Westshore Wealth *Insights*

Paper Dragons

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WESTSHORE WEALTH

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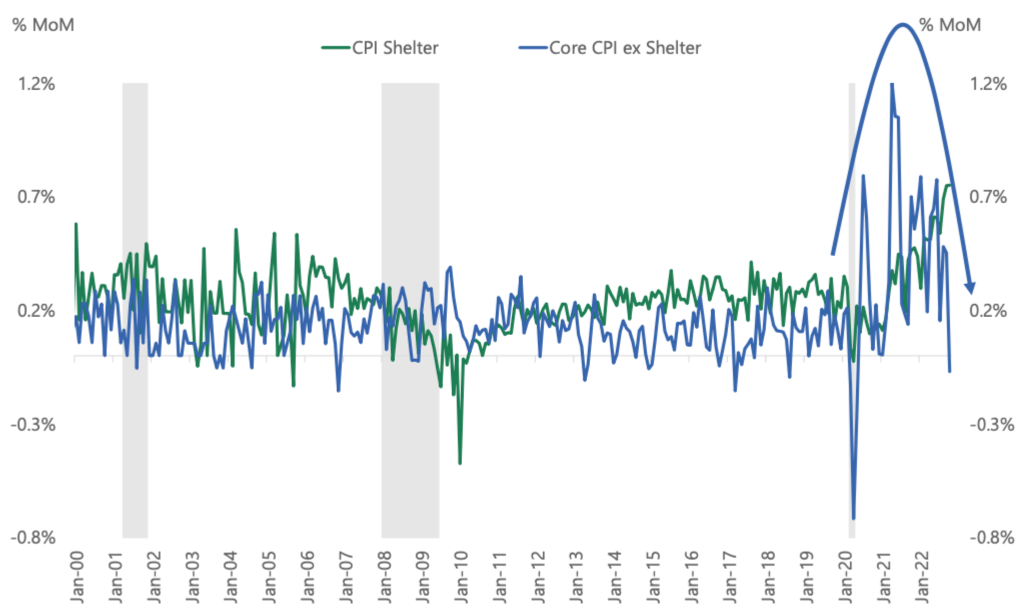
The Federal Reserve recently slowed its ongoing monetary tightening campaign at its December 13 - 14 meeting, but nonetheless warned that the work is not yet done. What surprised investors most, and continues to roil markets since, is the fact that the Fed signaled that short term interest rates would need to rise to 5.5% to achieve the goal of vanquishing inflation. Keep in mind that Fed Funds rate resides in a range of 4.25% - 4.5% today, meaning another 100 basis points of further tightening would be required. Given that the incoming economic data is already showing considerably weakness, the magnitude of additional tightening has the market concerned that the Fed is making a policy error, one that will result in recession. Were they to do it, we would absolutely agree. That said, where we differ from consensus is that we believe the upcoming Consumer Price Index (CPI), Producer Price Index (PPI), and the Personal Consumption Expenditure (PCE) readings will make it abundantly clear that inflation is already dead. The Fed will realize they are battling a paper dragon and the pause in further tightenings will arrive at, or immediately after, their February 1, 2023, meeting. If we are correct, the relief rally in the market could be substantial.

Let us examine why we are so convicted that the Fed will pivot. The Fed divides inflation into four categories: core goods, housing services, services ex-housing, and finally, food and energy. In November, all three inflation gauges showed demonstrable improvement. The Core CPI increased 0.2% month over month and fell from 6.7% to 6.0% year over year. Core PPI rose 0.4% month over month and fell from 6.6% to 6.1% year over year. Finally, the Fed's preferred measure, PCE increased 0.1% month over month and fell from 5.0% to 4.7% year over year. Keep in mind, the Fed explicitly said they need to "raise interest rates to a level that is sufficiently restrictive to return inflation to 2%." They did not say they need to raise interest rates until inflation returns to 2%. The distinction is important because the data is showing significant progress and it should only continue.

