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3rd Quarter Commentary

2023

Fool's Gold?

The current economic environment is predicting good and bad things to come. So, which is it? Why are recent equity markets moving ahead as if the market environment is supporting risk-on investing, yet simultaneously the bond market with its inverted yield curve is suggesting choppy seas ahead?

The major events of 2023 seem to be a bump in the road of an eager market. Several themes are still firmly in place, strongly suggesting challenging markets yet to come. Excessive liquidity has paved the way to a certain extent, however, the U.S. savings rate over the past three years has declined to only 4.6%, while in December 2019 it was at 8.3%.

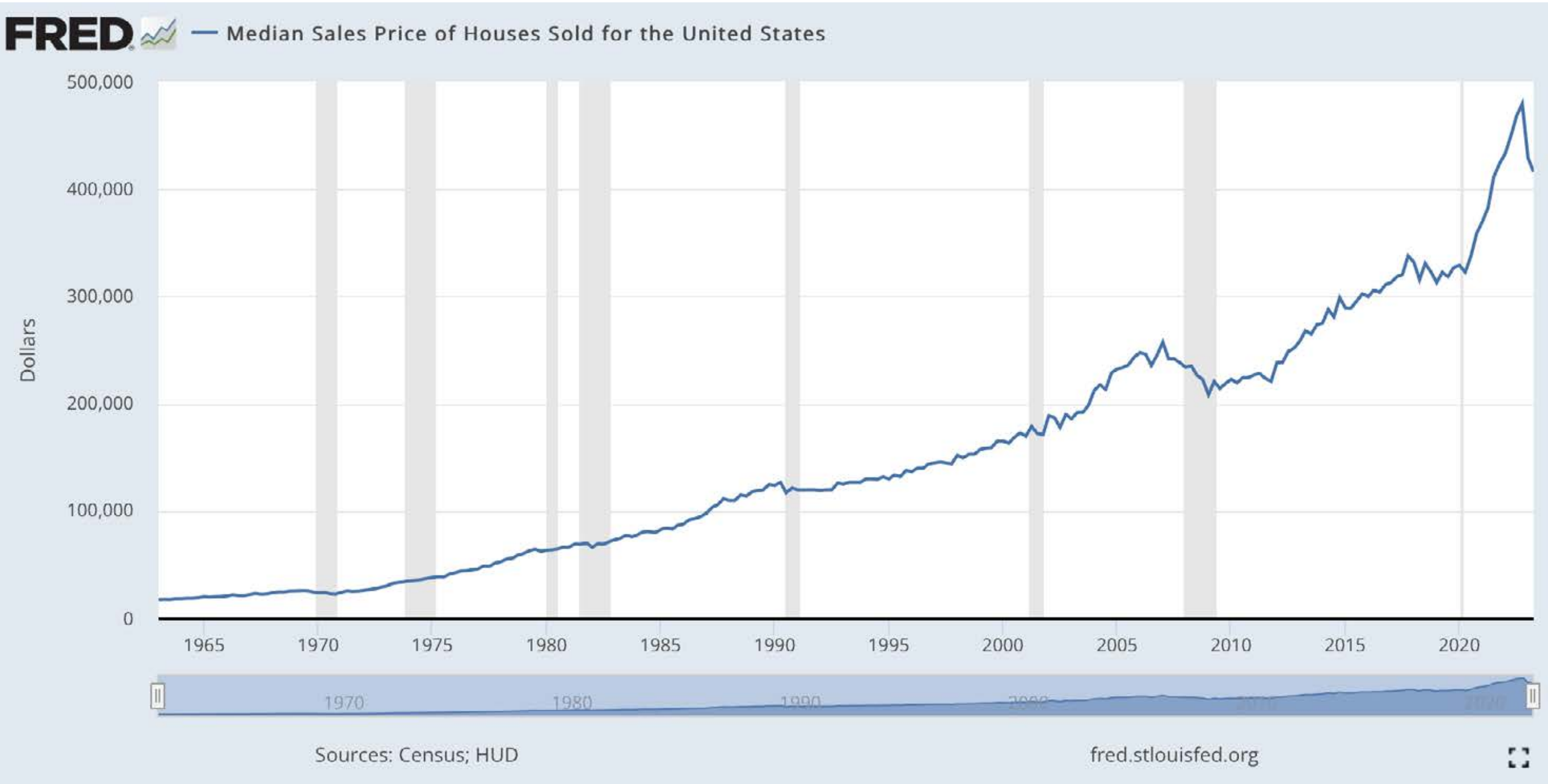
These days, there are several concerning themes that have emerged. Residential and commercial real estate, as well as regional banks, are in crisis. Loan and lease delinquencies are frighteningly higher than those of the "Great Recession" of 2007-2009, and we haven't had a recession yet.

