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@WarrenPies
SEPTEMBER 21, 2023

Time for a Rotation

*"And now, gentlemen, like your manners, **I must leave you**."* – Dylan Thomas

*"I demolish my bridges behind me…then **there is no choice but to move forward**."* – Fridtjof Nansen

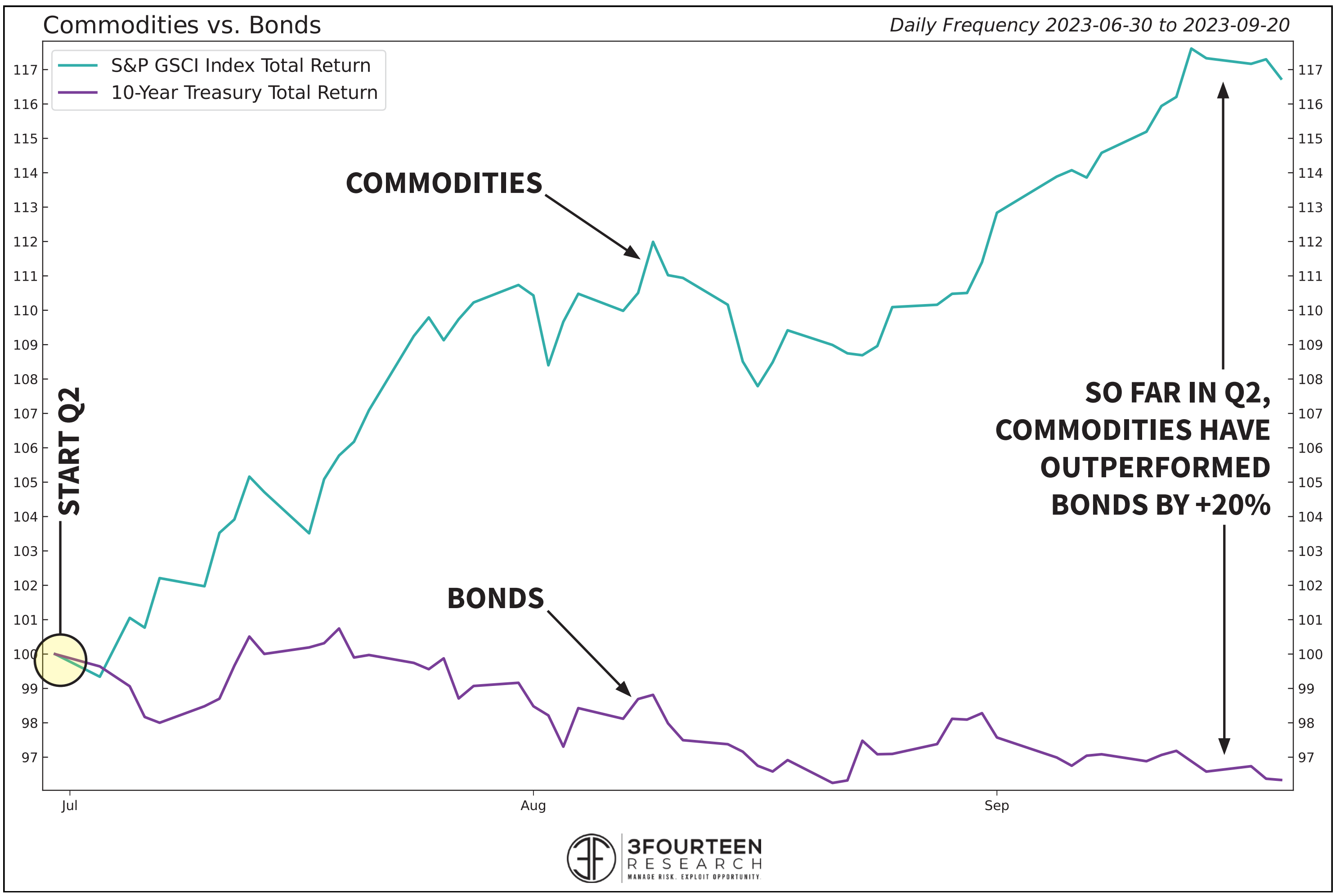
*"We meet ourselves time and again in a **thousand disguises** on the path of life."* – Carl Jung

*"Whenever **a theory appears to you as the only possible one**, take this as a sign that **you have neither understood the theory nor the problem** which it was intended to solve."* – Karl Popper

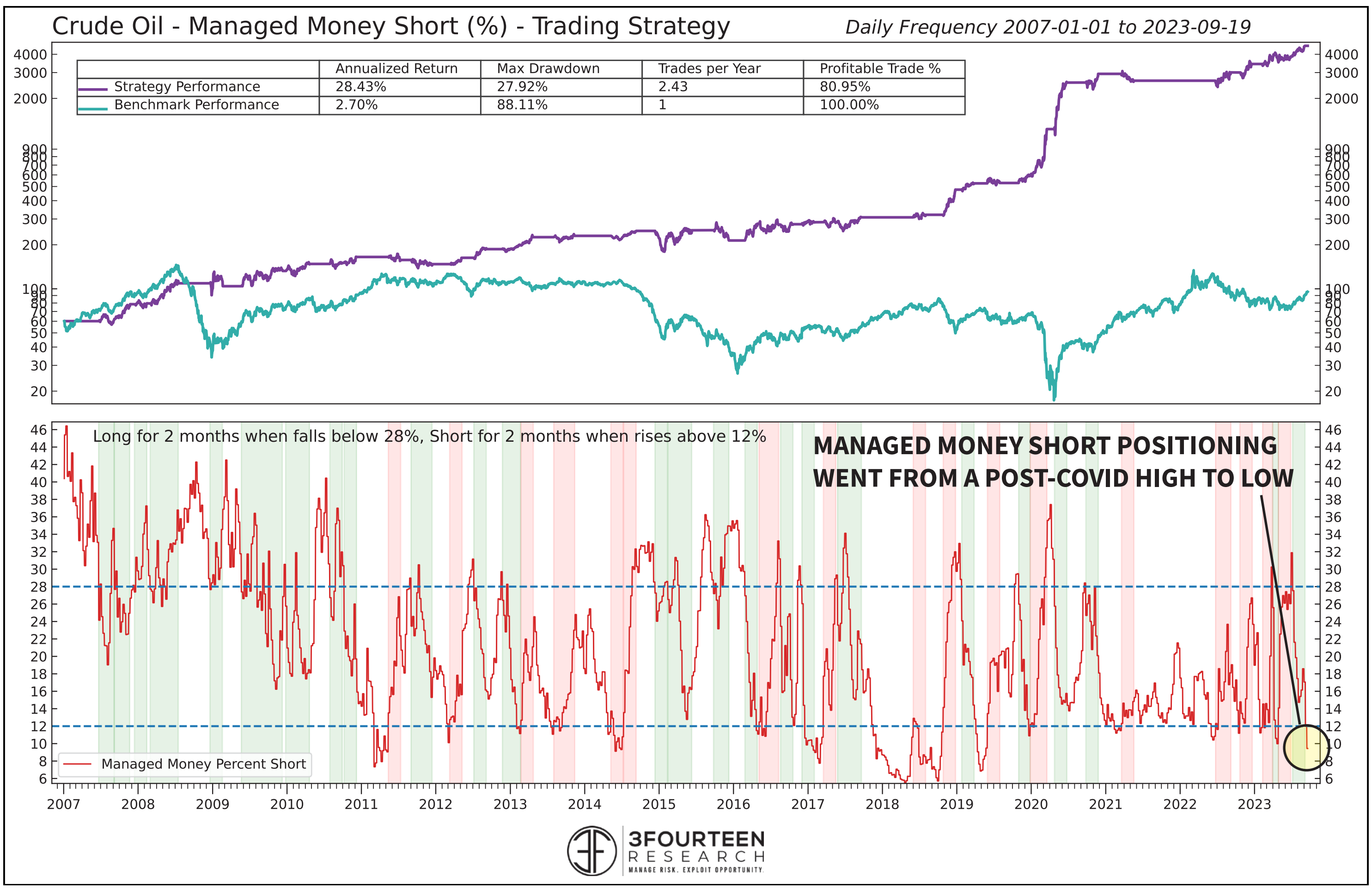
*"If the economy evolves as projected, the median participant projects that the appropriate level of the federal funds rate will be 5.6% at the end of this year, 5.1% at the end of 2024, and 3.9% at the end of 2025. **Compared with our June SEP, the median projection** is unrevised for the end of this year but **has moved up ½ percentage point at the end of the next two years**."*
– Jerome Powell, September 20, 2023 press conference

EXECUTIVE SUMMARY

- Oil has almost hit our upside target ($100), and bonds are approaching fair value (4.5% 10-Year).
- For the S&P 500, forward estimates are rising (bullish), but Q2 reactions to ostensibly positive earnings is a red flag.
- Today, we officially shift 5% out of commodities and into bonds in our Strategic AA Recommendations.

