 is an election year in the U.S. will indubitably impact both investor sentiment and behavior. It is also no surprise that the state of the economy affects voting behavior, so the Federal Reserve's decisions leading up to the election could have a significant impact on election results.

According to Forbes, in the 12 months leading up to an election, equity and bond returns tend to be a bit muted as investors try to navigate uncertainty. However, once election results are confirmed, the market tends to rally for the next 12 months because investors feel that they know what to expect. This pattern tends to emerge regardless of which party takes office.

11. Forbes

At Equi, we try to remain focused on the variables that are within our control and on helping investors stay diversified regardless of which political party may be in power. That said, we will be paying close attention to the election and Federal Reserve decisions so that we can continue to adjust our portfolio as needed.



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