Fiduciary Financial Group

October 2023
Economic Update

Tax Advisory | Portfolio Management
Financial Planning | Alternative Investments

www.ffgwealth.com

Boise | SF Bay Area

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FFG has a deep roster of professionals with decades of investment, tax, accounting, & legal experience who can deliver an unmatched value proposition. We serve high net worth retirees, executives, tech professionals, & successful business owners & strive to ensure they are maximizing their financial efforts. Our comprehensive advice spans across financial investments, real estate assets, tax strategies, equity compensation, estate plan design, insurance packages, & more. We earn no trade or financial product sales commissions & only have a fiduciary duty to our clients. This model, coupled with our partners' spotless records, reinforces a relationship built on trust & transparency.

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Topics Outline

1. **FED Reserve Actions / Impacts / Progress**

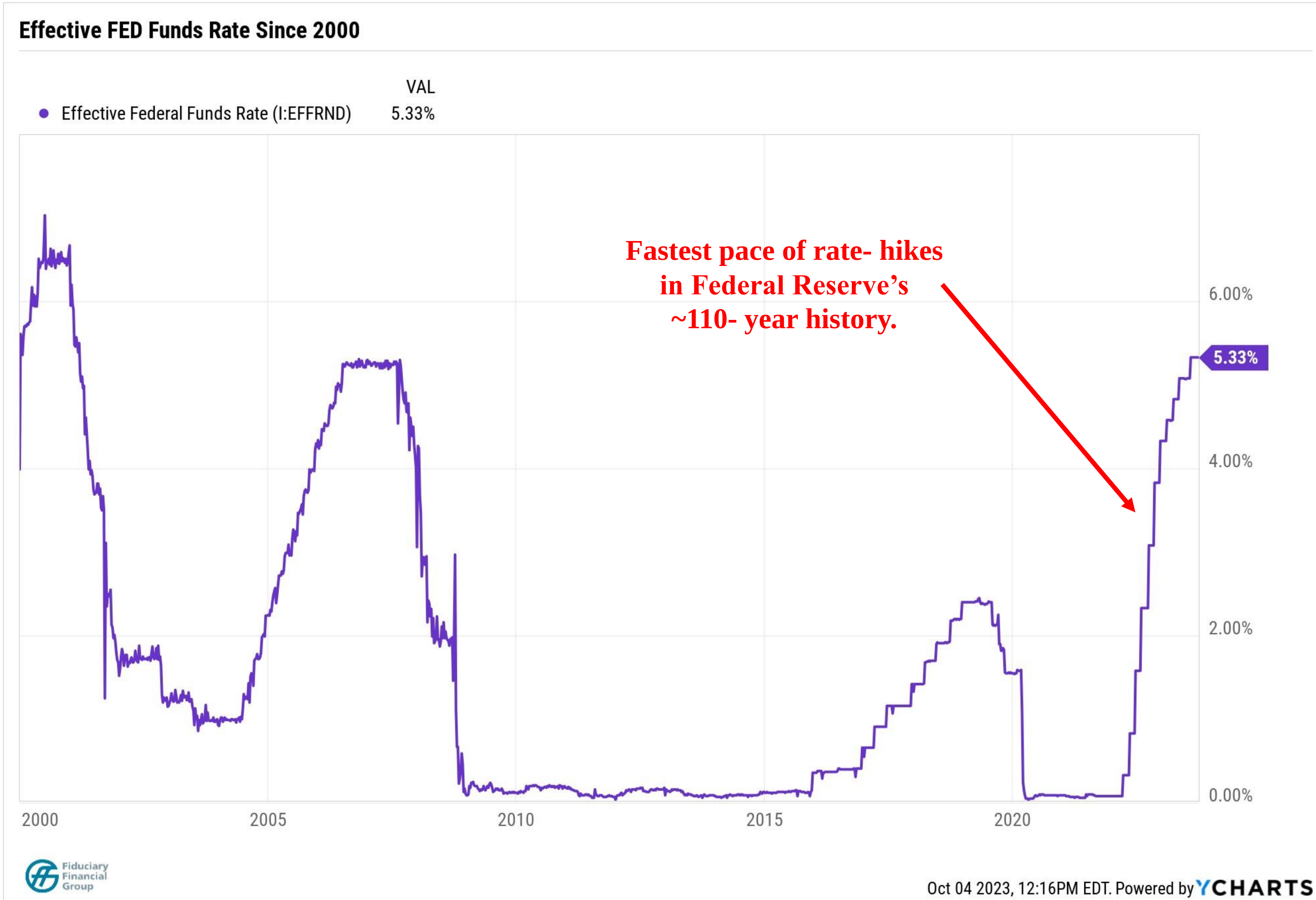
2. **Economic Indicators**
   - Are we nearing recession or rounding the corner to new expansion?