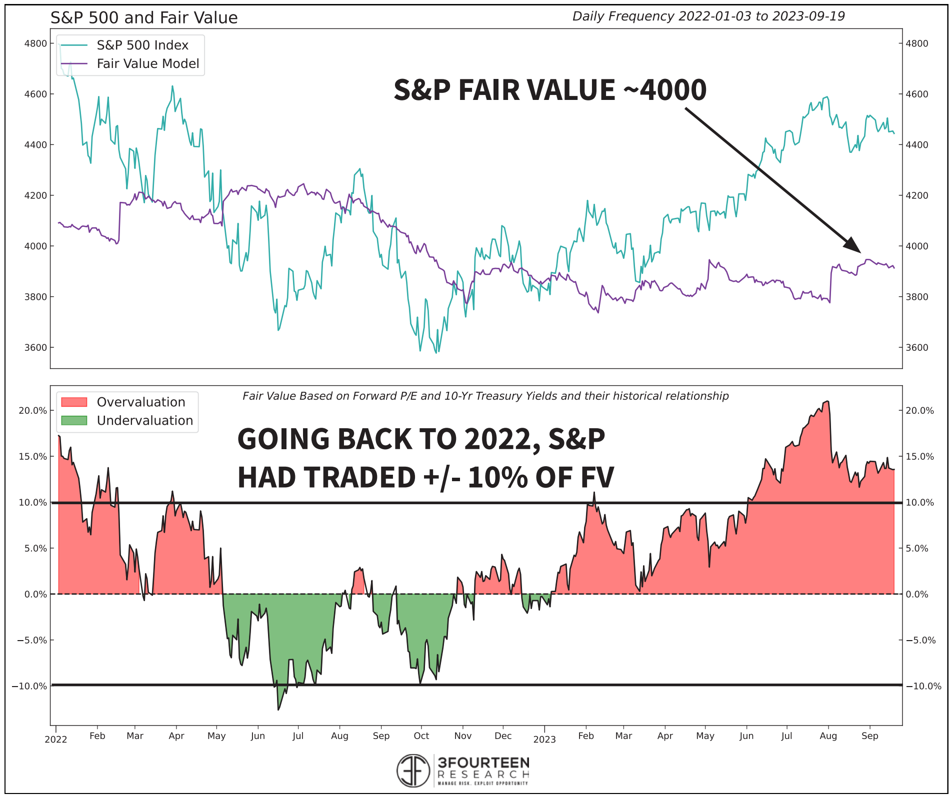


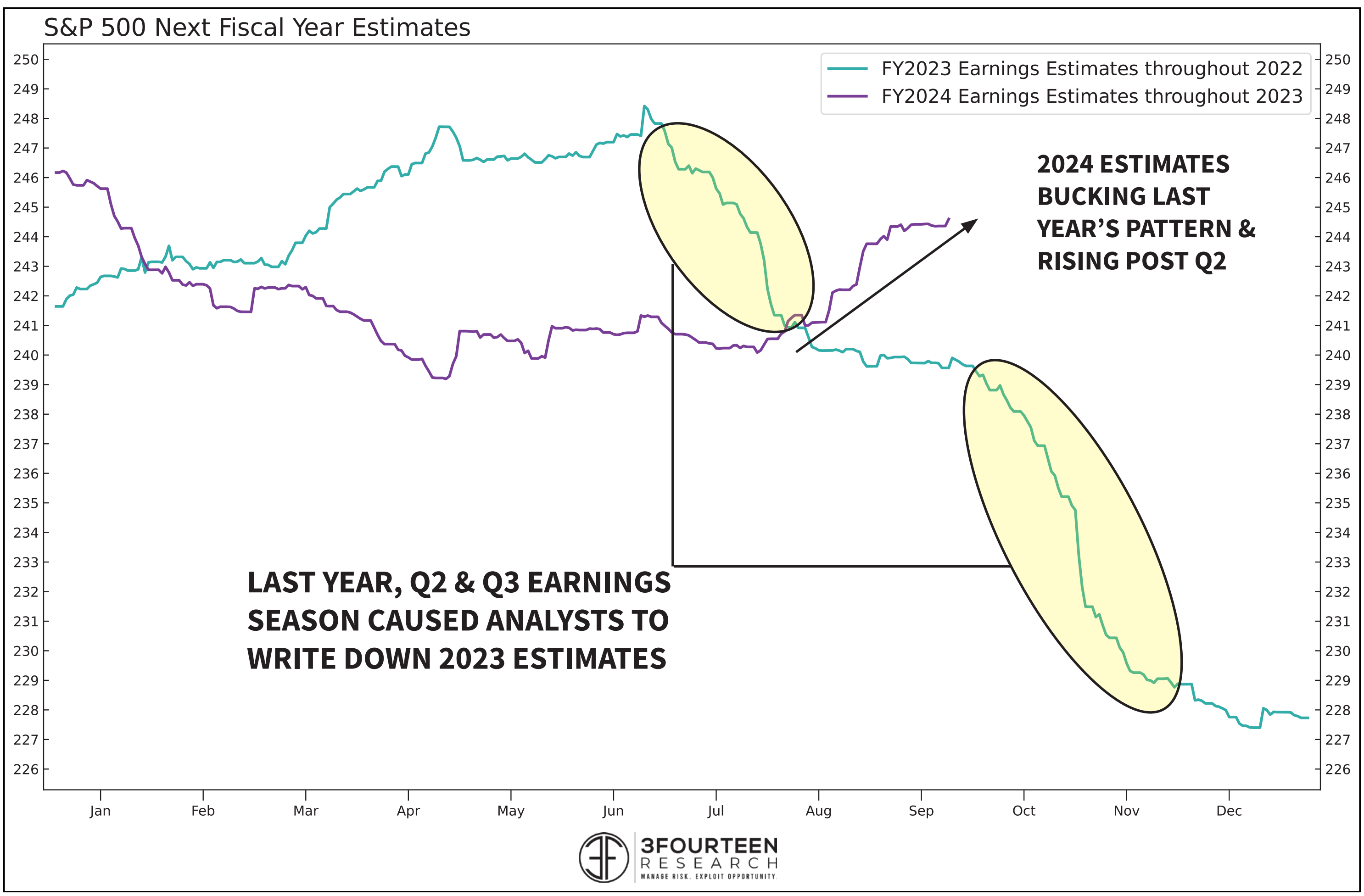
Summer is officially over and there are only nine days left in Q3. In the financial world, this is a time for reflection. Yesterday's FOMC meeting, and the market's reaction to it, have given investors much to ponder heading into year end. Ourselves included. [At the midpoint of 2023](), we had moved aggressively out of bonds and into commodities (see our Strategic Asset Allocation recommendations). So far for the quarter, commodities have shot higher by 17% (GSCI Index). Bonds have fallen by 4% total return (Bloomberg Long Bond Index). Of course, oil has led commodities higher—surging by ~30% this quarter. This week, Dated Brent popped up above $96/bbl. The 3Fourteen Core Crude Oil Model moved from NEUTRAL to BUY back on July 7 and then flipped back to NEUTRAL on September 14. Shifting futures positioning pushed the Model off its buy signal. Specifically, the Managed Money group within the CFTC, which includes hedge funds and CTAs, started this rally with short positioning at 32% (highest level post COVID). Now, the shorts within this pocket of the market have melted to 10% (chart below). Two weeks ago, we summarized the oil situation as follows: "*Oil is likely to run a bit further, but the pitch is no longer 'fat.' Once hedge fund positioning falls below 12%, we will look to make an allocation shift.*" So, hedge funds have capitulated. The Saudis have successfully flexed their market muscles. And, crude is within a few bucks of our $100 target. **It's time to consider moving on from the oil/commodity trade. The question on the table: Between stocks, bonds and cash, where should commodity investors rotate?** Within our Strategic AA framework, we are already maxed out on our cash position (20% = max positioning). This leaves us with a classic dilemma: Bonds vs Stocks—where to allocate? Currently, our positioning reflects a preference for stocks over bonds. [We have enumerated our issues with bonds many times.]() But, we agree with the mantra: There are no bad assets, only bad prices. And, bonds have indeed become cheaper (yields across the curve breaking out). Today, we consider moving chips out of the commodity trade and discuss the relative merits of stocks and bonds. **Skipping to the bottom line, we are increasing our bond weight by 5%. For clients following along, we fund this purchase by reducing our commodity exposure by an offsetting 5%.**

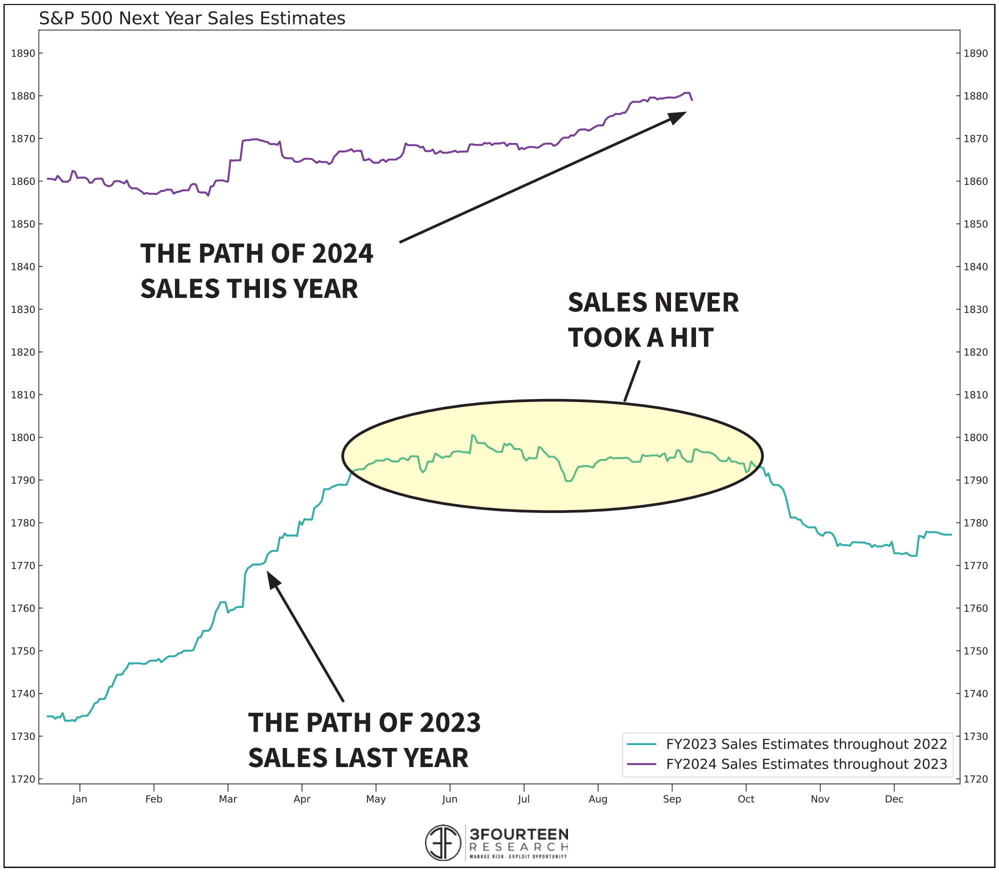


EQUITIES

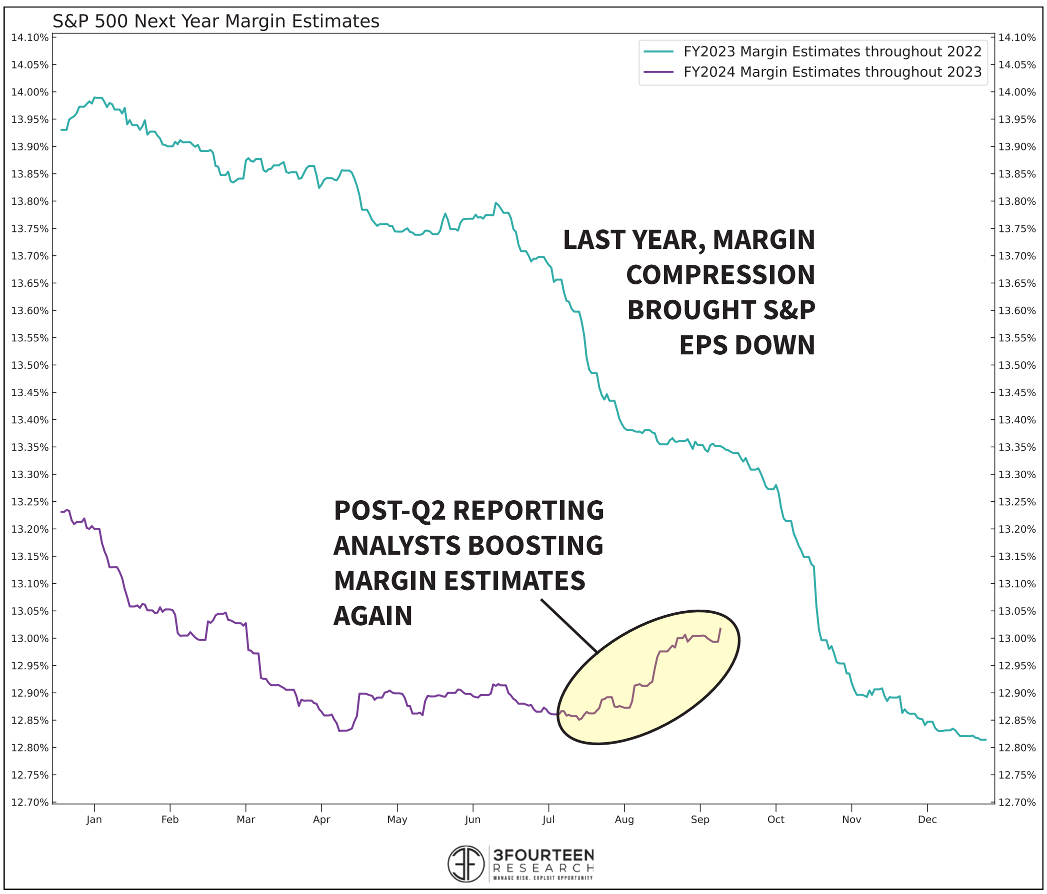
On the doorstep of Q4, stocks are a mixed bag. Valuations remain stretched (see our simple model of interest rates + forward multiples chart right). Positioning leans bullish (too much pessimism). And, technically, the market is chopping between support (4,300) and resistance (4,600). Many key charts are on the verge of a breakdown (see appendix charts of NVDA, AAPL, and EW S&P). **Notably, forward EPS estimates emerged from Q2 earnings season heading higher (chart below).** Previously, we ended our second-half outlook warning that "*our models point to downside for forward estimates from here. Q2 earnings season is a risk window (similar to last year).*" In the chart below, we compare the path of next year's estimates (2024 – purple line) to the path of 2023 estimates through 2022 (blue line). On an earnings basis, stocks passed the test of Q2 with flying colors.







