

What's New

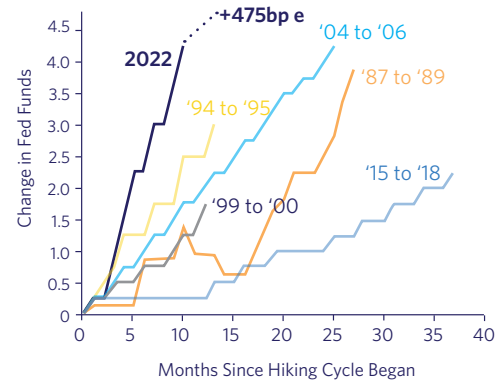
COVID and its economic dislocations, government policy responses, and their after-effects continue to materially alter the global landscape. While Lyell Wealth Management sees some pre-existing investment themes as enduring, such as cloud computing and healthcare advancements, some different industries and asset classes are likely to prosper in this new era. Some market analysts are using the 1970s as a comparable period to today, while others are looking to the early 2000s. Although there may be similarities from these periods, we view the current environment as having its own unique characteristics. Modern technologies, economic structure, and geopolitics are not directly comparable to earlier times. Looking to these earlier periods to see which investments “work” will likely be insufficient. This Perspective attempts to identify where the economy and markets currently stand, and which industries and sectors should benefit by either structural change or more tactical intermediate opportunities.

The economy and markets over the past year experienced considerable volatility primarily due to high inflation and the Federal Reserve’s aggressive approach to suppress it. The Fed has been raising overnight rates at the fastest pace and highest levels in decades (Chart 1).

Fortunately, high-frequency, real-time data continues to indicate that inflation is dropping, particularly in manufacturing, transportation, and goods. Lyell Wealth Management’s September 2022 Perspective had numerous charts indicating improving inflation metrics, all of which are still valid and have ameliorated further since then.

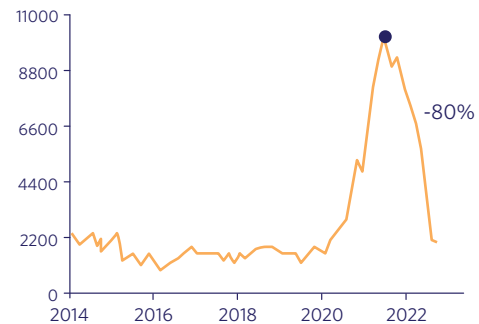
For example, the World Container Index freight rate has now dropped over 80% from its peak, and the queues of container ships off the Los Angeles and Long Beach ports are gone (Chart 2).

CHART 1
Record Increase in Fed Funds



Source: Evercore ISI

CHART 2
WCI Container Freight Rate
Jan 20: \$2079

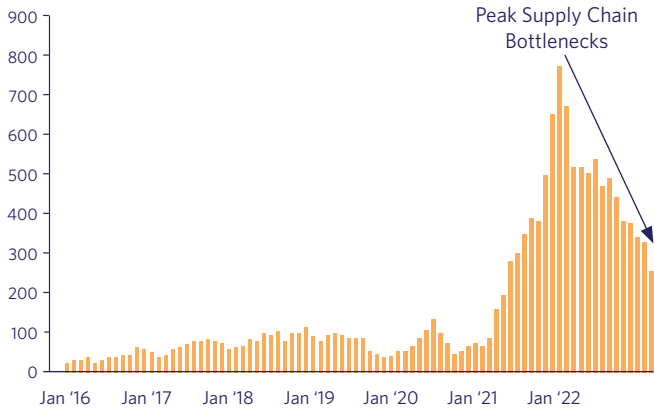


Source: Drewry, Evercore ISI



Executives of S&P 500 companies are referencing “shortages” at a significantly lower rate, and it is likely that many of these references are in the past tense (Chart 3).