The bond market has an inverted yield curve. Leading Economic Indicators (LEI) are signaling an impending recession. The Real GDP has entered negative territory and the Industrial Production Index is currently at deflationary levels. Furthermore, the Fed is very near its decision to end its tightening stance. While each of these issues may not seem significant on their own, taken together they paint a worrying picture. Let's break each of these themes down.

Residential Real Estate

Real estate is teetering, with building costs higher, property taxes rising, home sales down, inflation dragging down consumer purchasing power, and mortgage rates substantially higher.

U.S. home prices have come off their highs, is this only the beginning?



Assuming a $100,000 household income with a 20% down payment, the average affordability pricing for a home would be $500,000 in 2021. In 2023 the average affordability for that same household is now only $295,000. That's a decline of 41%.

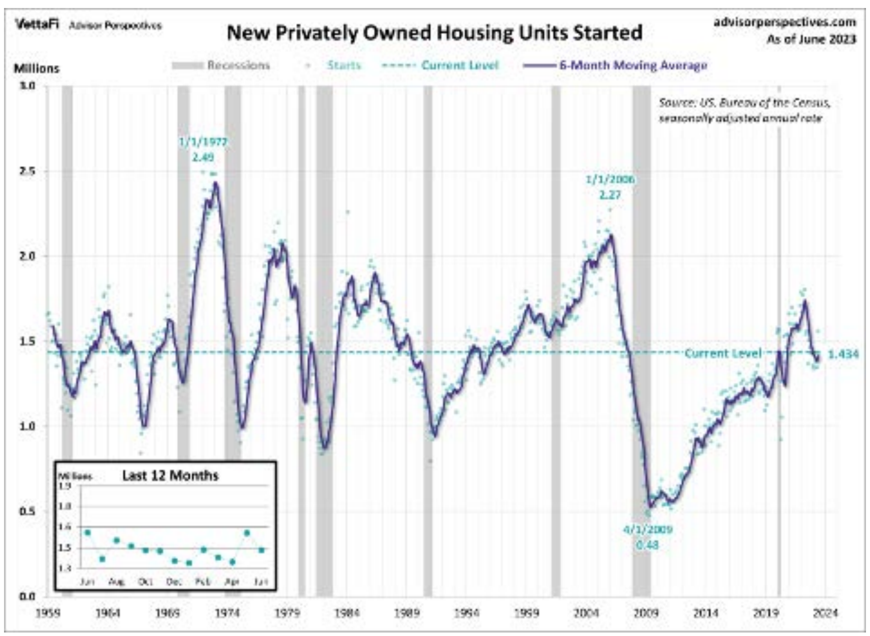
A major change in mortgage rates is at hand, a 30-year mortgage averaged 2.96% in 2021 in 2023, the average is 7.06%.

In the case of a conventional 30-year mortgage, with $6250 in property taxes, $1750 in home insurance, and a credit score of around 700.

In 2021, the total monthly payment was $2,353. In 2023, the total monthly payment is $,3,328. That's more than a 41% increase in monthly costs.

To account for this shift, the price of a $500,000 home would need to decrease by $205,000 to offset the recent increase in the cost of mortgage payments.

In our opinion, something has to give, and we believe it will most likely be the price of real estate.



Commercial Real Estate

Executives from three of the largest national U.S. banks, Wells Fargo, Citigroup, and JP Morgan, issued warnings in April predicting a worsening commercial real estate market.

Nationally, the office space vacancy rate in 2021 was 11.5%, and as of June 30th, 2023, it is 16.9%. It doesn't seem like much, however, that is nearly a 47% increase in vacancies. The challenges are just beginning to emerge, and they are having a real impact.

A July 19th, 2023, article written by Kohrman Jackson & Krantz LLP noted the financial strain faced by property owners:

"Recent defaults on significant real estate investments illustrate the severity of the issue. A real estate investment fund defaulted on $750 million in mortgages for two skyscrapers in Los Angeles, while a private equity firm devalued its investment in the former Sears Tower (now Willis Tower) in Chicago by nearly one-third. Additionally, Monday Properties defaulted on an $841 million loan, putting seven high-rise office buildings in Rosslyn, Virginia, at risk of foreclosure."

