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MKM MacroStrategy Deck

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MacroStrategy Deck
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See last page for analyst certification and important disclosures.



Top Themes

Dark clouds are gathering over 2023. We have now seen the fastest rise in real policy rates in more than four decades. This has occurred against the backdrop of 1) an increasingly broad-based collapse in commodity prices; 2) a soaring dollar exchange rate; 3) various parts of the yield curve in a multi-month inversion; 4) negative growth in real base and broad money; 5) a sharp fall in bond market inflation expectations from the YTD highs; 6) an abrupt tightening in lending standards and 7) a deepening recession in residential real estate.

Backward-looking monetary policy risks repeat boom/bust cycles. The Fed ignored a two-year boom in commodity prices, a soaring residential real estate sector and a v-shaped rebound in nominal activity due to the quiescence of wages, rents and core services price inflation (all lagging indicators). Now, with monetary conditions tightening forcefully, these same lagging indicators remain strong. This is a setup for repeated boom and bust cycles and an erosion of Fed credibility over time.

Watch the unemployment rate. The unemployment rate tends to bottom nine months before a cycle peak and will rise 0.5 percentage points (or more) from year-ago levels in the early innings of a downturn or near a cycle peak. Thus far we have seen what appears to be a “double bottom” in the unemployment rate, but not a rise of 0.5 percentage points or more against year-ago levels. That eventuality likely will occur next year regardless of whether we have (another) two down consecutive quarters of GDP.



Investment Strategy

The bear market rally will have run its course when equities and bond yields begin to fall simultaneously. The equity market weakness from January to June and again from August to October had one common theme: relentless upward pressure on market interest rates. The surge in equities from June to August and again from mid-October were associated with falling yields. However, a recession and a material fall in the level of earnings could disrupt this relationship (equities falling while rates fall).

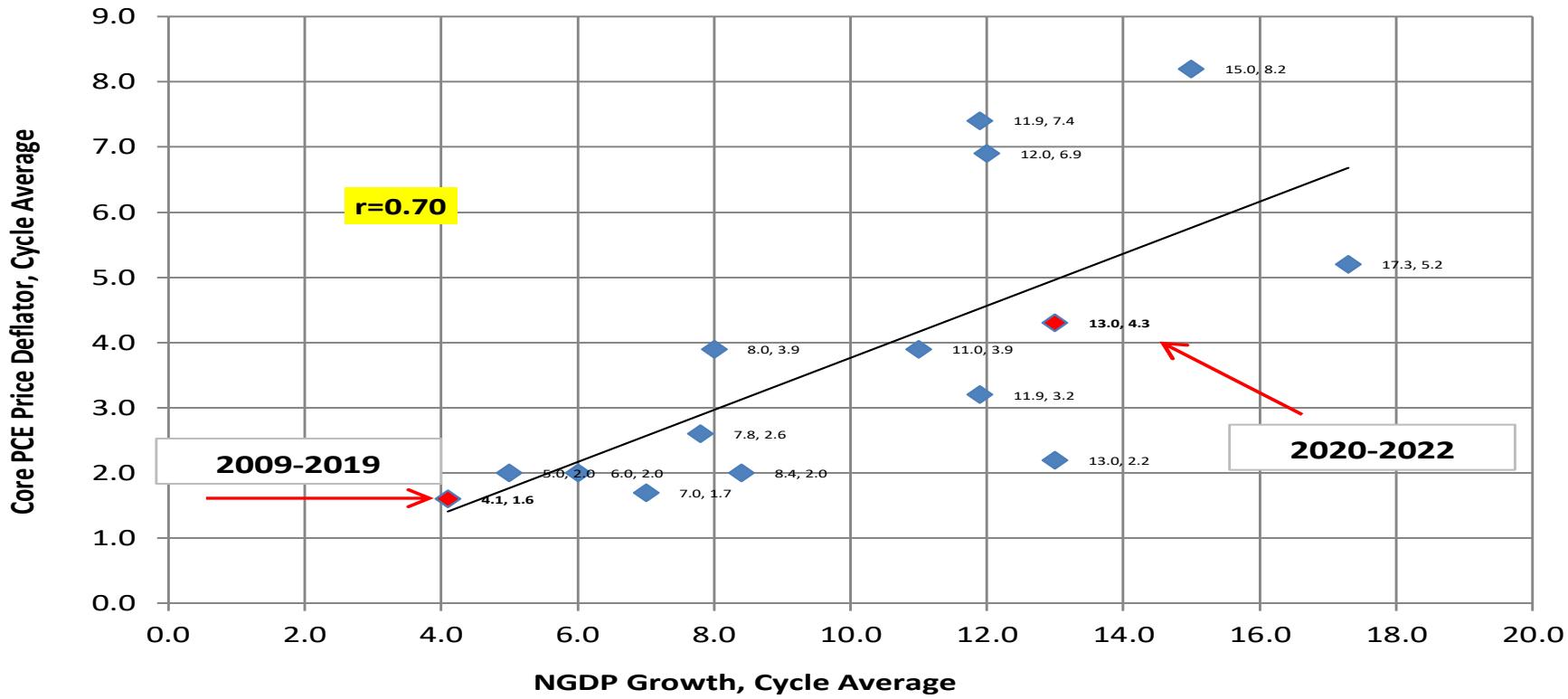
The FTX debacle doesn't look "systemic" but does have some similarities to the Enron fiasco more than two decades ago. A collapse in energy prices, weakening growth and eventual recession yanked back the curtain on the Enron house of cards. Similarly, a huge surge in real interest rates from the 2021 lows caused highly speculative asset classes (crypto, MEME stocks, SPACS, profitless tech) to collapse. FTX appears to simply be the afterglow of the crypto implosion.

We are bullish on duration across the Treasury curve and bearish on high yield/junk. On the equity side, small cap value and GARPY tech may be places to hide in 2023. Inverted yield curves, negative real base and broad money growth, tightening lending standards and a high likelihood of a 2023 recession all suggest that the path of least resistance for credit spreads is wider. **Both the equity market and the level of credit spreads tend to bottom/peak about two-thirds (or more) of the way through a recession, not before they even begin.** Healthcare screens as the least expensive defensive sector in our work while staples is the most expensive. Small cap value and GARPY tech may also be areas that outperform next year.



Booming nominal demand has created significant inflationary pressure.

NGDP Growth vs. Core Inflation: Cycle Averages



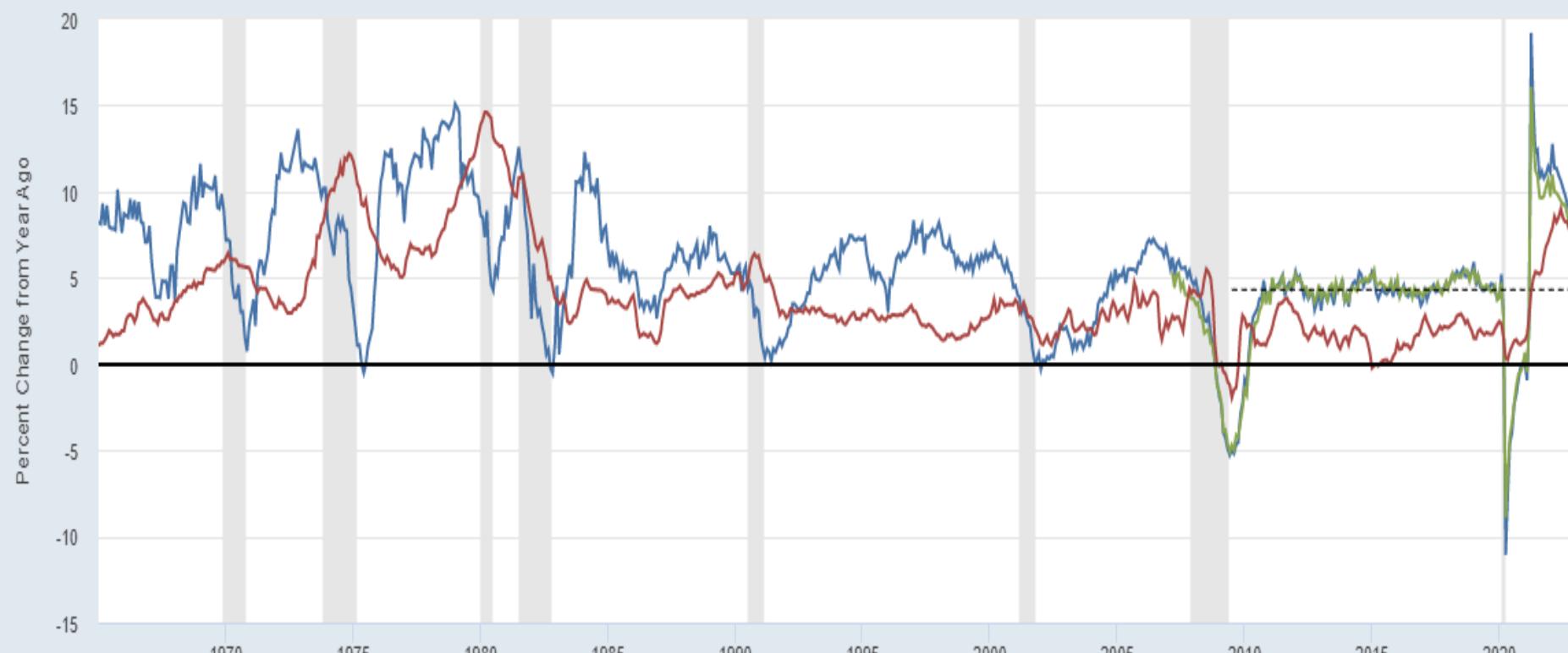
Source: Bloomberg; MKM Partners



Average weekly payrolls (a NGDP proxy) decelerating from a breakneck pace.

FRED

- Indexes of Aggregate Weekly Payrolls of Production and Nonsupervisory Employees, Total Private
- Indexes of Aggregate Weekly Payrolls of All Employees, Total Private
- Consumer Price Index for All Urban Consumers: All Items in U.S. City Average



Shaded areas indicate U.S. recessions.

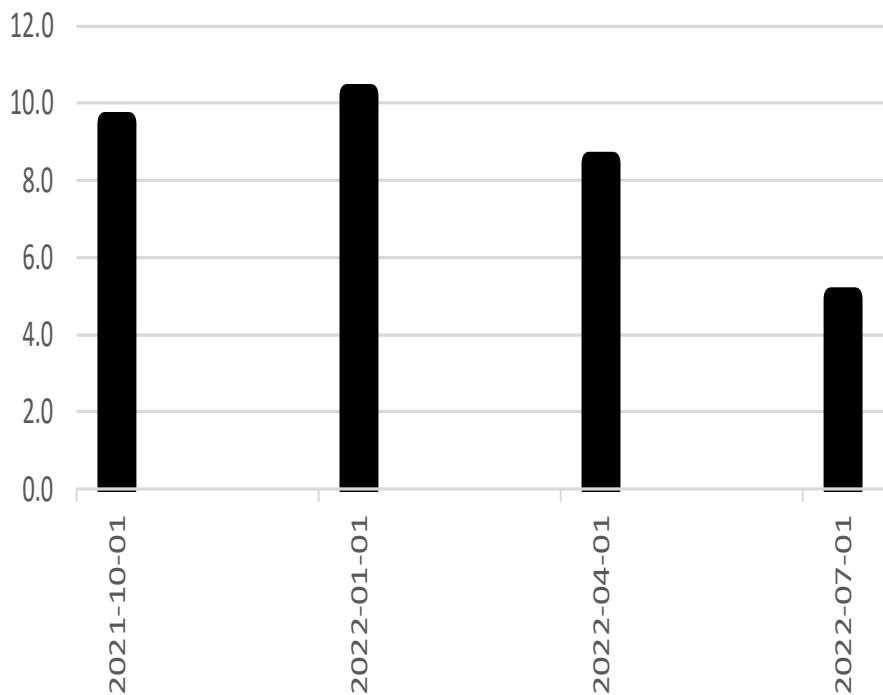
Source: U.S. Bureau of Labor Statistics

fred.stlouisfed.org

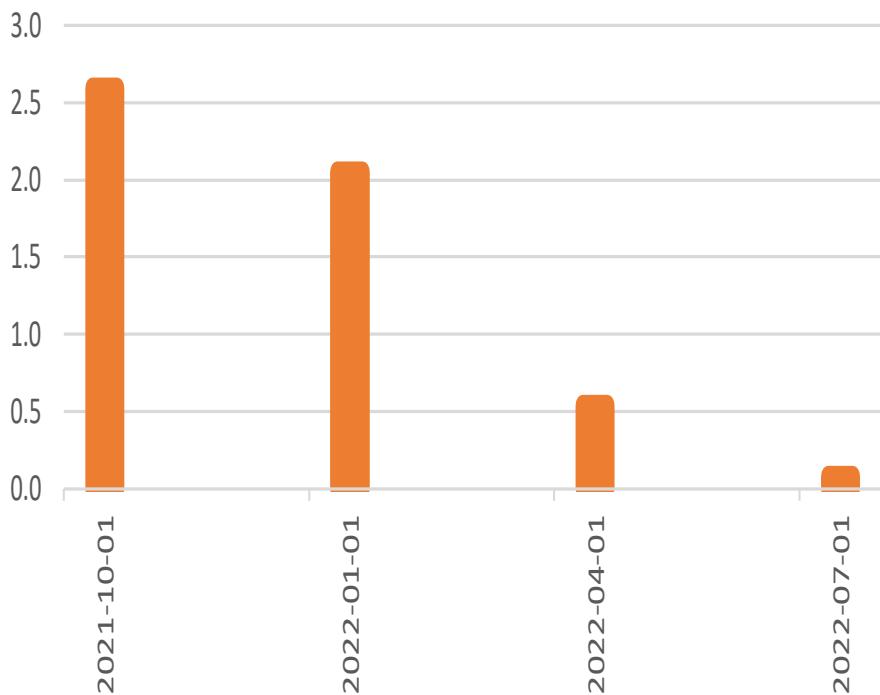


Nominal final sales has begun to slow sharply and real growth has stalled.

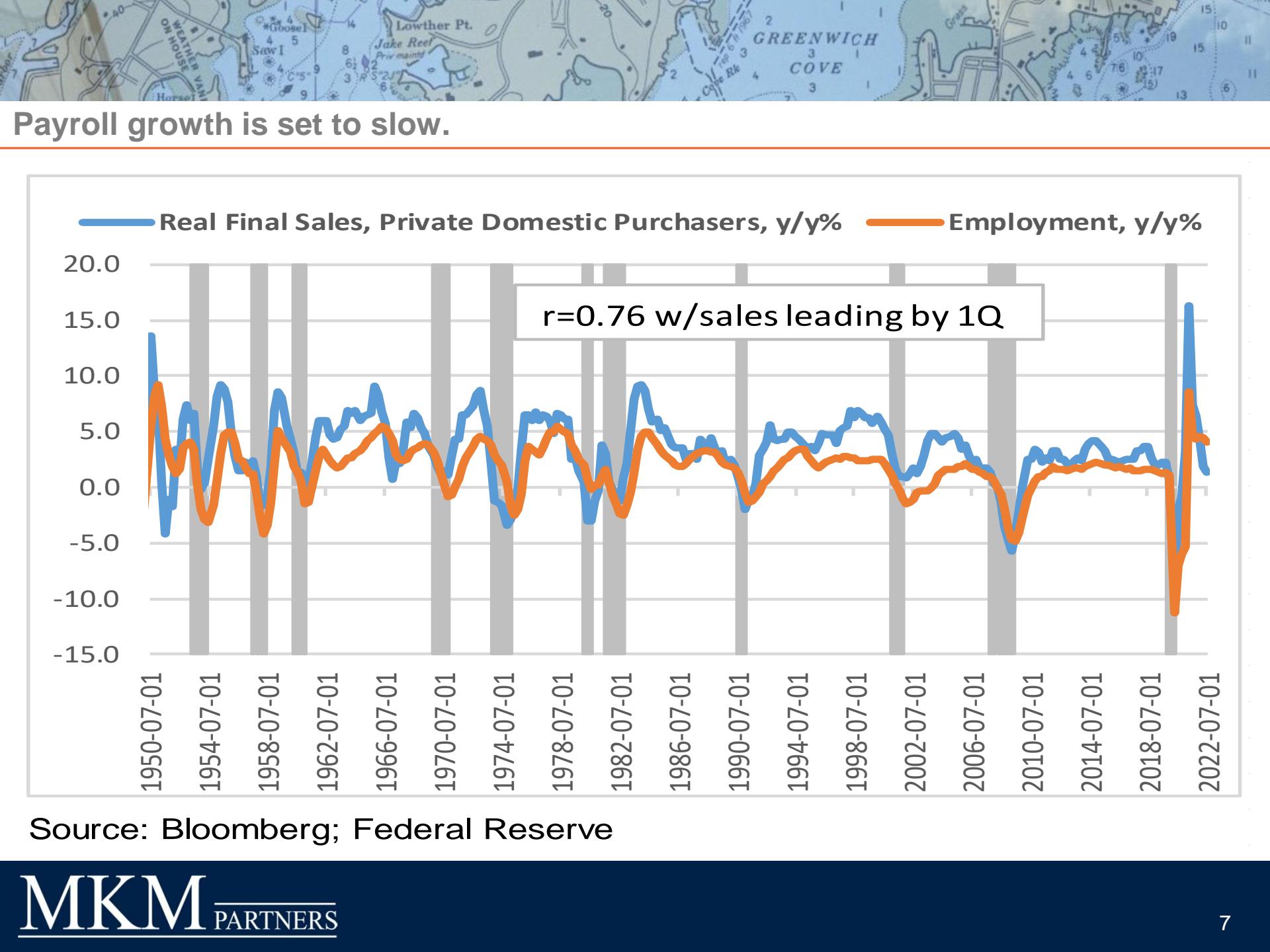
Nominal Final Sales, Private Domestic Purchasers, Quarterly Annualized Rate



Real Final Sales, Private Domestic Purchasers, Quarterly Annualized Rate



Source: Bloomberg; Federal Reserve

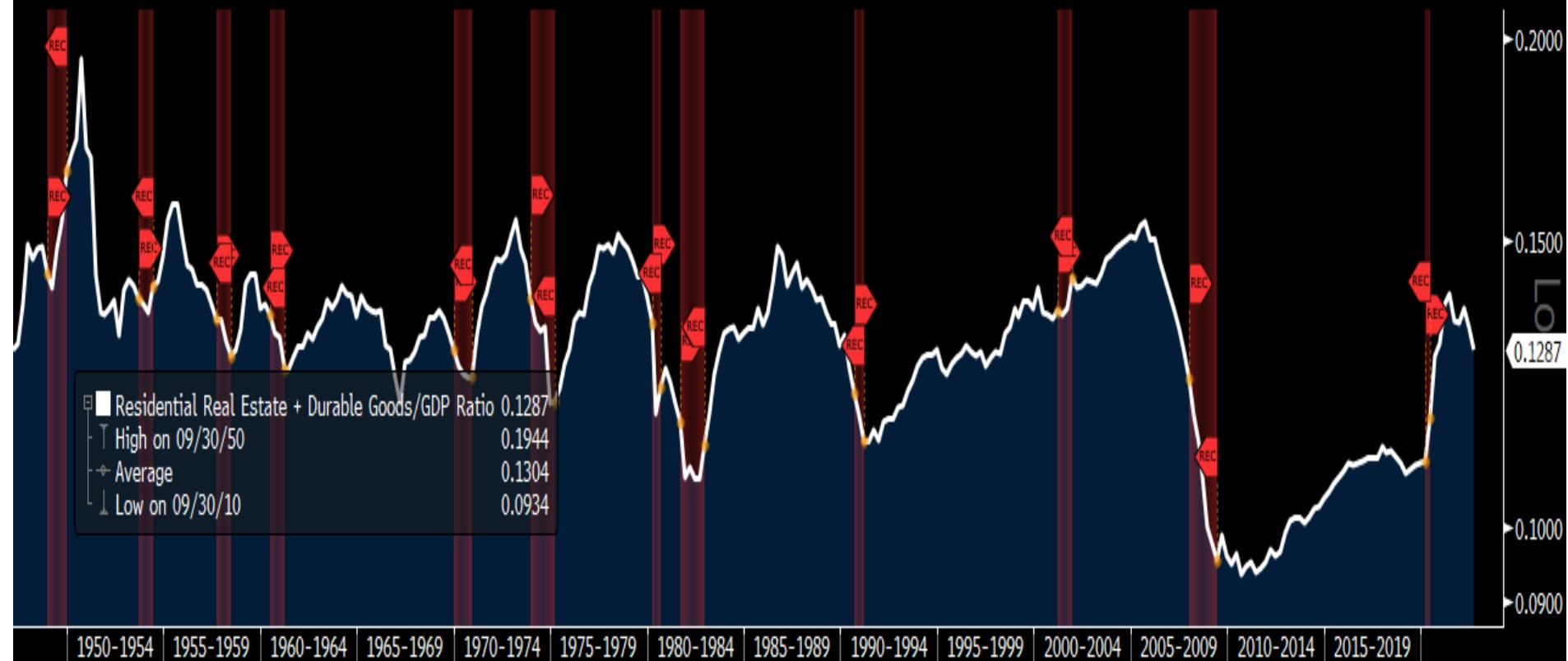




The residential real estate sector is in steep decline.

Durable Goods & Housing GDP Share

Peaks Usually ~ 2 Yrs. Before Recessions



Source: Bloomberg

.CYCGDP U Index (CYCGDP) durable and housing gdp Quarterly 01JAN1946-31DEC2023

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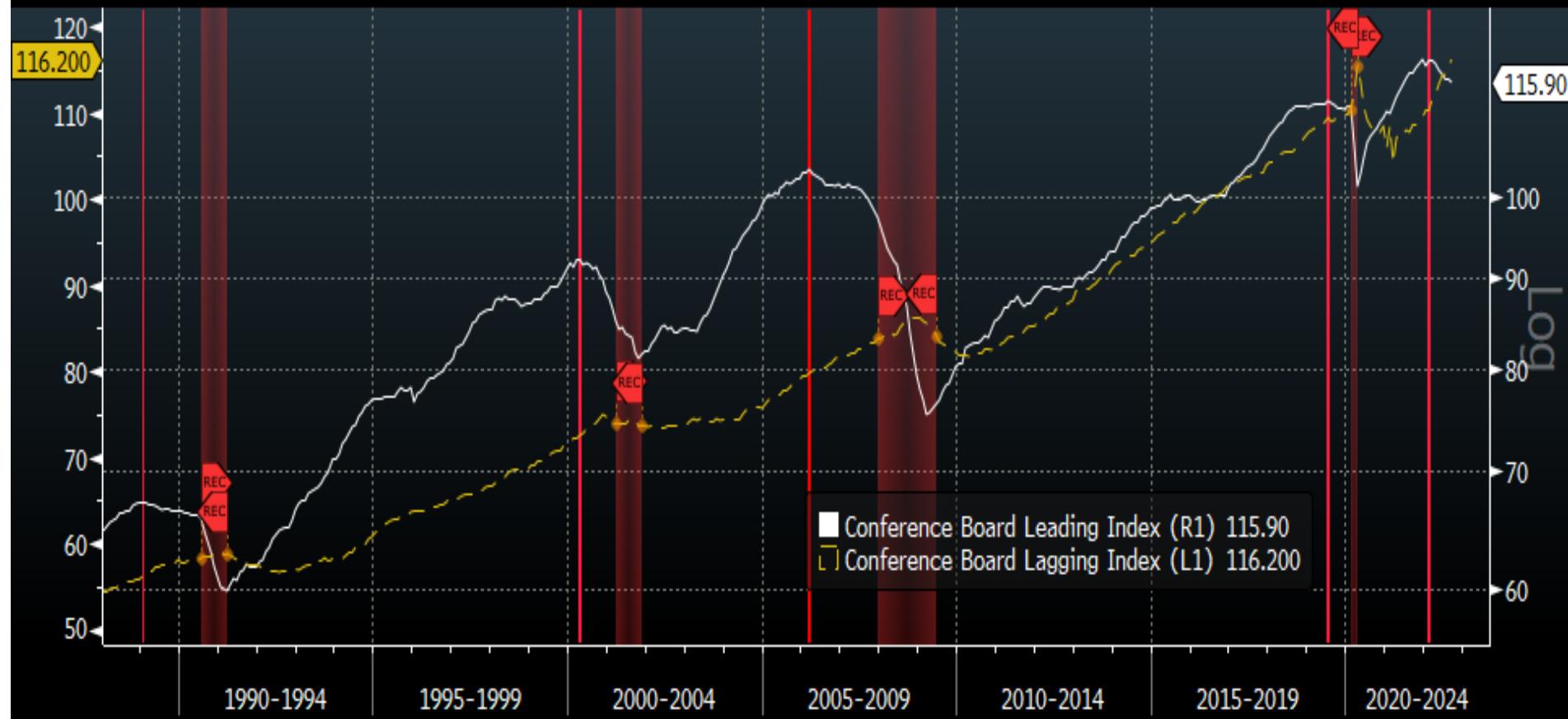
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Leading indicators have rolled over while the laggards have remained strong.