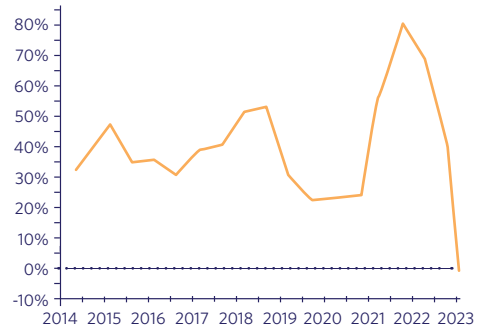
CHART 3
S&P 500 Transcript Analyzer: “Shortages”
Rolling 3-Month Sum



Source: Strategas Securities

The Fed’s primary concern is a labor shortage that results in elevated wages which become embedded in consumer expectations; no data indicates that this has yet occurred. As a result of the Fed’s fears, the markets are very focused on weekly and monthly employment data, in addition to the monthly inflation Consumer Price and Producer Price index releases. There is still a large gap in job openings versus unemployment, and substantial progress is needed to reduce this difference. Evercore ISI’s January survey of 53 corporations showed the lowest level of expected wage growth since it started the survey in July 2014 (Chart 5) and that labor availability has improved over the past three months across most industries.

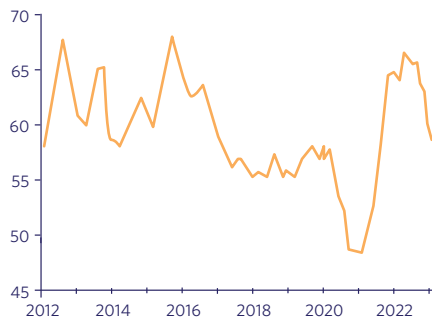
CHART 5
Evercore ISI Company Surveys
Corporate Next 12 Mos. Expectation of the
Growth Rate on Wages Paid to Employees
\$ Increase minus % Decrease Jan 19 0%



Source: Evercore ISI

Apartment rents continue to cool, having fallen in 22 of the past 25 weeks (Chart 4).

CHART 4
Evercore ISI Apartment Cos. Survey: Rents
0=Weak, 100=Strong, 4 Wk. Avg. Jan 11 58.5

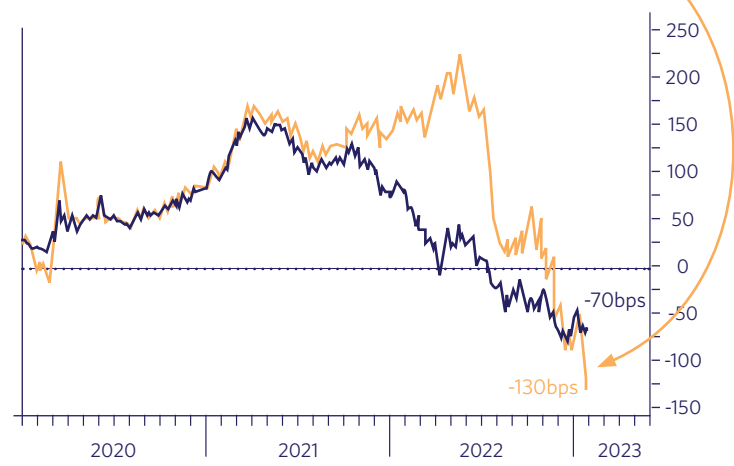


Source: Evercore ISI



The markets have increasingly shifted their anxiety from inflation to economic recession. Unsurprisingly, higher rates are seriously impacting housing as reflected in a homebuilders sales survey, currently at recessionary levels (Chart 6). Trucking is typically an excellent coincident economic indicator, and it is also nearing recessionary levels (Chart 7).

CHART 8
 Deepest Inversion for 3-Month/10-Year Since 1981
 U.S. 2-Year / 10-Year Yield Curve & 3-Month/10-Year Curve

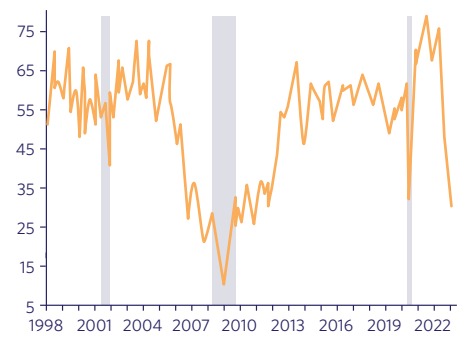


Source: Strategas Research Group

A historically reliable recession signal is a yield curve inversion whereby long-term rates are lower than short-term rates. The U.S. Treasury curve has become increasingly inverted since mid-2022 (Chart 8).