Last year, analysts took down forward estimates during Q2 and Q3 reporting. Conversely, through the most recent quarter, analysts have bumped their 2024 EPS estimates up from $239 to $245. Growing topline has contributed about $1 to next year's estimates. At present, analysts expect 2024 S&P 500 revenues to grow by ~5.6% (year-over-year). Compared to nominal GDP, this seems reasonable. Historically, topline estimates only come down once recession fears become palpable (see the fall in late 2022 as an example).

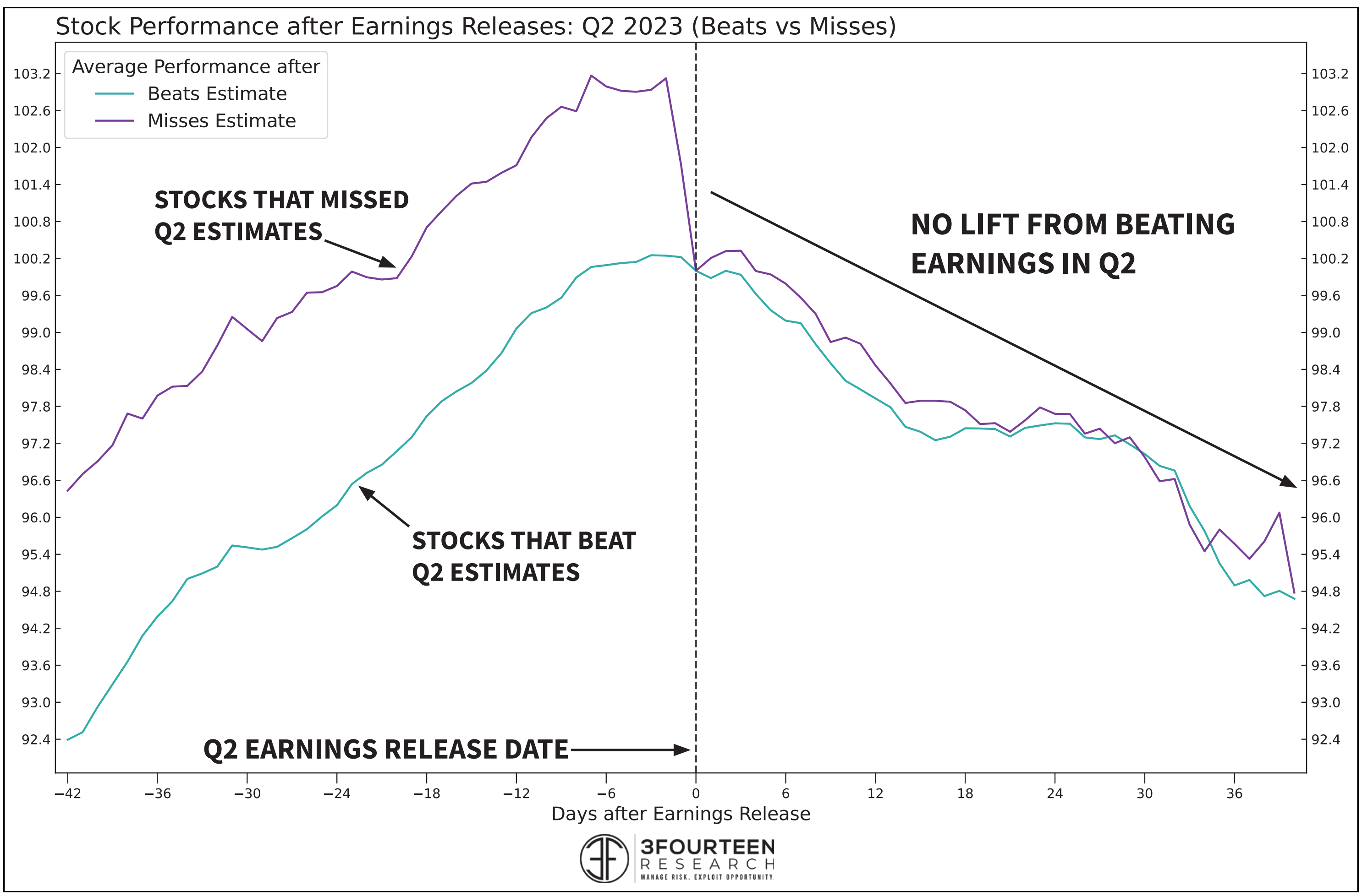


In our opinion, the expected margins growth baked into next year's estimates is more controversial. Expanding margins have added $5 to 2024 EPS estimates this quarter. Said differently, ~80% of the recent EPS bump is due to an expectation of fatter 2024 profit margins. As we discussed in our H2 Outlook, last year it was shrinking margins that brought EPS expectations down. Now, for the first time since 2021, analysts are forecasting margin expansion (currently above 13%). Recall, pre-COVID 12% represented peak margins. Based on current revenue forecasts, every 100 basis points of margin expansion adds $19 to S&P EPS. Of course, the math works the same way in reverse.

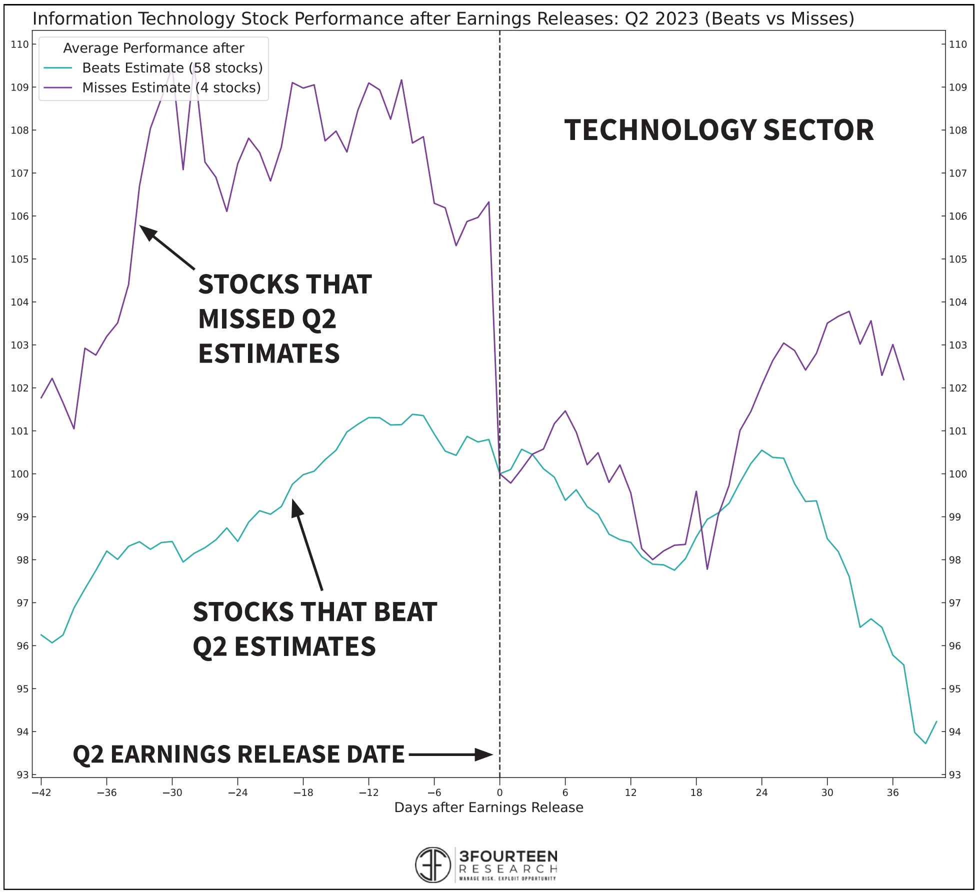
Harkening back to our H2 Outlook, we reiterated that "*the durable economy favors stocks and commodities over bonds.*" We pointed to forward earnings as a key variable. To quote: "*Rising analyst estimates would propel us to add to our (equity) position.*" **So, the market has come through Q2 earnings season unscathed. Instead of falling earnings and margins, analysts have ratcheted up estimates. These are unequivocally bullish developments.** So, if we are going to rotate out of commodities, there is a case to be made for increasing our equity weight.

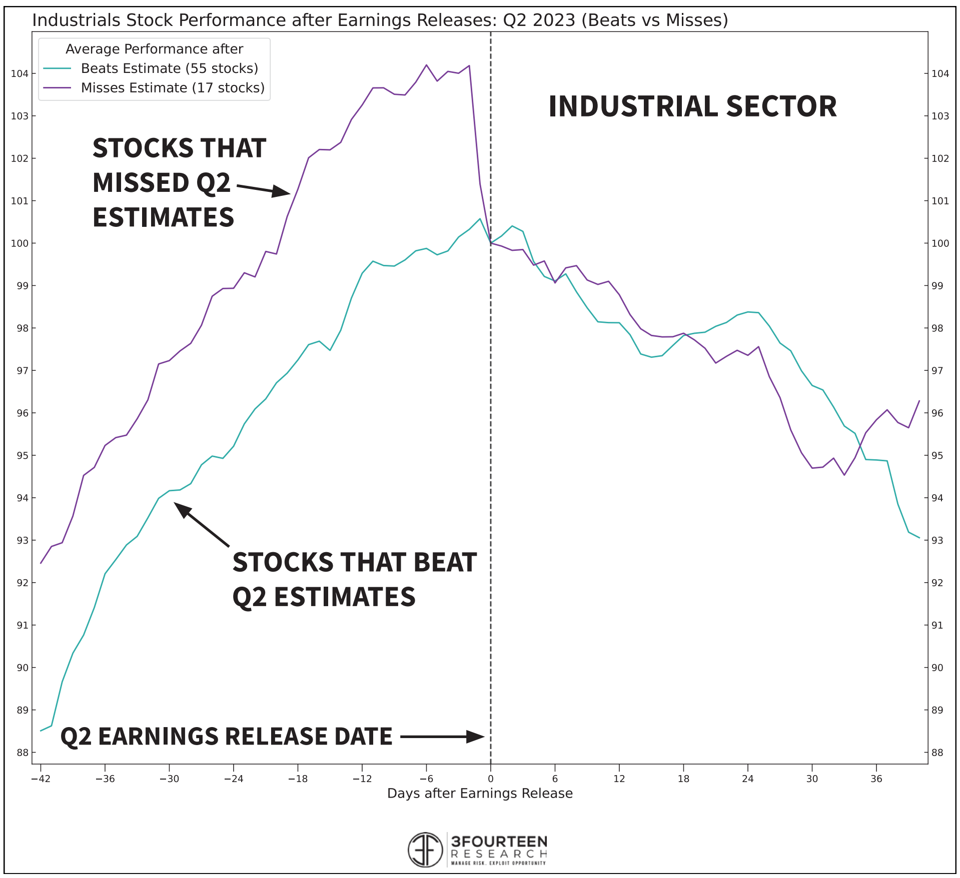
However, as is so often the case in markets, new concerns have surfaced. There are always potential red flags. Often, they are opaque macro concerns like "liquidity." These are classic bricks in the "wall of worry" that the market climbs again and again. There are another class of concerns worth taking more seriously. This is what we would call a "news failure" (hat tip to Jason Shapiro for adding this term to our vocabulary). This is when the market sells off on ostensibly good news (a bullish news failure occurs when a market rises on what should be bad news). **Put simply, when the market does not behave like it is "supposed" to, it is worth paying close attention. From this perspective, the Q2 earnings season has been one big news failure event.** In the chart below, we revive our last Chart of the Week. Here, we look at the reactions of S&P 500 stocks around Q2 earnings releases. The study breaks the universe into stocks that beat estimates (blue line) and those that missed estimates (purple line). Unsurprisingly, investors sold the stocks that missed estimates following the announcement (notice purple line gapping down). More interesting, stocks that beat earnings last quarter also sold off (blue line).