3. **Stock / Bond / Real Estate Valuations**

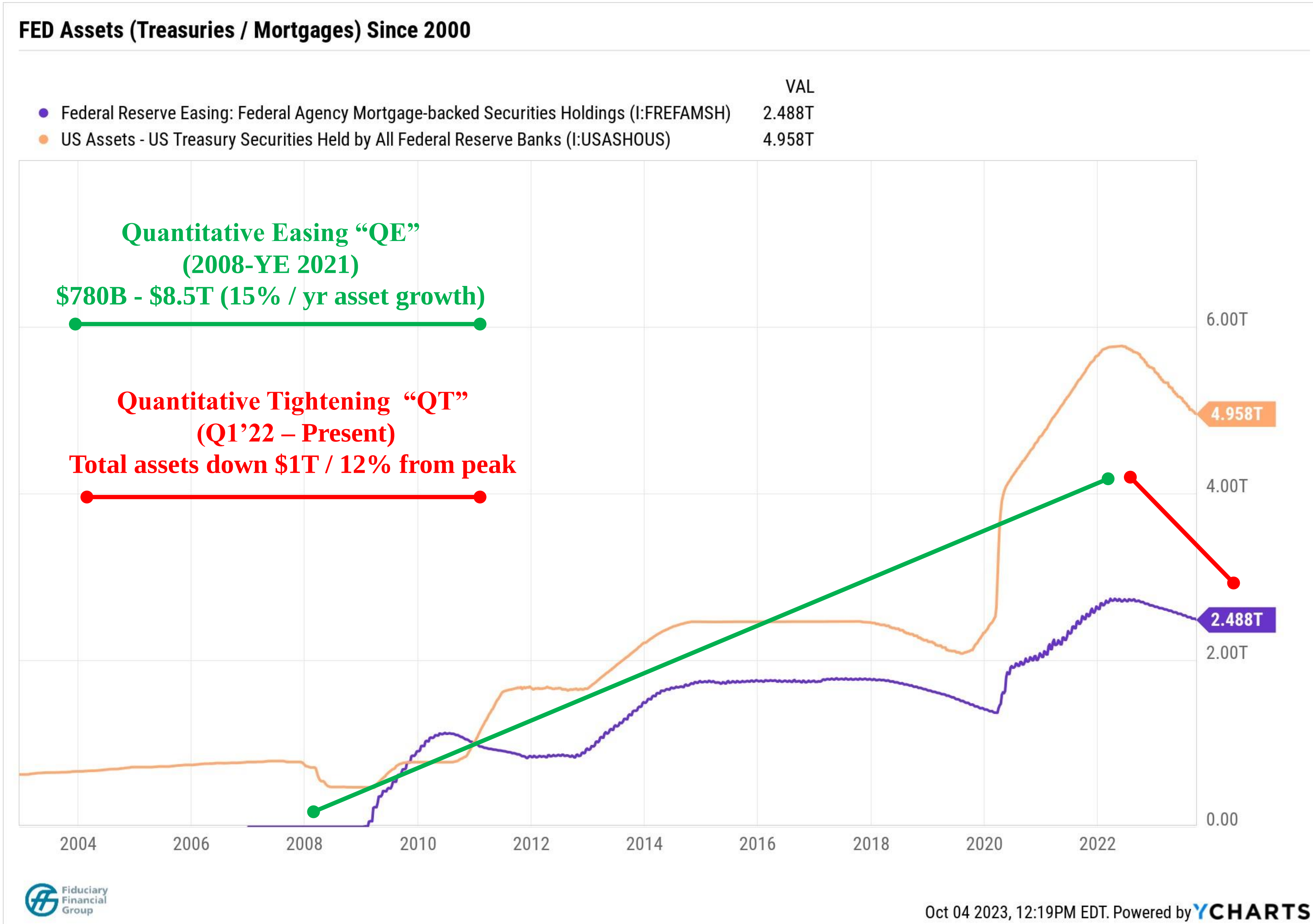
4. **Conclusions**
   - See blue slide on last page for CliffsNotes

FED Reserve Action (Interest Rate Policy):