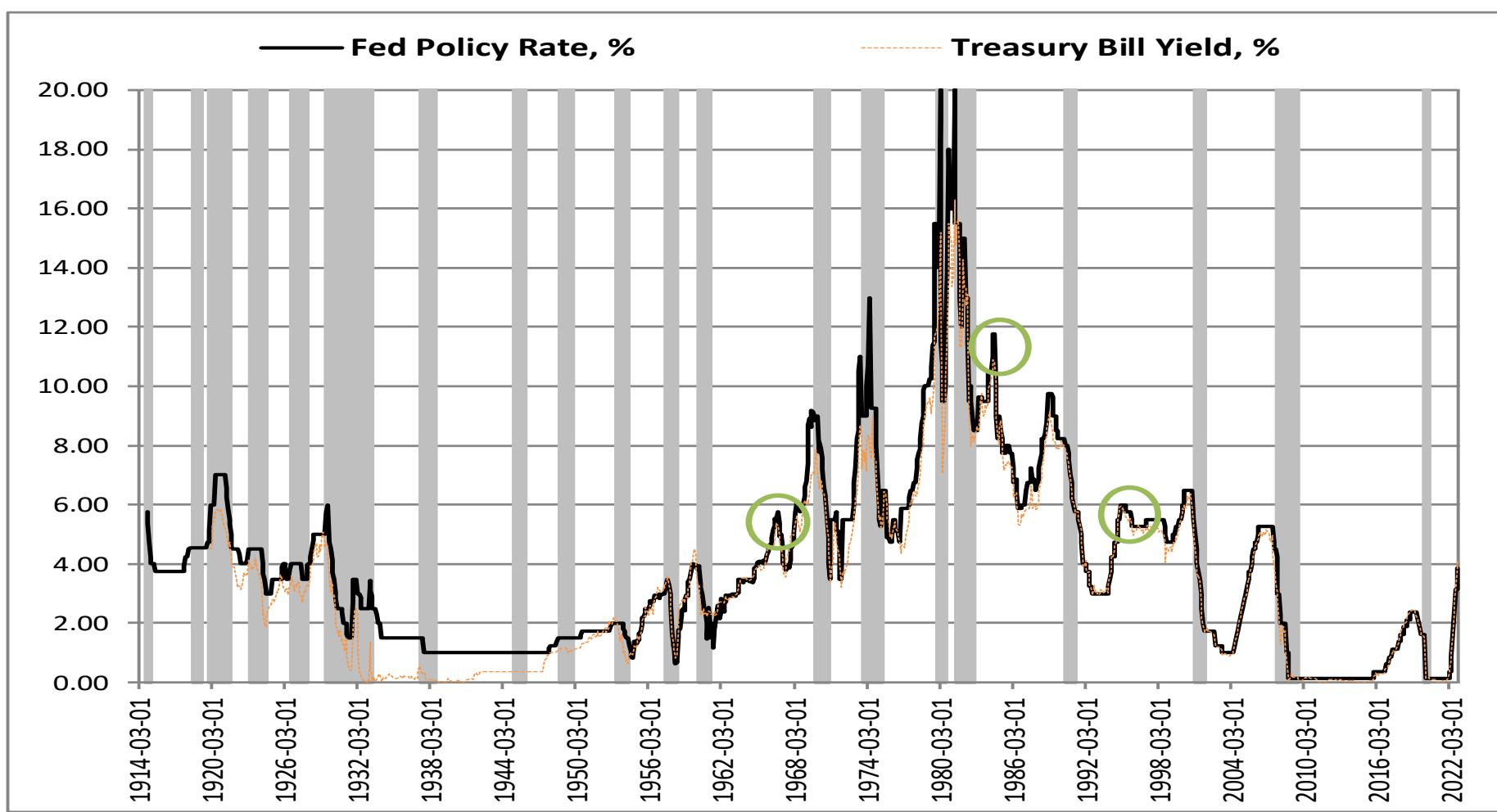
The FOMC Remains Focused on Lagging Indicators

Wages, Rents, Services Inflation LAG the Cycle



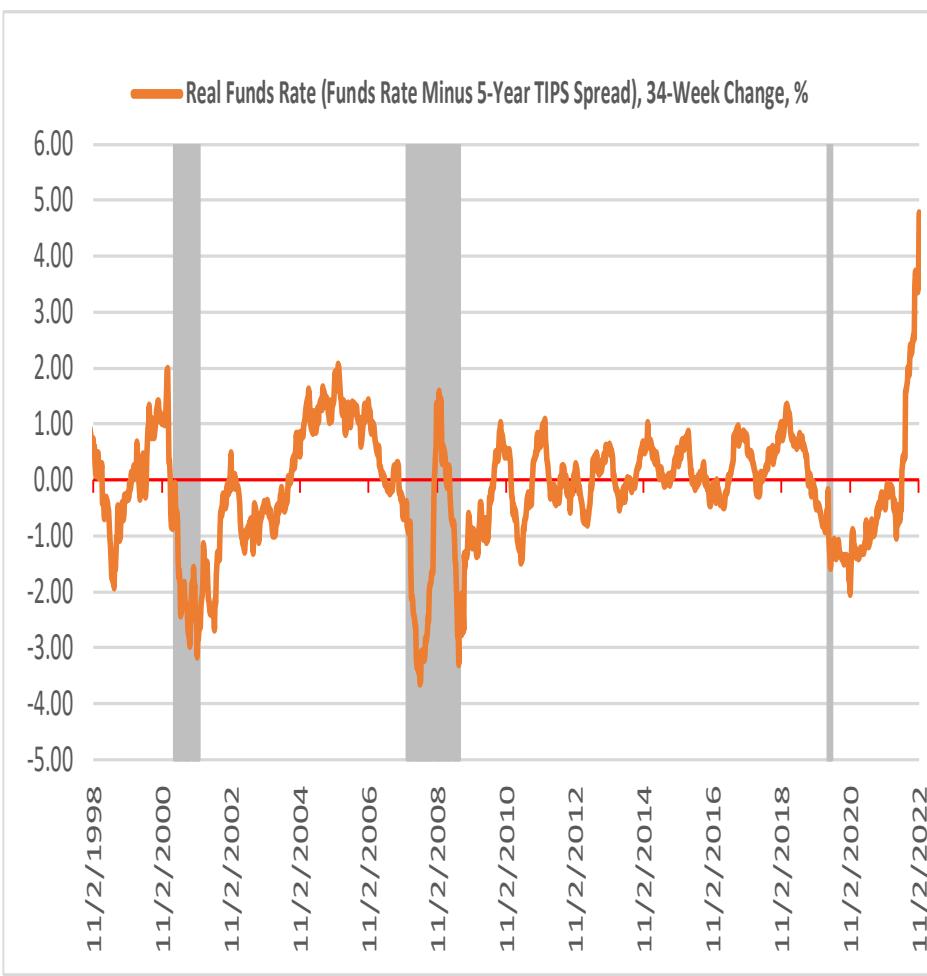
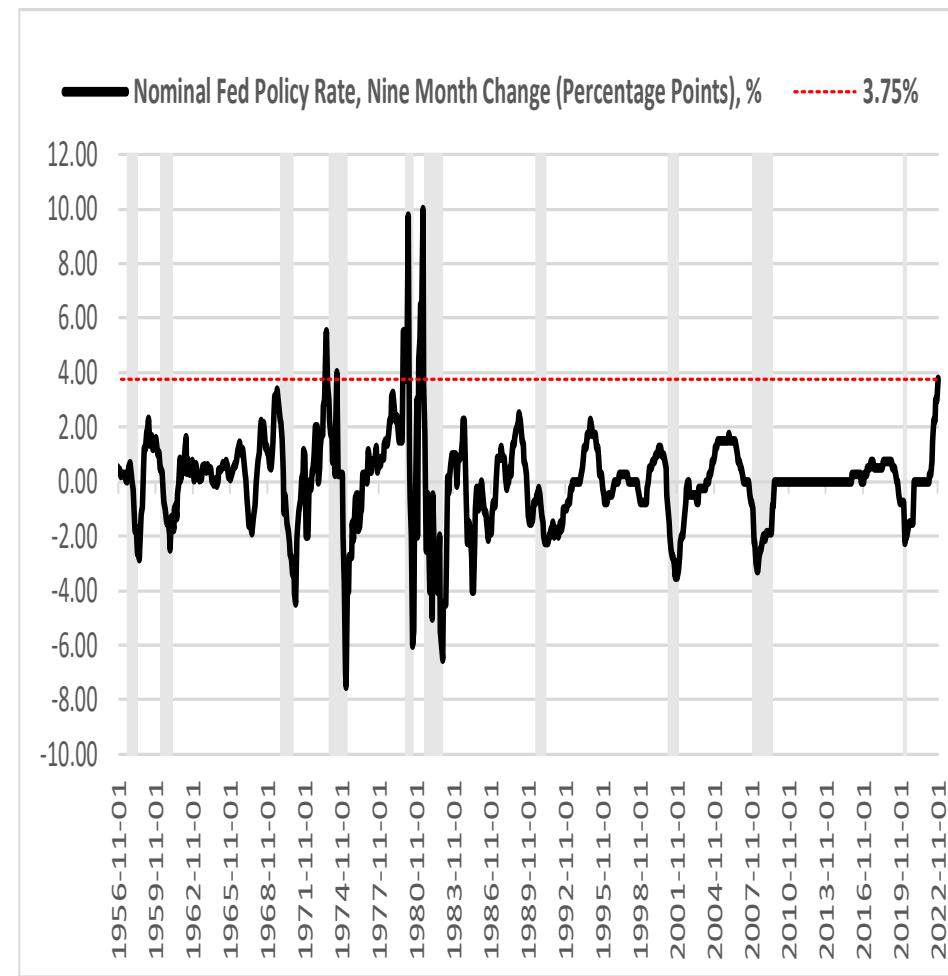


Fed rate hike cycles have mostly ended in recession.





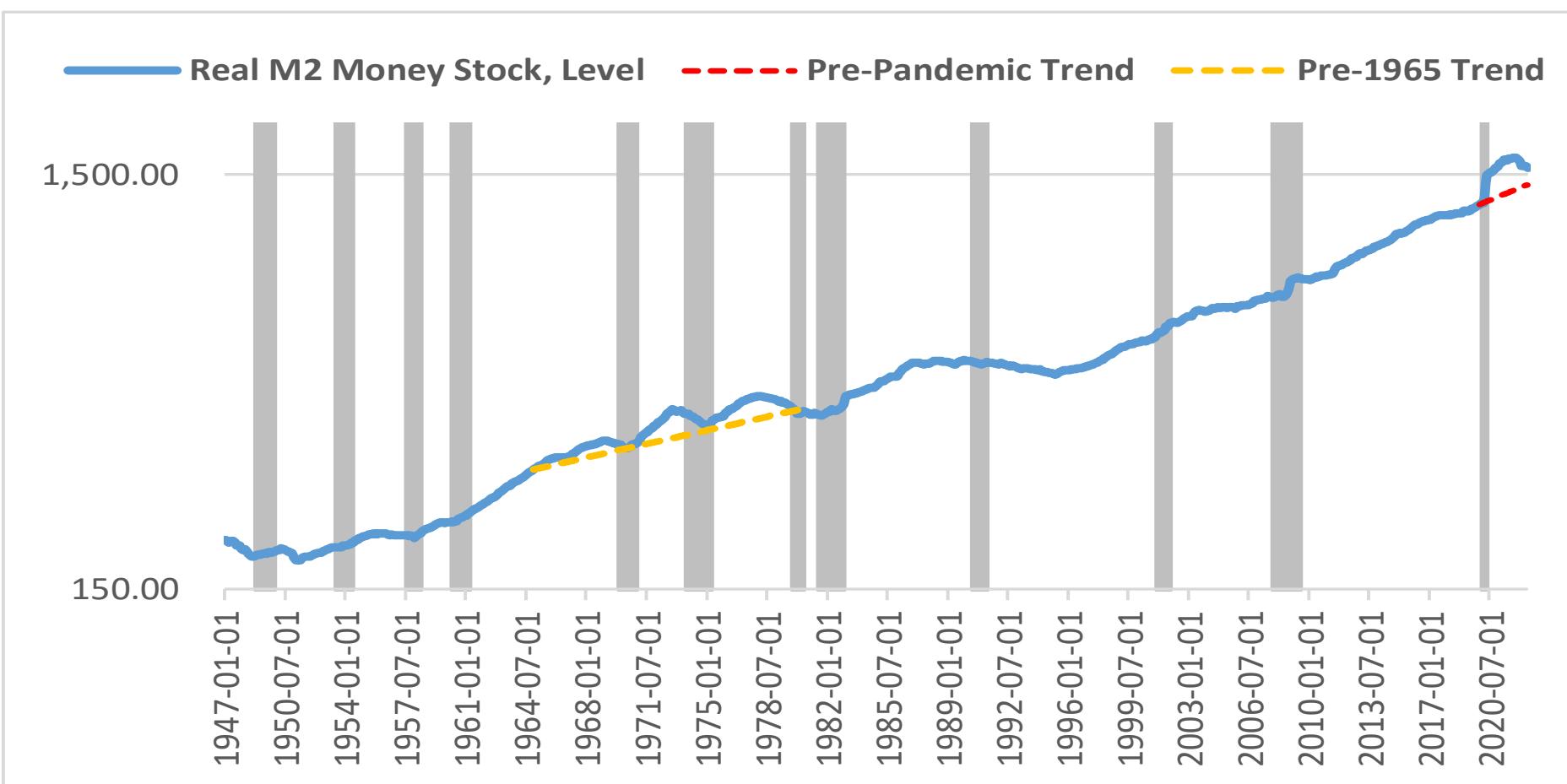
The most rapid rise in nominal and real policy rates in four decades.



Source: Bloomberg; MKM Partners



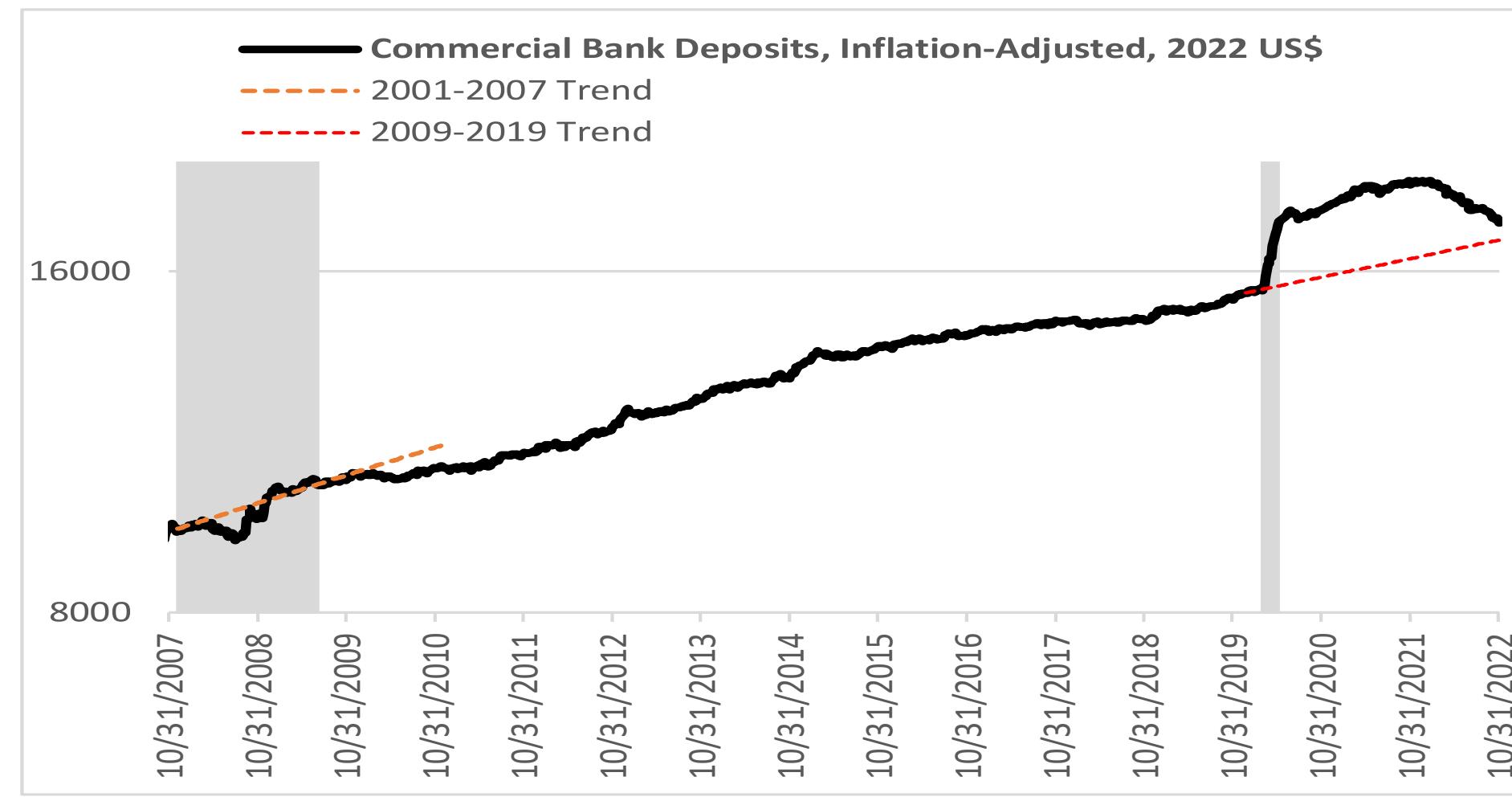
The *real* broad money stock peaked 21% above the pre-pandemic trend growth path last May, but now is down to less than 9% above the pre-pandemic trend.



Source: Bloomberg; Federal Reserve



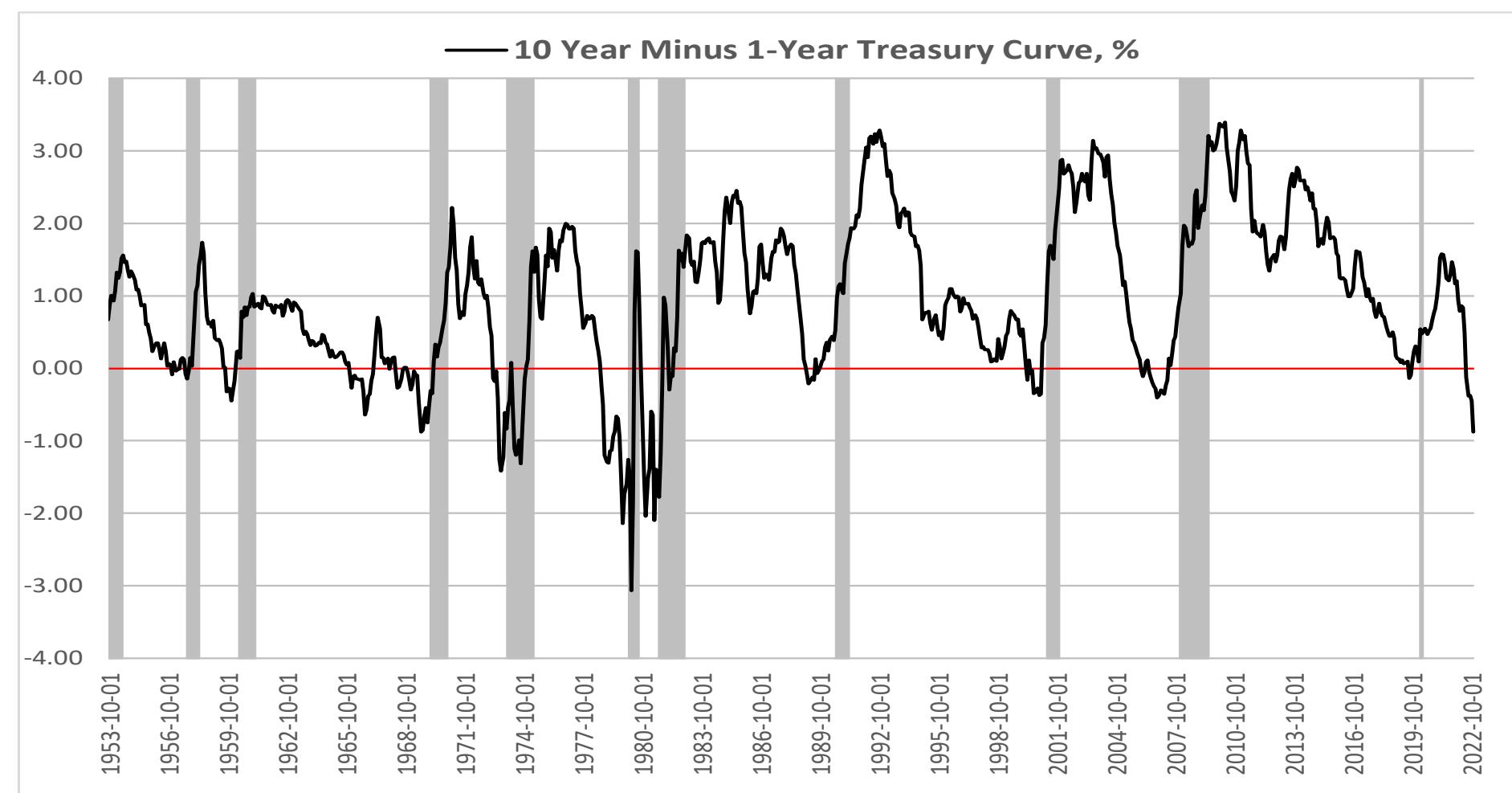
The run-up in deposits vs. trend is likely to be fully reversed by early to mid-2023.



Source: Bloomberg; MKM Partners



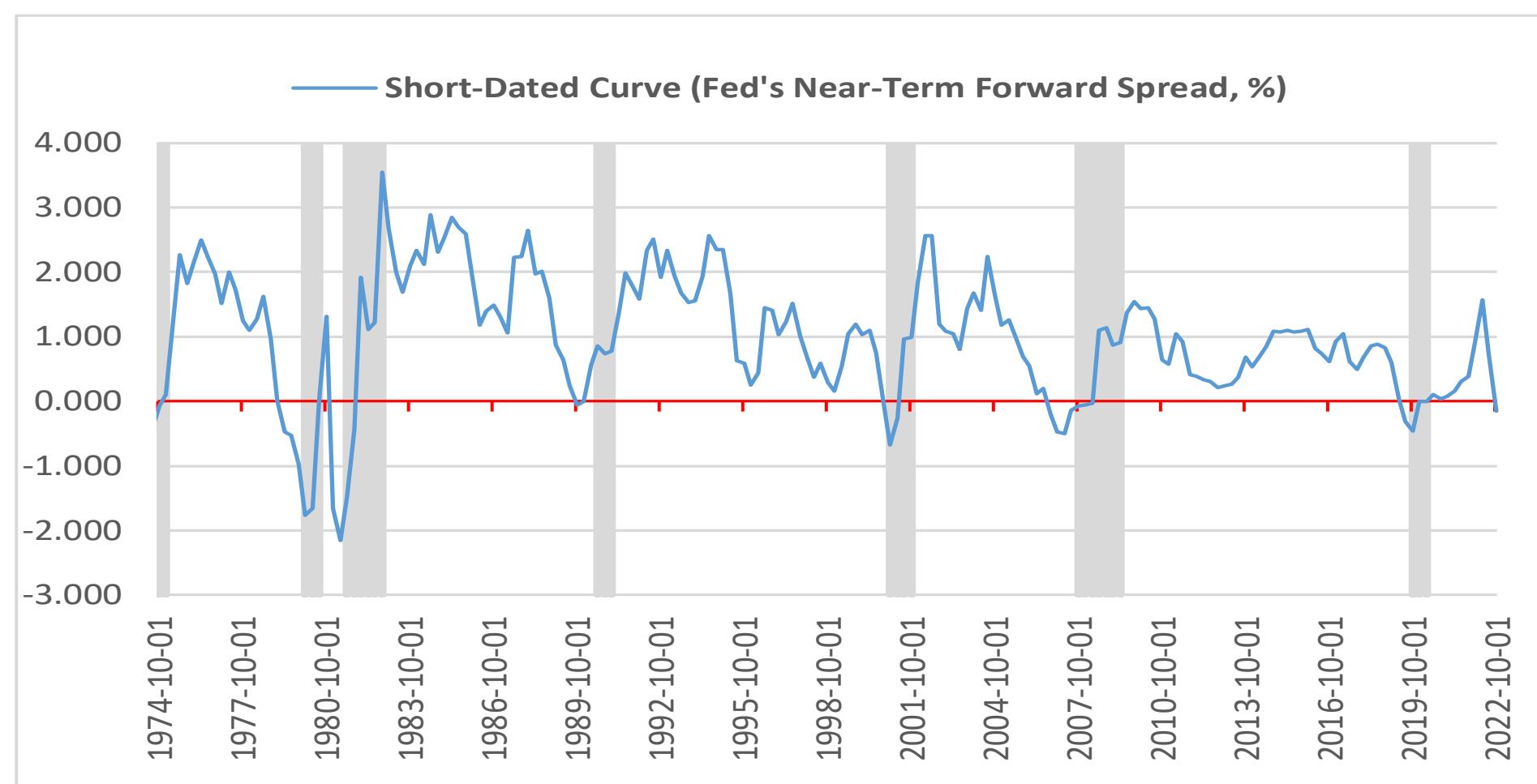
The 10s1s spread has become deeply inverted.