NVDA is the most prominent "news failure" from the last earnings season. Prior to Q2 earnings, Fernando deftly summarized the future priced into this AI darling: "*If Nvidia meets expectations, the world will be awash in more than enough capacity to keep us all spending dozens of hours per week chatting with today's most advanced language models…Our conclusion is that Nvidia is uninvestable at its current valuation.*" NVDA went on to blow away expectations: Management reported higher revenues and earnings. In addition, they upped guidance and initiated a buyback. Basically, there were no nits to pick. Yet, the stock has fallen from $500 to $410.



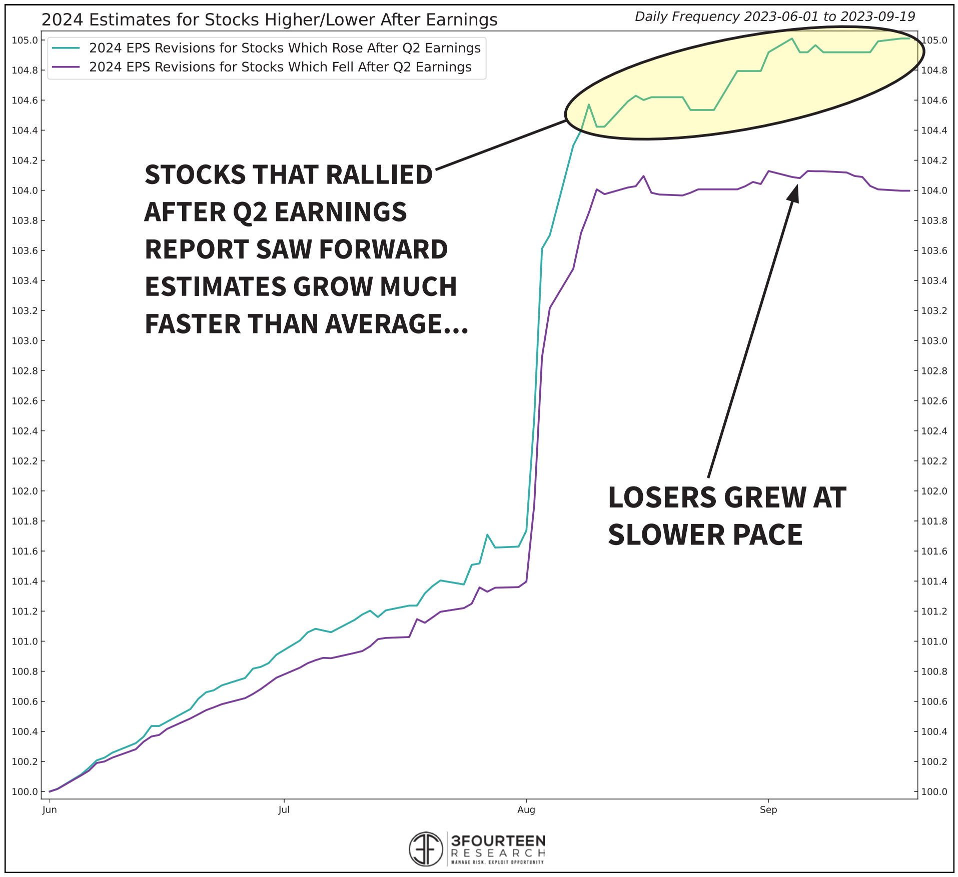
NVDA's post-earnings reaction is the quintessential news failure. All of the good news—and then some—was priced into the stock. **Within the market, three sectors have largely driven the rise in 2024 estimates: Tech, Discretionary, and Industrials. Interestingly, these three sectors have exhibited the same pattern as the broad market—selloffs despite earnings beats.** To the right, we display the same study but only include Tech stocks. For the Tech Sector, the negative reaction took a few weeks post-earnings to take hold (blue line).

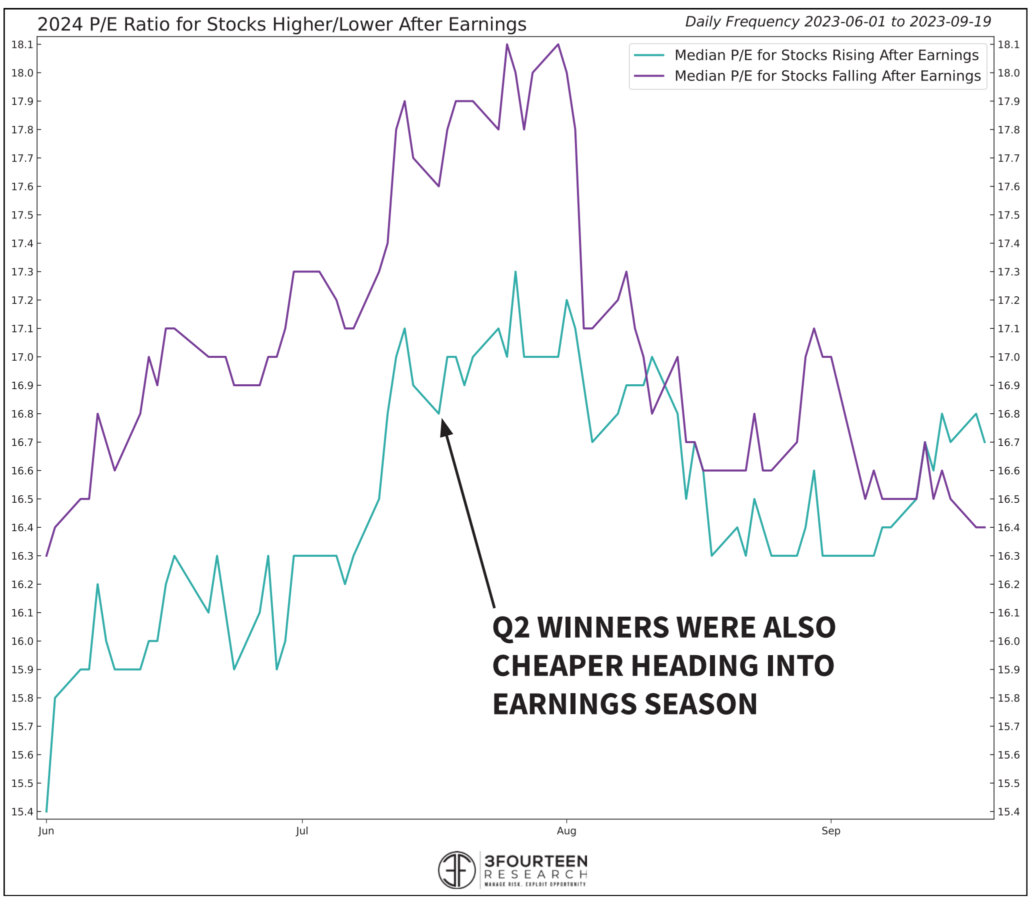




The market has reacted similarly to Industrial stocks beating earnings this quarter (chart left).

How do we interpret this price action? A deeper dive into the Q2 winners/losers provides some insight. For Q2, about 30% of the S&P 500 rose following their earnings announcement. **Looking closer, there were a couple interesting characteristics that defined the winners this quarter. First, these stocks saw earnings estimates rise even further than the rest of the market.** The chart to the right displays the median growth of analyst estimates for the post-earnings winners (blue line) and losers (purple line). In sum, both groups saw a rise in median 2024 earnings estimates, but the post-earnings winners received a significantly larger boost to forward earnings (~25% more than loser basket). Translation: The market is not satisfied with stocks simply hitting earnings and raising estimates. At current valuations, companies must blow the doors off of earnings to stage a rally (i.e. guide significantly higher).



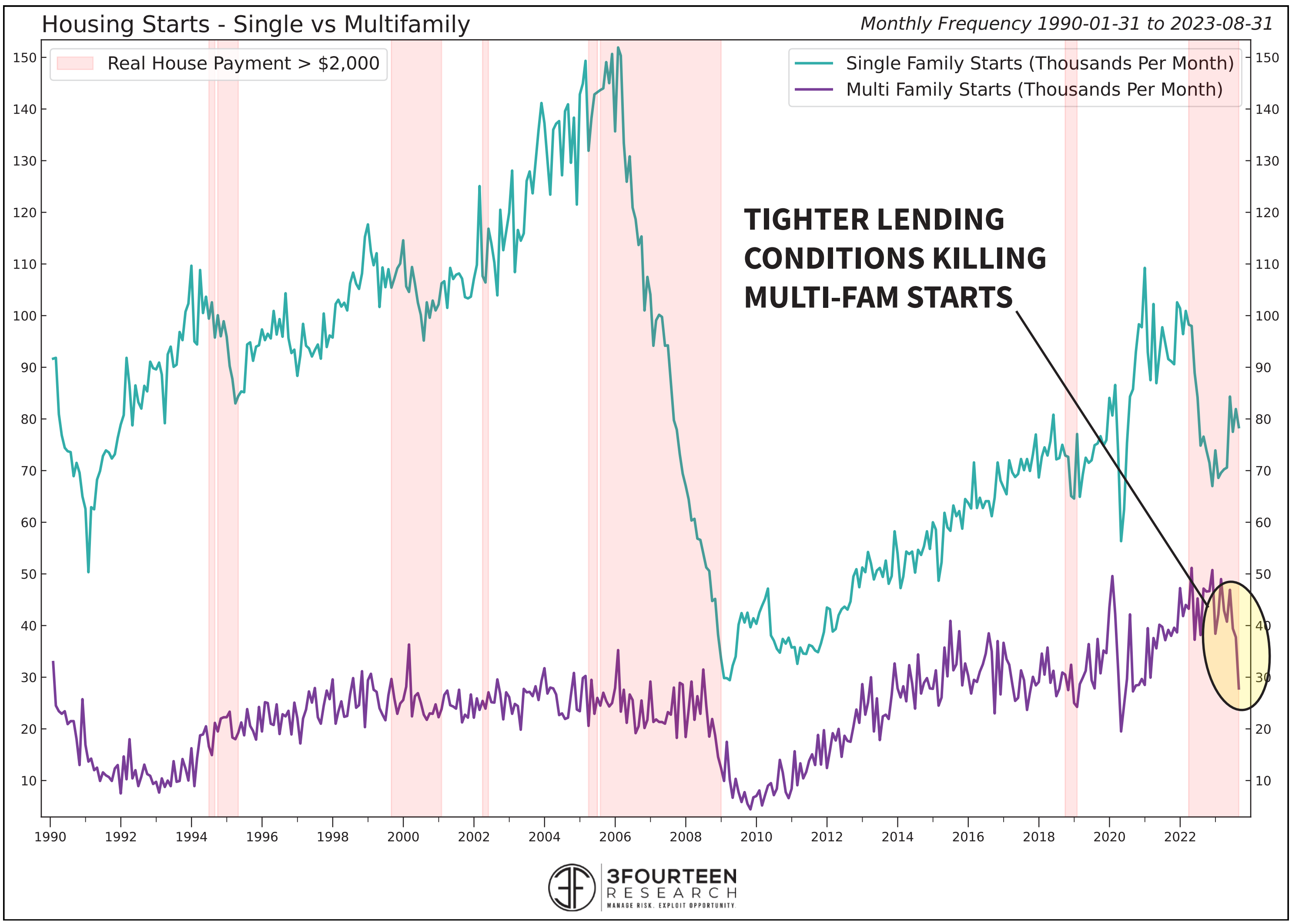


Not only did the Q2 winners exit reporting season with larger increases in 2024 earnings, they also entered the quarter with lower multiples. The chart to the left, once again, breaks the S&P 500 universe into our two buckets: Those stocks that rose following Q2 earnings (blue line) and those that declined (purple line). Heading into earnings, the underperformers carried an +18x P/E ratio (median of the group). On the other hand, the winners entered earnings with a more reasonable 17x P/E ratio. Now, on the other side of Q2, both groups carry similar valuations (hair under 17x). As we see it, the lesson of Q2 is simple: Much good news is already priced into the stock market. Increasingly, hitting numbers—even if accompanied by decent guidance—is no guarantee of higher prices.

