MH & ASSOCIATES • SECURITIES MANAGEMENT CORPORATION

INVESTMENT VIEWS

NOVEMBER 30, 2022

RECESSION INEVITABLE?

There has been plenty of chatter over the last few months about the potential for a recession in 2023 with more and more signals pointing its inevitability. The most talked about signal is an inversion of the yield curve which occurs when shorter term Treasury yields (generally 2 year Treasuries) are higher than the yield on a 10 year Treasury. When this occurs, it is generally expected that a recession will occur in the next 18 months (i.e the end of next year). An even more timely recession reading is an inversion of the 3 month Treasury yields and the same 10 year Treasury. This inversion occurred in early October and generally means a recession is very close.

Another measure that is closely watched is the index of Leading Economic Indicators (LEI). These have been declining for eight consecutive months, a streak that is always followed by a recession. The LEI was down 2.7% from the same period last year which is worse than the average of -2.2% at the start of past recessions. The Philly Fed State Coincident Index also signaled the economy is near or at the start of a recession with its most recent reading as well. However, it is not all doom and gloom. Several components of the LEI have shown consistent improvement, like capital goods, durable goods, and unemployment claims remain strong.

Overall, the picture is not very encouraging, but many of these issues are dependent on the level of inflation. Should inflation cool (see inflation article), then interest rate increases will moderate or come to an end. This will be a salve to both stock and bond markets, as well as the economy, since it is likely that high inflation and higher interest rates are somewhat priced into the market at this point.

CHINA UNREST

Recent unrest in China has caught the worlds attention just as it appeared that Xi had cemented his power over the Chinese Communist Party (CCP). Citizens there have had enough of the strict lockdowns that have been in place for the past year. Some areas have been under lockdown for months and many industries have come to a standstill.

We do not believe that the unrest is a real threat to the CCP, but do think it will have some effect as far as encouraging the CCP to loosen the so called “Zero COVID” policy. A locked down China definitely has a cooling effect on the global economy. Note that many commodity prices such as oil, natural gas, copper and other industrial metals remain elevated with the Chinese economy basically halted. Once it reopens, we expect that many of these commodities will really start to move up.

HAS INFLATION HAS PEAKED?

There is good reason to believe that CPI will cool even more over the next few readings since the rates of change at this time last year were very high. Core CPI numbers in November, December & January last year came in between +0.5% and +0.6%. Since May there has been only one such high reading, meaning it is quite likely that the rate of change in Core CPI will be lower than versus last year. When you replace big increases with moderate ones, the annual rate will fall.

More evidence of expected inflation easing can be seen by the previously talked about Treasury yields since they reflect investor expectations for what short term rates (those set by the Fed) will average over the life of the bond. Longer yields are lower than shorter yields, thus investors are clearly expecting rates to moderate. The positive here is that investors are saying that rates will be lower in the long term as the Fed is forces to cut rates to shore up a slowing economy. While a slowing economy does not seem like good news (and it is not), the positive is that the Fed will only consider lowering rates when inflation is under control. So even investors see inflation waning from here and this can change the Fed's narrative.

INVESTOR EDUCATION: BOND DURATION

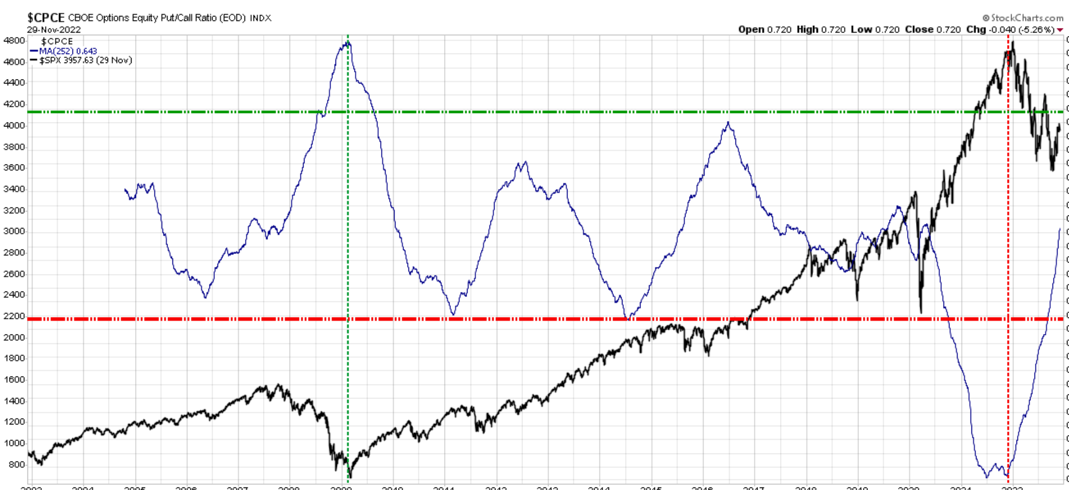
As discussed in our previous newsletter, 2022 has been one of the worst years on record for bonds. Traditionally thought of as a safe haven, they turned out to be anything but. Those with large bond portfolios suffered losses on par with that of the equity markets—solid double-digit declines! We have long been bearish on bonds, seeing that the ultra-low interest rate environment offered investors all risk and virtually no reward. Investors who chose cash over bonds, giving up the tiny interest rates they offered did well.

The financial concept that helped guide our decision is known as **bond duration.** Bond duration measures a given bond's price sensitivity to a change in interest rates. Although related, duration should not be confused with maturity, which is the length of time a bond has until it must be repaid. Generally, factors such as time, credit quality and future expectations of interest rates affect a bonds duration.

As an example, the 10-year US Treasury has a duration of 14, meaning that for a change (rise) in interest rates of 100 basis points (1%), the value of the bond would decline 14%. Since interest rates increased over 200 basis points this year, the 10-year US Treasury has declined nearly 30%! So, it is easy to see that when the 10-year rate was 1% it indeed offered a miniscule reward for much larger risk…like picking up pennies in front of a steamroller. Going forward, the risk/reward for bonds has significantly improved. Taking bond duration into account, we think bonds in the intermediate term (2-7 years) look the most attractive since interest rates have risen sharply. We are looking to add quality intermediate term government and corporate bonds over the next few months.

OPTIONS CAN TELL YOU A STORY

People play options as either a hedge or a way to invest with less initial capital outlay. But looking at the options market can provide a useful sentiment indicator about the equity market. If more people are buying puts than call options, then they are generally more bearish and vice versa. Pictured below is a chart of the one year moving average of the Put/Call ratio (in blue) and the S&P 500 (in black). When this ratio rises, more puts are being bought and when it falls, more calls are being purchased. So as this ratio rises, there is a more bearish sentiment on the market and the opposite is also true. The one year moving average has tended to stay within the thick green and red lines, with the exception of two occurrences...it peaked well above at the market bottom in 2009 and bottomed below at the 2021 market top. In general when it changes direction it will stay in that direction. We will be watching this for a possible reversal to indicate a new market bottom.



PRECIOUS METALS UPDATE

We continue to believe that precious metals are due for at least a substantial rally into early 2023. The Fed recently indicated that it will slow the pace and size of rate increases while allowing current higher rates to cool off inflation. It is our thesis that inflation is likely to ebb and flow but remain elevated over the next few years due to problems on the supply side. Additionally, it is likely that gold and silver may face their own supply issues as costs rise and miners face labor and parts shortages. The fundamentals continue to improve for this tarnished sector.

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