As Blackstone President Jonathan Gray noted:

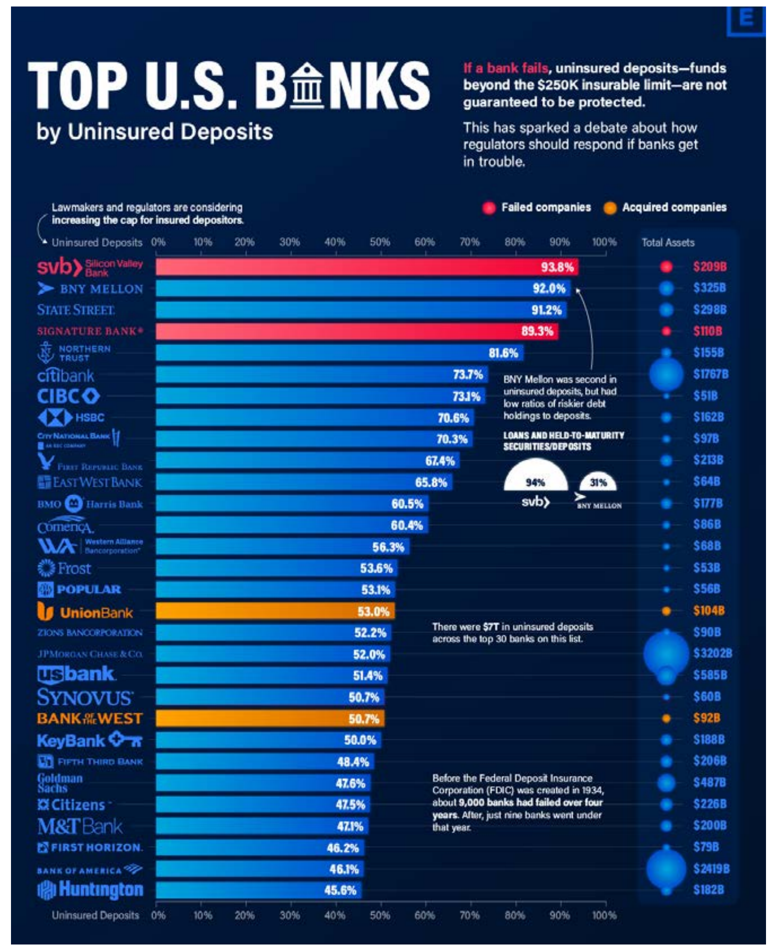
"Vacancy is 20-plus percent, rents are declining, and companies now are obviously thinking about their space needs in light of remote work and the economic climate that is ahead. Lenders are reluctant to have exposure to office buildings. Buyers are reluctant. Valuations are going down."

The ripple effects are coming and there are no short-term solutions to bail out commercial real estate. With higher rates, lower valuations, and 20% plus vacancy rates, the outlook is bleak.