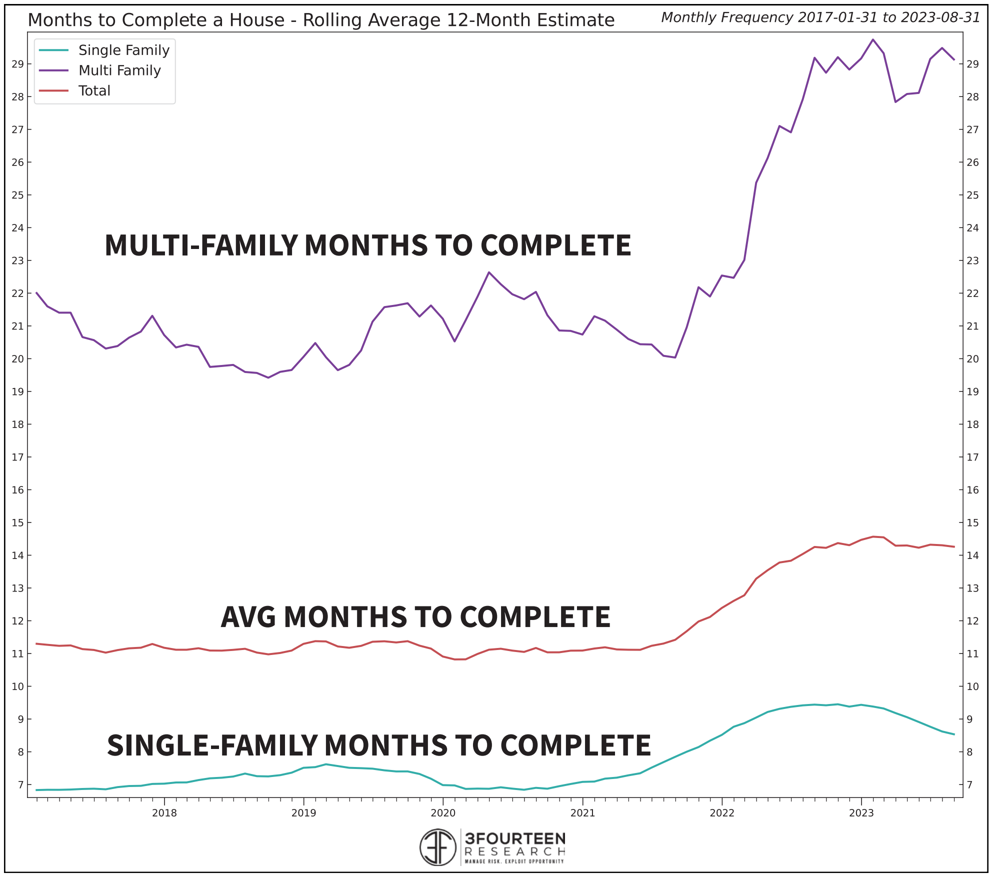
BONDS

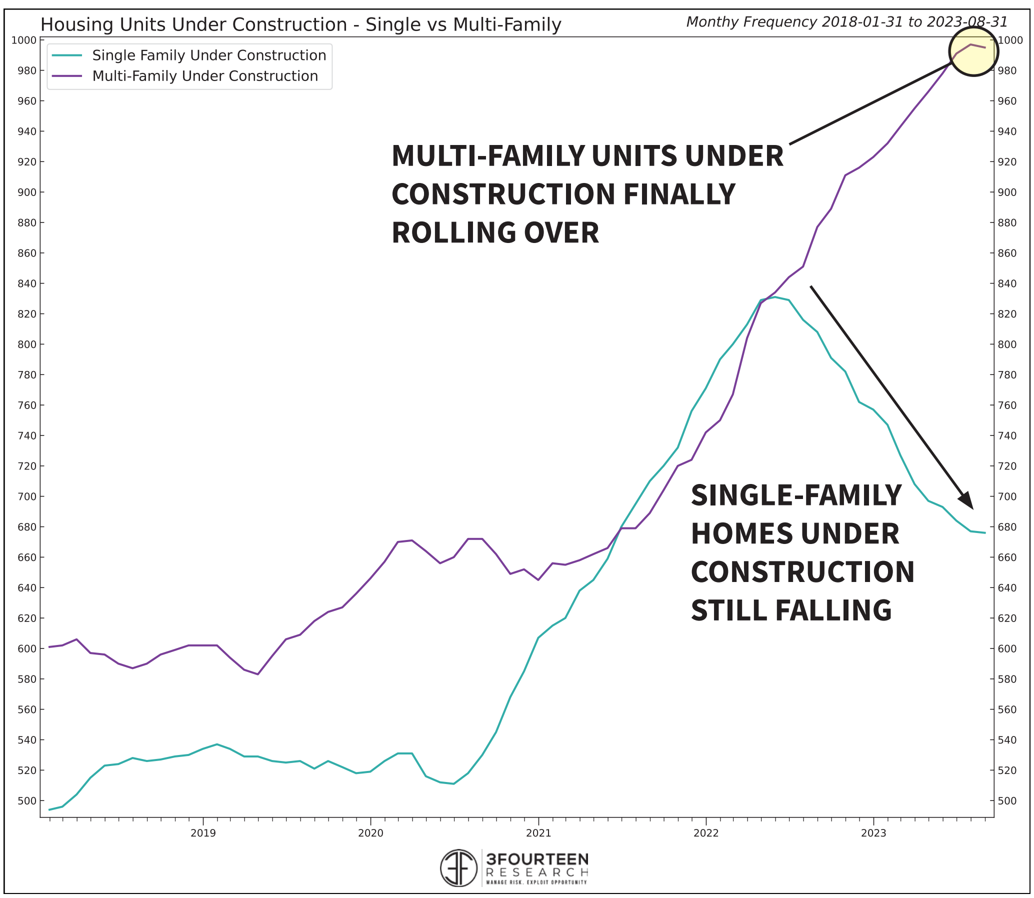
At the beginning of June, we increased our equity exposure and decreased our bond exposure. Since then, the 10-year yield has risen by ~85 bps (2-year +70). Then, [in our July strategy report](), we enumerated the reasons bonds were unattractive. Our conclusion: Based on supply/demand, NGDP or term premium, bonds were overvalued. Fiscal policy had changed the regime. We ended the report with the following: "*In the final analysis, we have to ask ourselves 'what could drive a stampede of new bond buying?' The answer is obvious: A recession. Without an economic downturn, though, we believe higher yields will be necessary to bring marginal dollars into the bond market.*" Since then, yields have indeed broken out across the curve. After Jerome Powell's press conference yesterday, the 2-year hit 5.17% and the 10-year touched 4.5%. **Going back to our July analysis, little has changed…except for price. Quite simply, the 10-year is much closer to fair value at 4.5% than it was at 3.9%. Moreover, intervening macro data points to a deteriorating economic backdrop.**

Two weeks ago, we discussed the [late-cycle evidence](). Negative payroll revisions are piling up, residential construction payrolls are in decline, the yield curve has bear steepened (from an inverted curve), and oil prices are starting to bite. On net, the data is pointing to some kind of "landing" (whether it be hard or soft). This week, the recessionary vibrations continued. Powell struck a more hawkish tone (Fed's SEP pointing to higher real rates next year). **For us, though, the housing data was notable. This week, housing starts fell to their lowest level in years. Long-time clients know [we view the housing industry (and residential construction payrolls) as a leading transmission channel for Fed policy]().** Last month, single family starts declined to a muddle-through ~78k/month (blue line). Multi-family collapsed to 27k new starts (purple line). As a review, we are focused on residential construction jobs to give us a read on recession timing. Our thesis: Housing construction employment falls by 8-10% prior to modern recessions. Housing starts reside at the opening of the residential construction job "funnel."



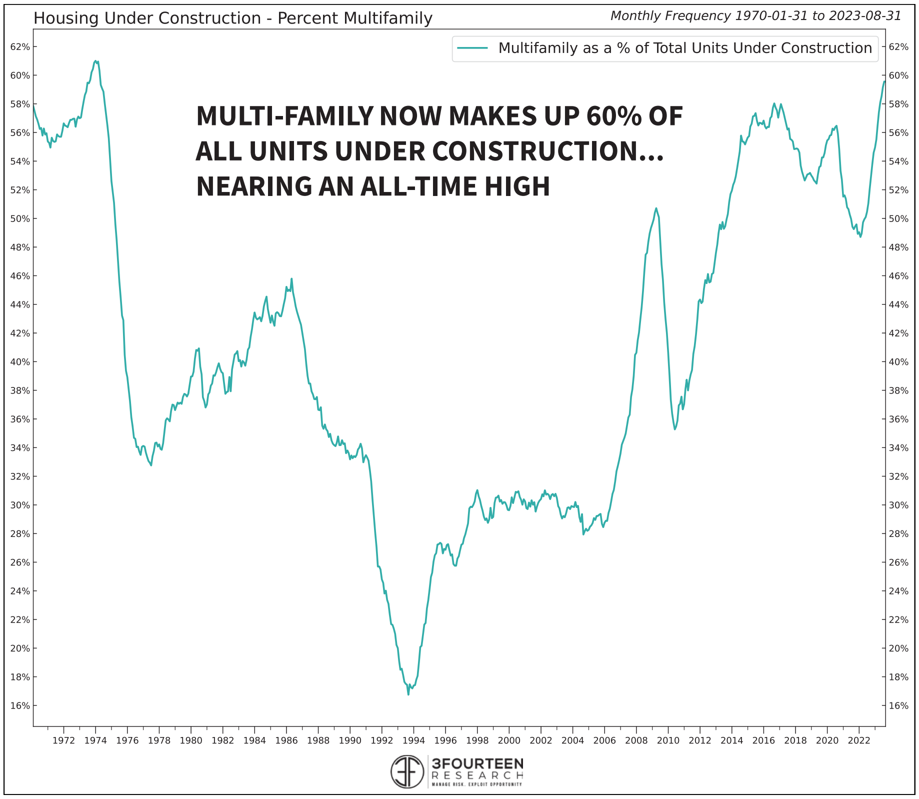
In our recessionary base case, we assumed housing starts would fall to 100k/per month, and that the time to complete a home—pushed higher due to COVID jamming supply chains—would continue to normalize. **Housing starts are now down around the 100k level and, for the most part, the time to complete a unit is falling (chart right).**