Federal Funds Rate Historical Chart: Jan'2000 - present

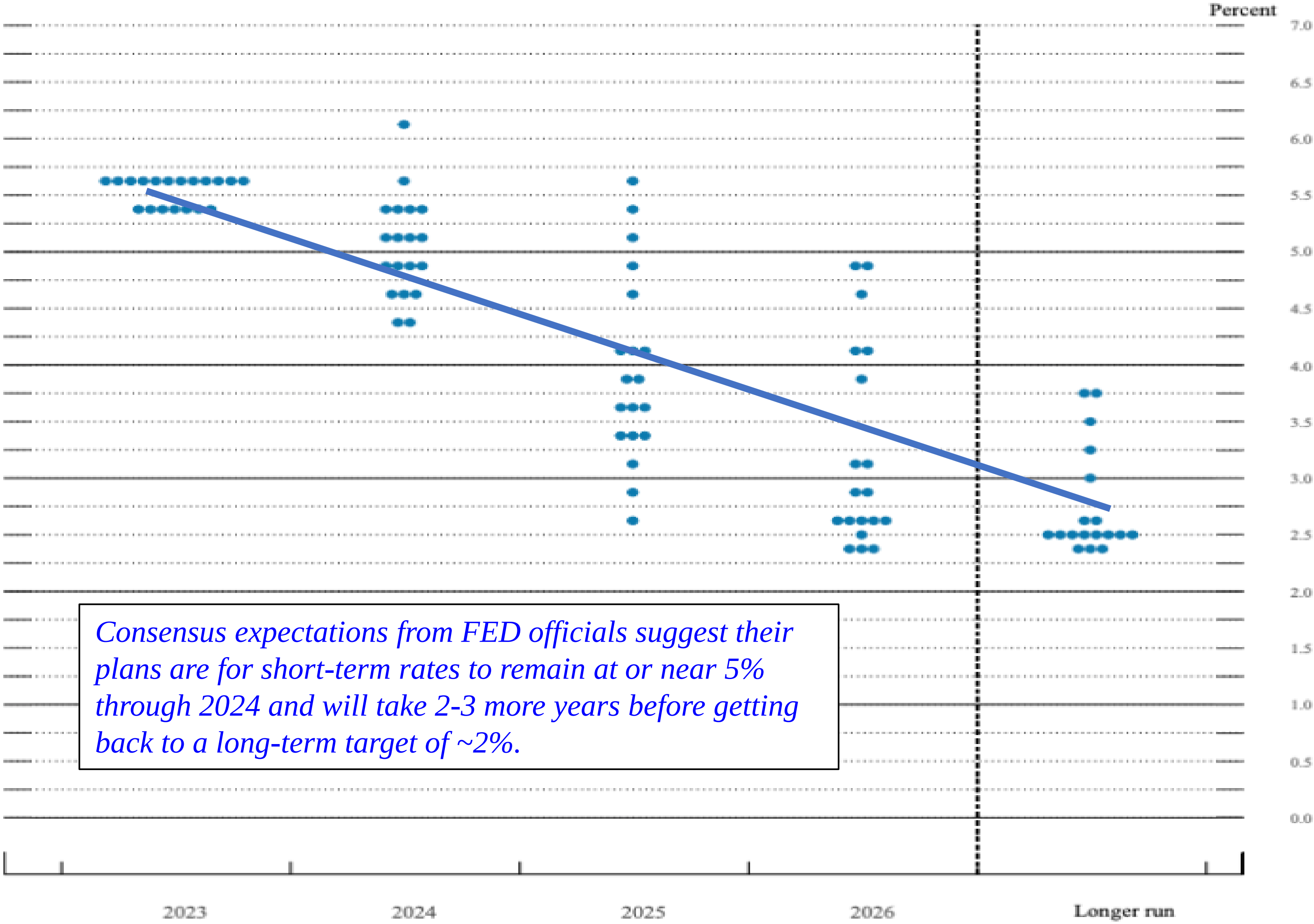


FED Reserve Action (Open Market Operations):



FED Reserve Action (Interest Rate Policy):

Fed Funds Rate (Current levels vs. FED Governor / Regional Bank President Expectations)



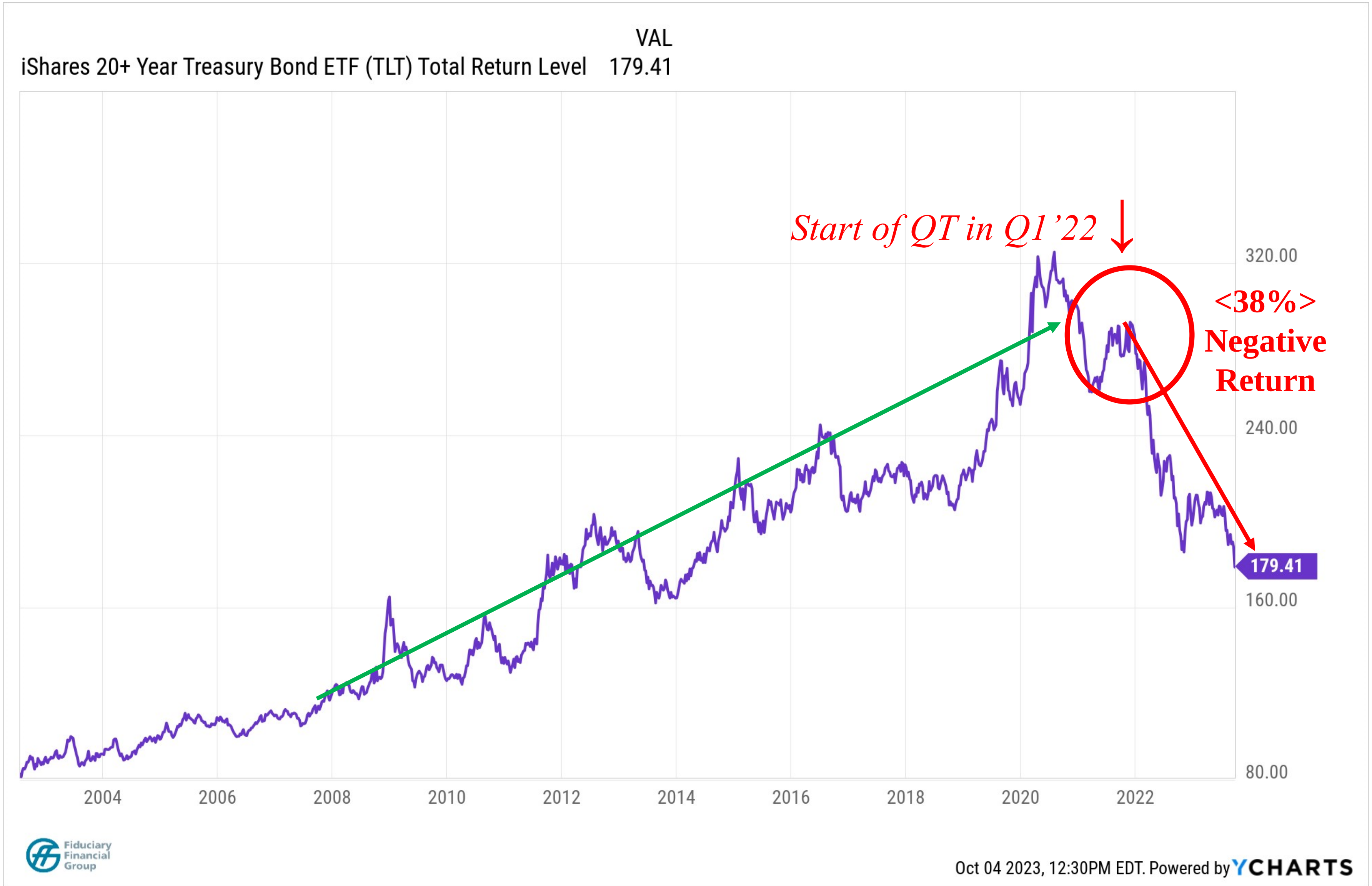
Source: Federalreserve.gov – September 20, 2023