Source: Federal Reserve; MKM Partners



Even the Fed's so-called near-term forward spread is now inverted.



Source: Federal Reserve; MKM Partners



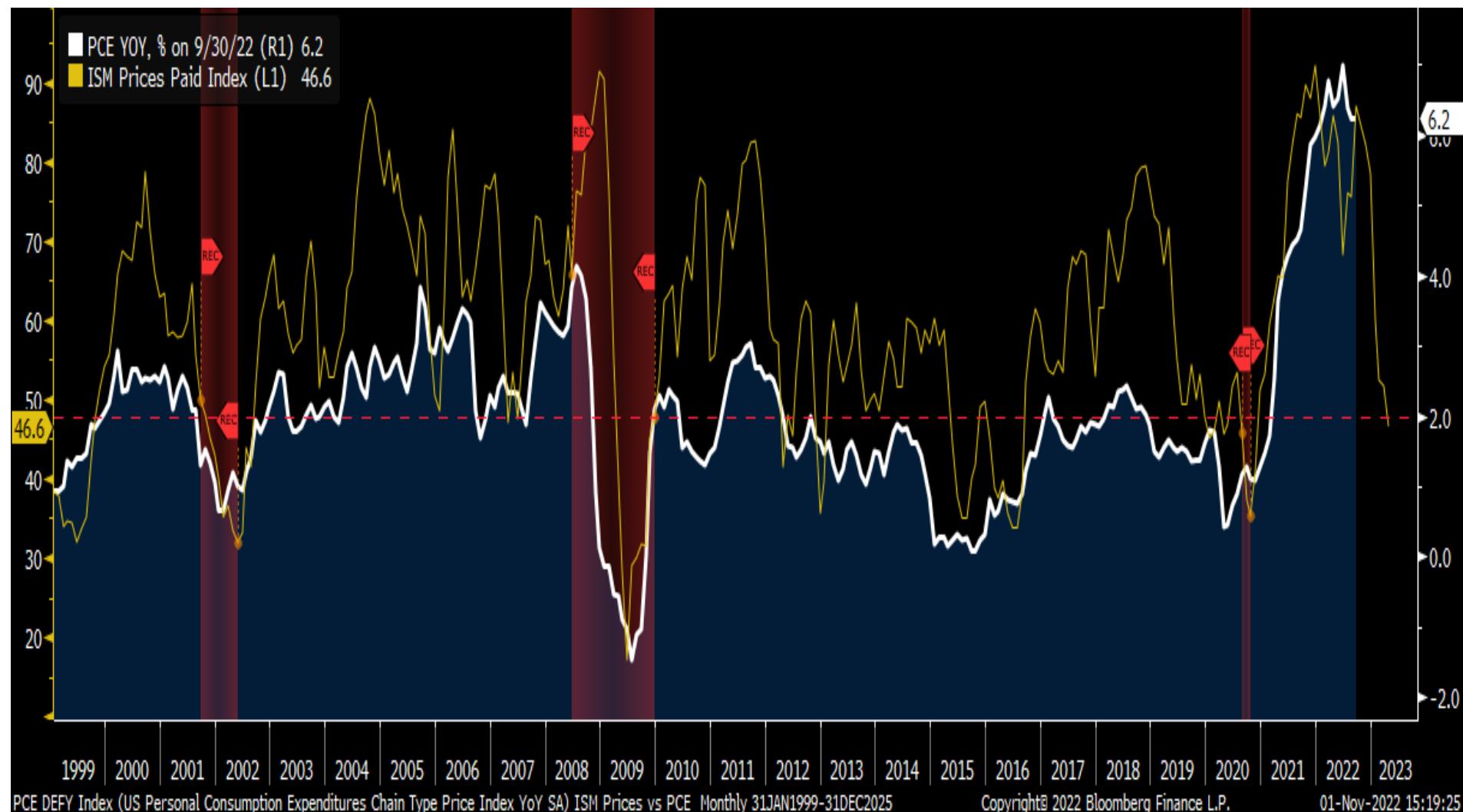
Yield curves, money growth and recessions.

Recession	10s bills curve (Inversion, Months Prior to Recession)	10s1s curve (Inversion, Months Prior to Recession)	Real Base (Negative y/y Growth Prior to Recession)	S&P 500 (Peak, Months Prior to Recession)
1957	7	9	17	13
1960	6	8	8	9
1970	21	25	7	1
1973	9	9	0	11
1980	17	17	15	0
1981	11	11	n/a	9
1990	14	18	16	2
2001	9	12	6	13
2008	17	24	12	3
2020	9	7		1
avg.	12.0	14.0	10.1	6.2
med.	10.0	11.5	10.0	6.0
mode	9.00	9.00	n/a	13.0

Source: Federal Reserve; Bloomberg; MKM Partners

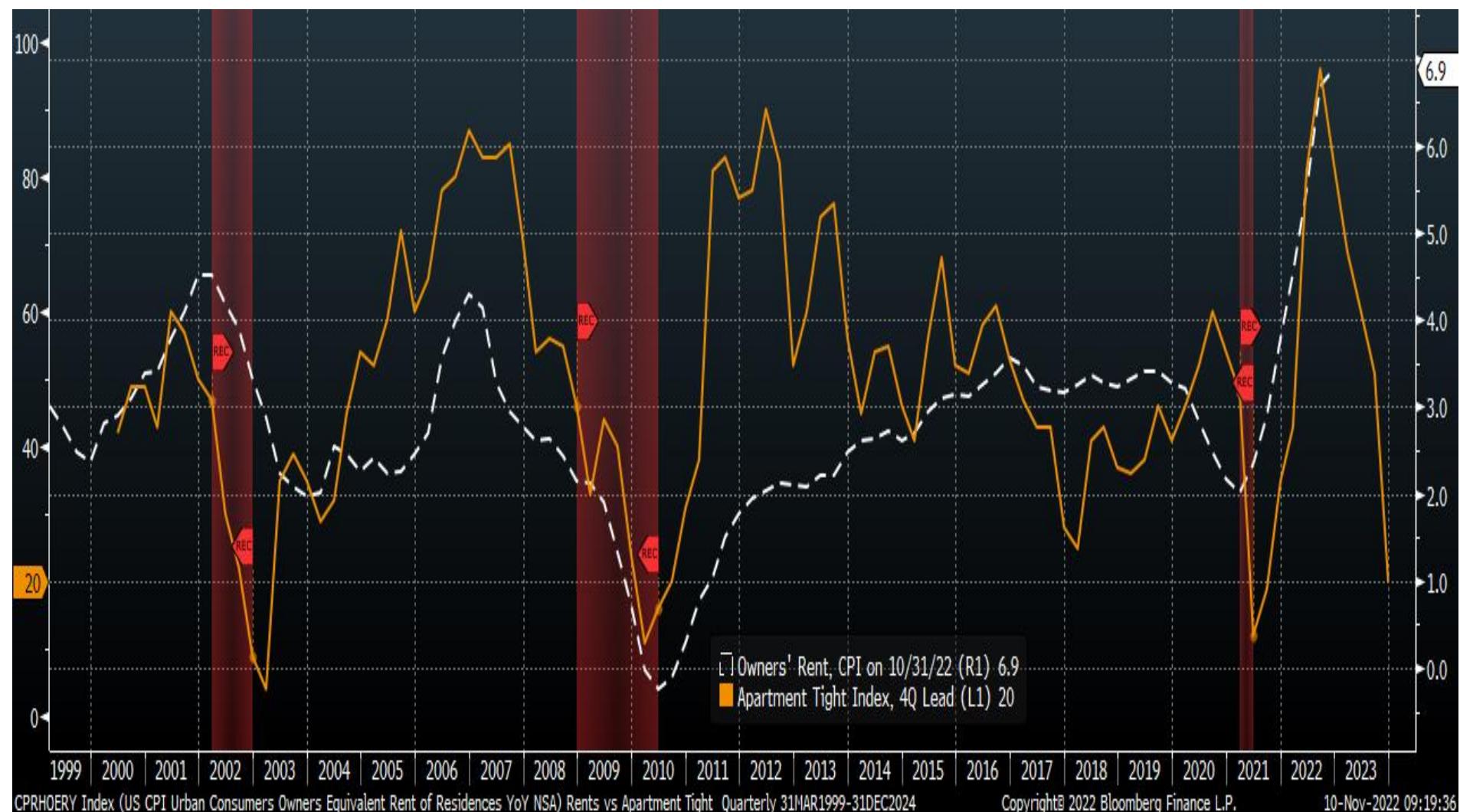


A sharp easing in the prices paid PMI component points to lower inflation.





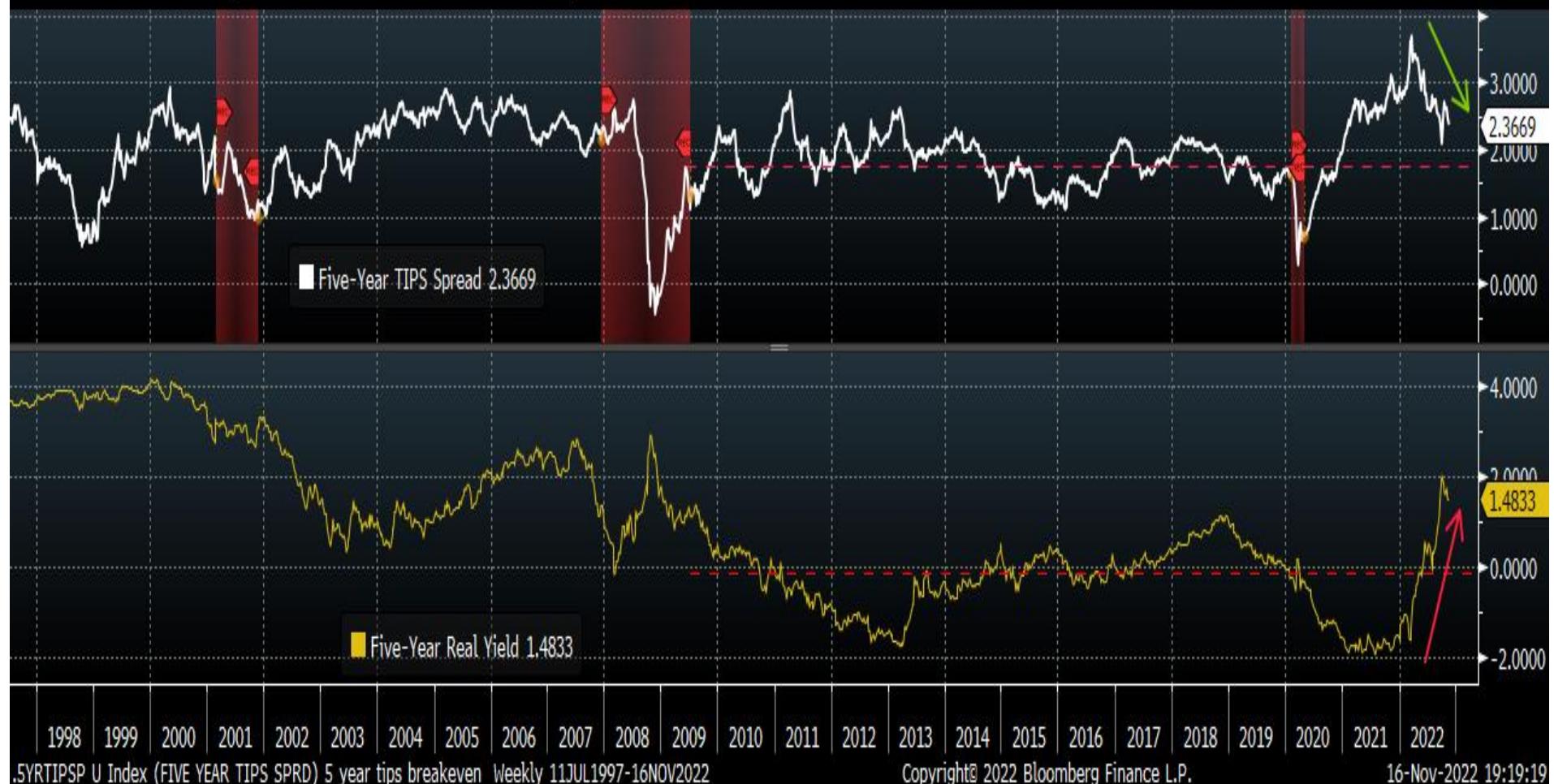
Rental inflation likely to fall sharply next year.





Five year real rates and expected inflation.

Five-Year Expected Inflation (Top) vs. Five-Year Real Rate (Bottom)





10-year real rates and expected inflation.

10-Year Breakeven Spread (Top) vs. 10-Year Real Rate (Bottom)



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The crypto crash (and MEME stocks, SPACS, profitless tech, etc.) has come at the hands of a dramatic surge in real rates.

Crypto vs. Real Rates

As Real Rates Soared, Crypto Imploded





The FTX debacle has some similarities with the Enron fiasco two decades ago.



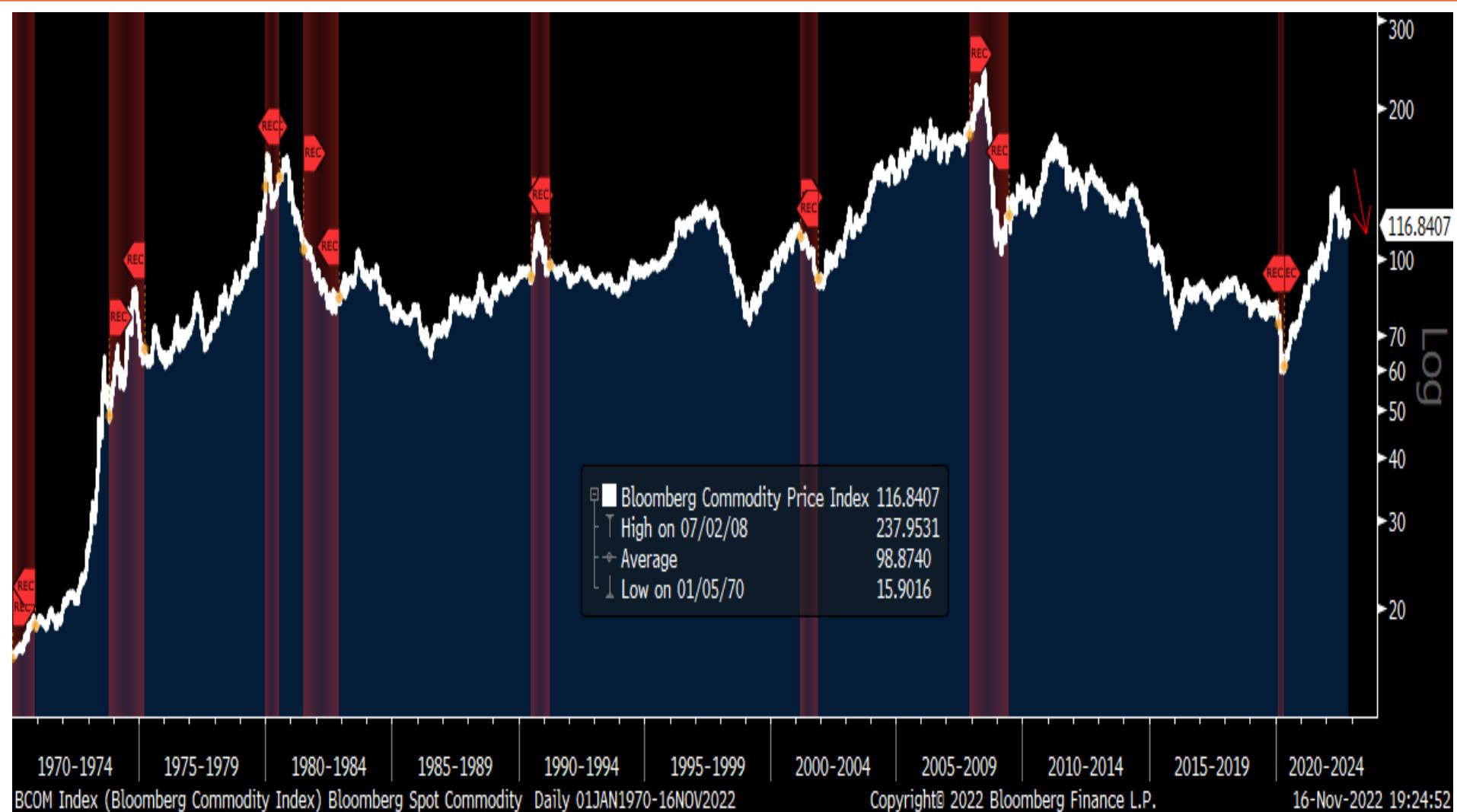
ENRNQ US Equity (Enron Corp) enron vs cry Daily 07SEP2000-01DEC2001

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Bloomberg all-commodities spot index.





CRB metals index.

CRB Metals Index



Source: Bloomberg

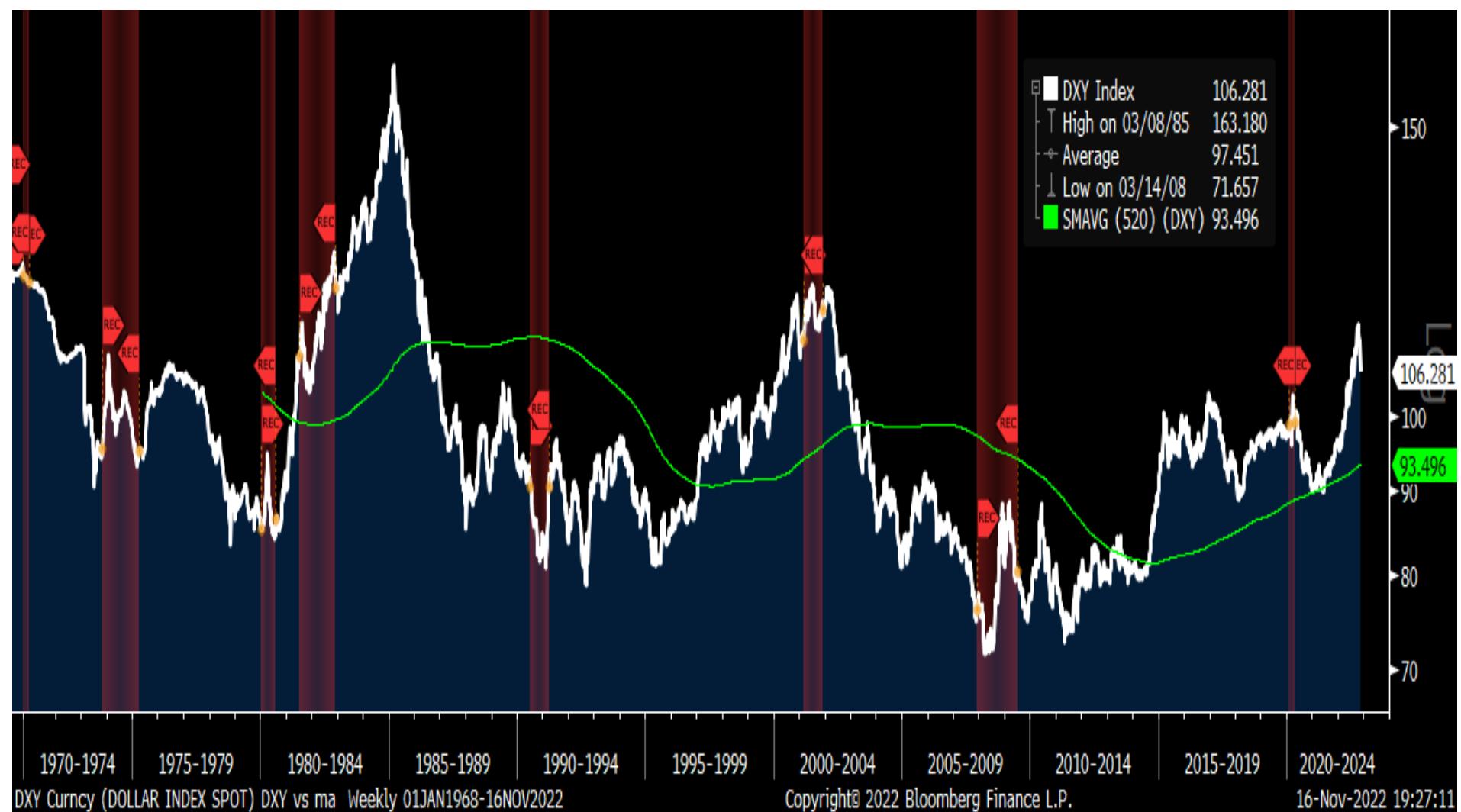
CRB METL Index (Commodity Research Bureau BLS/) CRB Metals Daily 04JAN1950-15NOV2022

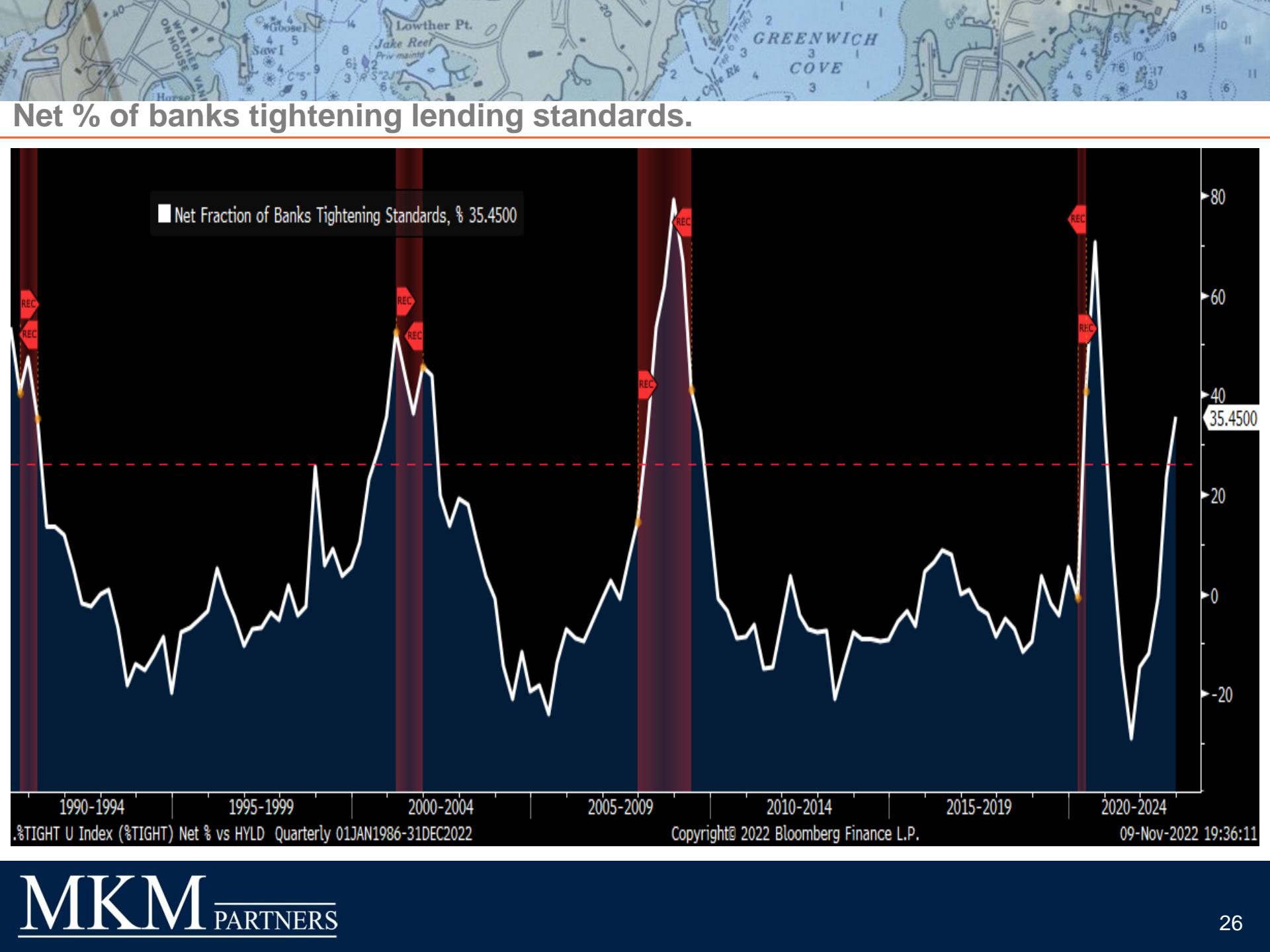
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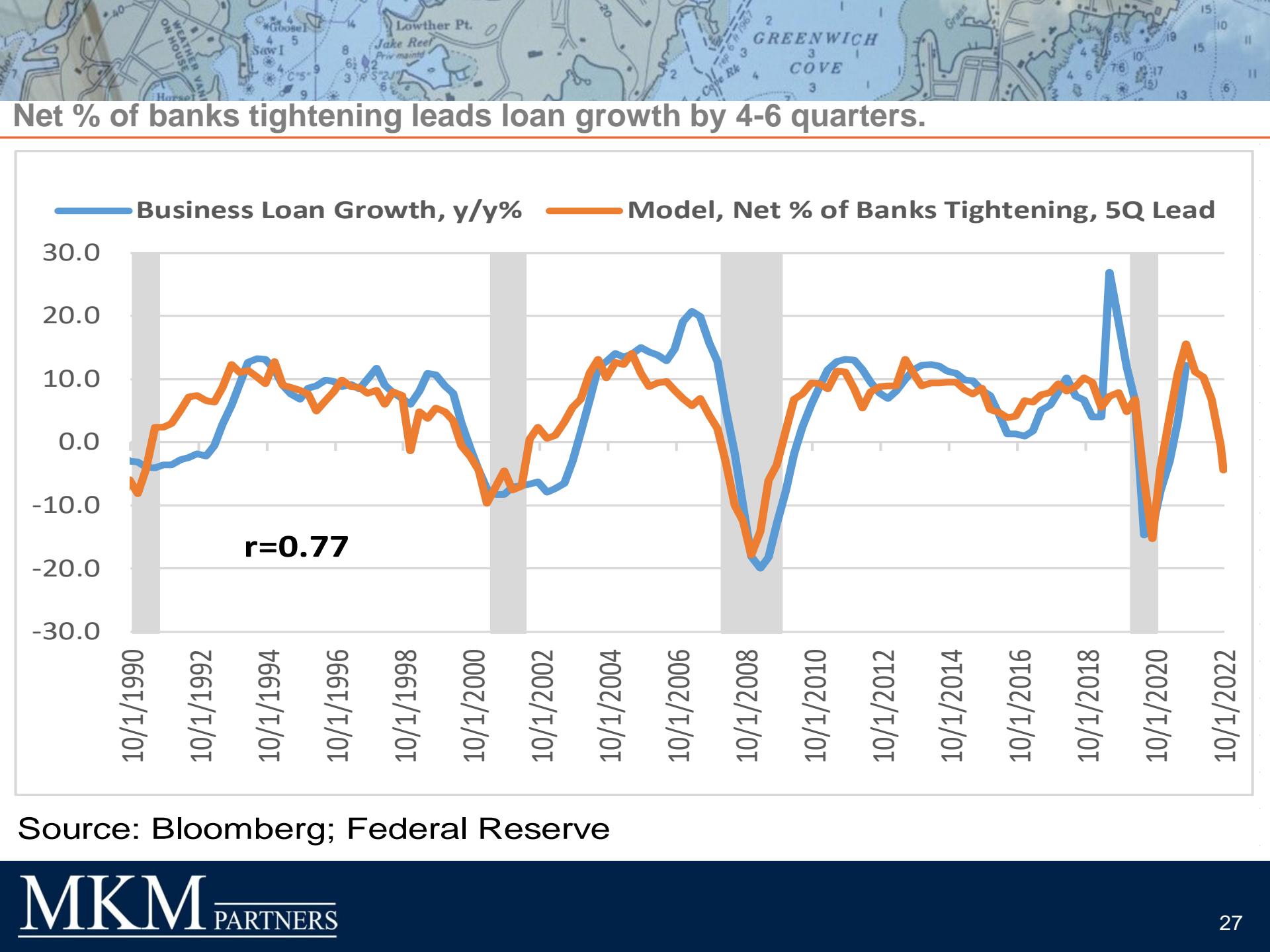
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The dollar.