Looking at the aforementioned buckets, core goods inflation actually fell 0.5% month over month. Diving deeper, the weakness was diffuse. Used car prices fell sharply, new car prices stayed flat, while technology equipment, furniture, appliances, and sporting goods all declined. Apparel was the lone standout and it only increased modestly. Is this a temporary blip or a trend? We think the latter. Why? Supply chains have normalized and inventories are rising rapidly. Look no further than automobiles. In October 2021, dealers had 680,000 units on hand. As of November 2022, dealers saw inventories swell to 1,610,000 cars. and that should only accelerate. While still low by historical standards, the dramatic increase is proof positive that supply constraints are easing. Ample evidence backs this up. Wholesale and retail inventories are up sharply. Freight rates are falling precipitously. Finally, consumer spending is cooling. Savings rates have declined from 7.3% at the beginning of the year to 2.3% in the latest period, while revolving credit balances are up 15% over the same time frame. This tells us that the consumer has likely spent a considerable amount of the excess stimulus savings. Taken together, this likely means that supply is increasing while demand is cooling. All of this points to the fact that core inflation has already been vanquished and the illustration below only cements that fact.

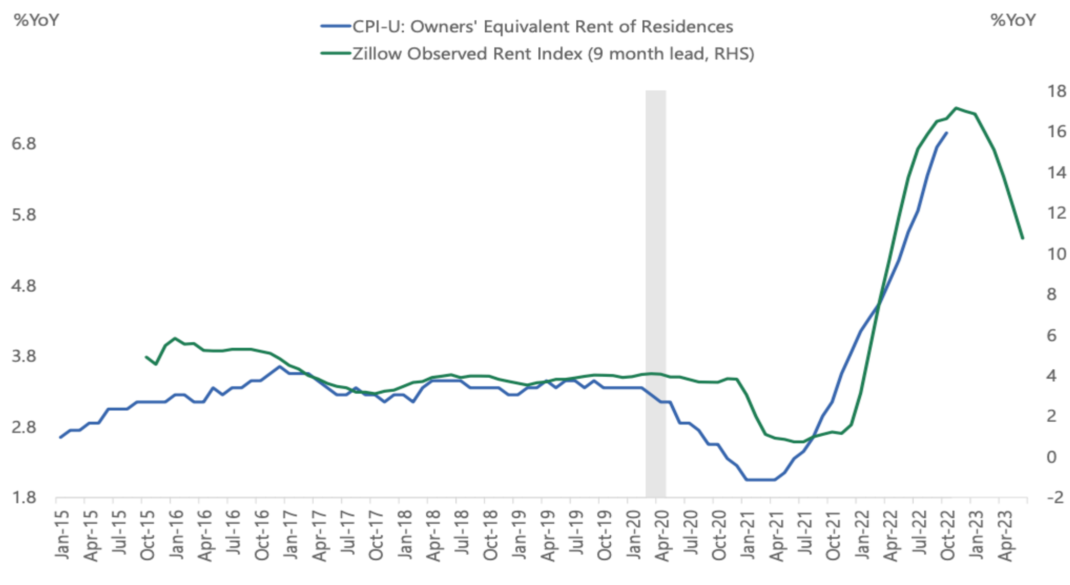
Core inflation ex-shelter is rolling over



Source: BLS, Haver Analytics, Apollo Chief Economist

Now, let's examine housing services, where shelter inflation continues to run hot, up 0.6% m/m in the latest period. For those who have been reading our work, you know that we have been highlighting for some time that real time measures of shelter inflation (Zillow, Rent.com, Case Shiller, etc.) are all declining, while the lagged data used to compose the CPI, are still accelerating.