FED Reserve Impacts

- **2009-2021:** Years of low mortgage rates subsidized by FED MBS Buying
- **Q2'22-Present:** Mortgage rates spiking *without* FED MBS assistance

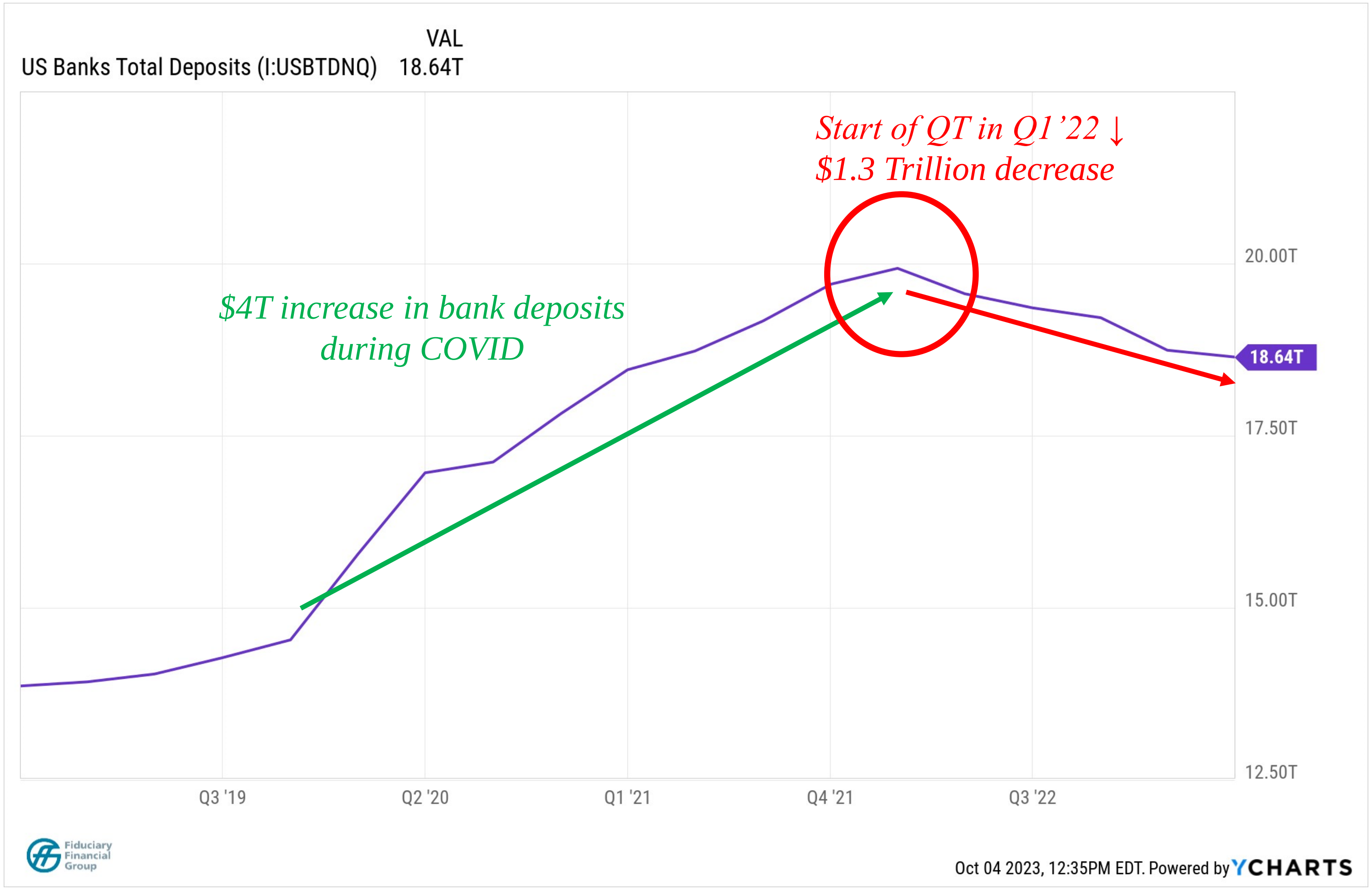
FED Reserve Impacts

- **2009-2021**: Easy money = Long treasury bonds rallied; yields remained low
- **Q2'22-Present**: QT – Sharp reversal in bond prices / yields. Banks left holding the bag.



FED Reserve Impacts

Bank stress caused by rapid outflows from deposits to treasury bills and money market funds. $4T in new deposits came in during COVID