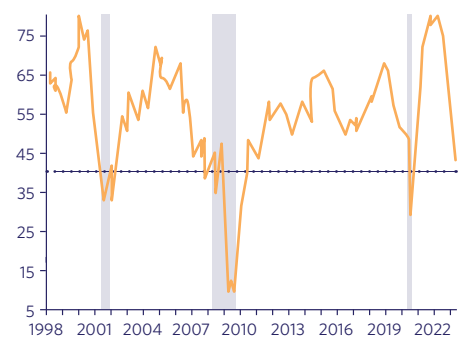
The markets view the Fed as being further into its tightening cycle than other major central banks, particularly the European Central Bank. If true, the Fed will stop raising rates, and perhaps decrease them, sooner. As a result, the U.S. dollar, which increased rapidly during 2022 to a 20+ year peak, has had a notable decline since last September. A stronger dollar tends to reflect tighter financial conditions, so a weaker currency is welcome news for global growth, emerging economies, and U.S. corporate profits. The Trade Weighted U.S. Dollar index has had five pronounced seesaw moves over the past 40+ years, and we could be in the early stages of a secular move towards a weaker currency (Chart 9).

CHART 6
 Evercore ISI Homebuilders Sales Survey
 0=Weak, 100=Strong, 4 Wk. Avg. Jan 10 32.3



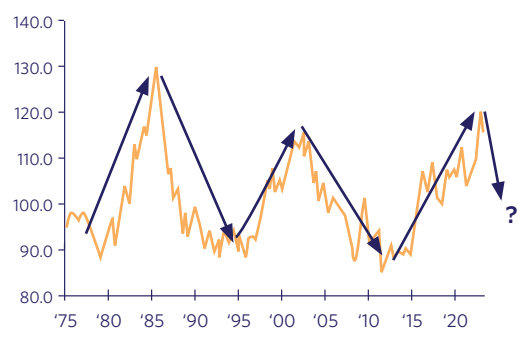
Source: Evercore ISI

CHART 7
 Evercore ISI Trucking Cos. Sales Survey
 0=Weak, 100=Strong, 4 Wk. Avg. Jan 10 41.4



Source: Evercore ISI

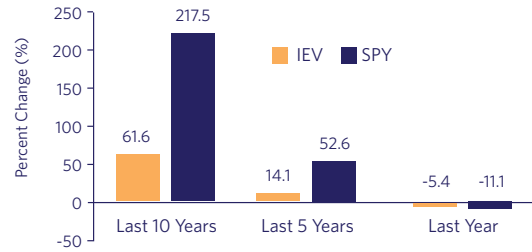
CHART 9
 Real Broad Trade Weighted Dollar Index



Source: Federal Reserve Board, Evercore ISI



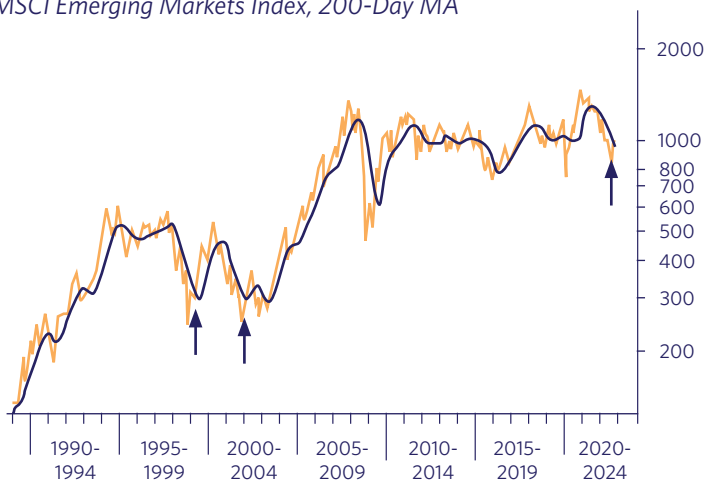
CHART 11
Performance of IEV and SPY (Total Return)



Source: Bespoke Investment Group

The MSCI Emerging Markets index has just emerged from its third longest streak of consecutive trading days below its 200-day moving average. The prior long streaks and the one just ended are noted with arrows (Chart 10). Emerging market stocks have trended sideways for over 15 years, but it's worth noting they had outsized performance during the last era of U.S. dollar weakness.