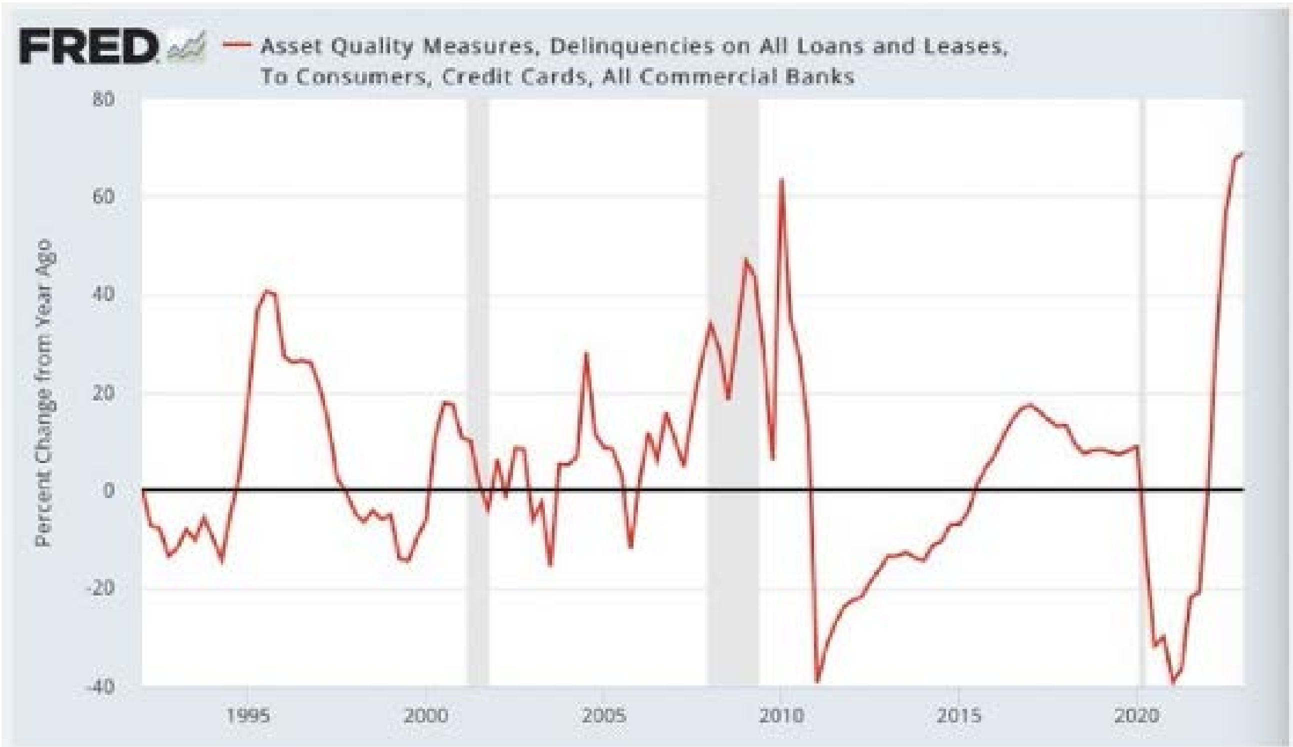
Regional Banks

The economy is operating as if the banking industry recovered from its bank runs and eventual failures. Unfortunately, declining bank deposits, increasing loan and lease delinquencies, and bonds held with losses at banks tell an entirely different story.

Today, there is at least $7 trillion in uninsured bank deposits in America. The U.S. Treasury decided to ensure every uninsured deposit -- shifting the responsibility from each account holder to the responsibility of every U.S. citizen and taxpayer!



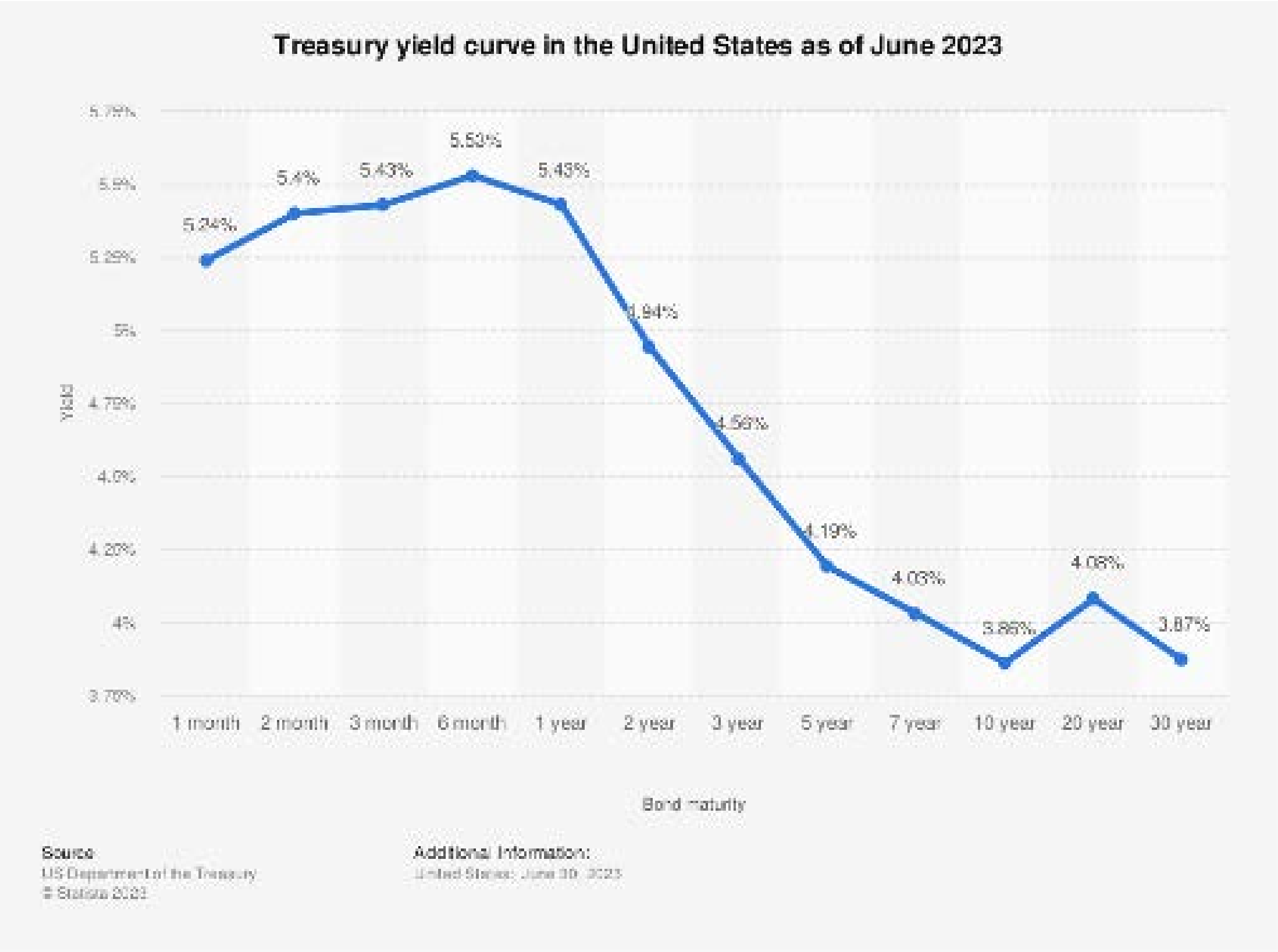
Delinquencies on All Loans and Leases are at 30 Year Highs