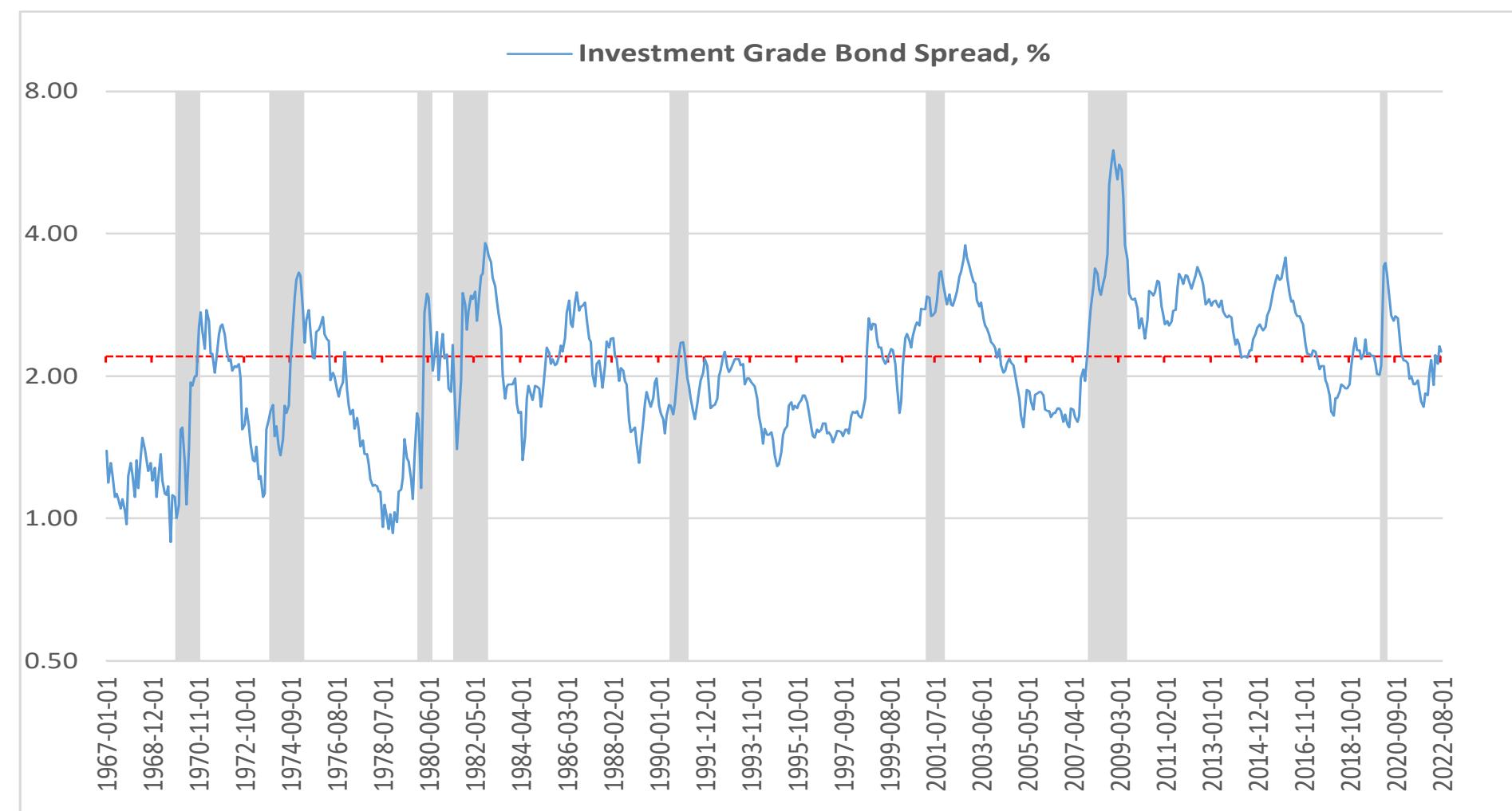




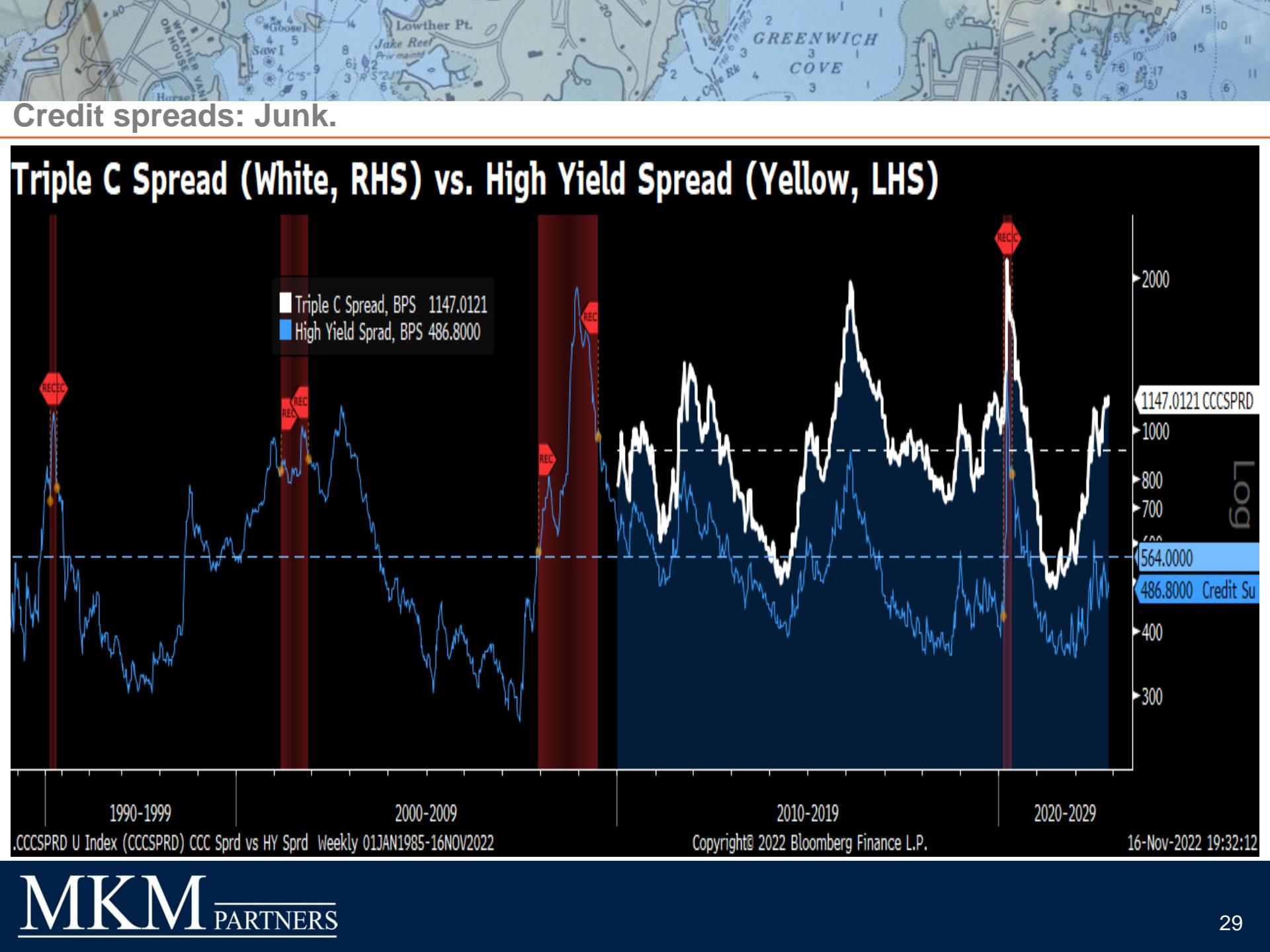


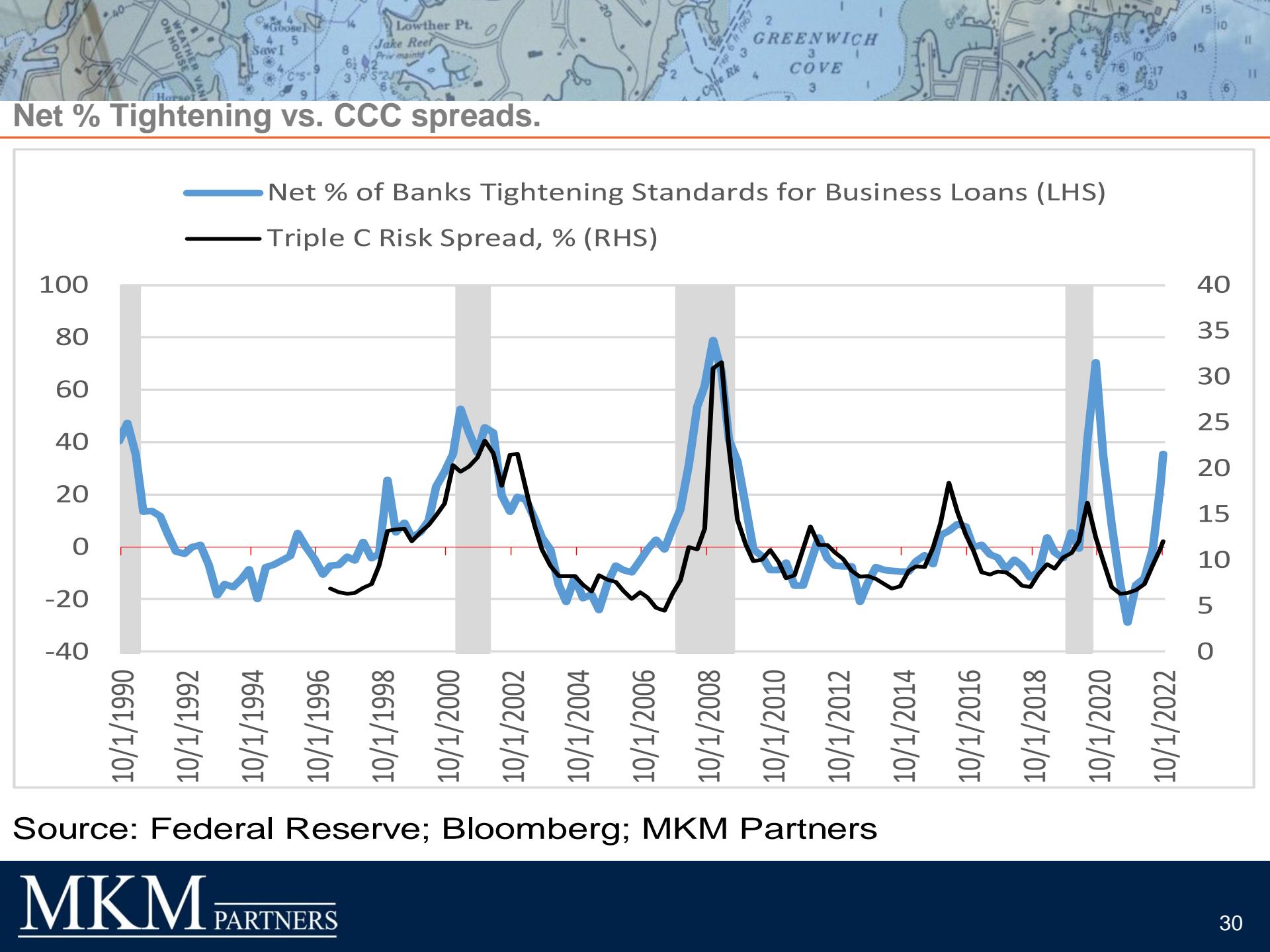


Credit spreads: IG.



Bloomberg; MKM Partners

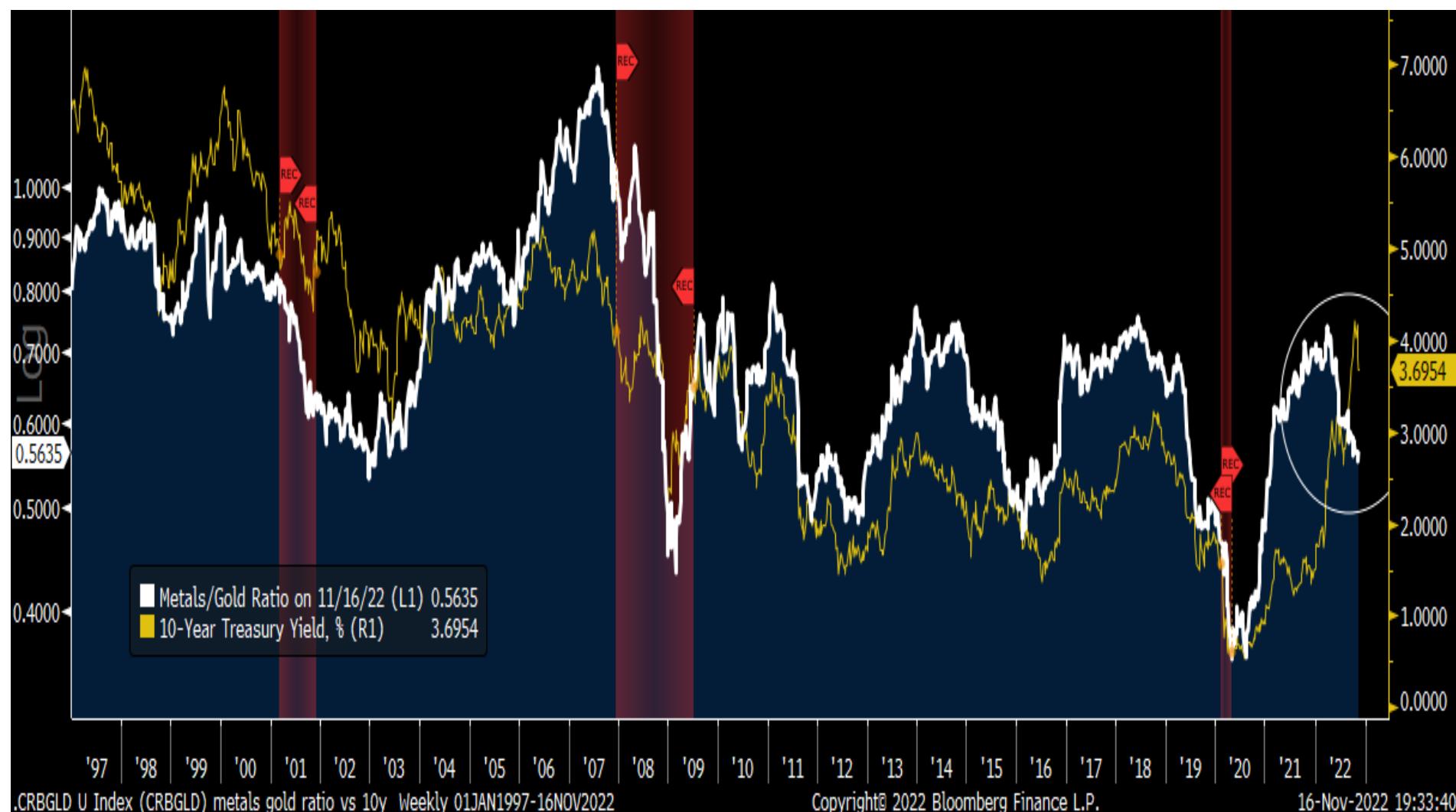




Source: Federal Reserve; Bloomberg; MKM Partners



The metals/gold ratio suggests a downward inflection point for long rates.





First-time claims have been volatile this year but remain above the YTD lows.

Initial Jobless Claims, Adjusted for the Labor Force



Source: Bloomberg

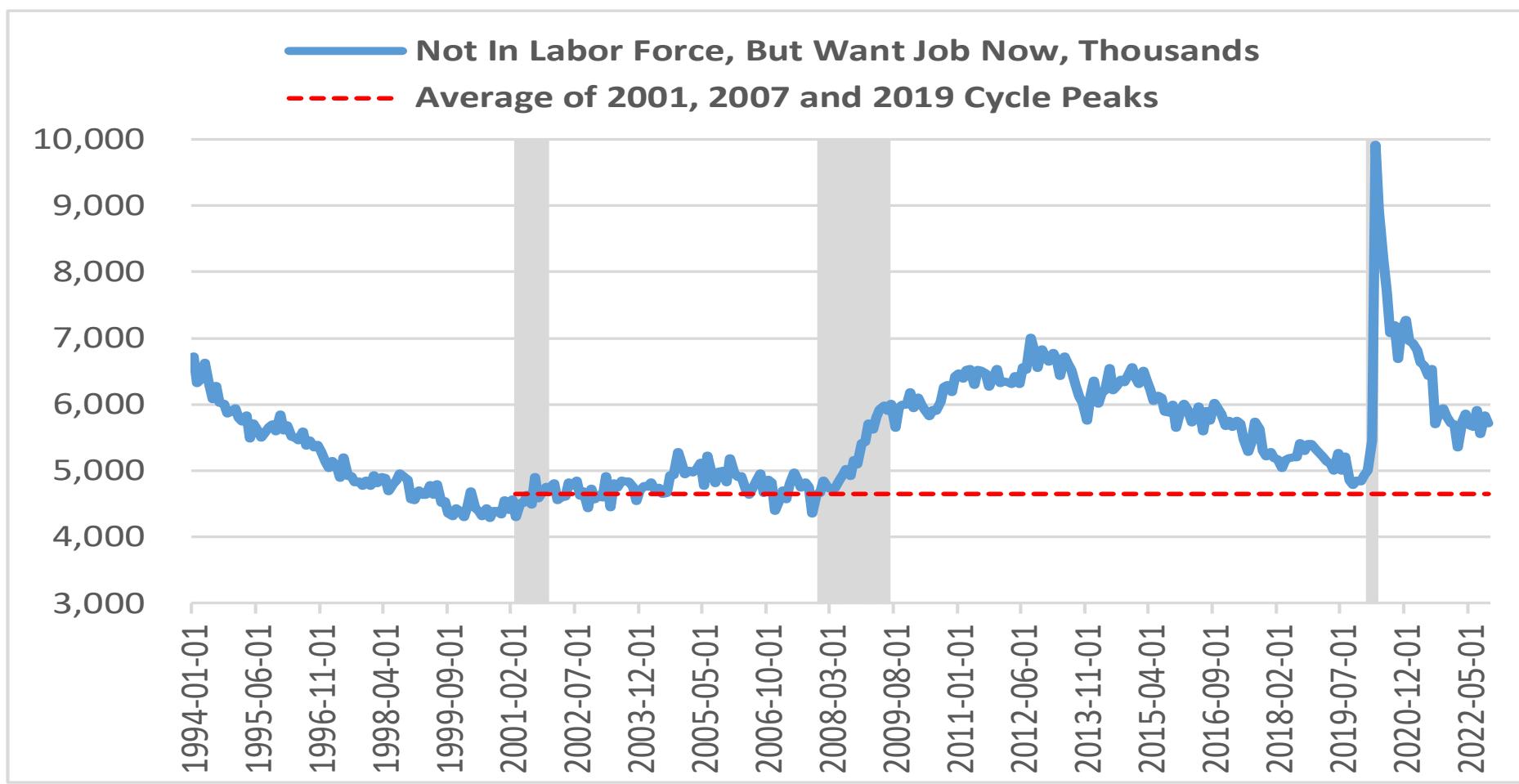
.LFADJUST U Index (LFADJUST) Claims LF Adj. Daily 01JAN1967-31DEC2023

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How many people are out of labor market commission but “could” come back?



Source: BLS



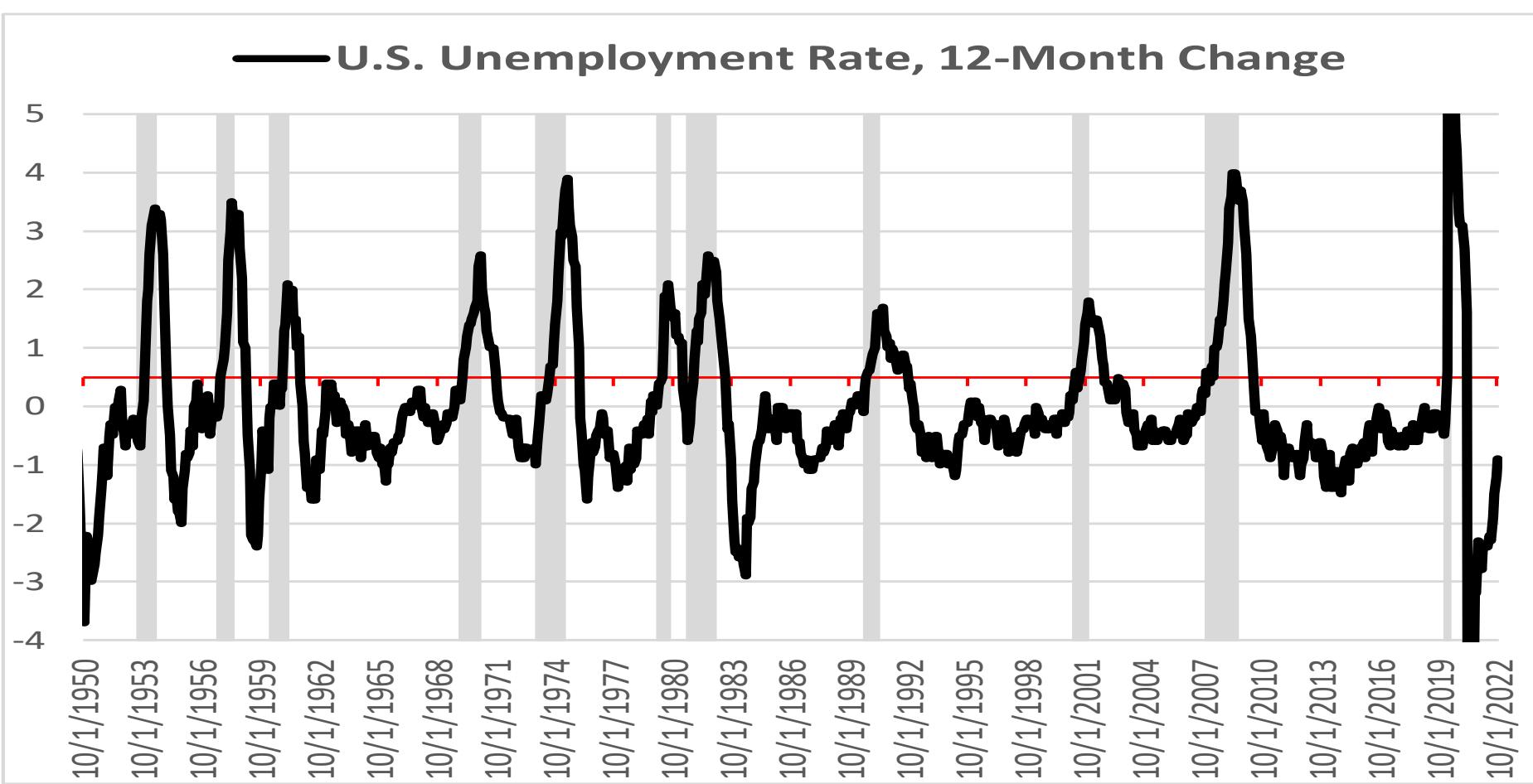
The unemployment rate may have bottomed for the cycle.