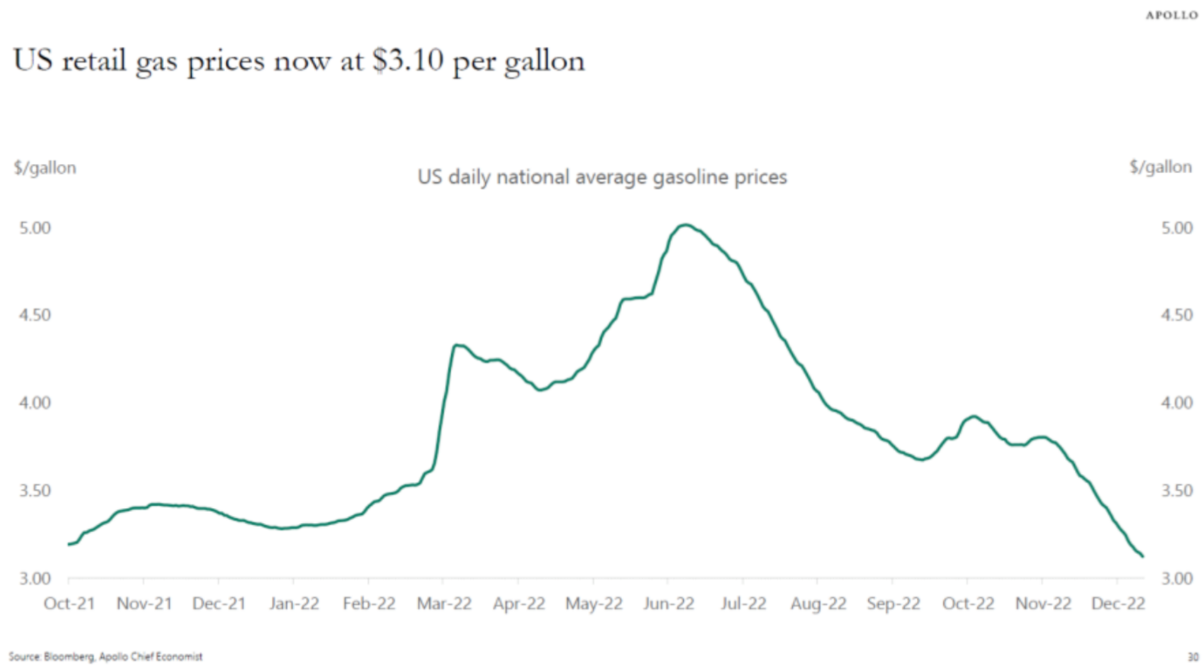
Housing inflation about to come down



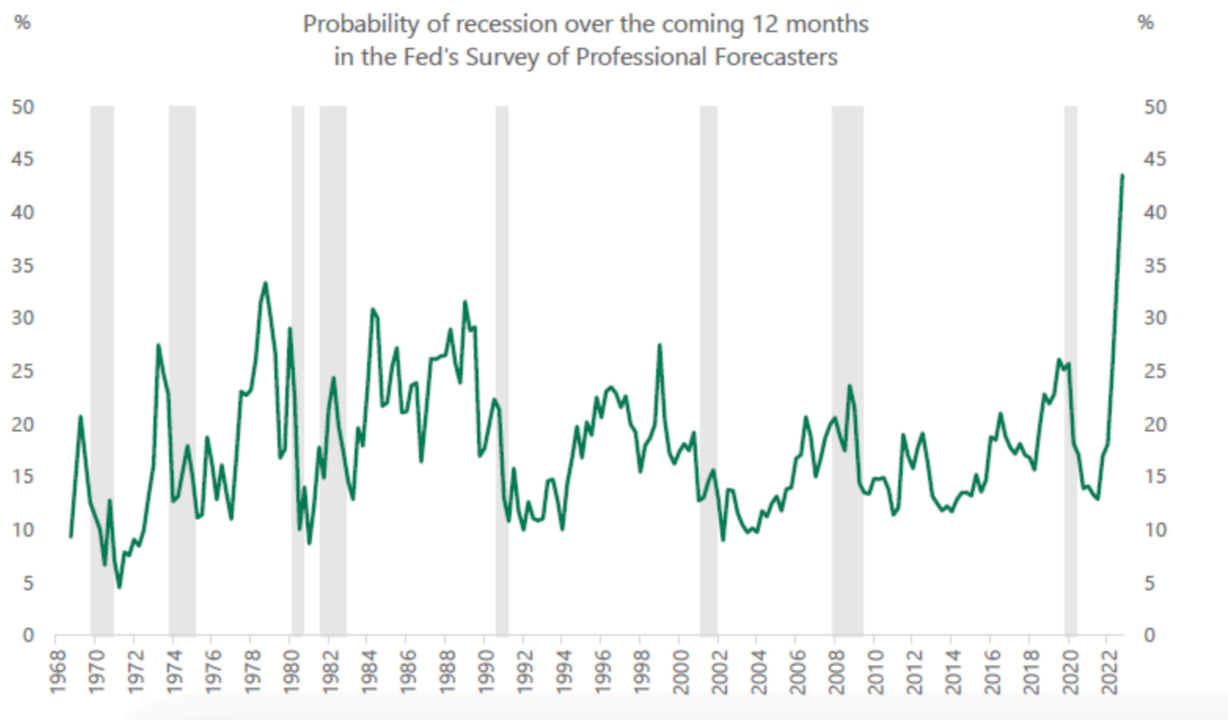
Source: Zillow, BLS, Haver Analytics, Apollo Chief Economist