Source: The Federal Reserve

Inverted Yield Curve

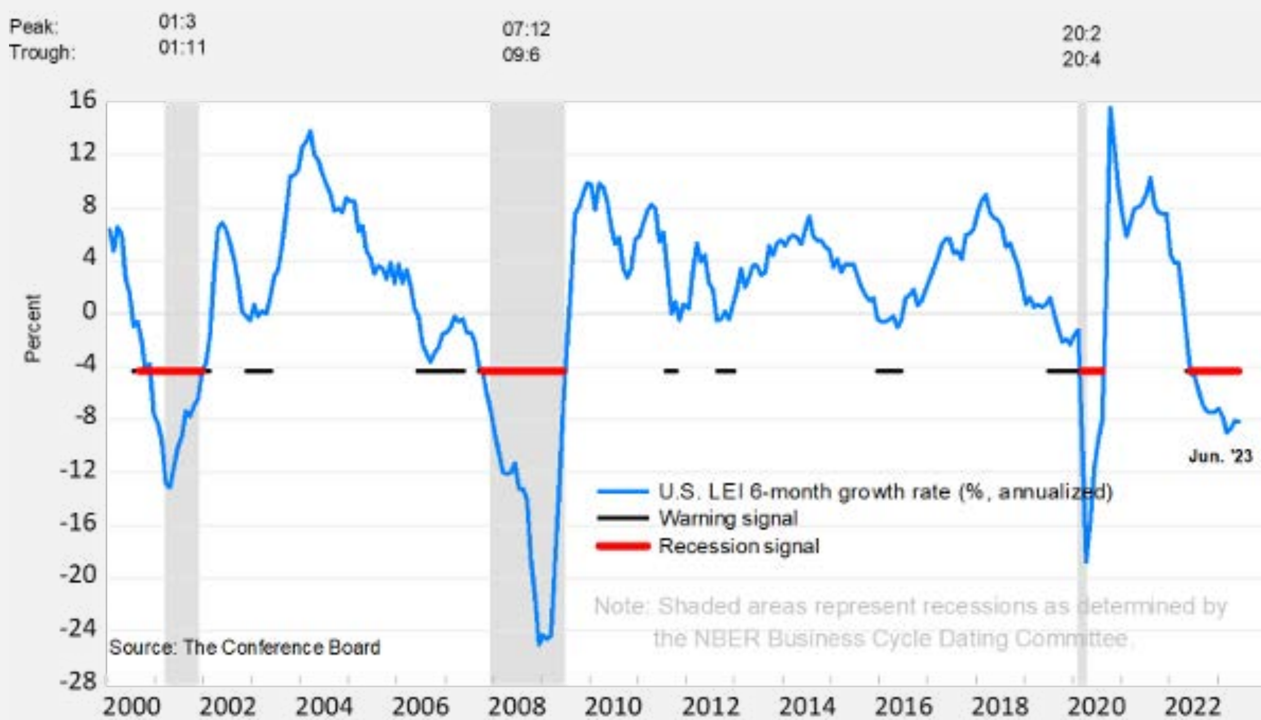
An inverted yield curve has preceded every U.S. recession since 1950, and the yield curve inverted April 1, 2022. Historically, a recession ensues within 18 months, which brings us to August/September 2023 as the potential beginning of a recession.



Leading Economic Indicators (LEI)

LEI is composed of both financial and non-financial components. Financial includes leading credit index, S&P 500 index stock prices, interest rate spread, and 10-year T-bonds, less the Fed funds rate. Non-financial includes average consumer expectations for business conditions, ISM index of new orders, building permits, private housing, average weekly hours of manufacturing, manufacturers' new orders, non-defense capital goods (excluding aircraft), consumer goods and materials, average weekly initial claims, and unemployment insurance.

Overall, they are down 4.2%, which is both bearish and deflationary. Historically, this has led to a recession.