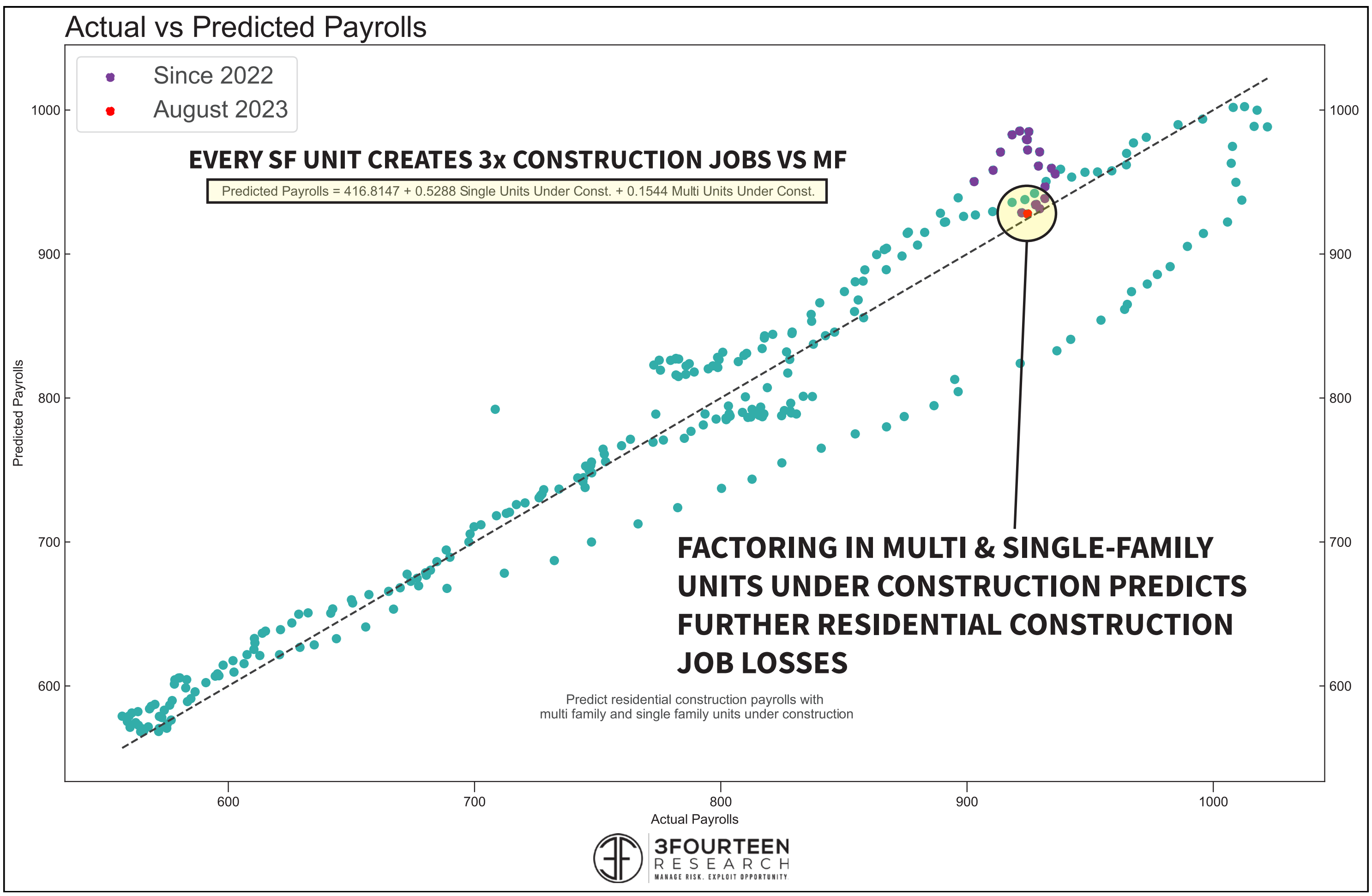




Together, these two factors are reducing the number of housing units under construction. Until August, multi-family units under construction had continued to rise. **Now, units under construction are falling for both single AND multi-family (chart left). Slowly, but surely, higher interest rates are cooling housing construction.** The evaporation of multi-family starts last month is most likely attributable to the tighter financing conditions rippling through the banking system. Still, there is optimism just under the surface. Even as starts collapsed, multi-family (and SF) permits rose for the month. Pulling permits gives builders the option to begin projects that higher rates have killed. This underlying ebullience is another factor arguing that the Fed will have to keep rates higher for longer to subdue activity.

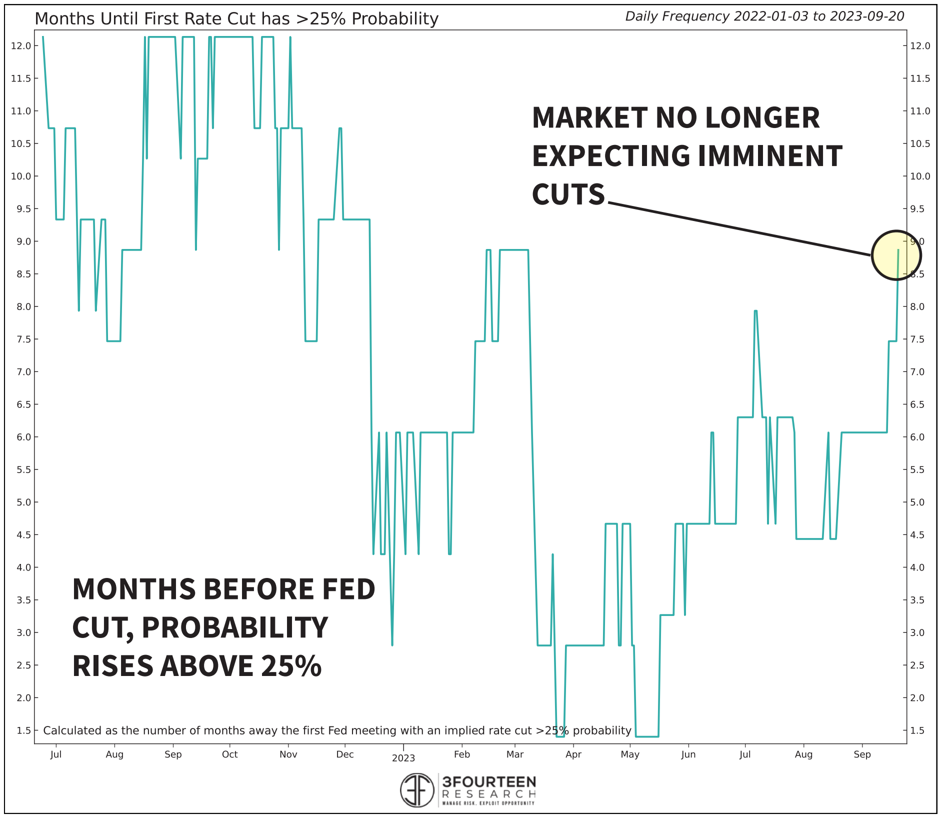
More than usual, multi-family is an important factor this cycle. For the first time in 50 years, multi-family now comprises ~60% of total units under construction (chart right). In our previous research, we have noted that singly-family units employ ~3x as many workers as a multi-family unit (see regression equation in scatter below). So, we must adjust our housing model to account for the less labor-intensity of multi-family units. Once we make these adjustments, the fall in housing starts is not quite as dire as the headline suggests. However, given the August housing data, our model predicts a continuing decline of residential construction payrolls. Also, as we mentioned two weeks ago, negative revisions are hitting housing construction jobs data. All in all, at the current pace, the housing market—and thus the economy—is grinding towards a recession (H1 2024).

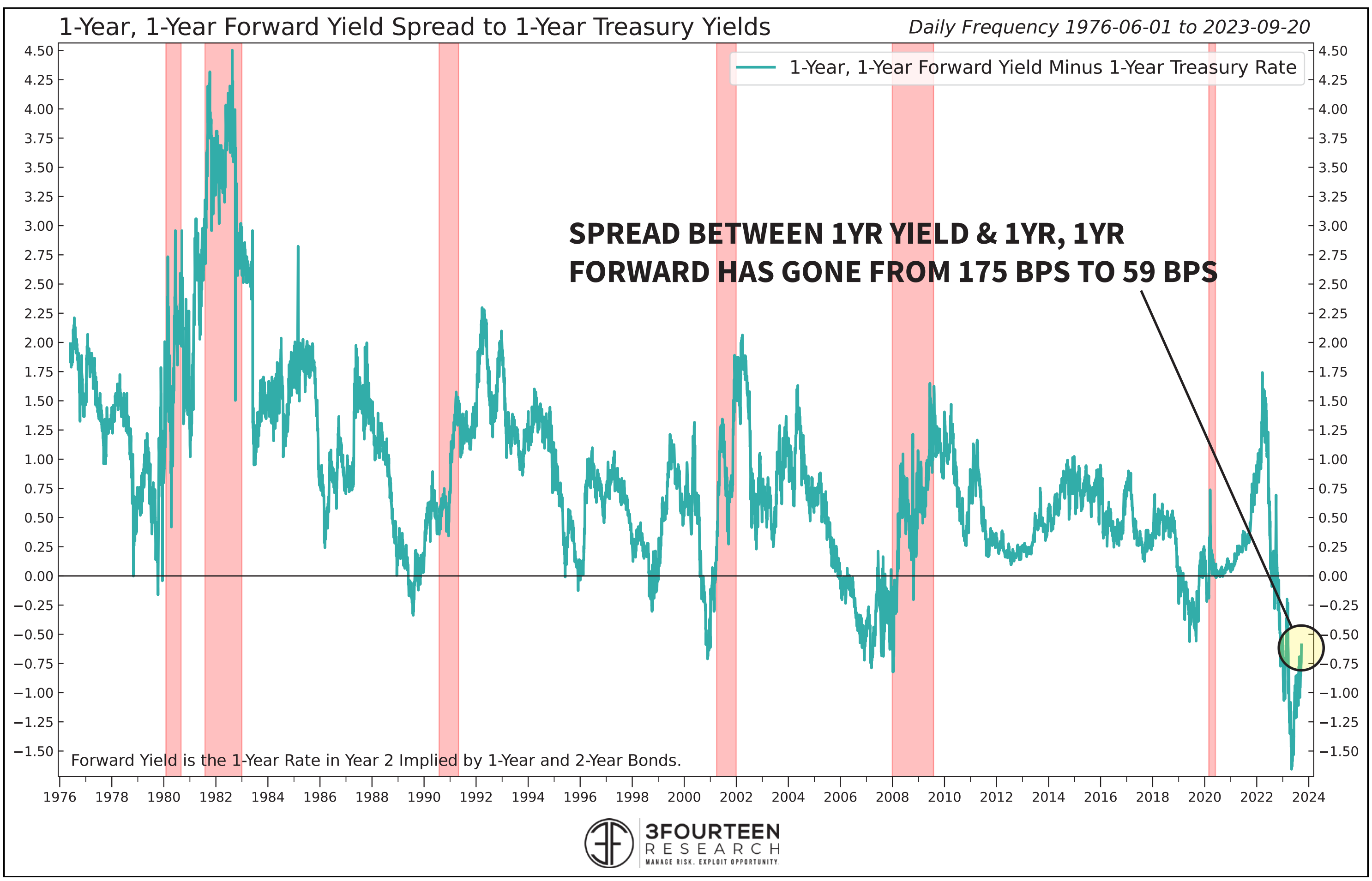




CONCLUSIONS

Our move today—from commodities into bonds—is a step towards recession positioning. However, it is less of a prediction of the future and more a reflection of what each market is pricing relative to the probabilities as we see them. **This is a long-winded way of saying that oil has just about hit our target on the upside ($100) and bonds have hit our target on the downside (4.5% 10-year).** At mid-year, we determined that commodities and bonds were priced too pessimistically (i.e. expecting a recession too soon). To quote: "*Cash is king in this environment but commodities may be the best bet for upside in the second half of 2023.*" Q3 restored sanity. Oil is no longer priced like we are in a recession. Simultaneously, the bond market has backed the first rate cut out to nine months from now (chart right).