CHART 10
3rd Longest Streak Below 200-Day Now Over for E.M. MSCI Emerging Markets Index, 200-Day MA



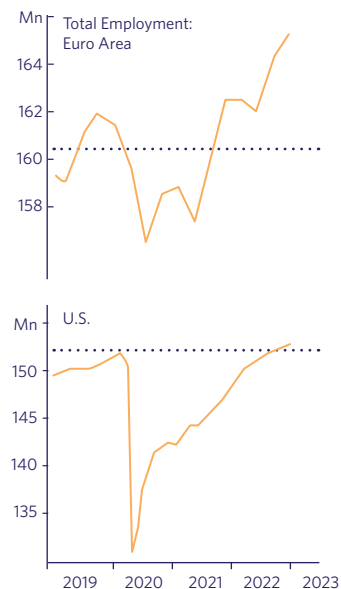
Source: Strategas ETF Research

Likewise, European stocks have had a pronounced period of underperformance relative to the U.S. markets. Over the past 10 years the S&P 500 returned 217.5% versus the IEV Europe index's 61.6%, and the relative underperformance over the past 5 years was even more extreme. However, this has shifted over the past year to European outperformance (Chart 11).

Expectations of a stronger Chinese economy likely explains much of the recent overseas market strength. China's sudden exit from "Zero Covid" as well as its easing of repressive policies toward the real estate and technology industries are pivots welcomed by the markets. China is the largest trading partner for many countries and regions, including the European Union, and they will benefit from a stronger Chinese economy.

The prior relative European weakness is easily explained by the paltry number of leading technology companies headquartered in the "Old World." There are no Amazons, Googles, Facebooks, Microsofts or Apples of Europe. However, a combination of factors could explain why we are now seeing outperformance. Regulations, restrictions, taxes and fines on "Big Tech" may constrain their growth and absorb cash flow which would otherwise benefit shareholders. Second, some of the industries more highly represented in European indices, such as Consumer, Pharma, Energy and Industrials, could be in a period of outperformance. Lastly, Europe is currently less labor-challenged than the U.S. European total employment and labor participation rates are substantially above pre-pandemic levels, while the U.S. has a labor shortfall (Chart 12). If the U.S. participation level was at its pre-pandemic level, the unemployment rate would stand at 5.6% instead of the reported 3.7%.

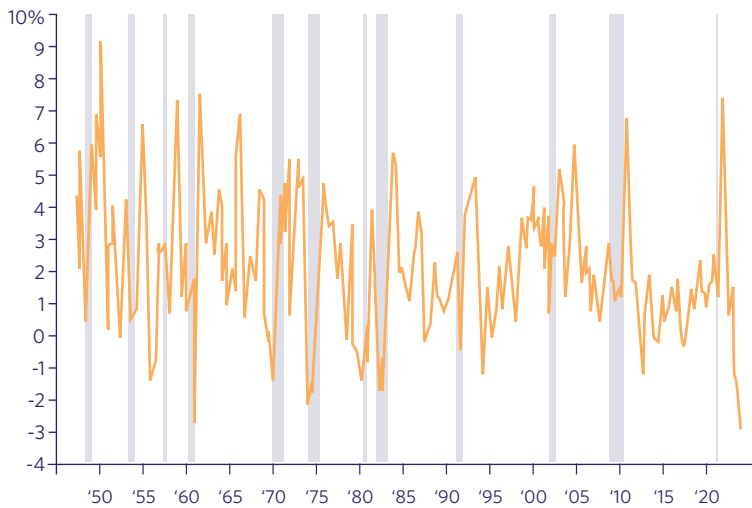
CHART 12
More Jobs in the Euro Area



Source: Alpine Macro

CHART 13

U.S. Productivity, 3 Quarter % A.R.



Source: Bureau of Labor Statistics, Strategas Research Group

The stock market is demanding better shareholder orientation from the executive management teams of growth companies. For many years topline revenue growth was seemingly the only metric rewarded by investors. Large companies could invest substantial dollars in various “moonshot” ventures, most of which didn’t provide any financial return. Companies over-hired and invested in R&D, Marketing, and other areas without any regard to expense. Perhaps not surprisingly, U.S. productivity has recently plummeted (Chart 13).