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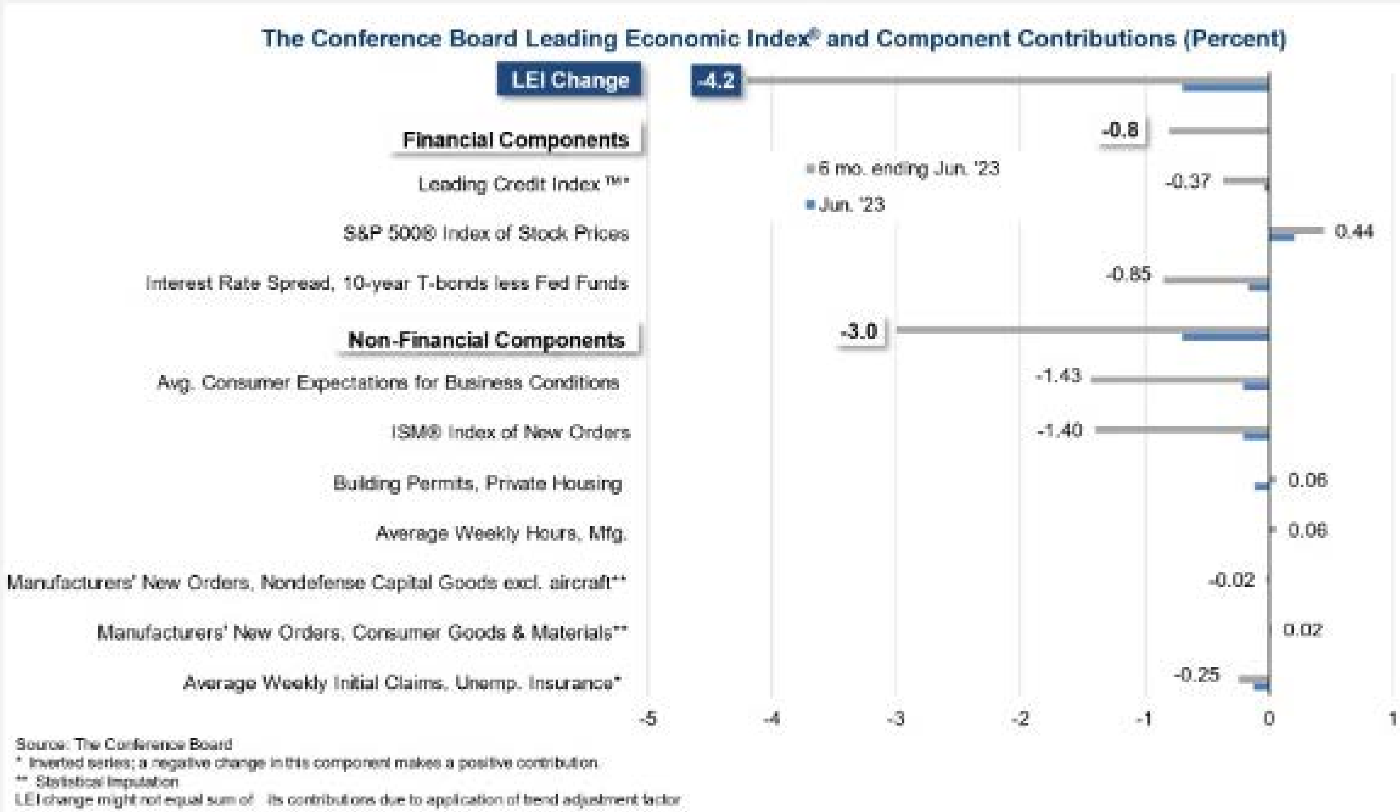
Past performance is no guarantee of future returns. Please see attached disclosures.

The Conference Board Leading Economic Index and Component Contributions (Percentage)



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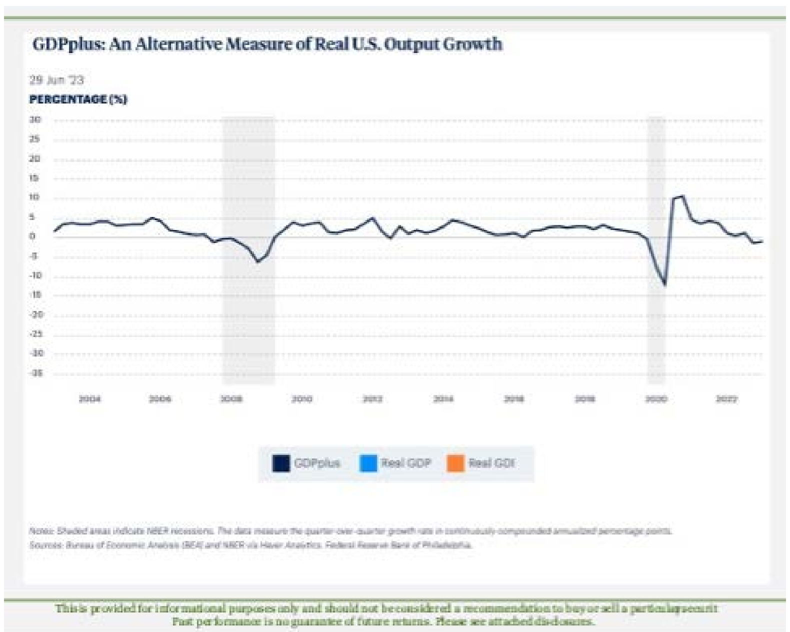
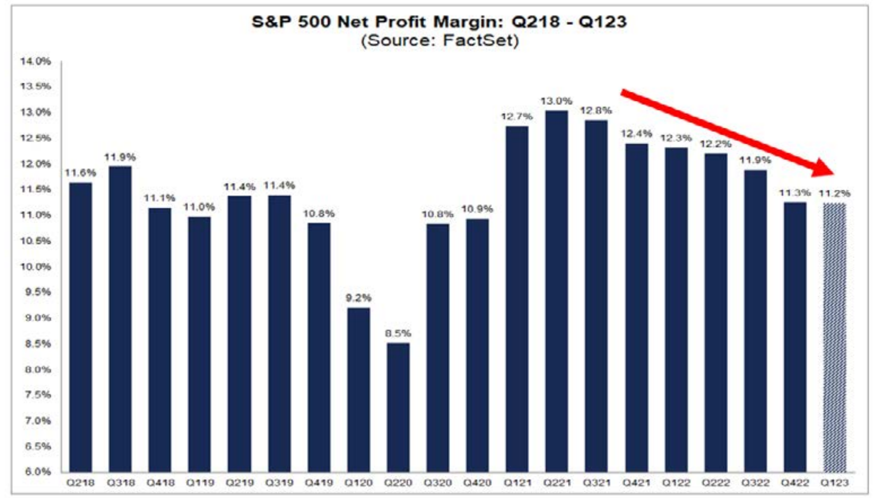
Real GDP and Net Profit Margins