Source: BLS; Bloomberg



The ultimate (singular) cycle barometer: the 12-month change in the unemployment rate. A 12-month rise of 0.5 percent or more = recession.



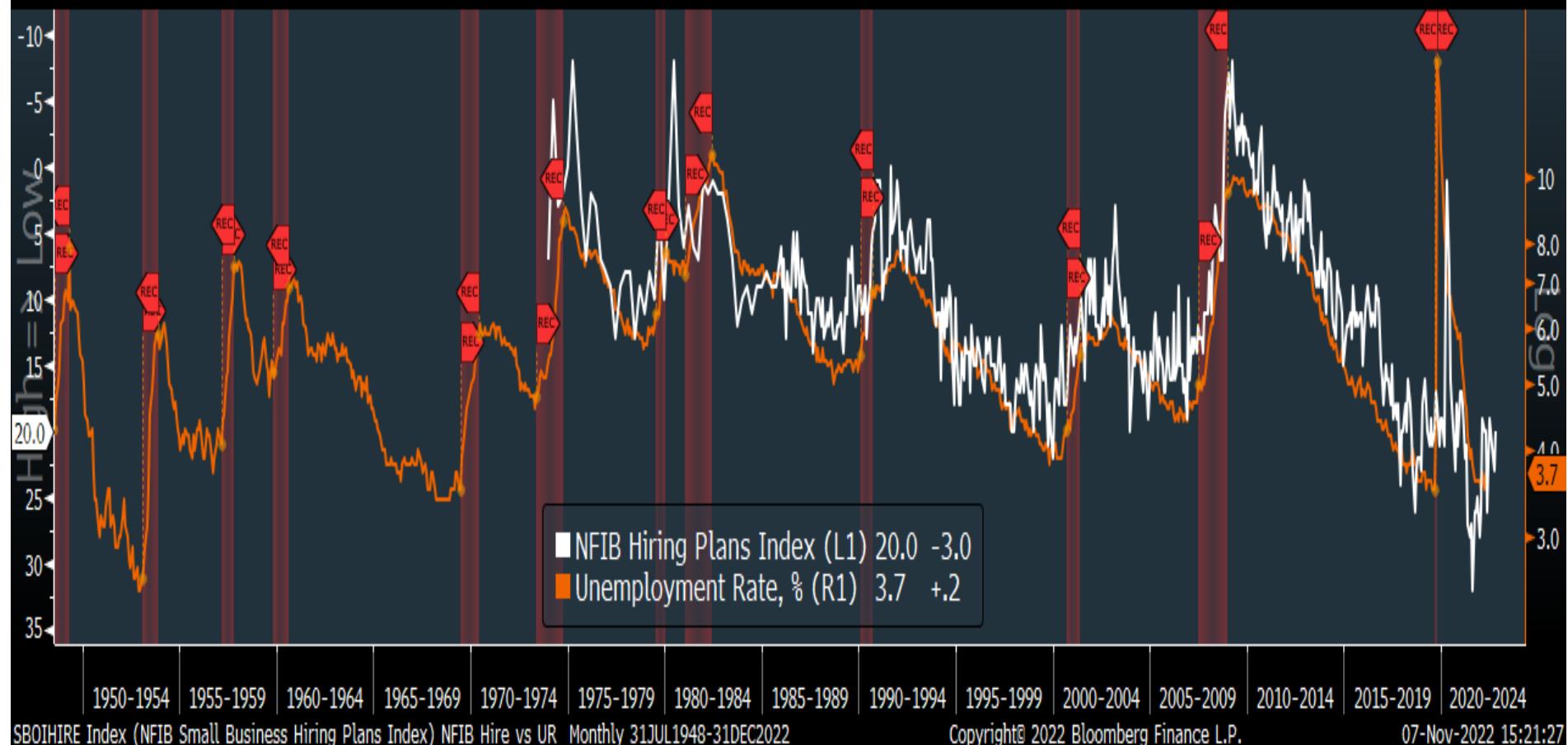
Source: Bloomberg; MKM Partners



Hiring plans lead UR by about six months.

Hiring Plans vs. Unemployment

Hiring Plans (Inverted) Leads UR by 6 Months...





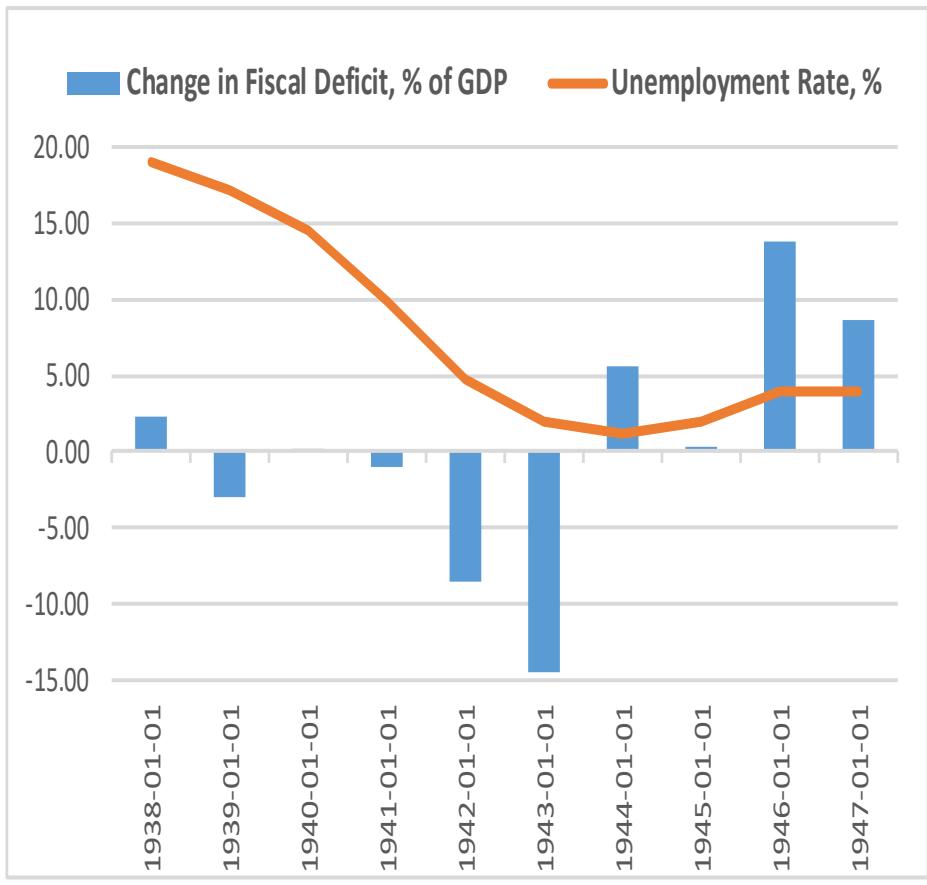
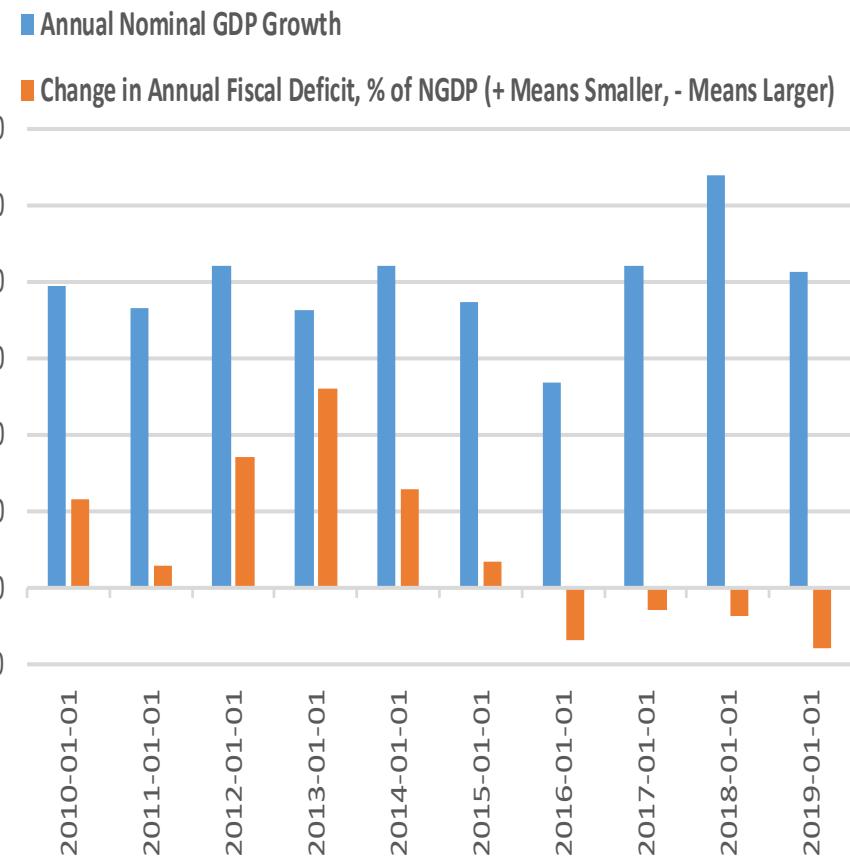
No recession in post-war history has occurred without the UR rising > 200 bps.

Recession	Trough-to-Peak Rise in Unemployment Rate, Percent	Unemployment Rate Bottom vs. Start of Recession (Months)	Peak-to-Trough Stock Market Decline, Percent	Peak-to-Trough Stock Market Decline, Inflation-Adjusted, Percent	Draw Down Duration (Months)
1948-1949	4.5	11.0	20.6	24.2	28.0
1953-1954	3.2	3.0	14.8	15.5	8.0
1957-1958	3.8	7.0	20.7	21.2	4.0
1960-1961	2.3	11.0	13.9	15.2	15.0
1969-1970	2.7	16.0	36.1	41.1	20.0
1973-1975	4.4	2.0	48.2	56.5	22.0
1980	2.2	9.0	17.1	33.7	49.0
1981-1982	3.6	8.0	27.1	36.6	21.0
1990-1991	2.8	7.0	19.9	21.7	5.0
2001	2.5	12.0	49.1	52.3	32.0
2007-2009	5.6	15.0	56.8	57.5	18.0
2020	11.2	7.0	33.9	34.1	2.0
Average (Pre-2020)	3.4	9.2	29.9	34.1	18.7
Median	3.2	9.0	23.9	33.9	19.0

Source: Bloomberg; MKM Partners



Although the previous cycle's slow growth was largely blamed on fiscal austerity, swings in the fiscal balance were associated with about the same growth rates.

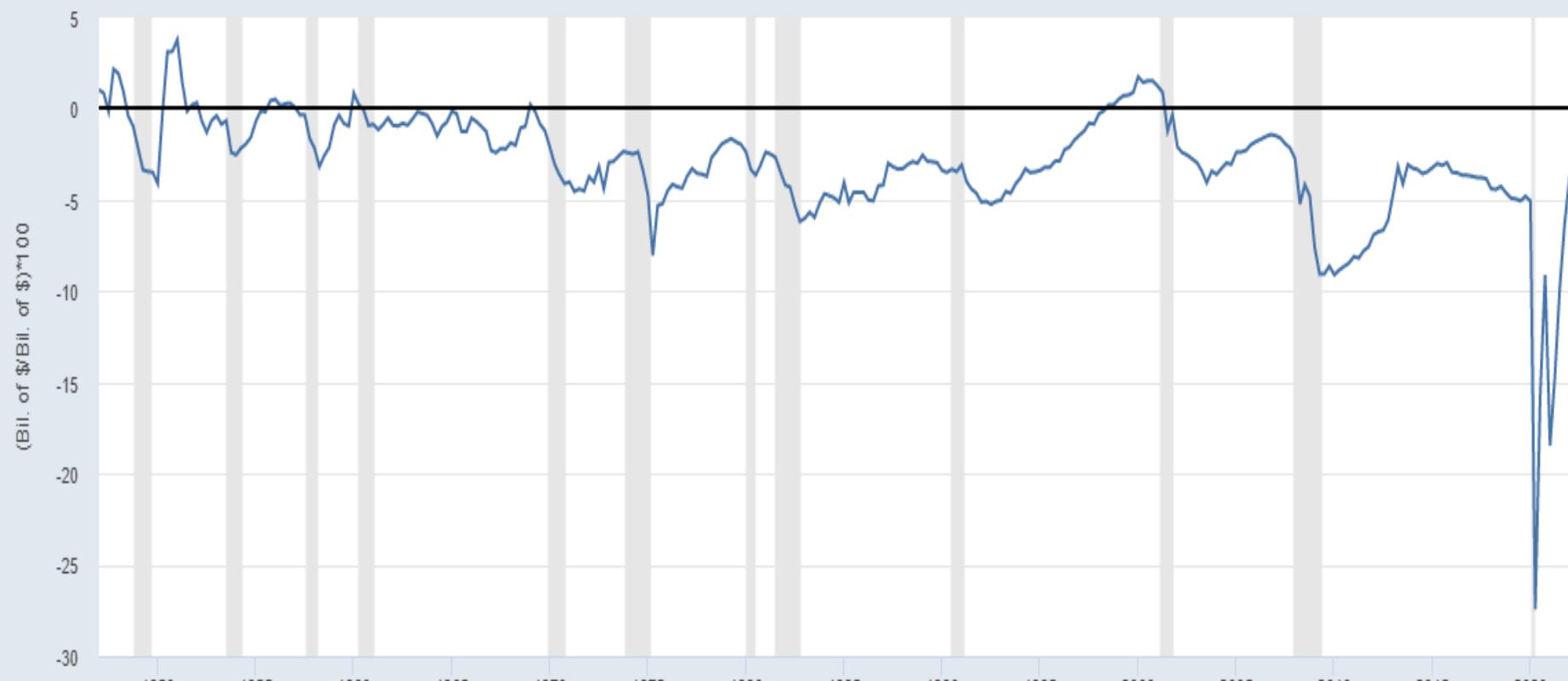


Source: Federal Reserve; MKM Partners



The fiscal deficit has fallen rapidly from the levels seen in 2020 and 2021.

FRED  — (Net Federal Government Saving/Gross Domestic Product)*100



Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Economic Analysis

fred.stlouisfed.org



If demand (NGDP) exceeds supply (productive capacity), inflation will rise.

Cycle (Peak to Peak)	Non-Farm Productivity Growth	LF Growth	Trend Real	Nominal Growth Consistent with 2% Inflation
1948-1953	2.1	0.8	2.9	4.9
1953-1957	1.6	1.3	2.9	4.9
1957-1960	2.7	0.9	3.6	5.6
1960-1969	2.6	1.8	4.4	6.4
1969-1973	2.3	2.7	5.0	7.0
1973-1980	1.1	2.7	3.8	5.8
1980-1981	2.0	1.8	3.8	5.8
1981-1990	1.5	1.6	3.1	5.1
1990-2001	2.0	1.2	3.2	5.2
2001-2007	2.7	1.0	3.7	5.7
2007-2019	1.6	0.7	2.3	4.3
10-year moving average	1.4	0.5	1.9	3.9

Source: Federal Reserve; Bloomberg; MKM Partners

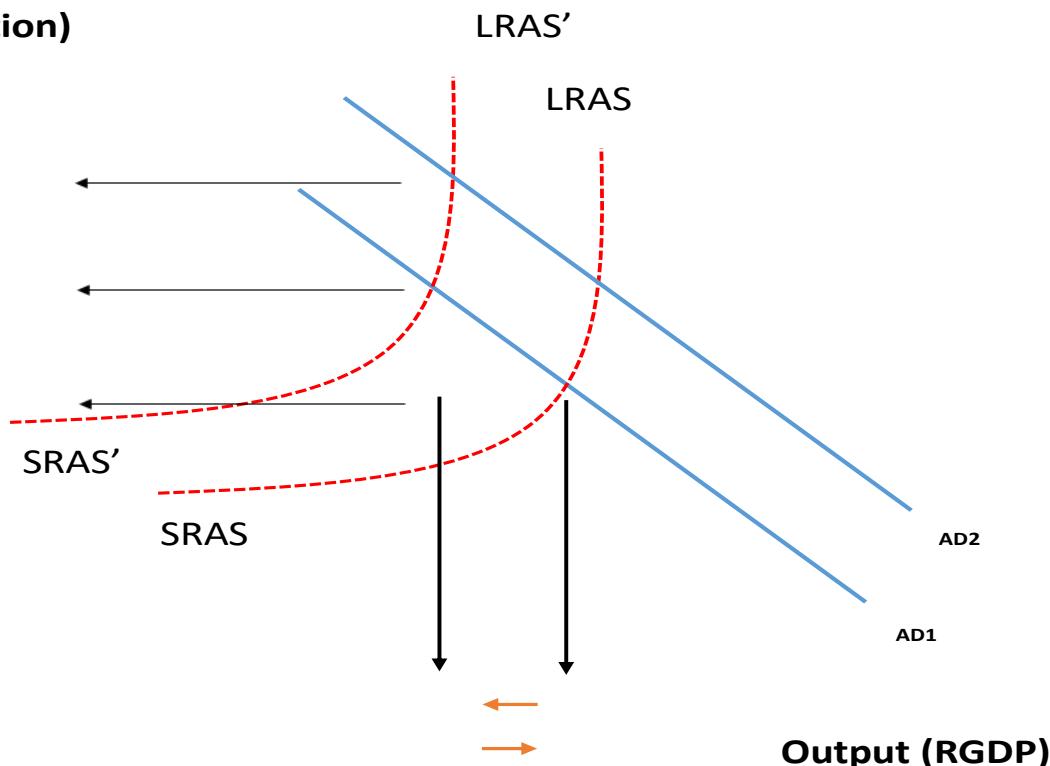
*Growth rates are cycle-to-cycle median values



A basic ASAD model can help to clarify the difference between supply and demand shocks. In the current environment, we have both.

ASAD Model: Supply & Demand Shocks

Prices (inflation)

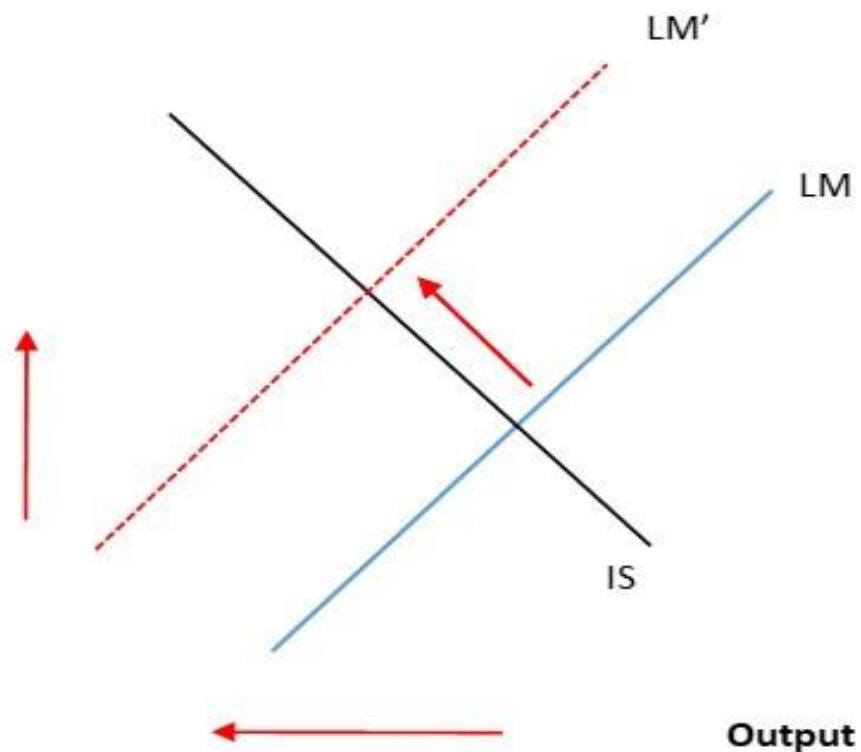


Source: MKM Partners



A basic ISLM model can help to clarify if movements in real rates are expansionary, contractionary, or both.