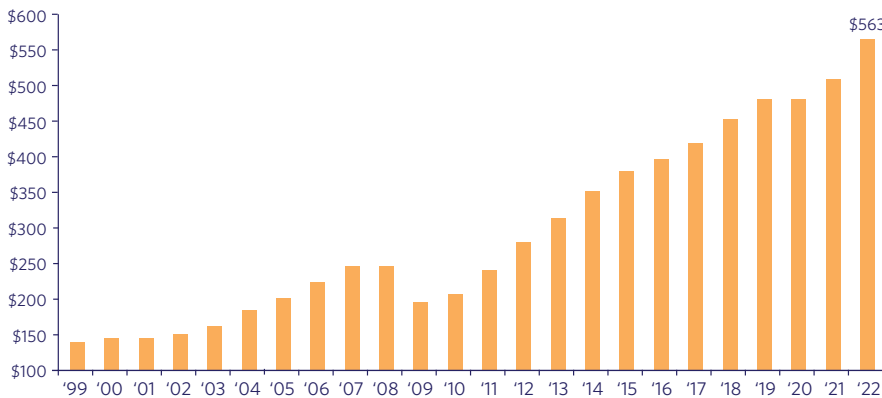
We are finally seeing widespread corporate headcount reductions, but it is Lyell Wealth Management’s view that some of these companies could use further expense rationalization. There is likely an advantage to companies with executive teams who have managed through prior challenging periods such as 2000-2002 and 2008-2009. Companies which significantly cut costs in early 2022 have been rewarded, while companies which dragged their feet on cost reduction are being punished. Investors are demanding that companies balance revenue growth with profits and cash flow. They are also more insistent on dividends in addition to stock buybacks.

We would expect more non-dividend paying companies to succumb to paying dividends as part of their shareholder return strategy. It is interesting to note that 2022 set a record for S&P 500 annual dividends paid (Chart 14).

There is certainly the financial capacity to increase dividends. The “payout ratio,” defined as the amount of dividends paid to shareholders in relation to the total amount of net income, is historically low (Chart 15).

CHART 14

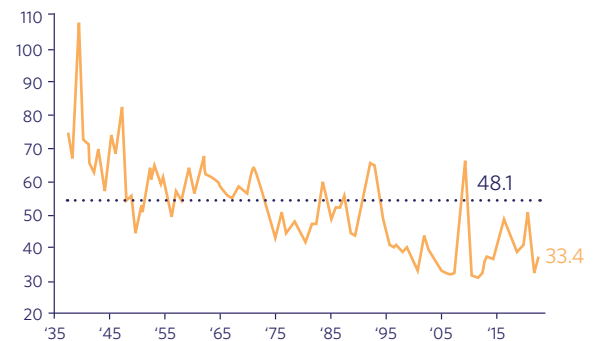
S&P 500 Annual Dividends Paid (\$BN)



Source: Strategas Securities

CHART 15

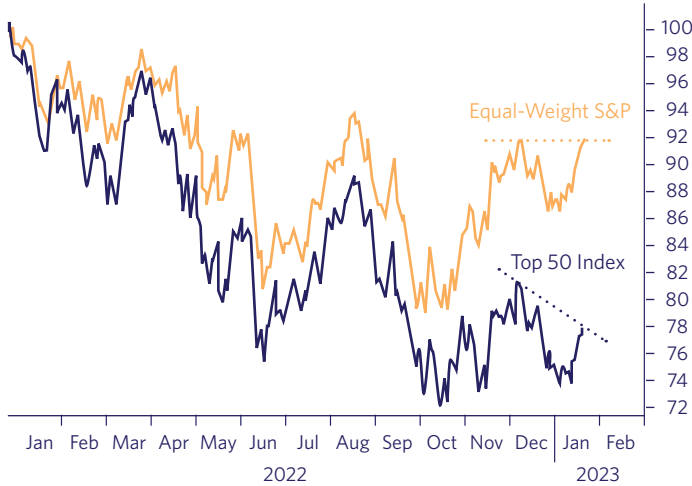
S&P 500 Dividend Payout Ratio



Source: Strategas Securities

CHART 16

Equal-Weight S&P 500 vs. Top 50 Index



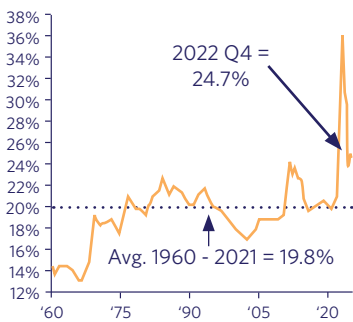
Source: Strategas Technical and Macro Research