stimulus which banks largely invested in longer dated loans (treasuries being the favorite). Since QT began, $1.3T of deposits have gone back out the door forcing banks to dump treasuries, mortgages, commercial loans, auto loans, etc at lower prices.



FED Reserve Actions – Logic

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2008 - Q1’2022

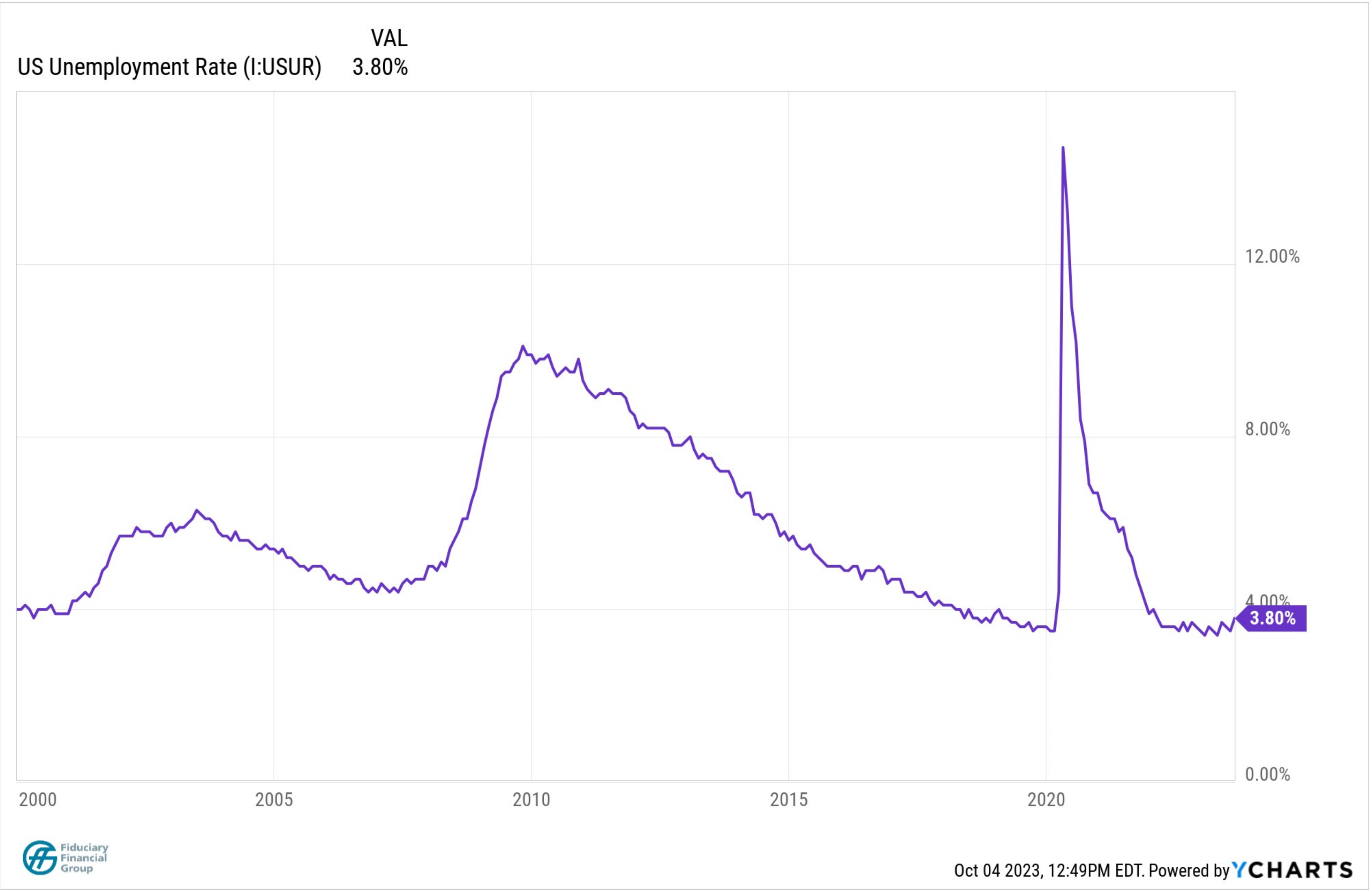
- Inflation subdued
- Growth slow
- System too vulnerable to raise rates or shrink FED balance sheet
  - See Q4 2018 TAPER TANTRUM (S&P 500 crashed 20% in 3 months)