Few people are talking about the leader in profit margin growth is in the utilities sector, and the biggest loser in profit margin declines is the technology sector. In other words, defensive stocks are advancing, and growth stocks are slowing.

It appears the markets are running on fumes in terms of net profit margins. The Fed's mission to slow down the economy is clearly taking hold. To calculate real GDP, we look at GDP less inflation.



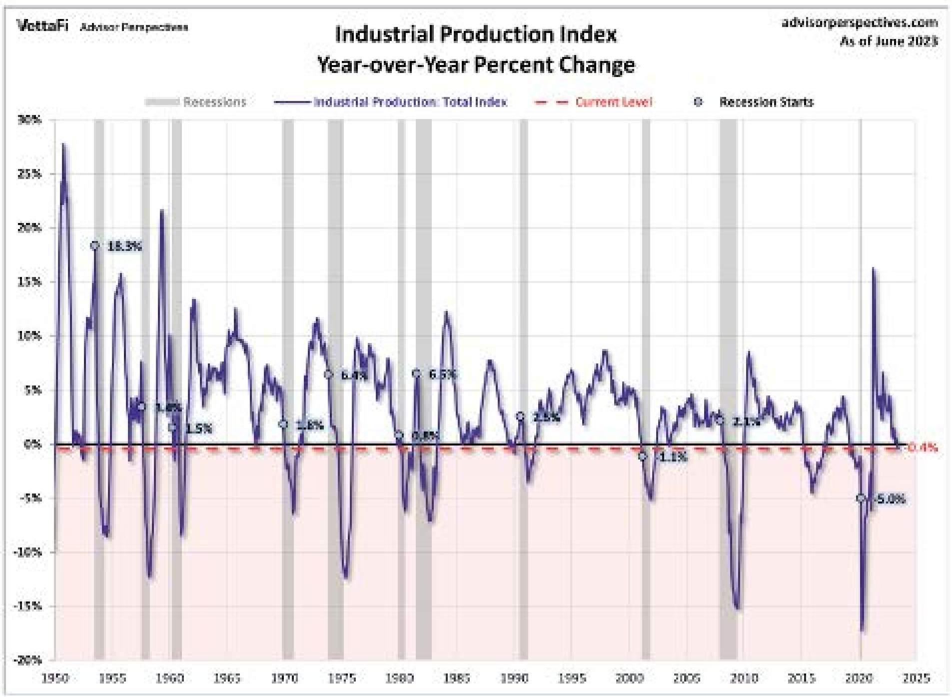
S&P 500 reporting a lower net profit margin for 7th straight quarter



Source: Factset

Industrial Production

The Industrial Production Index is in deflationary territory, which historically leads to challenging times ahead. Manufacturing is signaling a reduction in consumer demand and a weakening economy.



Federal Interest Rates

In the past, after the Fed stopped raising rates, the bond market responded very favorably. Moreover, if you look at the two worst pre-pausing of rates periods, the next 12 months have achieved exceptional returns. While we know past performance is not a guarantee of future results, we are noting that 2022's performance is the worst bond market performance by 79%. The possibility of substantial outperformance of the bond market has an increased probability like we have never witnessed before.