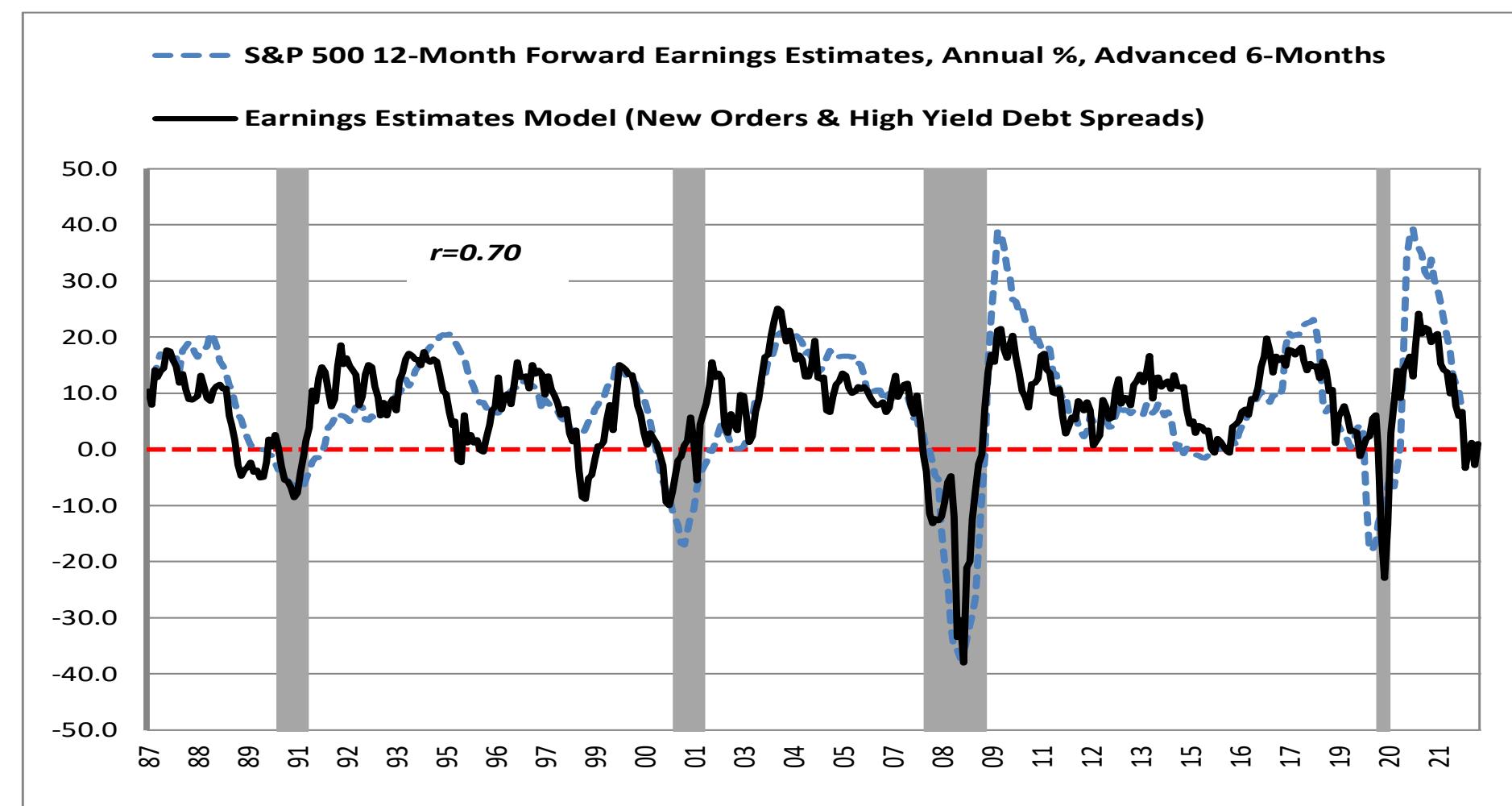
Real Interest Rate (Negative Liquidity Shock)



Source: MKM Partners



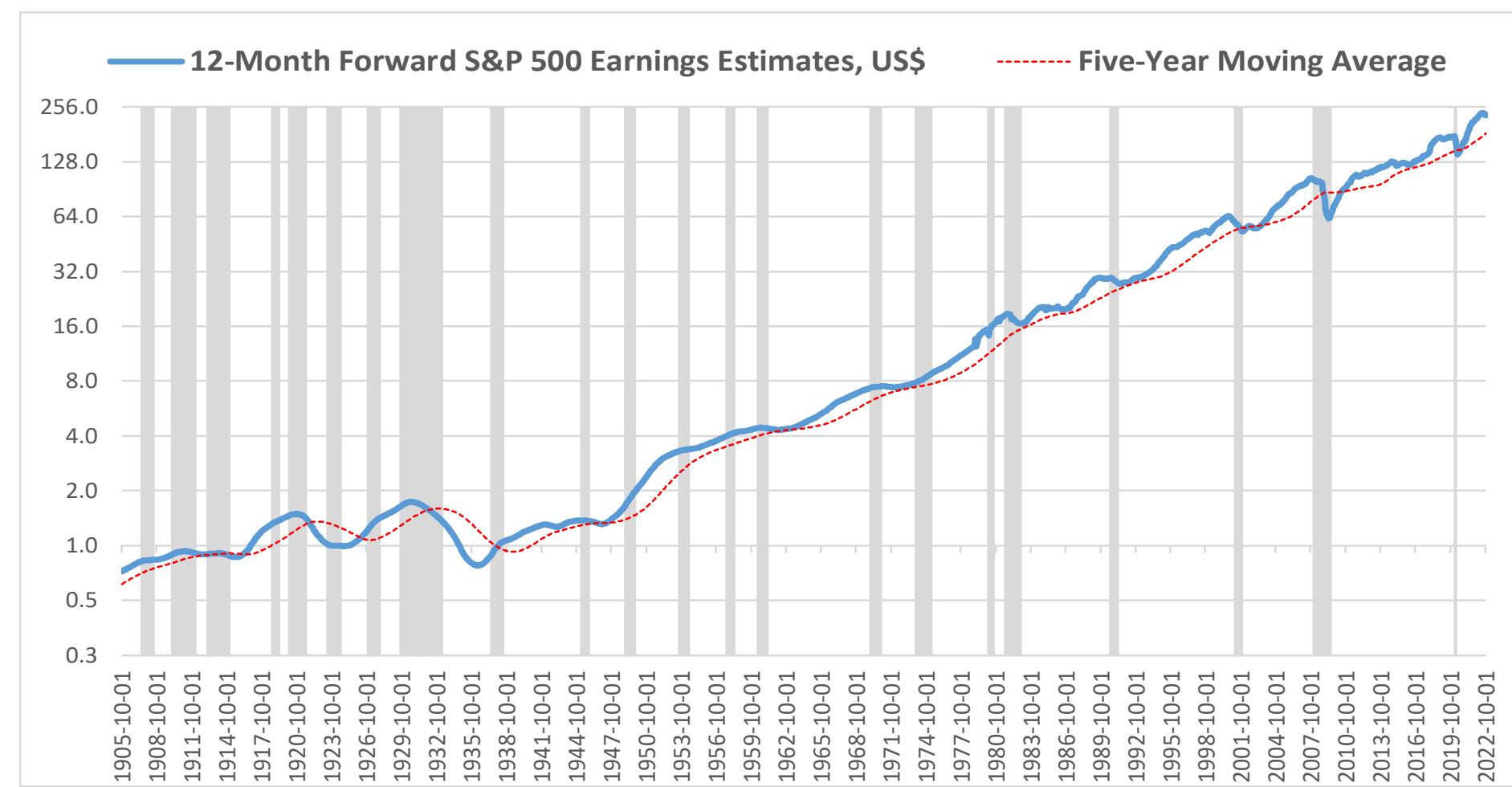
Leading indicators for earnings and capex have weakened.



Source: Federal Reserve; Bloomberg; MKM Partners



Estimates tend to fall to (or below) the five-year average during recessions.

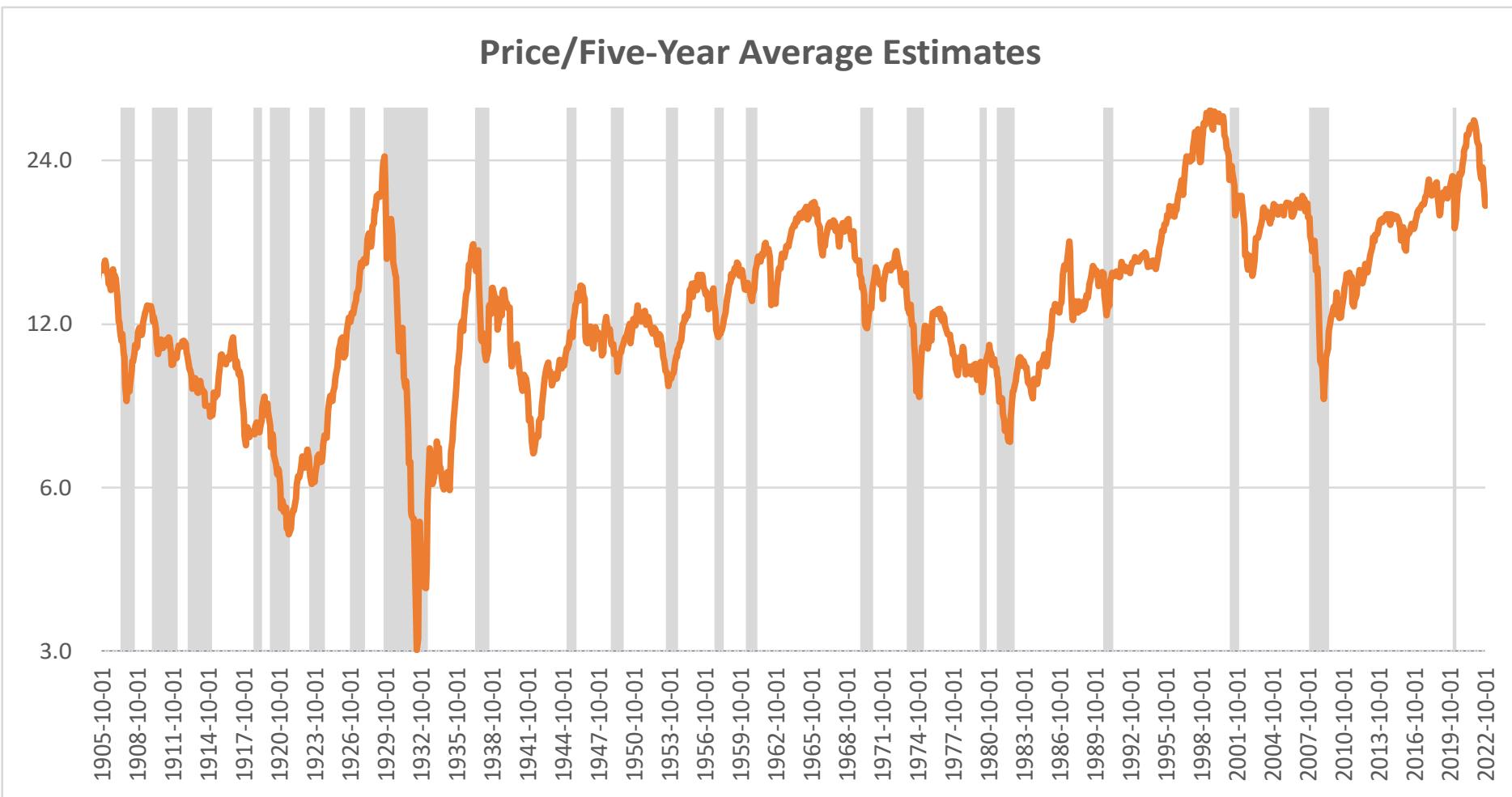


Source: Shiller; Datastream; MKM Partners



“Normalized” valuations remain elevated.

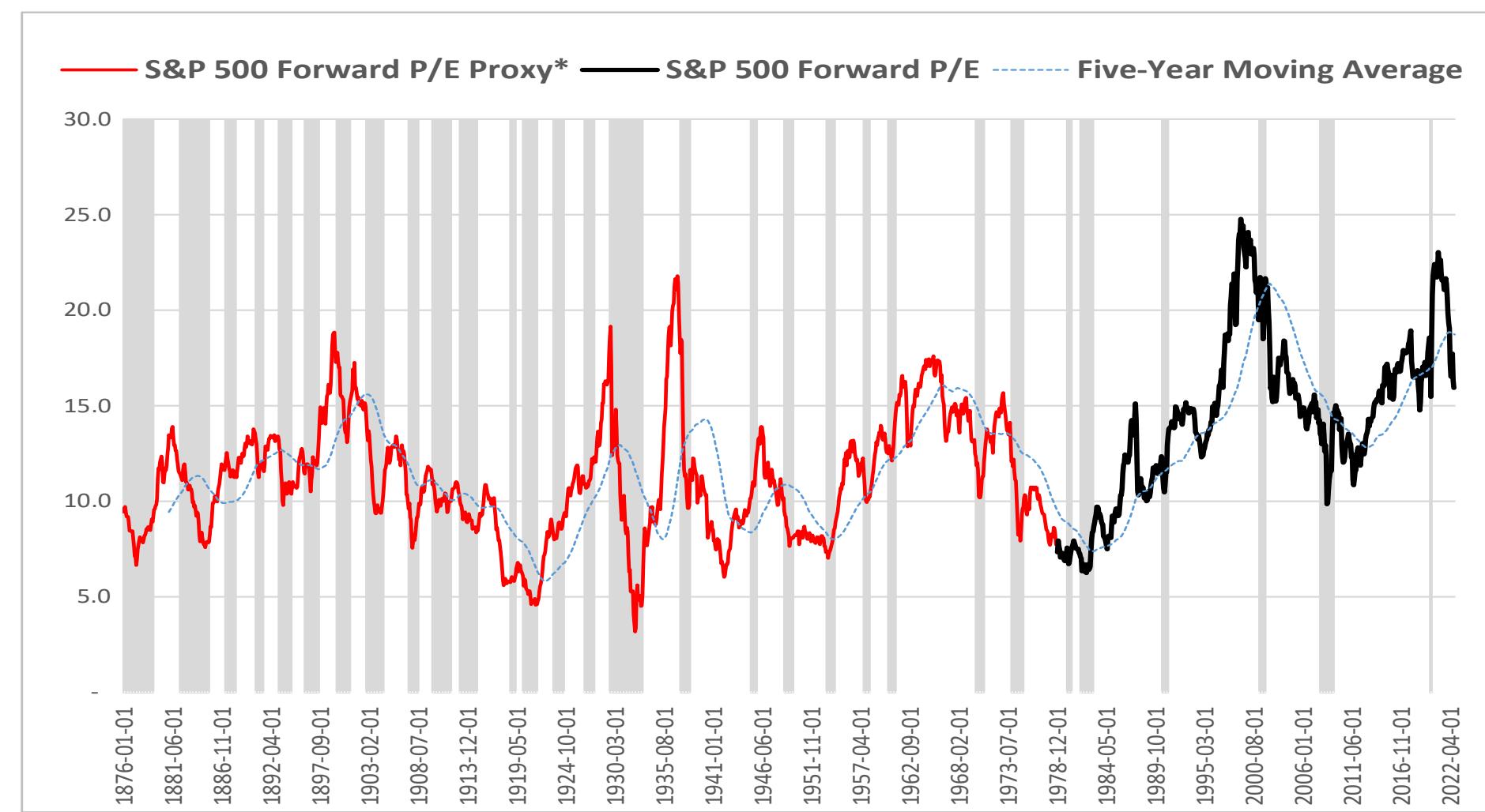
Price/Five-Year Average Estimates



Source: Shiller; Datastream; MKM Partners



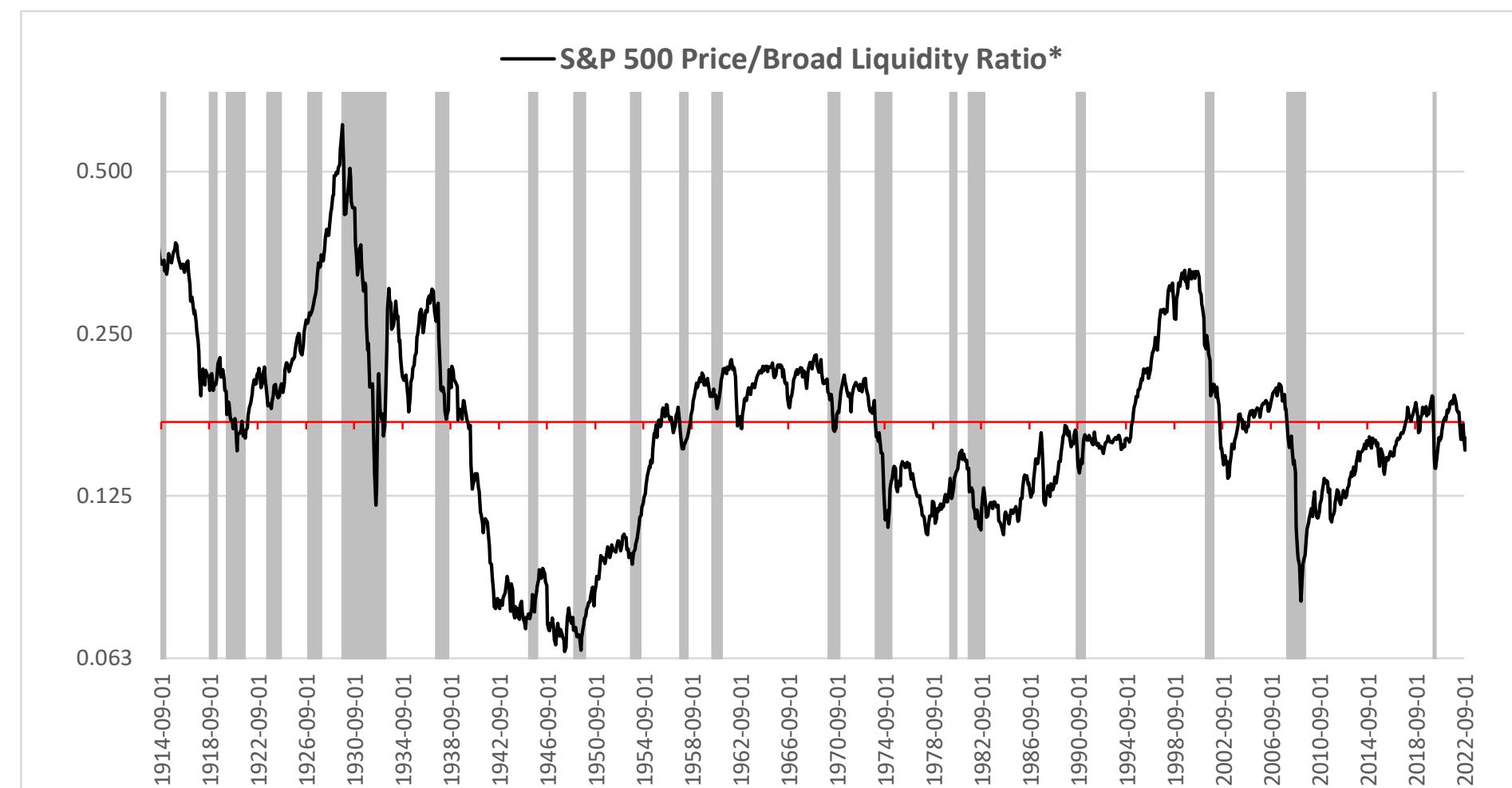
S&P 500 forward P/E ratio looks better, but estimates are now in decline.



Source: Shiller; Bloomberg; MKM Partners



S&P 500 price/liquidity ratio (liquidity = M2 + money funds).

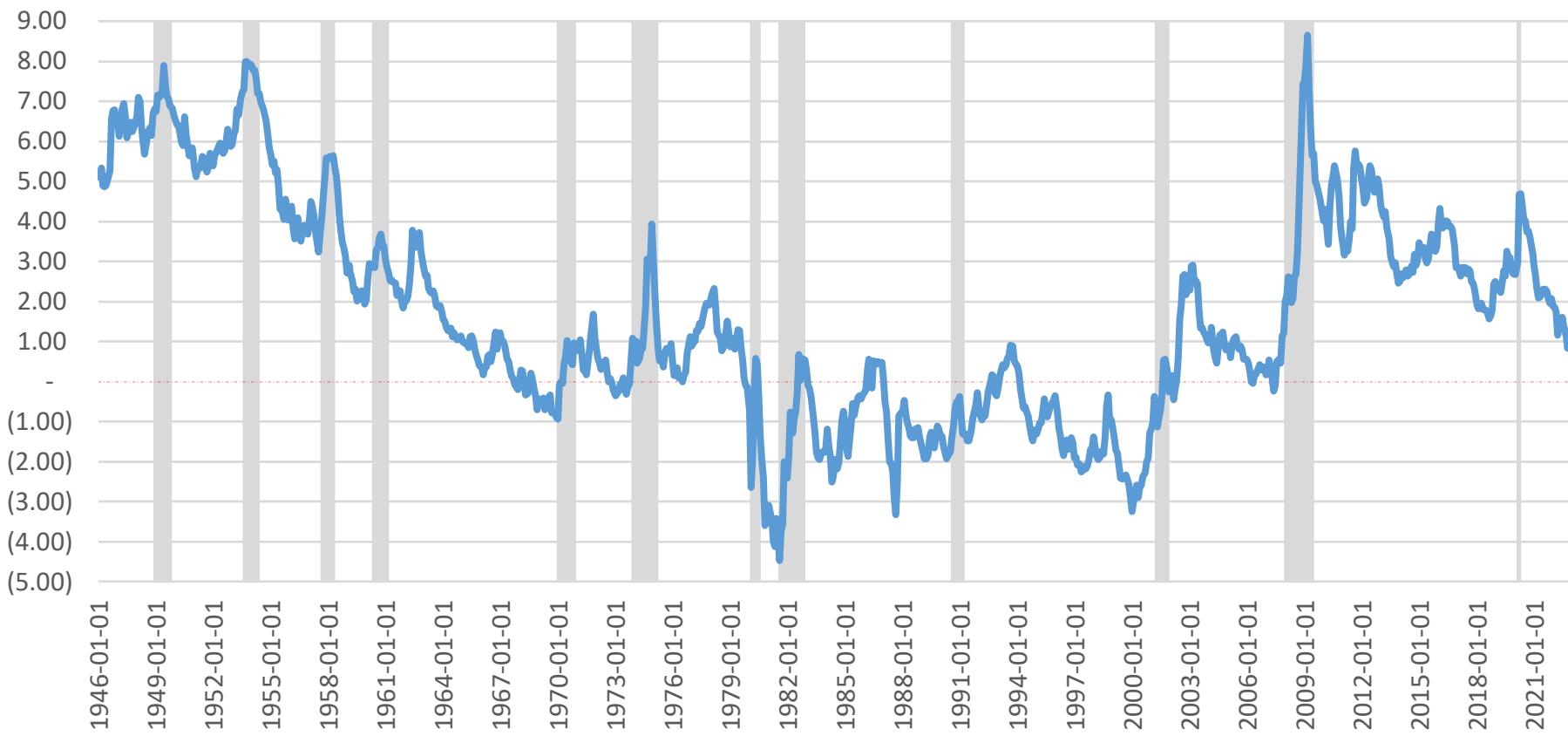


Source: NBER; MKM Partners; A Monetary History of the United States



S&P 500 equity risk premium (earnings yield minus risk free rate).

Normalized Equity Risk Premium

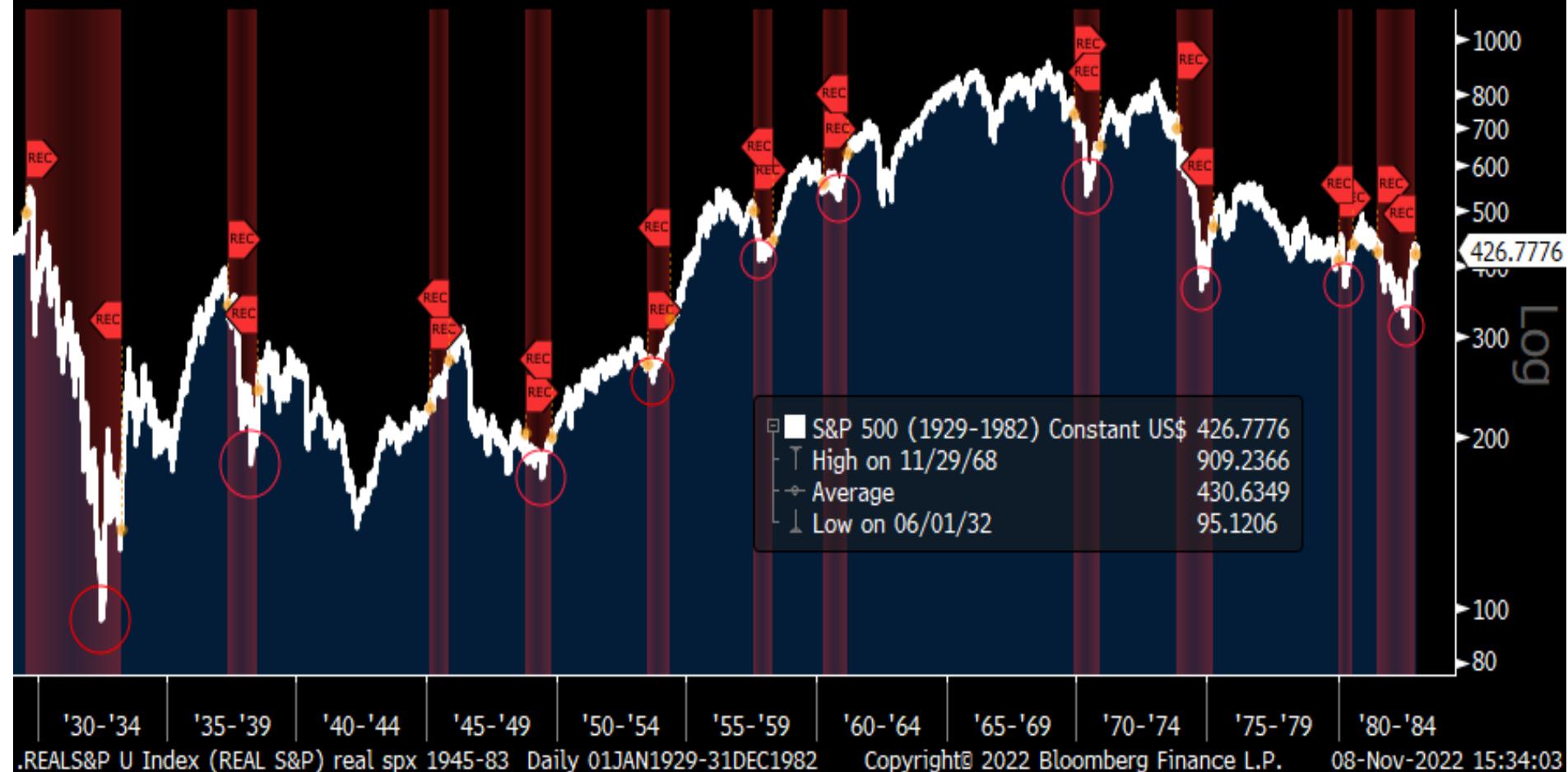


Source: Shiller; Datastream; MKM Partners



If we are headed into a recession next year, it would be unprecedented for the bear market to end before the recession even began.