Q2’2022 – Present

- Inflation not transitory, but rather stubbornly persistent
- Employment market very tight
  - Inflationary pressure from wage growth / labor shortages
- Powell is inclined to hold rates higher for longer to avoid a “double inflation spike” such as that seen in the late 1970s / early 1980s

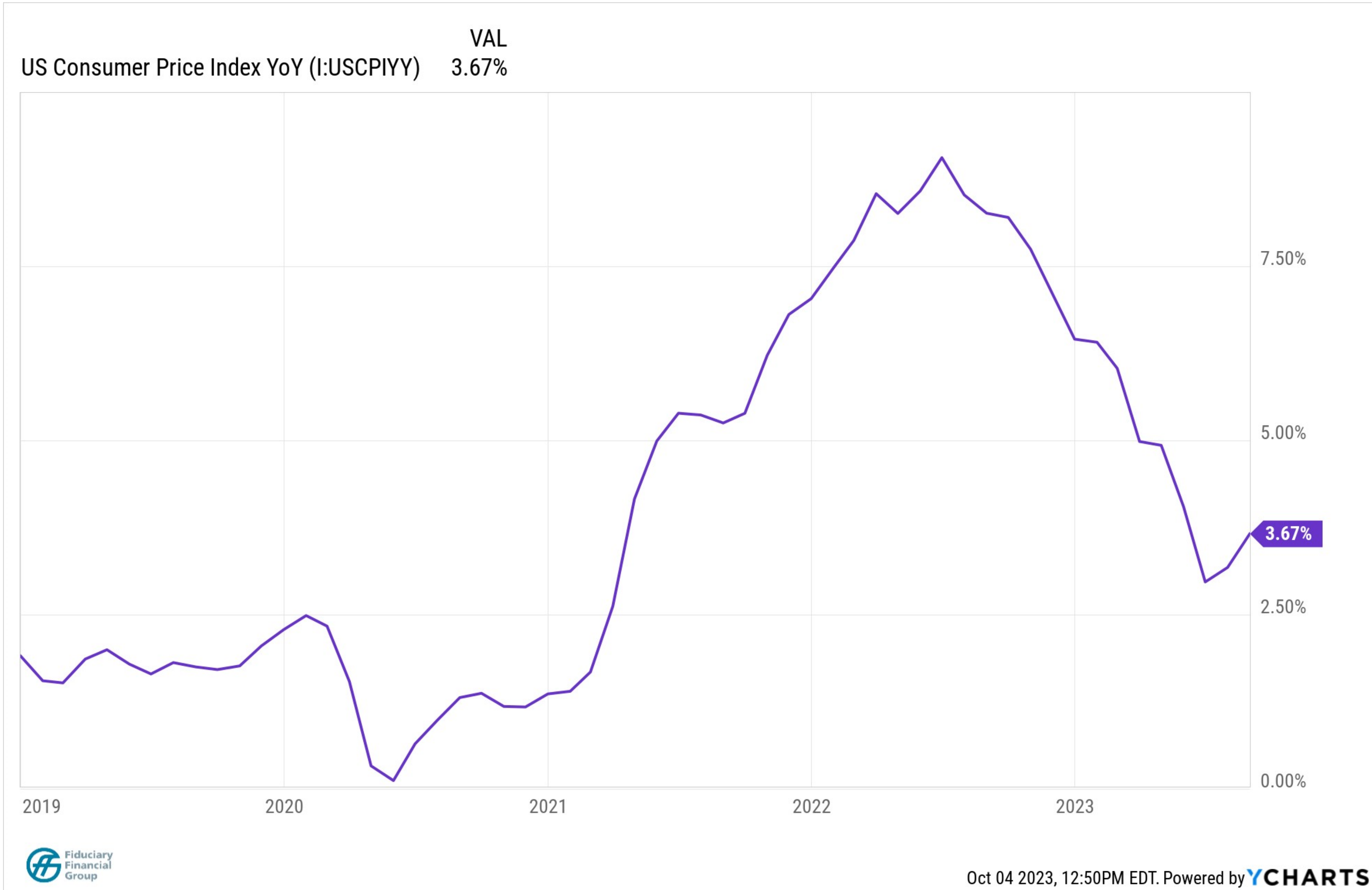
FED Reserve – Progress

Goal One – Maximum Employment



FED Reserve – Progress

Goal Two – Stable Prices Marked by Low YOY Inflation at 2%



FED Reserve

The FED will likely meet its goal of stabilizing prices…
But will it result from a *soft landing* or a *painful crash*?