This leads to a misrepresentation of our current situation and could influence the Fed to overstate the inflation problem. However, much to our delight, the Fed finally seems to be paying attention. On 12/20/22, the Cleveland Fed, in conjunction with the Bureau of Labor Statistics (agency responsible for CPI) launched a new index to track rental price changes for new and existing tenants https://www.reuters.com/markets/us/new-cleveland-fed-data-points-easing-shelter-inflation-outlook-2022-12-20/. Not surprisingly, the new measure shows that shelter inflation has already halved from the peak. If the Fed starts to incorporate this into their calculus, it could mean an earlier cessation in rate hikes.

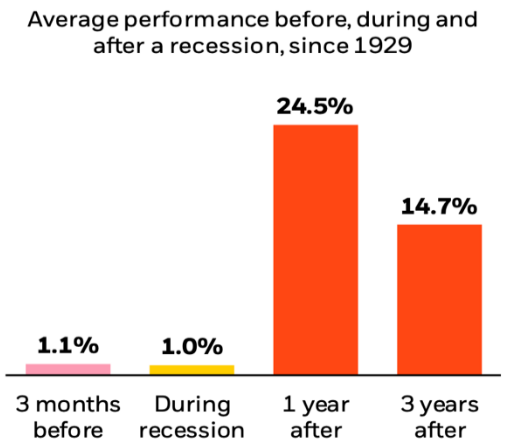
Moving on to services, ex-housing, that figure was flat m/m in November. In fact, airlines fares, hotel rates, and medical services all declined. Restaurant prices continued to rise, but at the slowest pace since March 2022. Finally, in the food and energy bucket, we are starting to see very welcome news. Oil and gasoline prices nationally are now down year over year, below levels seen prior to the commencement of the Russian invasion of Ukraine.



Taken together, we think these data provide very strong evidence that inflation is rapidly cooling. We strongly believe that the Fed will follow the data and that will lead them to conclude their tightening campaign earlier than most expect. Why is so important? Inflections in monetary policy tend to usher in dramatic, positive moves in equities and bonds. But what happens if the damage has already been done and the prior tightenings cause an economic contraction? Not to sound cavalier, but judging by the illustration below, this will be the most anticipated recession of all time should it actually occur.