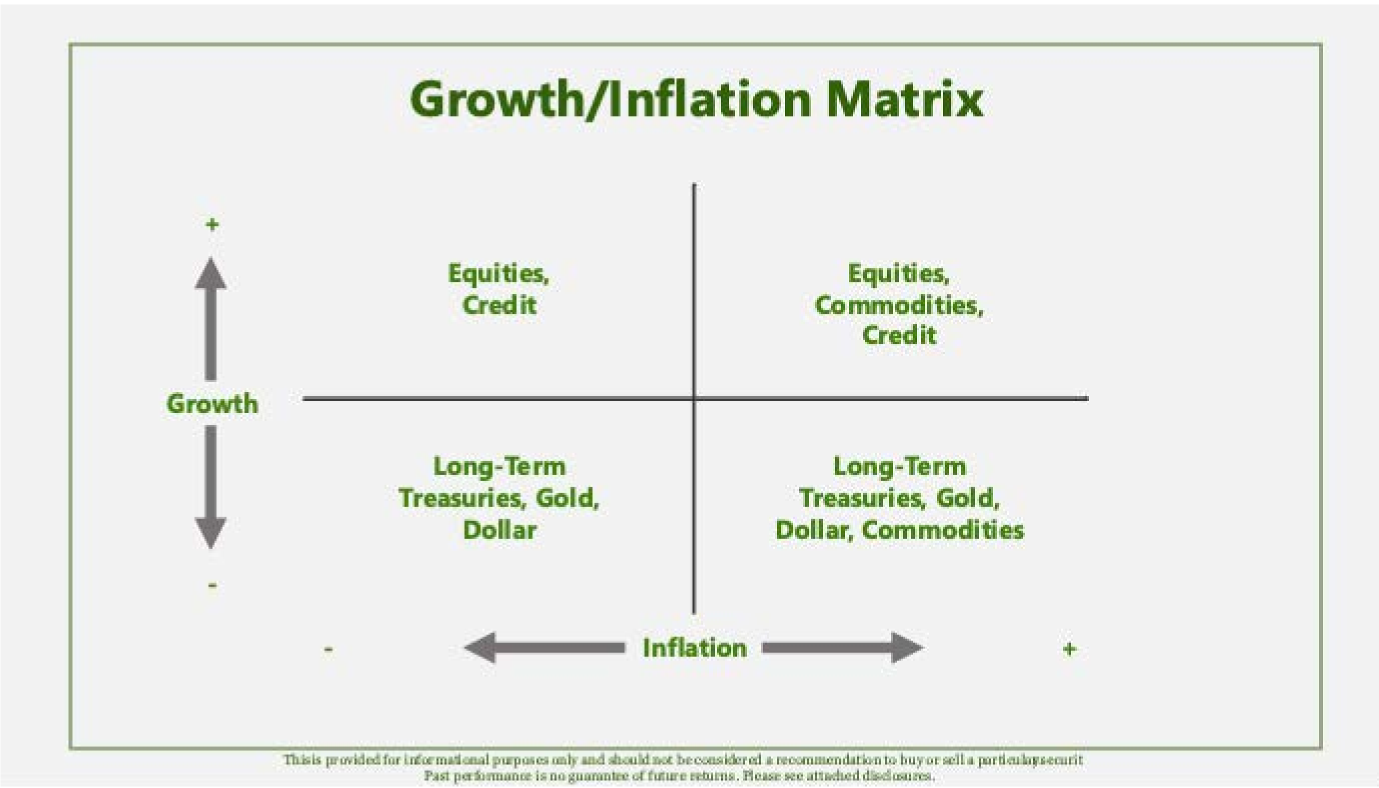
		Fixed Income Returns		
Hiking Cycle Start	# of Months in Hiking Cycle	During Hiking Cycle	6M After Pause	12M After Pause
3/1988	12	3.7%	8.9%	12.7%
2/1994	13	-1.6%	9.0%	17.1%
3/1997^	1	N/A	6.7%	11.4%
6/1999	12	1.4%	7.7%	13.7%
6/2004	25	5.6%	5.4%	6.5%
12/2015	37	5.7%	6.4%	9.0%
3/2022*	12	-7.6%	TBD	TBD
Average	**16**	**1.2%**	**7.4%**	**11.7%**

Source: Morningstar as of 2/28/2023. Fixed income cumulative returns calculated using Bloomberg US Aggregate Index Returns.

The Real Question

If growth and inflation are both slowing, what should an investor own who needs return and only wants or needs modest risks?

The answer is in the Growth/Inflation Matrix.



Source: WealthShield

We appreciate everyone's desire to participate in the stock market during its peaks. However, our team strongly believes in prioritizing risk management through diversification and investing in assets that align with significant trends and themes.

Our current strategy is based on owning long-term treasuries, gold, the U.S. dollar, private holdings over public, value over growth, and emerging market value over international for the foreseeable future. We believe these investments are the most practical and appropriate risk-adjusted choices.

If you have any questions, please do not hesitate to contact us.

Todd M. Schwartz, CFP®
Founder

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