Soft Landing Markers:

- Employment holds steady alongside moderate wage growth √
- Moderate-to-low volatility in asset prices **Ω**
- GDP growth continues √
- Inflation cools to 2% long-run target allowing FED to slowly lower rates / tightening **Ω**

Painful Crash Markers:

- Surges in unemployment - **X**
- Declines in asset valuations - **Ω**
- Credit crises marked by spikes in consumer loan, mortgage, & corporate loan delinquencies - **Ω**
- Rapidly shrinking availability of credit - √
- Sharp reversal from inflation to deflation - **X**
- GDP contraction - **X**

Legend: √ – Happening | **X** – Not Observed | **Ω** – Mixed Signals

So far, we've had a relatively soft landing (ex-March banking scare) with moderating inflation and a still-strong labor market. **Will the economy hold up?**

Economic Indicators

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Current vs. prior recessionary environments. Worst measures since 2007.

U.S. Recession Risk Indicators

		Current	2020	2007-2009	2001	1990-1991	1981-1982	1980	1973-1975	1969-1970
Confidence	Housing Permits	✕	⬆	✕	●	✕	✕	✕	✕	✕
	Job Sentiment	✕	●	✕	✕	✕	✕	●	●	●
	Jobless Claims	●	⬆	●	✕	✕	✕	✕	⬆	✕
	Retail Sales	✕	⬆	✕	✕	✕	✕	✕	●	✕
	Wage Growth	✕	✕	✕	✕	✕	✕	✕	✕	✕
Economic	Commodities	✕	⬆	✕	✕	✕	✕	●	●	●
	ISM New Orders	✕	●	✕	✕	✕	✕	✕	✕	✕
	Profit Margins	✕	✕	✕	✕	✕	✕	✕	●	✕
	Truck Shipments	●	⬆	●	✕	✕	✕	✕	n/a	n/a
Financial	Credit Spreads	✕	⬆	✕	✕	✕	✕	✕	⬆	●
	Money Supply	✕	⬆	✕	✕	✕	✕	✕	✕	✕
	Yield Curve	✕	✕	✕	✕	✕	✕	✕	✕	✕
	Overall Signal	✕	●	✕	✕	✕	✕	✕	●	✕