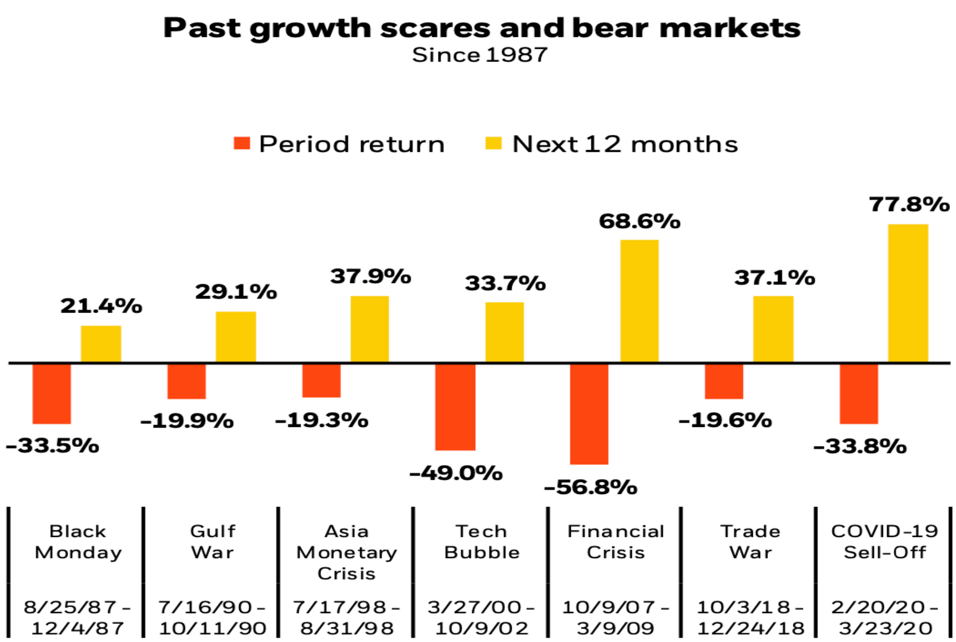
If the vast majority of investors believe we are going into recession, our contention is that equity prices already reflect that risk. The good news is that you don't need to take our word for it. You can rely upon historical precedent. In fact, since 1929, the average performance for equities is actually positive, both in advance of, and during recessions which tends to prove our point that the market isn't focused on the past or present, it is focused on the future. If investors gain confidence that monetary policy has shifted, they will focus on the recovery that always arrives.



Recessions	3 month prior	During recession	1 yr later	3 yrs later
1929-09-01 to 1933-03-31	28.6	-33.6	92.0	43.0
1937-06-01 to 1938-06-30	-9.0	-22.4	-1.9	0.3
1945-03-01 to 1945-10-31	12.6	19.5	-7.3	4.9
1948-12-01 to 1949-10-31	-5.9	15.2	31.5	23.4
1953-08-01 to 1954-05-31	2.1	24.2	35.9	22.5
1957-09-01 to 1958-04-30	-3.8	-1.5	37.3	18.5
1960-05-01 to 1961-02-28	-1.4	20.3	13.6	10.5
1970-01-01 to 1970-11-30	-0.3	-2.0	11.3	6.4
1973-12-01 to 1975-03-31	-7.1	-5.9	28.3	6.9
1980-02-01 to 1980-07-31	13.6	9.6	13.0	16.0
1981-08-01 to 1982-11-30	-0.2	10.5	25.6	18.6
1990-08-01 to 1991-03-31	8.7	8.0	11.0	9.1
2001-04-01 to 2001-11-30	-11.9	-0.9	16.5	2.7
2008-01-01 to 2009-06-30	-3.3	-25.0	14.4	16.4
2020-03-01 to 2020-04-30	-5.5	-1.1	46.0	21.0
Average	1.1	1.0	24.5	14.7