Related to issues referenced in the three preceding paragraphs, the “top of the market” comprised of the largest, most valuable technology firms has been significantly underperforming the “average” U.S. stock (Chart 16). In fact, the equal-weighted S&P 500 trend has turned positive for the first time since 2021, while the market-weighted S&P 500 index lags considerably.

The U.S. debt ceiling has recently emerged again, and the negotiations will likely be ongoing for several months. Although the issue itself seems silly with politicians arguing about expenditures already made, it creates political leverage. Federal spending spiked due to policies enacted during the pandemic, and it remains substantially higher than its historical average (Chart 17).

CHART 17

Federal Spending, % of GDP



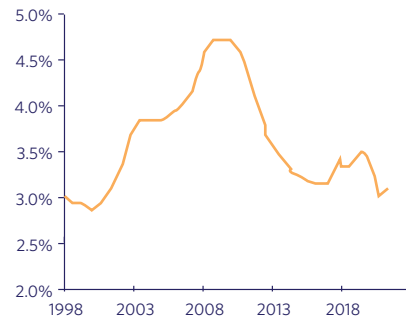
Source: Strategas Research Group

Typical D.C. budget negotiations involve Republicans focused on defense spending while Democrats want discretionary expenditures. The dynamic this year is unusual as the Democratic party’s broad support for Ukraine may shift the calculus. The Russian invasion was

a “wake-up” call for many countries recognizing the need to invest more in their military preparedness. U.S. defense spending as a percentage of GDP is near-multi-decade lows (Chart 18).

CHART 18

U.S. Defense Spending, % of GDP

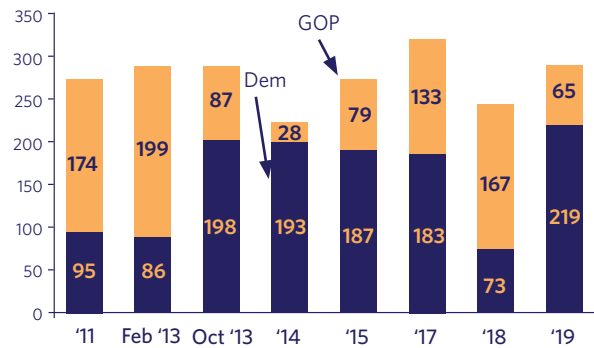


Source: Strategas Research Group

Brinkmanship around the debt limit negotiations seems inevitable. It will eventually be resolved, although market volatility may be necessary to spur the politicians to a deal. All things being equal, investors should buy debt ceiling market downdrafts when they occur. Since the debt ceiling became a tough vote, the majority vote has never been carried by the House Republicans. This suggests considerable drama prior to a resolution (Chart 19).