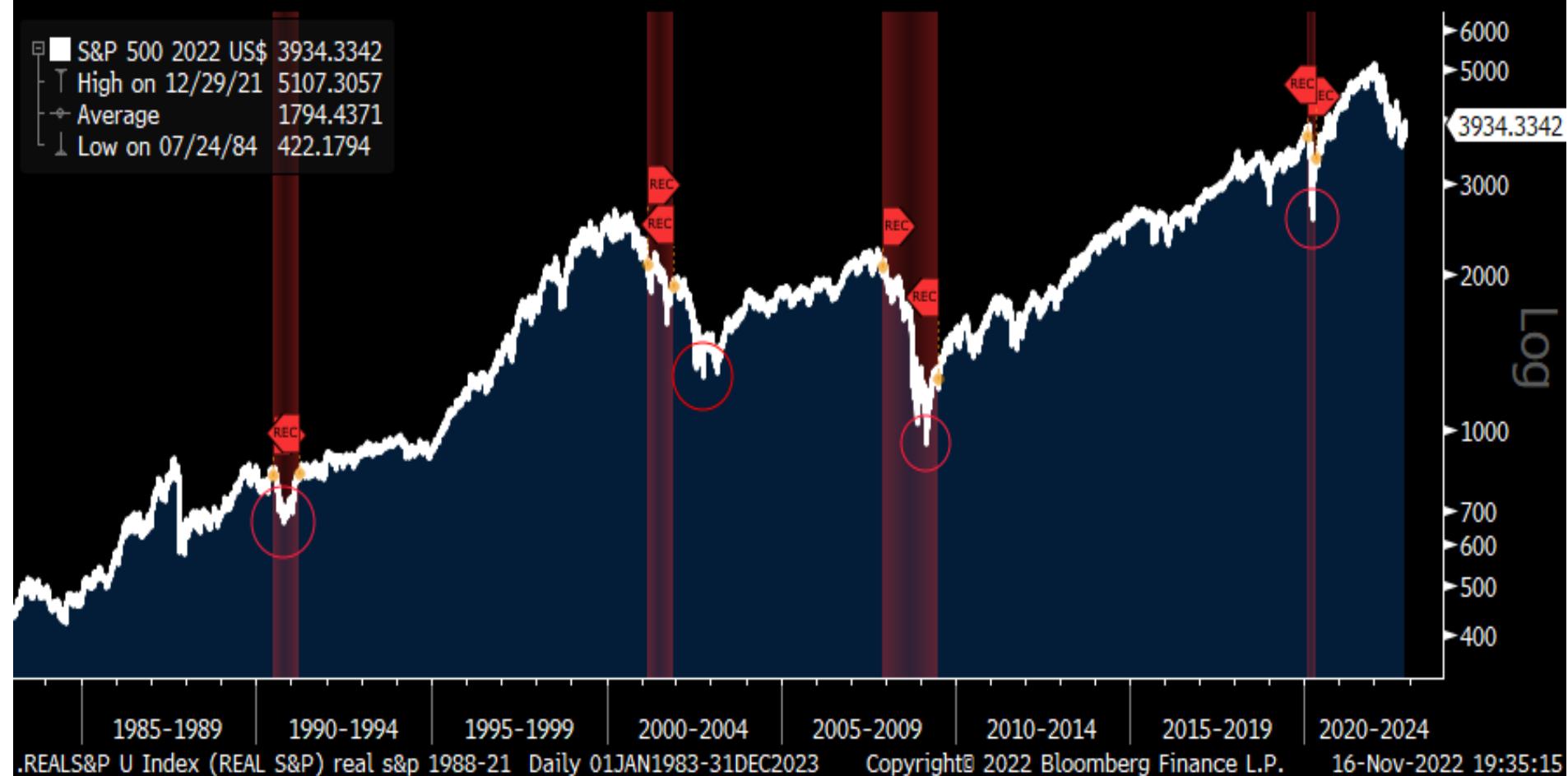
Real S&P 500: 1929-1982





If we are headed into a recession next year, it would be unprecedented for the bear market to end before the recession even began.

Real S&P 500: 1983-2022





Equity sector performance this year has largely been a risk free rate story.





Sector rankings.

Sector	Ratio to Fair Value (Normalized ERP Model)	Normalized P/E
Comm Services	0.84	14.3
Financials	0.76	14.6
Materials	0.75	18.3
Info Tech	0.72	23.2
Healthcare	0.72	18.3
Utilities	0.71	19.5
Discretionary	0.70	24.4
Staples	0.66	22.0
Industrials	0.63	21.9
Energy	0.55	24.0

Source: Datastream; MKM Partners



Homebuilder sentiment.

Buyer Traffic



Source: Bloomberg

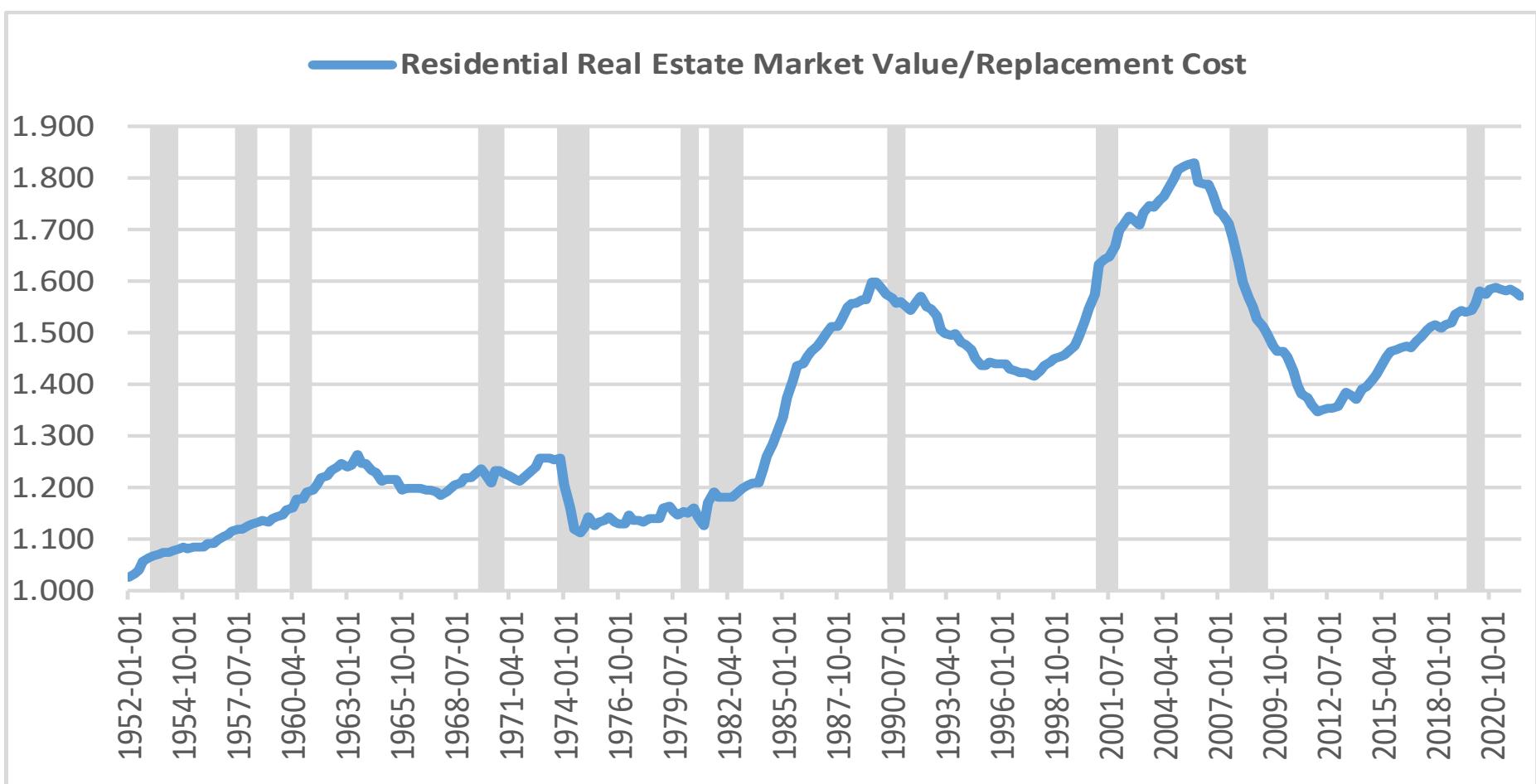
USHBTRAF Index (National Association of Home Builders Traffic of Prospective Buyers SA) Buyer Traffic Daily 31MAY1990-30NOV2022

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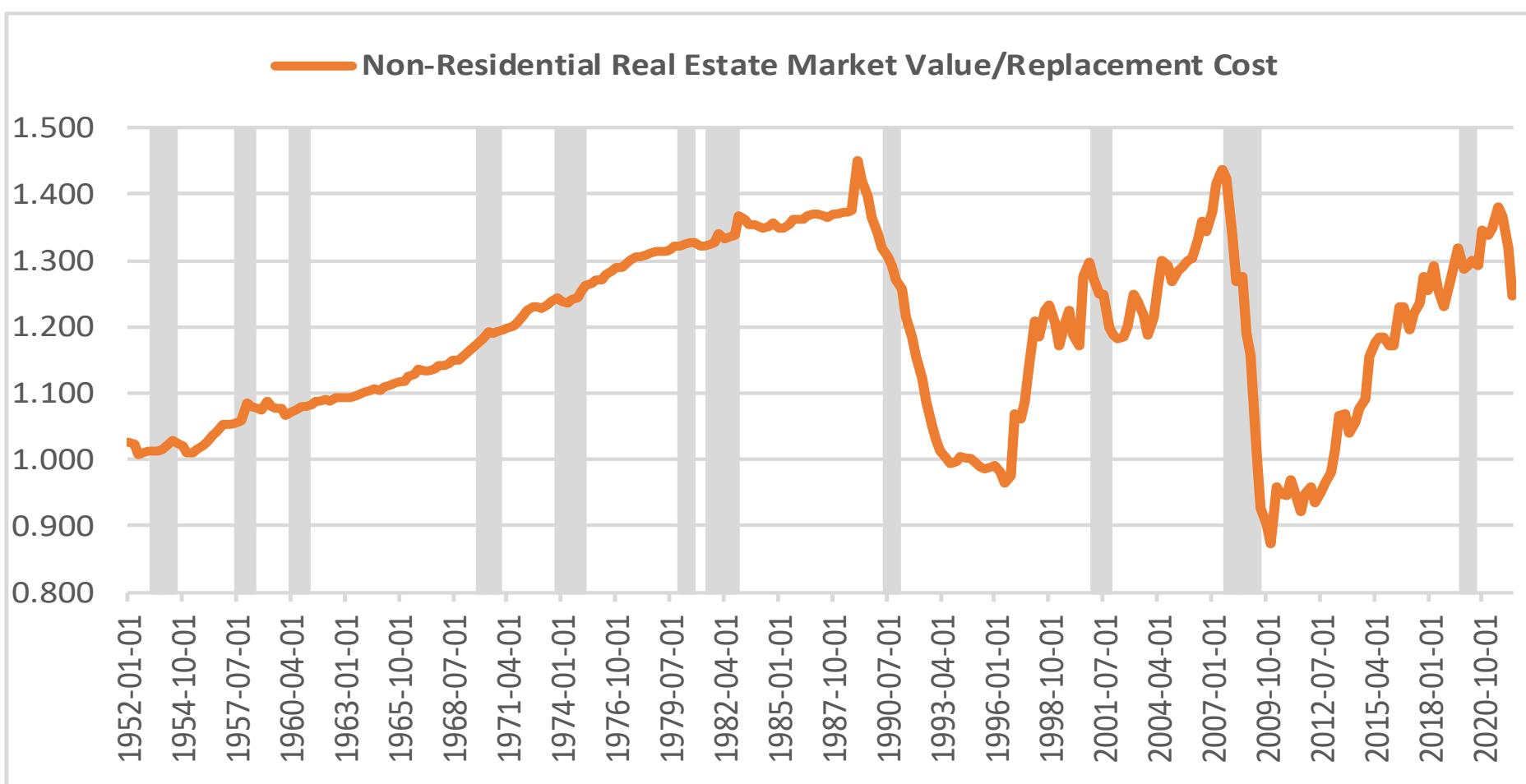
Real estate assets vs. replacement costs.



Source: Federal Reserve



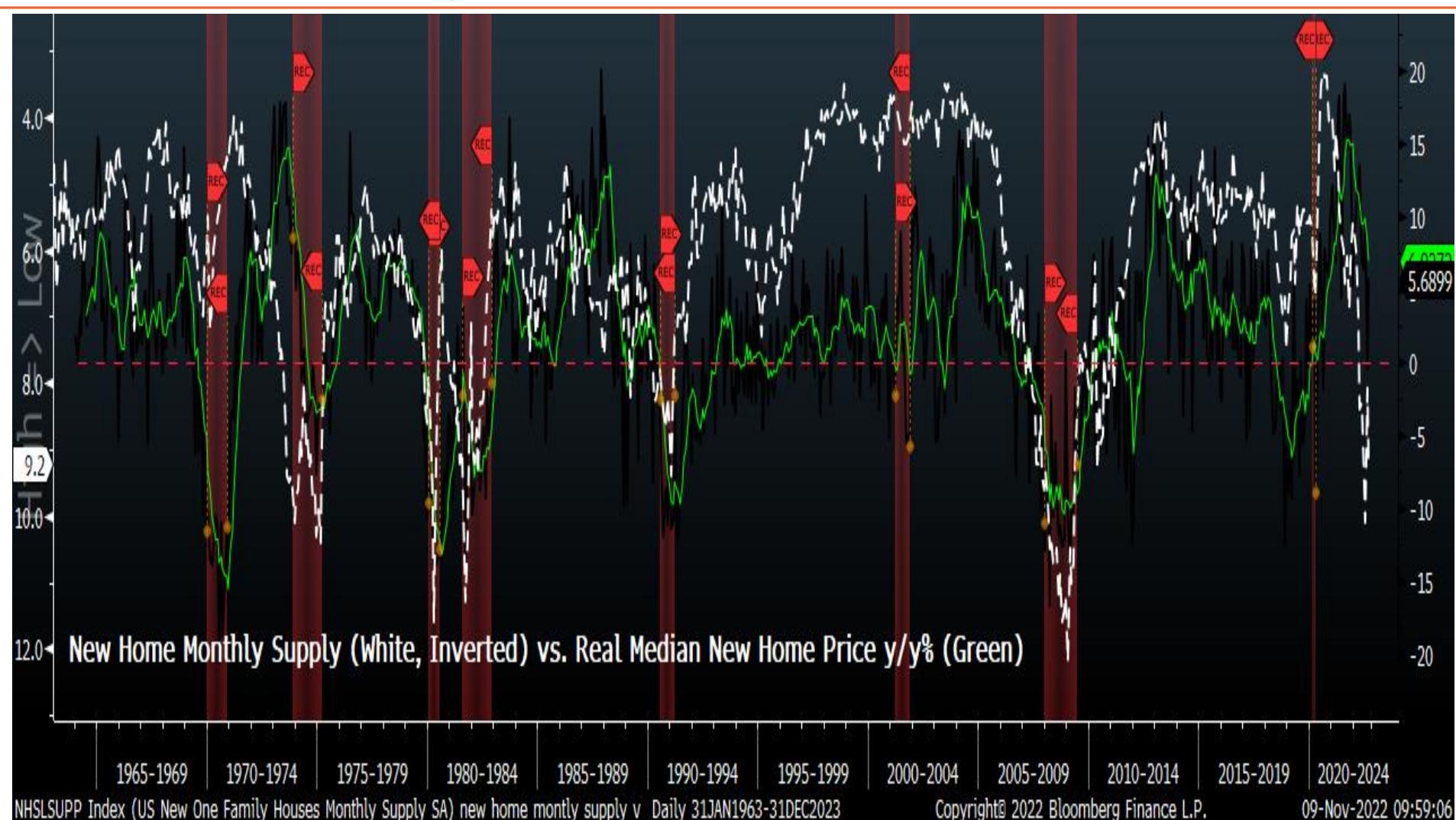
Commercial real estate assets vs. replacement costs.



Source: Federal Reserve

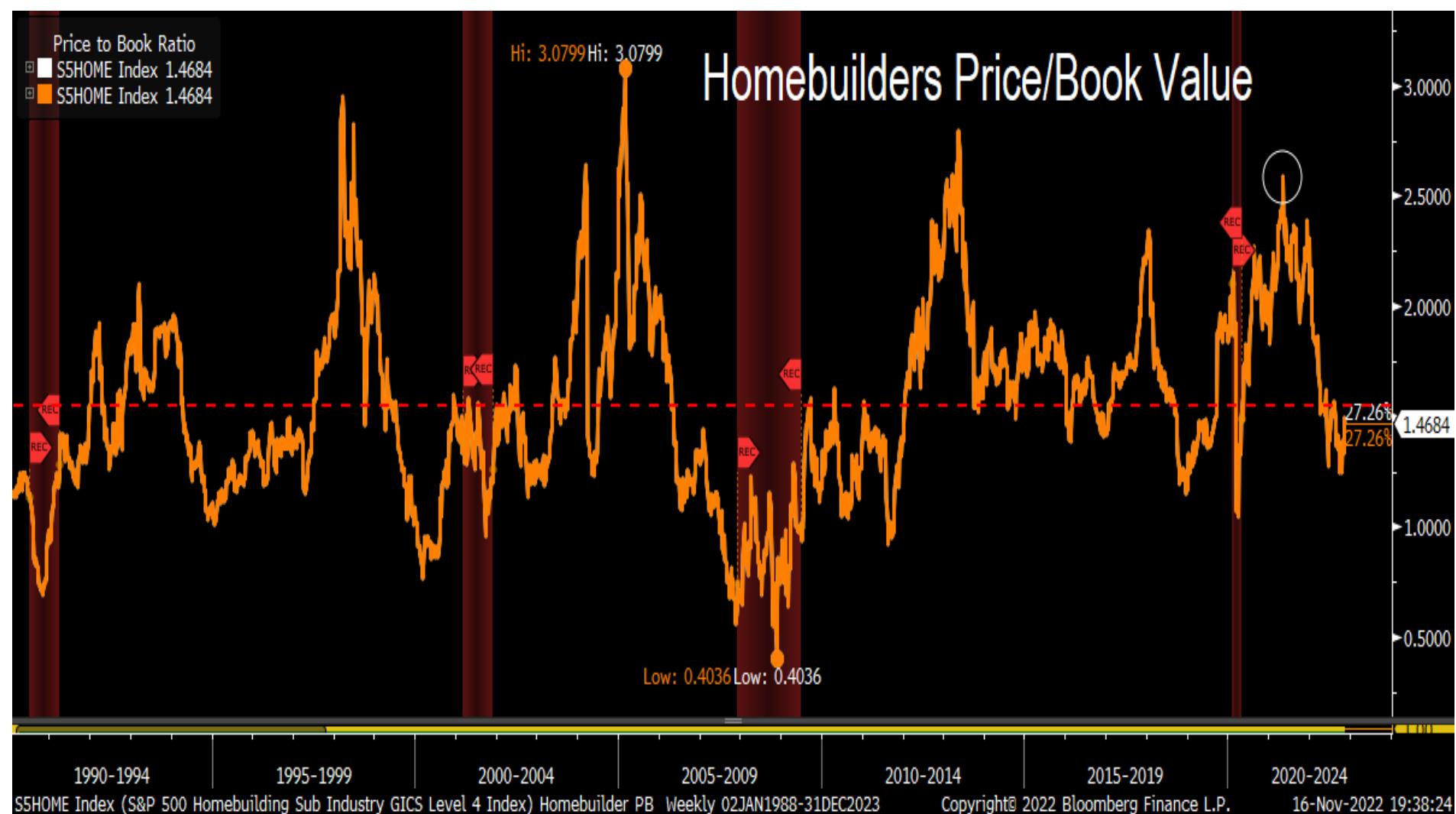


Home price inflation likely to turn into home price deflation.





Homebuilder valuations have compressed.





As go commodities, so go EM equities.

As Go Commodities, So Goes EM Equities...

CRB Metals Index vs. MXEF



Source: Bloomberg

MXEF Index (MSCI Emerging Markets Index) MXEF vs JOC Weekly 06JAN1995-16NOV2022

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The dollar is likely the most important force associated with emerging and foreign stocks' relative performance vs. developed and domestic.

The Dollar & EM Equity Relative Performance

As Goes The Dollar (Inversely), So Goes Relative EM Equity Performance...



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China RRR rate vs. M1.

China RRR Ratio (LHS) vs. China M1 Money Growth (RHS)



Source: Bloomberg

CHRRDEP Index (China Required Deposit Reserve Ratio for Major Banks) China RRR vs M1 Daily 01JUN2006-09NOV2022

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China M1 vs. risk spreads.

China M1 (Inverted) vs. China Risk Spread

Follow the Money (And Credit)

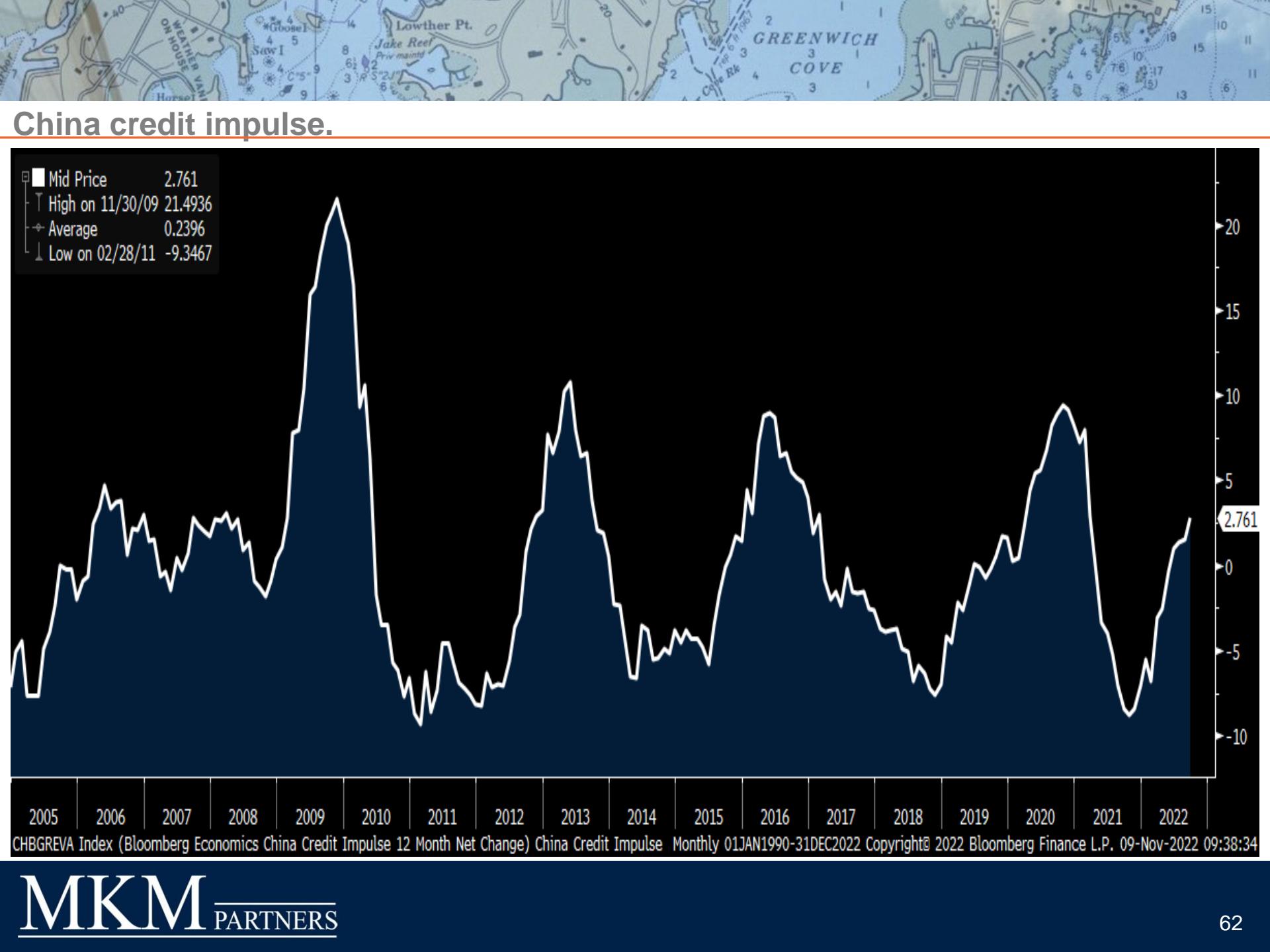


Source: Bloomberg

CNMS1YOY Index (China Monthly Money Supply M1 YoY) China m1 vs EMBI Monthly 31JAN2008-31DEC2022