CONCLUSIONS (CONT)

We now see asset pricing as more balanced relative to the macro future. Through the next couple of months, we will look to deploy our cash position (still at max 20%) opportunistically. In other words, we will wait for opportunities to emerge in either stocks, bonds or commodities. To be clear, the economy has perpetually surprised to the upside, we are not calling for an imminent recession. In the chart below, we highlight the divergence between consumption (PCE) and income that has helped extend the cycle. At first glance, this outspending of income seems unsustainable. However, on the bottom clip we accumulate each series post-pandemic to reveal that the "excess savings" written off by so many is still in the system. As always, we must move with the data and stay open minded. Below, we summarize our thoughts on the stock market.

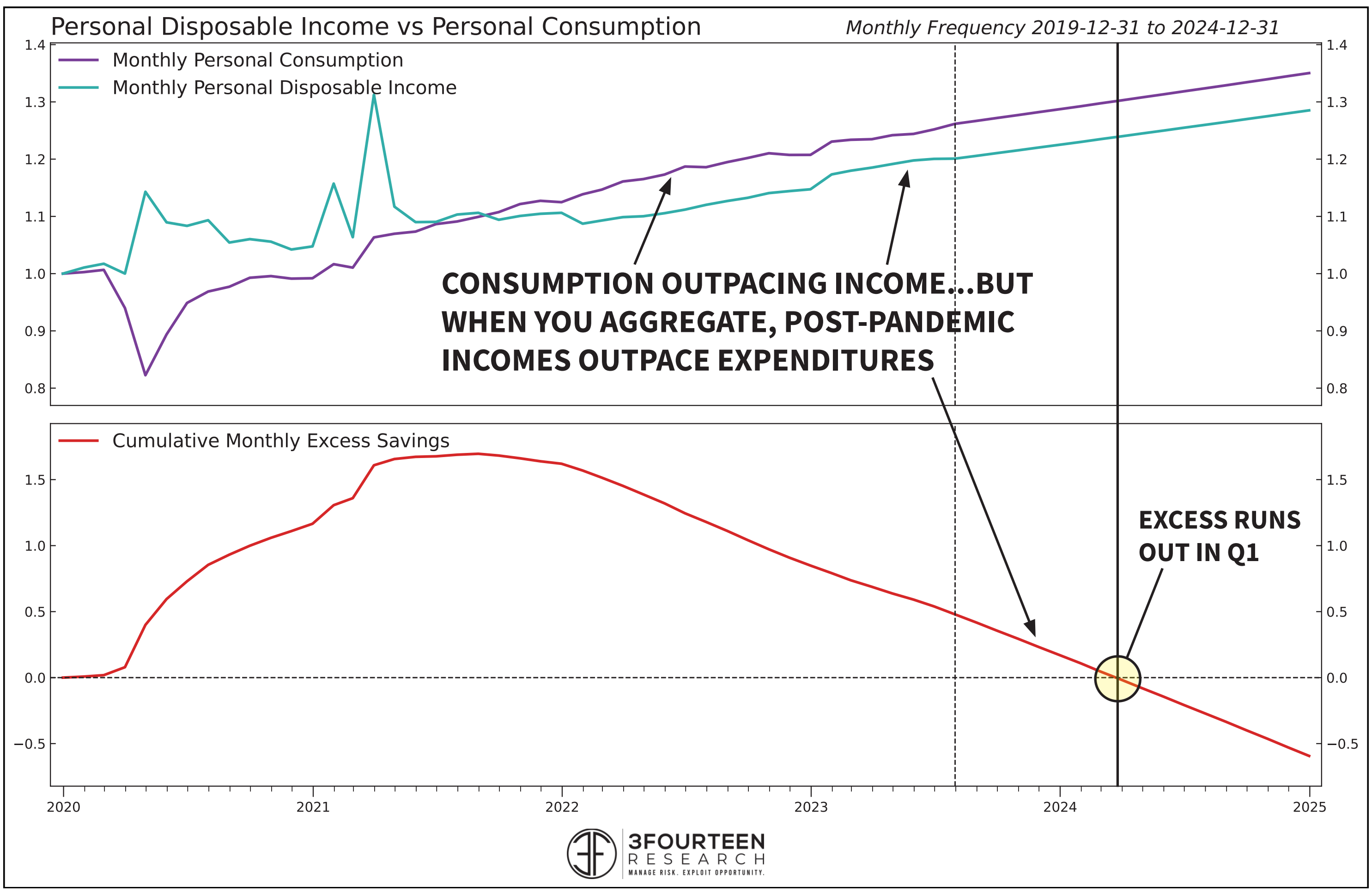
STOCKS

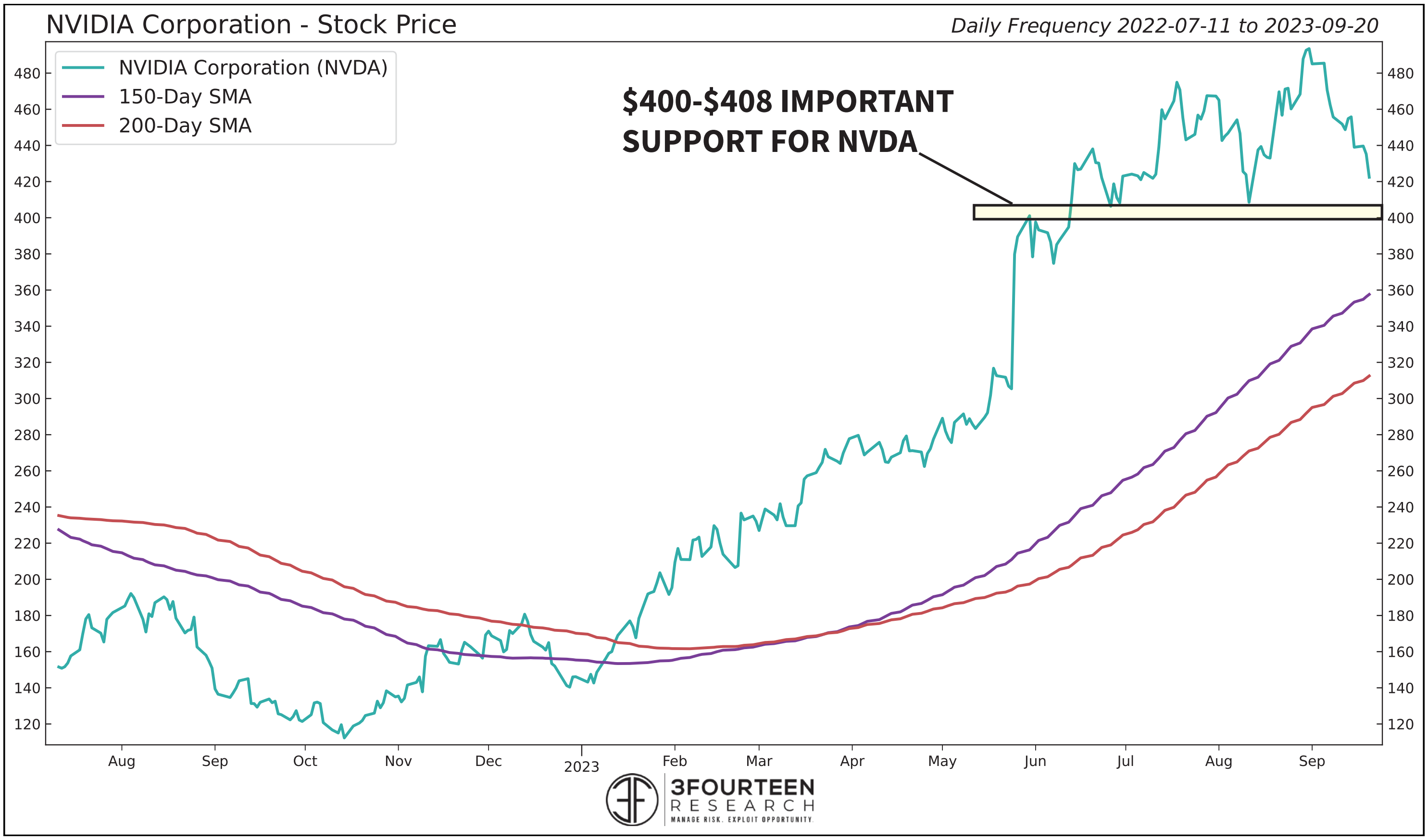
We considered bringing our equity exposure up to market weight today, but decided to pass. Philosophically, we don't have a problem buying "overvalued" equities if the trends are intact. On the other hand, we can stomach buying ugly charts if valuations are reasonable and sentiment is washed out. **At present, the S&P 500 is in "no-man's land." Trends are deteriorating. Yet, valuations remain rich. Within the market, it appears unlikely that the rotation we observed following the Mega-Cap Divergence in May/June will continue.** The equal-weighted S&P is breaking down through important support today (see chart page 14). Moreover, the Big Tech leaders of H1 are approaching dangerous levels. Specifically, AAPL and NVDA must hold key levels to stave off further index-level declines (see charts next page). The numerous prominent "news failures" mentioned earlier in the report are also concerning. **Bottom line: The S&P 500 Index is in search of leadership here. So far in H2, Energy has led. This is not healthy or sustainable.**