CHART 19

House Votes To Raise The Debt Limit Since 2011



Source: Strategas Research Group

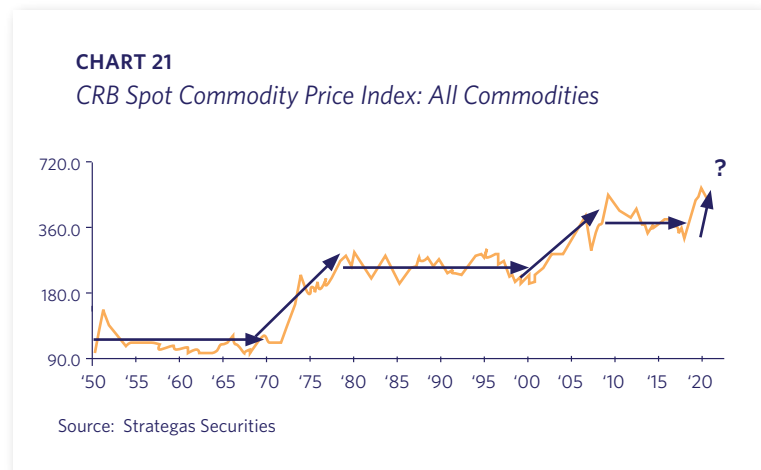


The debt ceiling tussle may be a cause for a declining U.S. dollar this year. There are multiple factors that argue for a weaker currency. The U.S. runs trillion-dollar fiscal deficits without much commitment from either party to address the wide discrepancy; this gap doesn't even include unfunded government programs or non-federal government obligations. The U.S. also has a perpetual trade deficit which generally weakens a currency. While well motivated, monetary sanctions with Iran and Russia incentivize our adversaries to dispose of U.S. dollars. China is eager to use its Yuan as a trade currency and recent discussions with Saudi Arabia has suggested some oil transactions could settle in Yuan. Lastly, the concept of "foreign reserves" itself is a modern construct that became much more widely utilized after the 1997 Asian financial crisis, and the rationale to hold them in large amounts could be reevaluated. Since approximately 60% of the world's reserves are held in U.S. dollars, less reserves would presumably decrease the demand for dollars.

There aren't good U.S. dollar alternatives on a large scale. The Euro and Yen are the two other fiat reserve currencies, and neither has gained much market share in the past couple of decades. Although China's economic size would argue for a significant role, it has closed capital markets and a low-trust political system. Perhaps for the reasons in the four preceding paragraphs, gold prices have perked up in recent months. For the first time in the post-Bretton Woods world of the early 1970s, gold has outperformed U.S. stocks in the first three months after a stock market bottom. Many countries have purportedly been adding to their gold reserves, including China (Chart 20).

Gold isn't the only interesting commodity. The commitment by developed nations to accelerate clean energy investments and infrastructure requires massive amounts of certain industrial metals and minerals. Hopefully, engineering advancements and

replacements can reduce the scale of what will be required, but the world appears woefully underinvested in reliable sources to deliver these materials. Copper in particular appears to be an industrial metal indispensable to the clean energy revolution. Commodities historically experience long periods of stable prices followed by significant leaps to then stabilize again at higher price levels. A weaker U.S. dollar would also bode well for the commodity landscape (Chart 21).





Related to the clean energy initiatives, we fear that the developed world is underinvesting in fossil fuels as the global energy transition is much further out than envisioned. Aside from prohibitions and restrictions placed on oil and gas companies in many developed nations, the companies themselves have been disciplined, to an unprecedented extent, about investing capital back into their own businesses. As much as Lyell Wealth Management wishes for a carbon-free future, we expect that oil and gas will be part of the global fuel mix for a long time.

Some respected market observers are stating that we are experiencing a “regime change,” and perhaps that is an appropriate reference. Certainly, we agree that many things are different. However, that term seems to imply that everything is different, and we don’t see it that way. We see certain pre-pandemic themes and business models enduring regardless of interest rate, commodity, or currency levels.

We still view the leading technology companies, broadly defined, as very well capitalized innovators pioneering new services and products. Much of the economy runs on platforms, such as the Apple App Store, Amazon Web Services and Microsoft’s Azure. Innovation still matters in fields such as robotic surgery, artificial intelligence, diabetes management, and implantable devices. Semiconductors are the “oil” for the digital economy and have never been more indispensable. Almost all of these companies have seen major stock price reductions, but, if they execute well, including making more disciplined capital allocation and corporate governance decisions, their stocks will eventually recover.

Reasonably attractive fixed income and money market fund yields are relatively new. After years of minuscule interest rates, investors are now able to earn yields in the 4% - 5% range on short-to-intermediate investment grade bonds. The most conservative money market funds offer yields near 4% which are likely to increase in the upcoming months. Lyell has been proactively buying bonds in many client portfolios over the past year.

Lyell continues to increase our asset allocation to newer investments in the defense, mining, and energy industries. We are also adding some exposure to international and emerging market stocks. Lyell Wealth Management is mindful that certain investments are not appropriate or desirable for every client.

Given the multiple issues of inflation, interest rates, war, recession and government deadlocks, it seems likely that 2023 will experience considerable volatility. The past year discounted a substantial amount of bad news, and we are optimistic that the markets will ultimately generate positive returns by year-end.