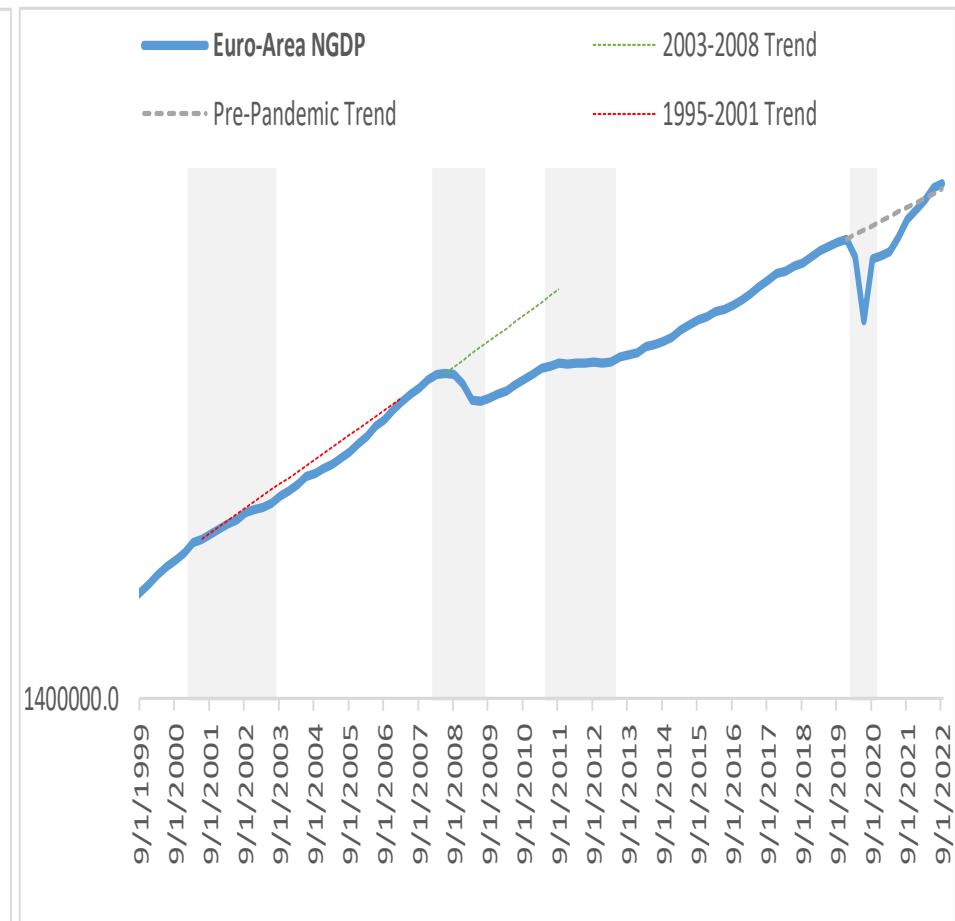
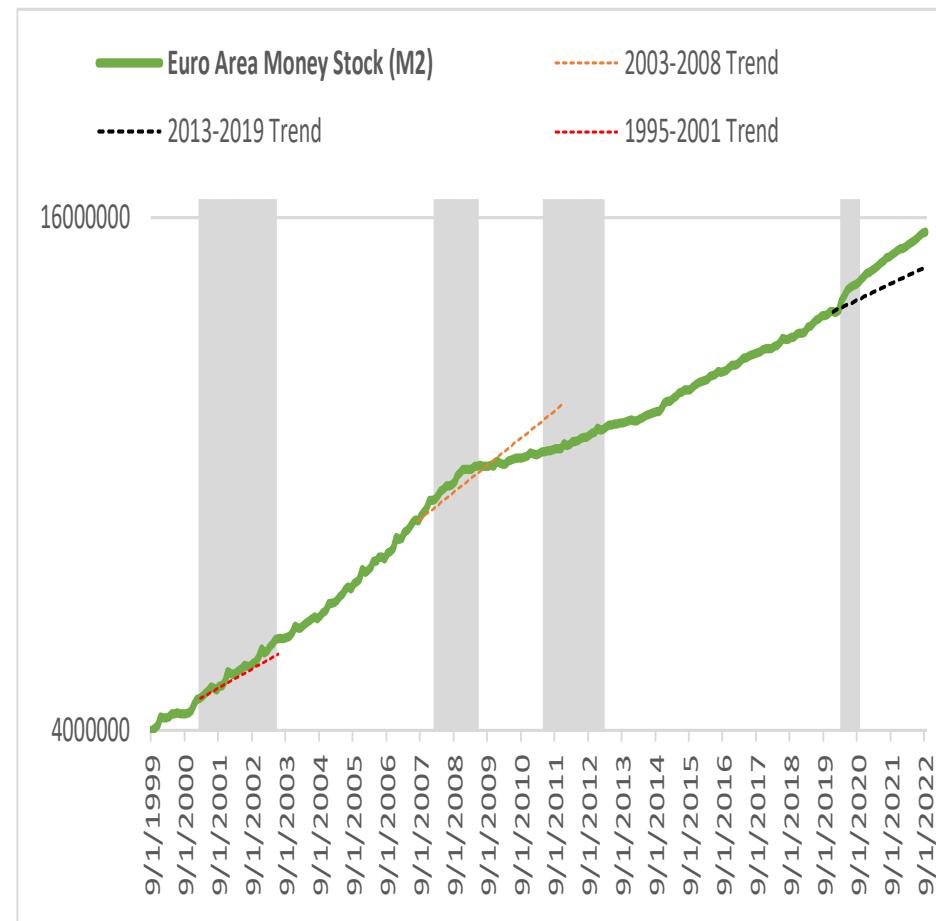
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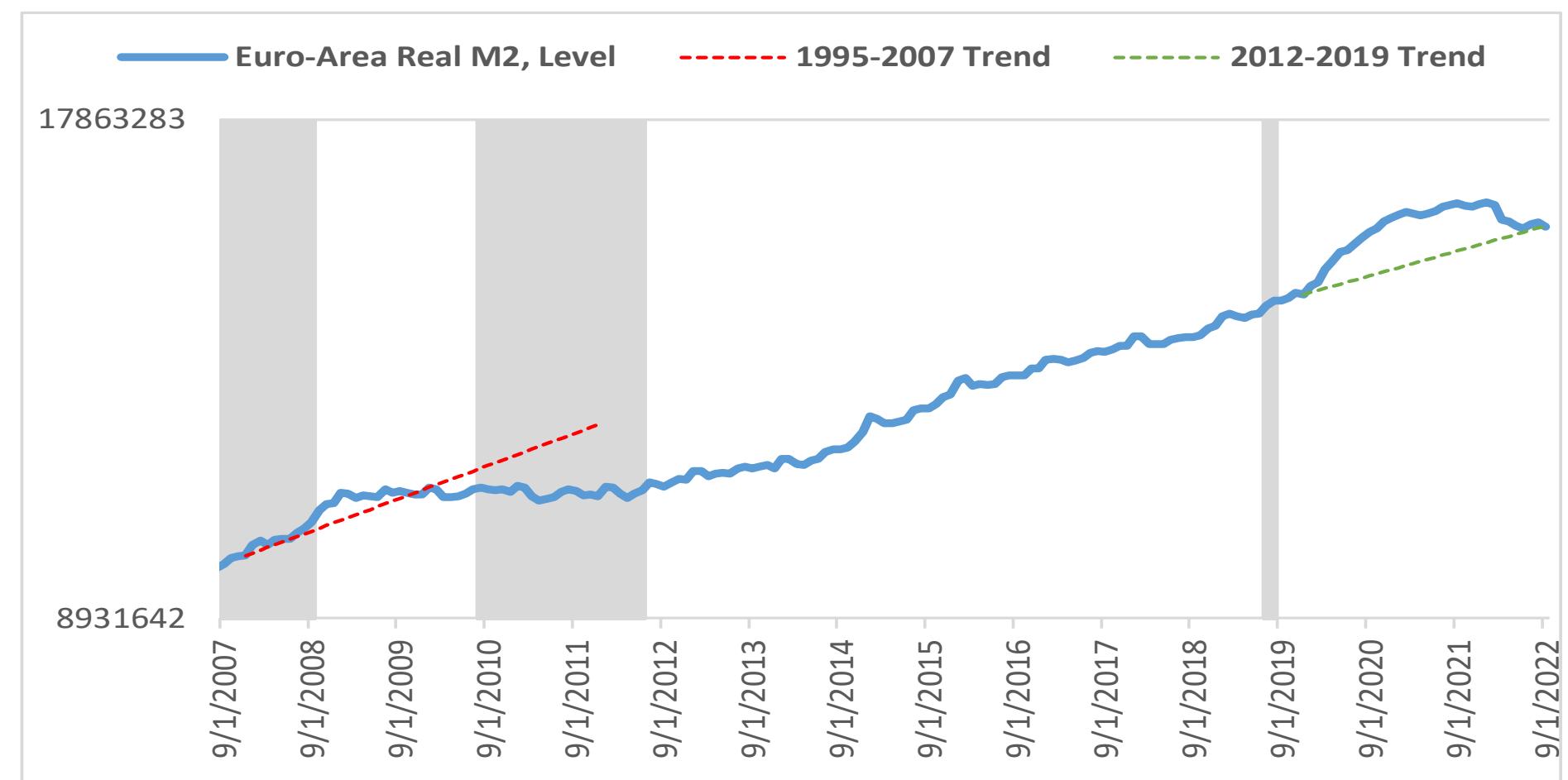
The euro area is undergoing a stagflationary shock, but had been enjoying rapid money and NGDP growth (i.e., an inflationary boom).



Source: Bloomberg; MKM Partners



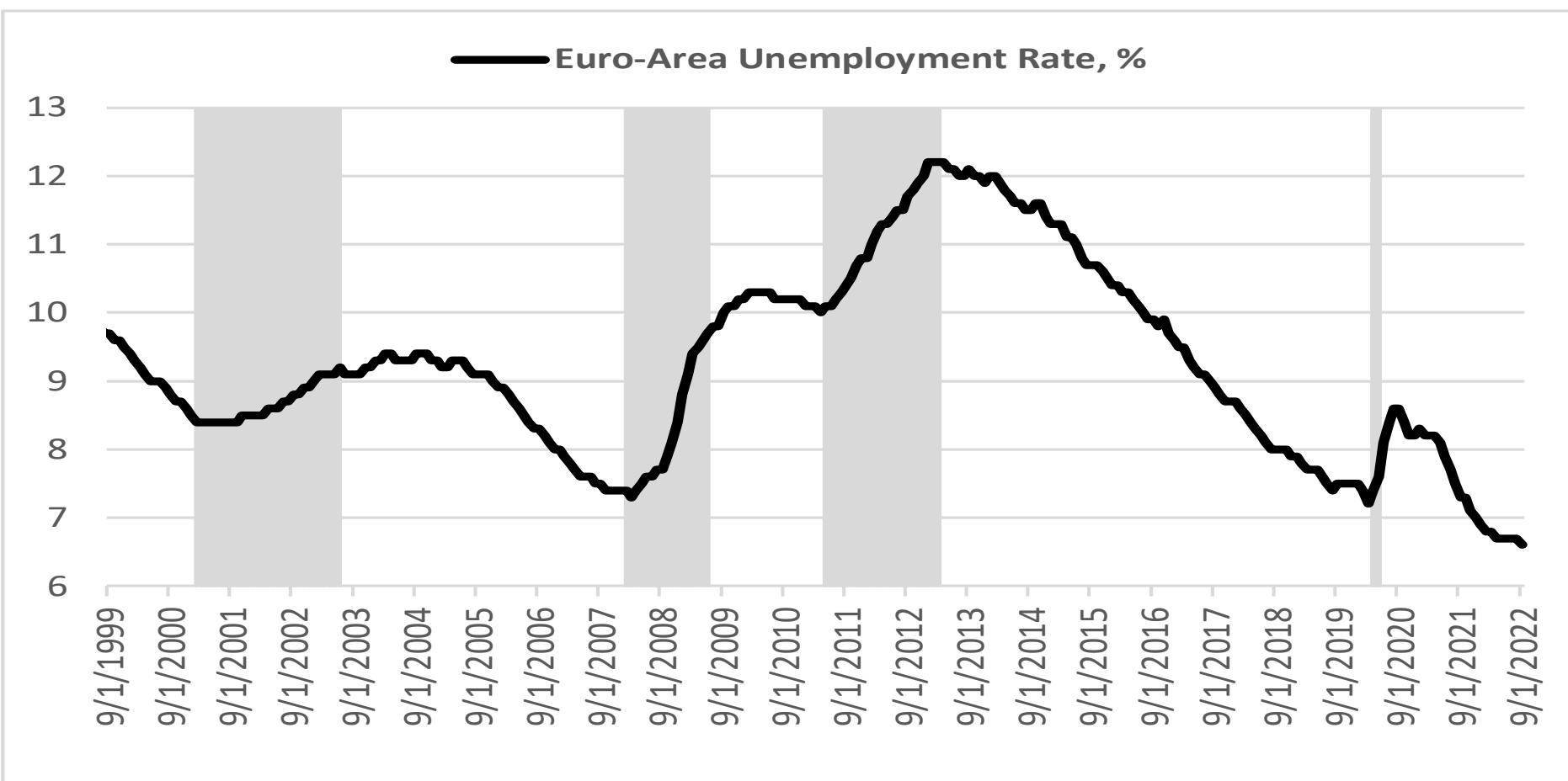
High inflation in the euro area has reduced the real money stock back to its pre-pandemic trend.



Source: Bloomberg; MKM Partners



The euro area unemployment rate has fallen to record low levels despite recent energy shocks.

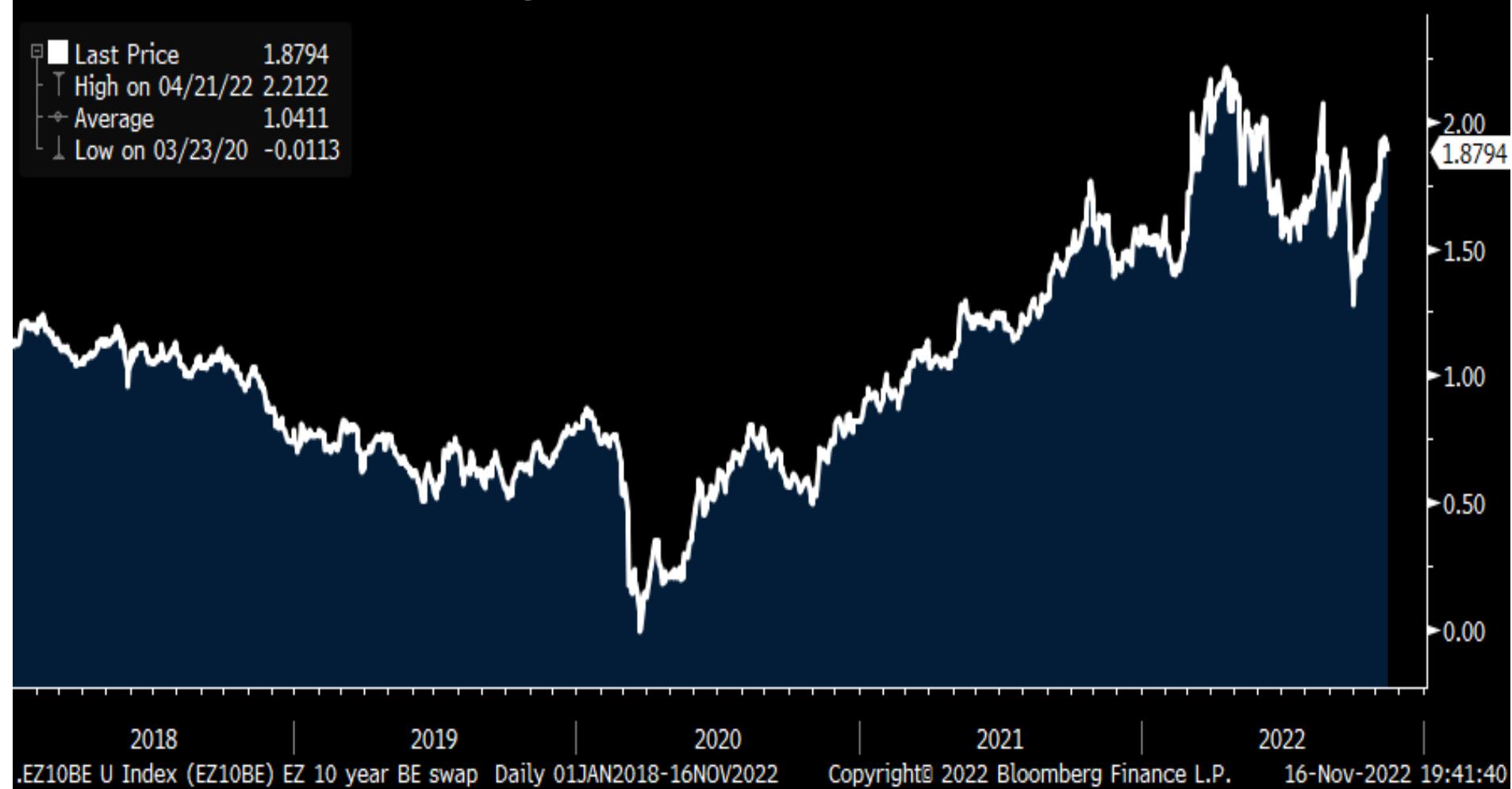


Source: Bloomberg



EZ inflation expectations.

Eurozone 10-Year Breakeven Spread





EZ credit markets.

European High Yield Spread

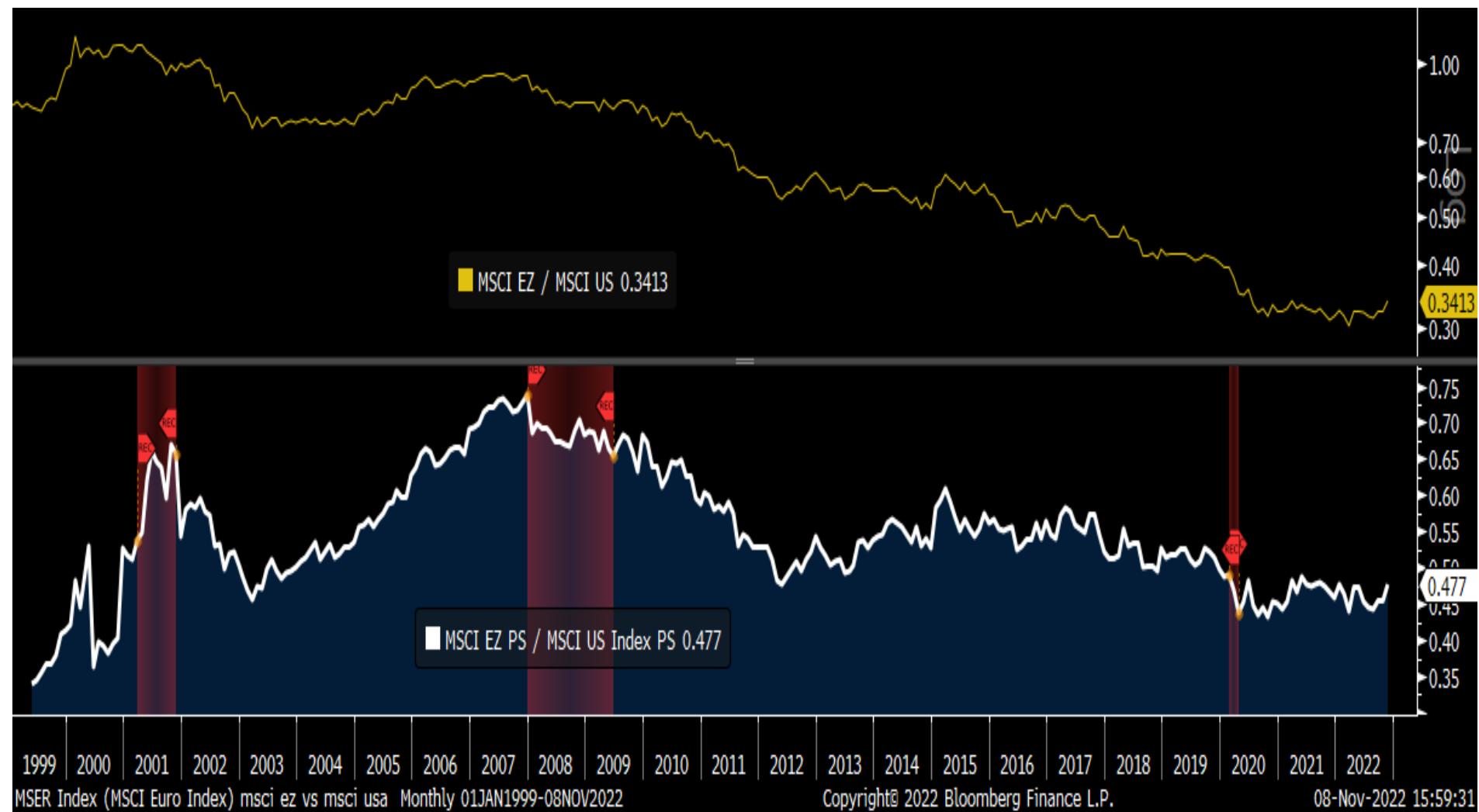


European energy squeeze in one chart.





A long period of underperformance for EZ equities





Japan NGDP appears to be softening.





Japan inflation expectations.





Weak yen or strong dollar?



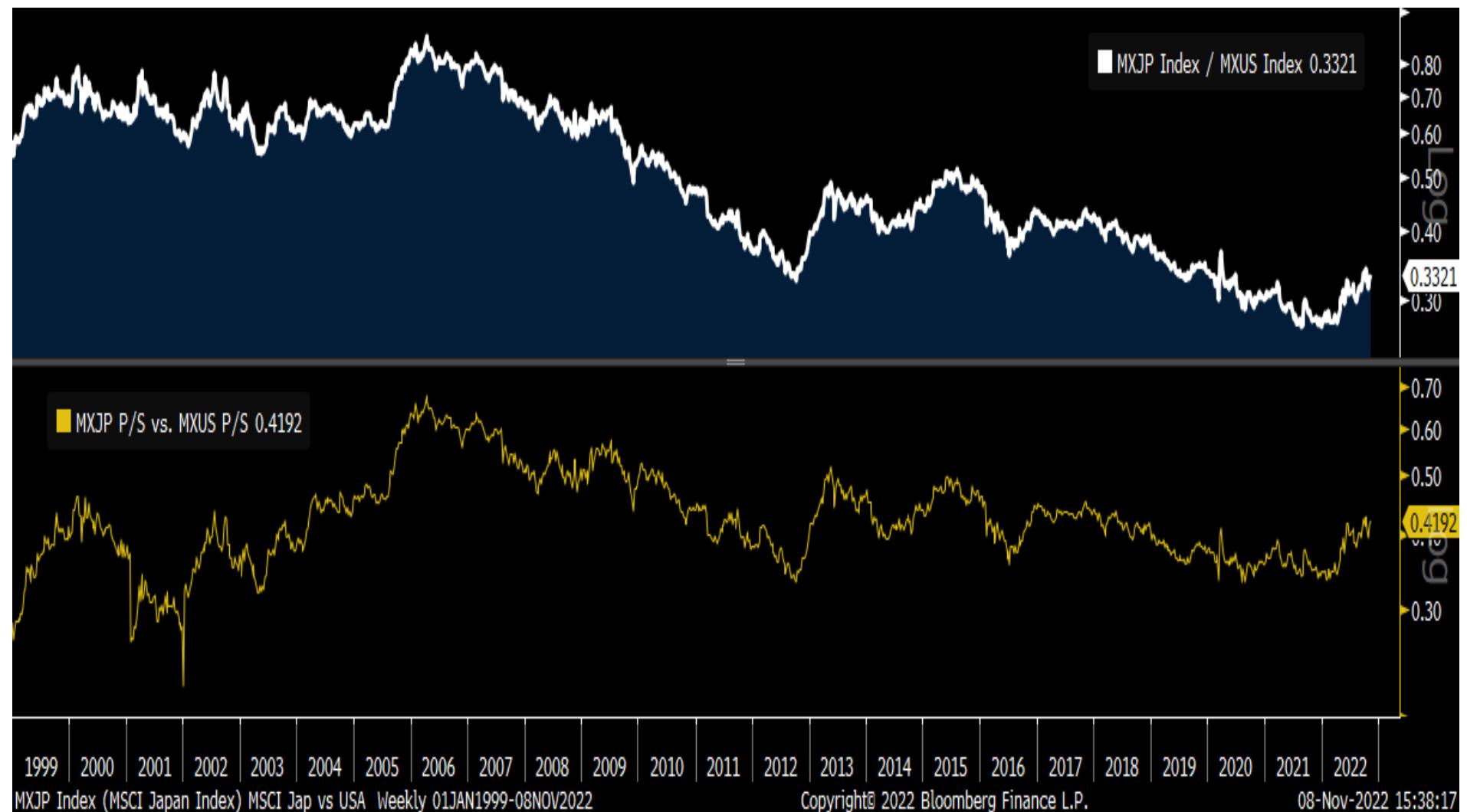
.YENGOLD U Index (YEN PRICE OF GOLD) Yen gold vs dollar gold Daily 31DEC2020-16NOV2022

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Japan MSCI relative price and P/S ratios.





A Wicksellian Monetarist framework: references and further reading.

The Role of Monetary Policy (Friedman, 1968)

The Influence of the Rate of Interest on Prices (Wicksell, 1907)

Monetary Policy: A Market Price Approach (Johnson & Keleher, 1996)

Friedman's Free to Choose (Bernanke, 2003)

The Great Recession. Market Failure or Policy Failure? (Hetzl, 2014)

The Money Illusion: Market Monetarism, the Great Recession, and the Future of Monetary Policy
(Sumner, 2021)



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