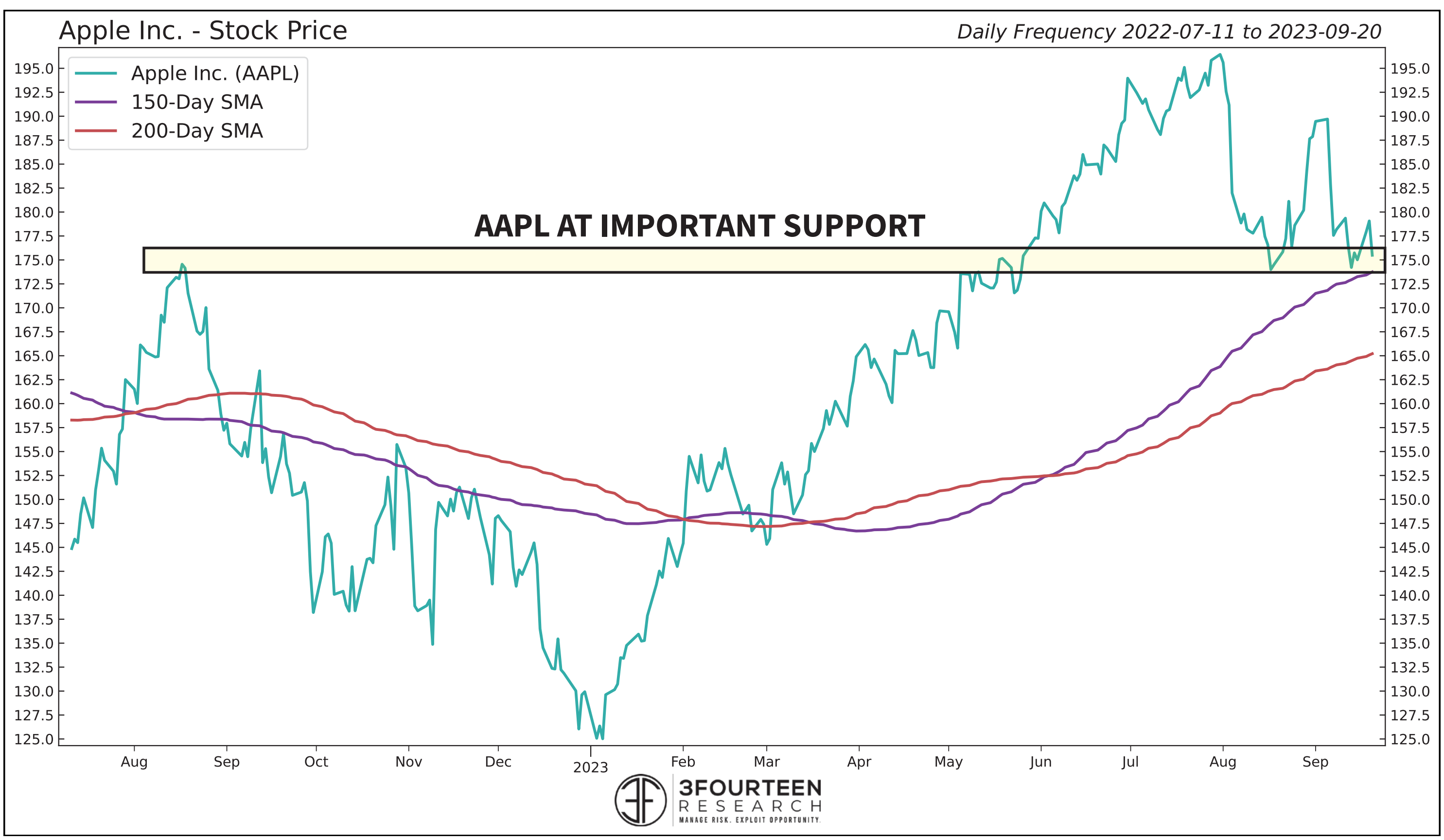
3FR STRATEGIC AA RECOMMENDATIONS

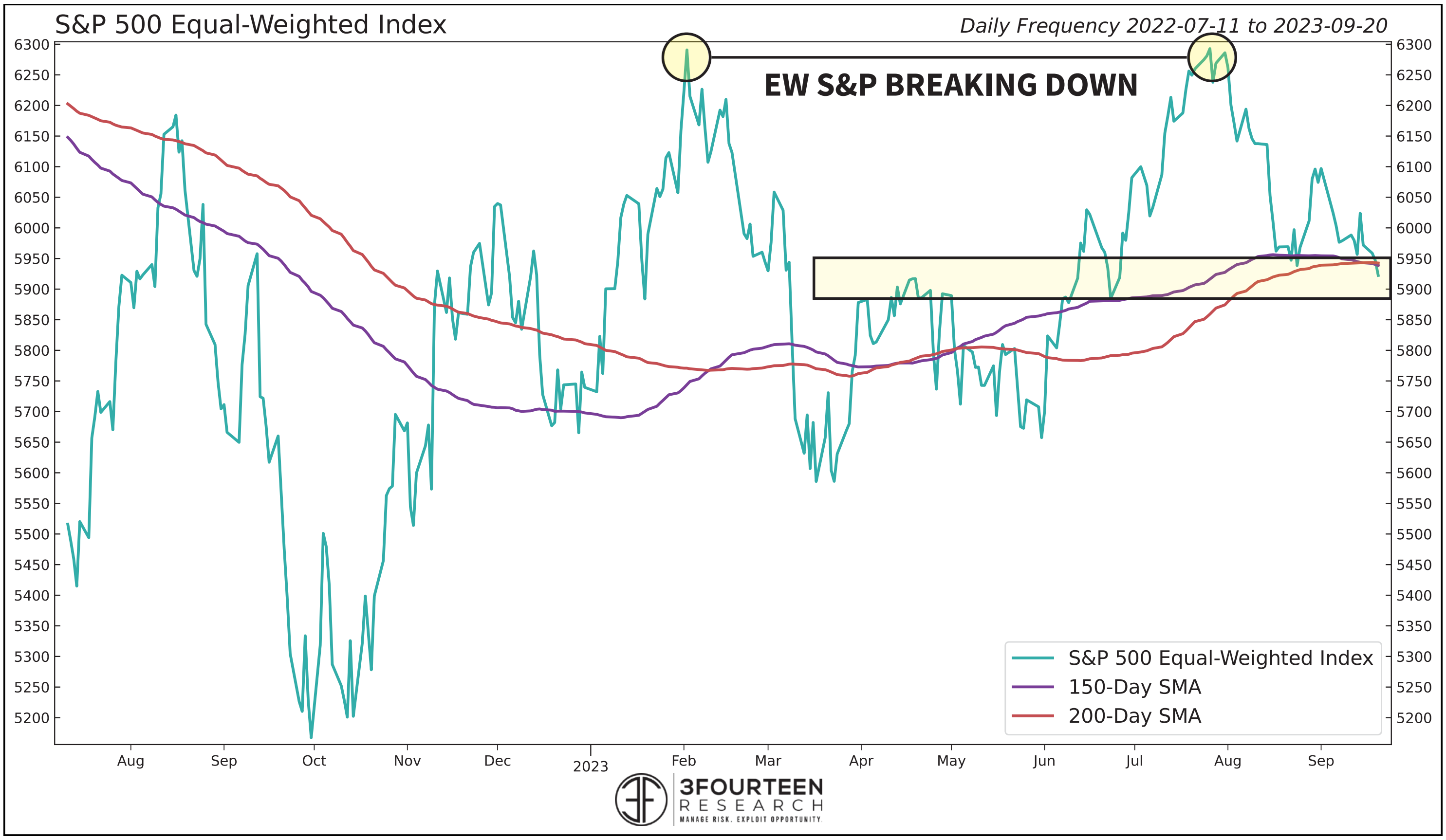
ASSET	RECOMMENDATIONS	BENCHMARK %	MAX	MIN
US Stocks	50% (UW)	55%	70%	40%
US Bonds	25% (UW)	30%	45%	15%
Commods	5% (UW)	10%	25%	0%
Cash/Bills	20% (OW)	5%	20%	0%

UW = Underweight; BMW = Benchmark Weight; OW = Overweight




NVIDIA Corporation - Stock Price
Daily Frequency 2022-07-11 to 2023-09-20
NVIDIA Corporation (NVDA)
150-Day SMA
200-Day SMA
$400-$408 IMPORTANT SUPPORT FOR NVDA
3FOURTEEN RESEARCH
MANAGE RISK. EXPLOIT OPPORTUNITY.


Apple Inc. - Stock Price
Daily Frequency 2022-07-11 to 2023-09-20
Apple Inc. (AAPL)
150-Day SMA
200-Day SMA
AAPL AT IMPORTANT SUPPORT
3FOURTEEN RESEARCH
MANAGE RISK. EXPLOIT OPPORTUNITY.


S&P 500 Equal-Weighted Index
Daily Frequency 2022-07-11 to 2023-09-20
EW S&P BREAKING DOWN
S&P 500 Equal-Weighted Index
150-Day SMA
200-Day SMA
6300
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6200
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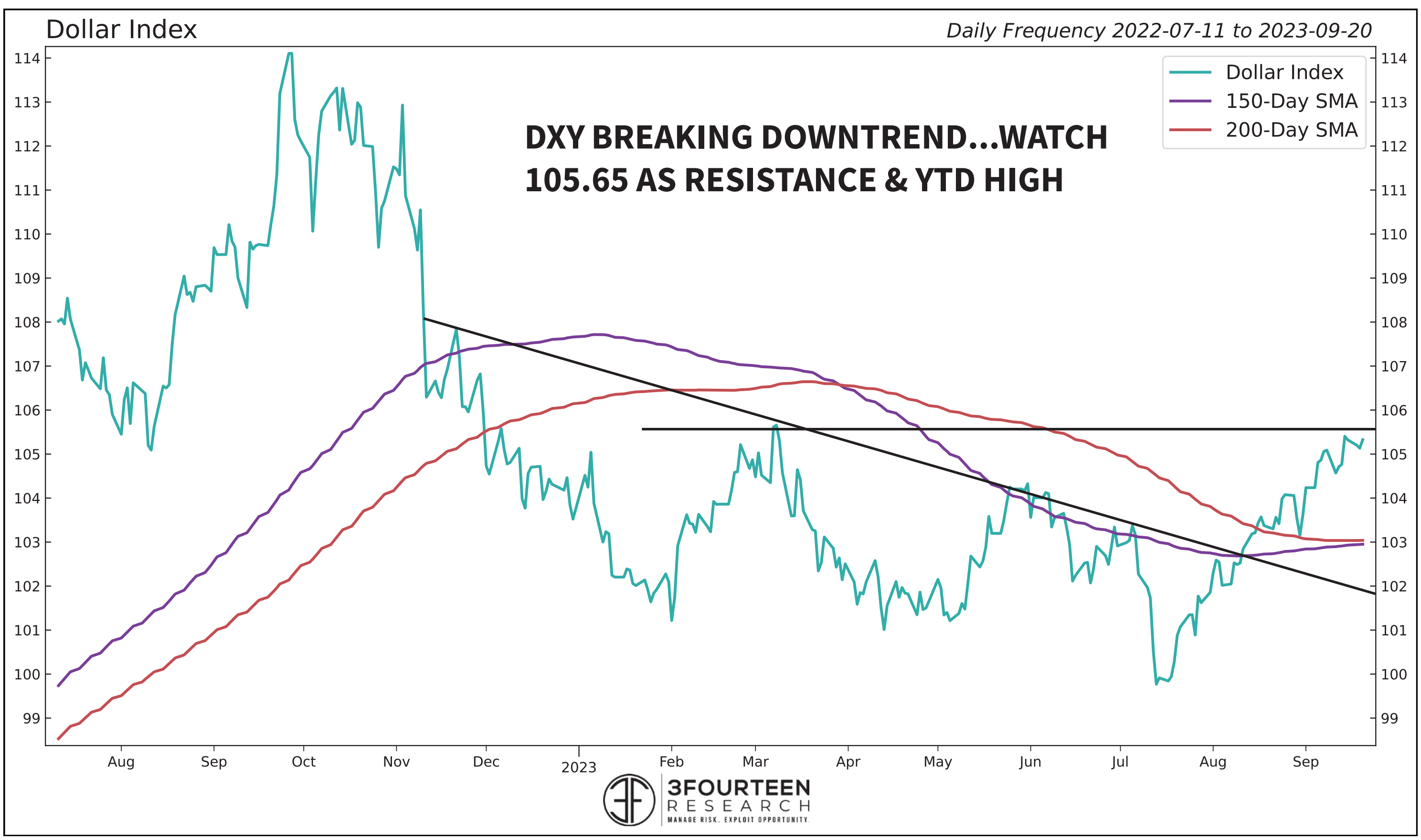
3FOURTEEN RESEARCH
MANAGE RISK. EXPLOIT OPPORTUNITY.


Dollar Index
Daily Frequency 2022-07-11 to 2023-09-20
DXY BREAKING DOWNTREND...WATCH 105.65 AS RESISTANCE & YTD HIGH
Dollar Index
150-Day SMA
200-Day SMA
114
113
112
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