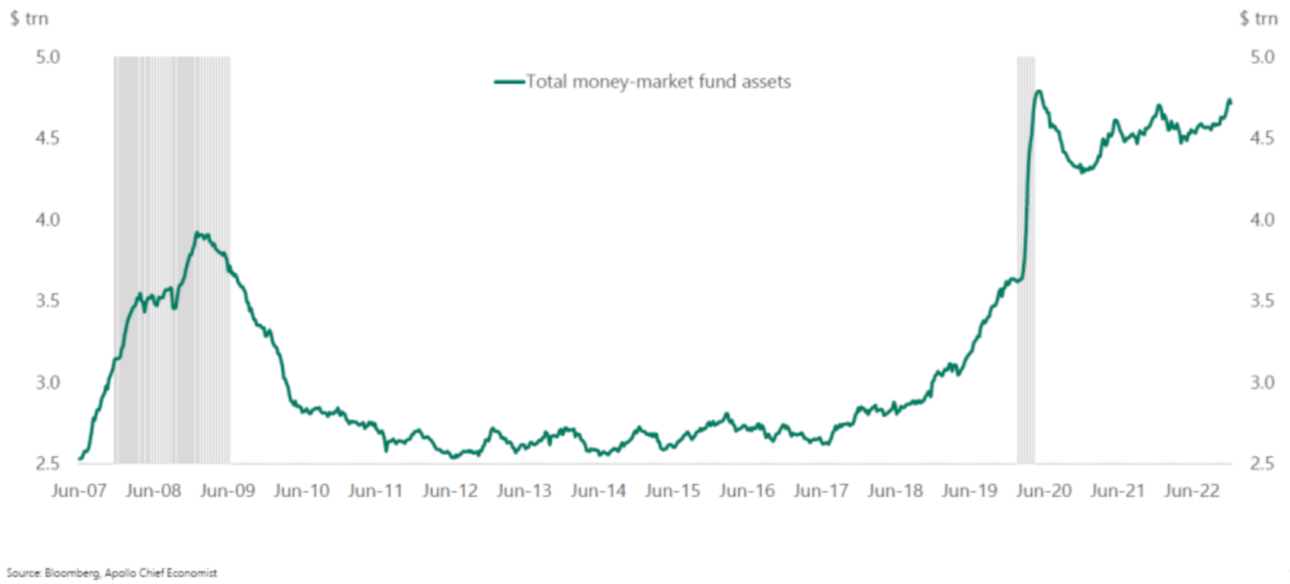
Morningstar as of 7/31/22. Stock market represented by S&P 500. Stocks represented by the IA US Large Cap TR Index and US Bonds by the IA US IT Gov Bond Tr Index. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

Finally, keep in mind the magnitude of the recovery post a growth scare is dramatic. It pays to be early, not late. This is the time to be intrepid.



But this time is different say the pundits. Actually, this time seems very similar to us. Consider the following. Since the Federal Reserve began targeting the Federal Funds rate as a policy lever in 1982, there have been six previous tightening cycles (not including the one Chairman Powell just initiated). On average, the Fed hiked rates 300 basis points (100 basis points equals 1%) from start to finish, with the largest being 425 basis points from 2004-2006. As of the December Fed meeting, the authorities have raised rates 425 basis points. In other words, we are already at the high end of the scale. Furthermore, the average equity bear market contraction is -28% and lasts 11 months. For reference, we hit our low 10 months into this correction and pulled back nearly -27% from peak to trough. Meanwhile, valuations are back to historical averages, and animal spirits that propelled everything from speculative meme stocks, to crypto, to NFTs have been extinguished. To illustrate how ugly investor sentiment has become, look no further than the latest American Association of Individual Investors poll. Over 53% of respondents identify themselves as Bearish. The long-term average is 31% for context. Recall the cycle of market emotions that we routinely publish. Markets generally reach bottom after investors capitulate and become despondent. How do we know that they have capitulated? You simply need to follow the money. Currently, $4.7 trillion dollars reside in US money-market funds. In other words, the very accelerant that usually propels the strong recovery is present.

$4.7trn in US money-market funds



At Westshore, we have employed a very conservative posture with respect to our asset allocation, using various shock absorbers and uncorrelated assets to reduce our downside participation. That served us well this year, allowing us to outperform our respective equity and fixed income benchmarks. That said, as you may recall, when the market reached 3700 on the S&P 500, we started the process of removing some of that conservatism. We plan to continue along that path as we enter the new year to more fully capture the upside that we foresee for both stocks and bonds. We welcome your thoughts and questions.

Important Disclosures

This commentary in this paper reflects the personal opinions, viewpoints and analyses of the Westshore Wealth employees providing such comments, and should not be regarded as a description of advisory services provided by Westshore Wealth or performance returns of any Westshore Wealth Investments client. The views reflected in the commentary are subject to change at any time without notice. Nothing herein constitutes investment advice, performance data or any recommendation that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person. Any mention of a particular security and related performance data is not a recommendation to buy or sell that security. Westshore Wealth manages its clients' accounts using a variety of investment techniques and strategies, which are not necessarily discussed in the commentary. Investments in securities involve the risk of loss. Past performance is no guarantee of future results.

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