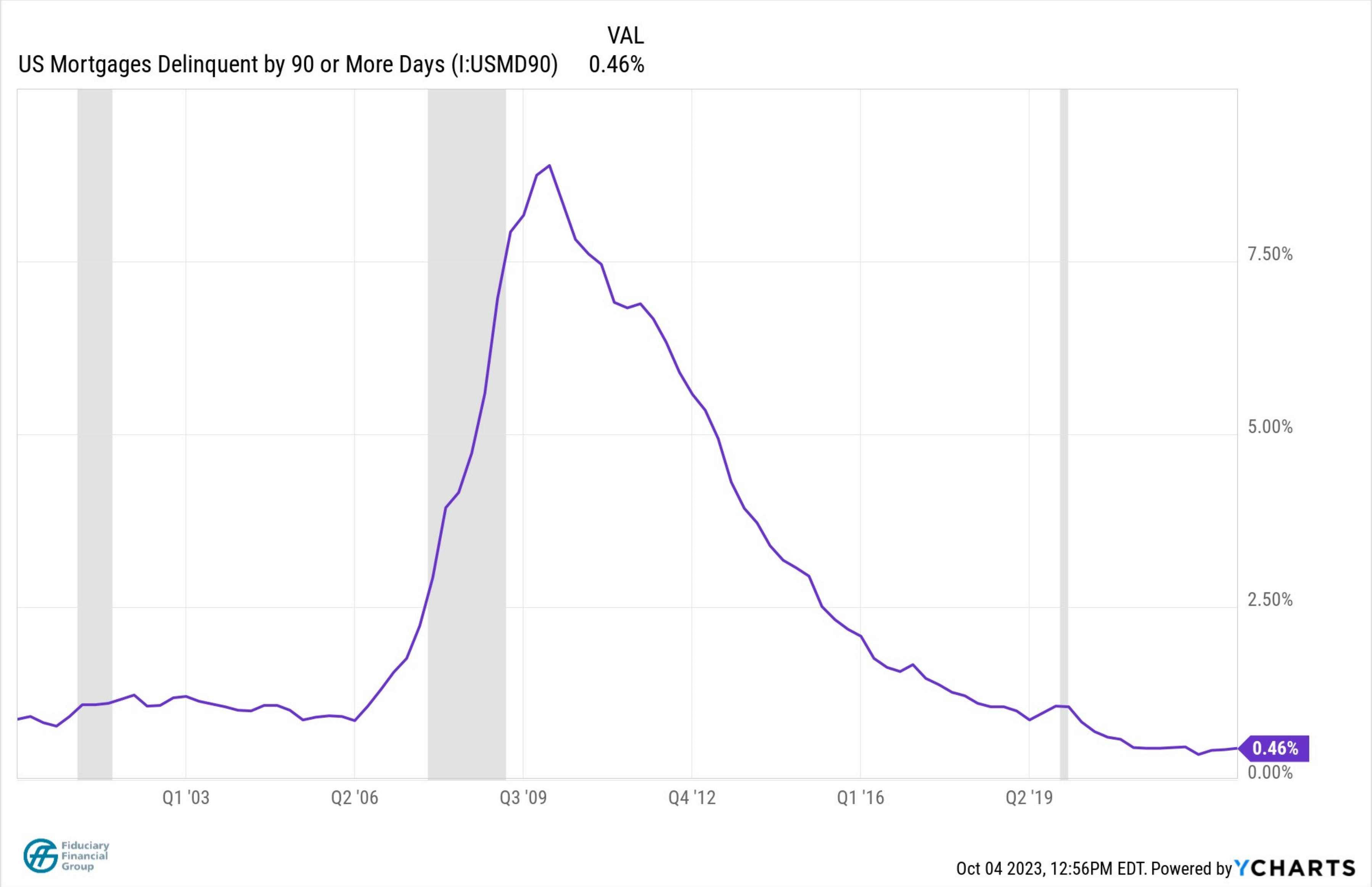
⬆ Expansion ● Caution ✕ Recession

Data as of September 30, 2023

Source: Franklin Templeton – Anatomy of a Recession – data as of 9/30/2023. FactSet, Bloomberg, Conference Board, Census Bureau, Federal Reserve, FRBPA, Chicago Fed, ISM, Dept. of Labor, Bloomberg/Barclays, AAII, Investors Intelligence, and Moody's.

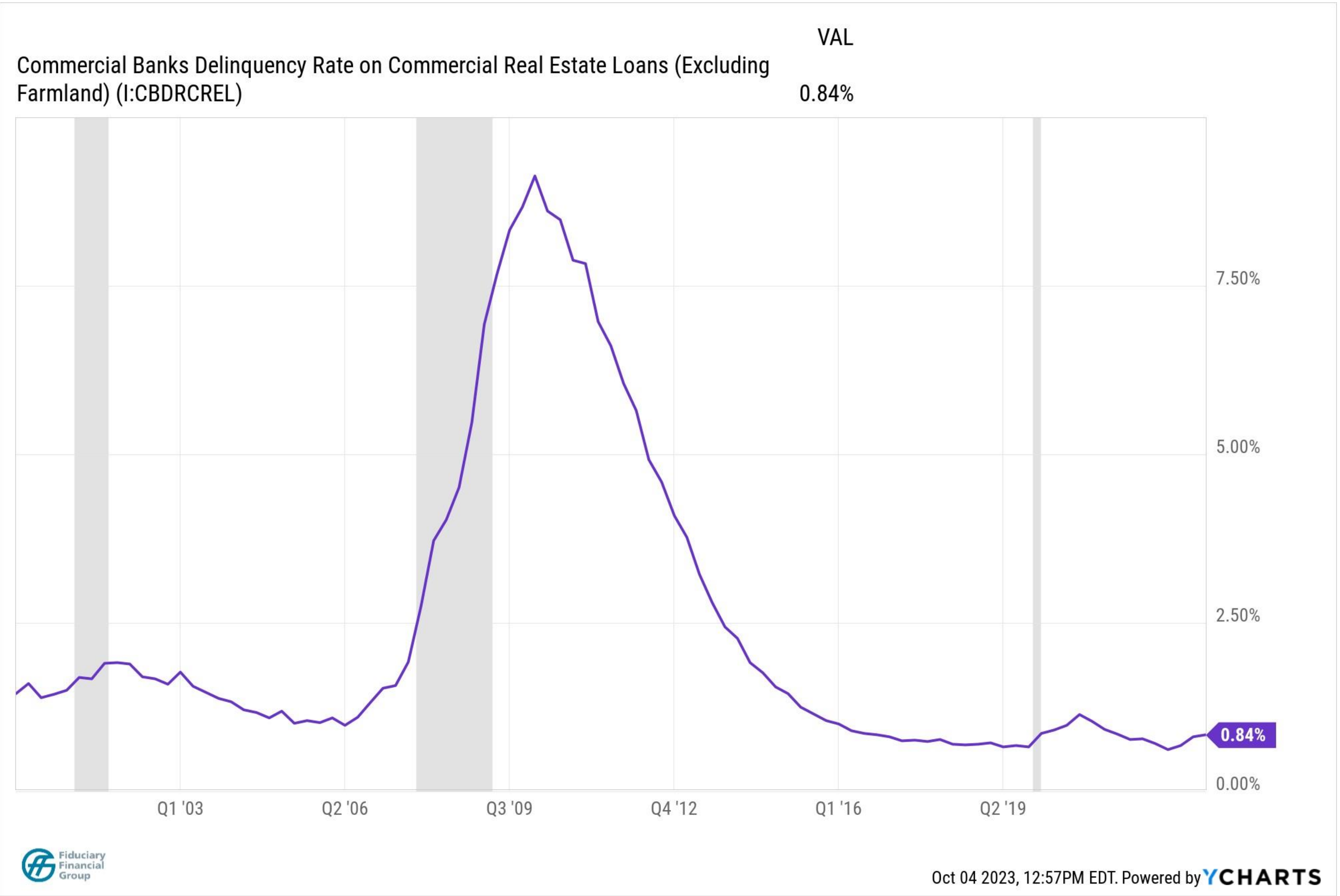
Economic Indicators

Delinquencies– Residential Mortgages



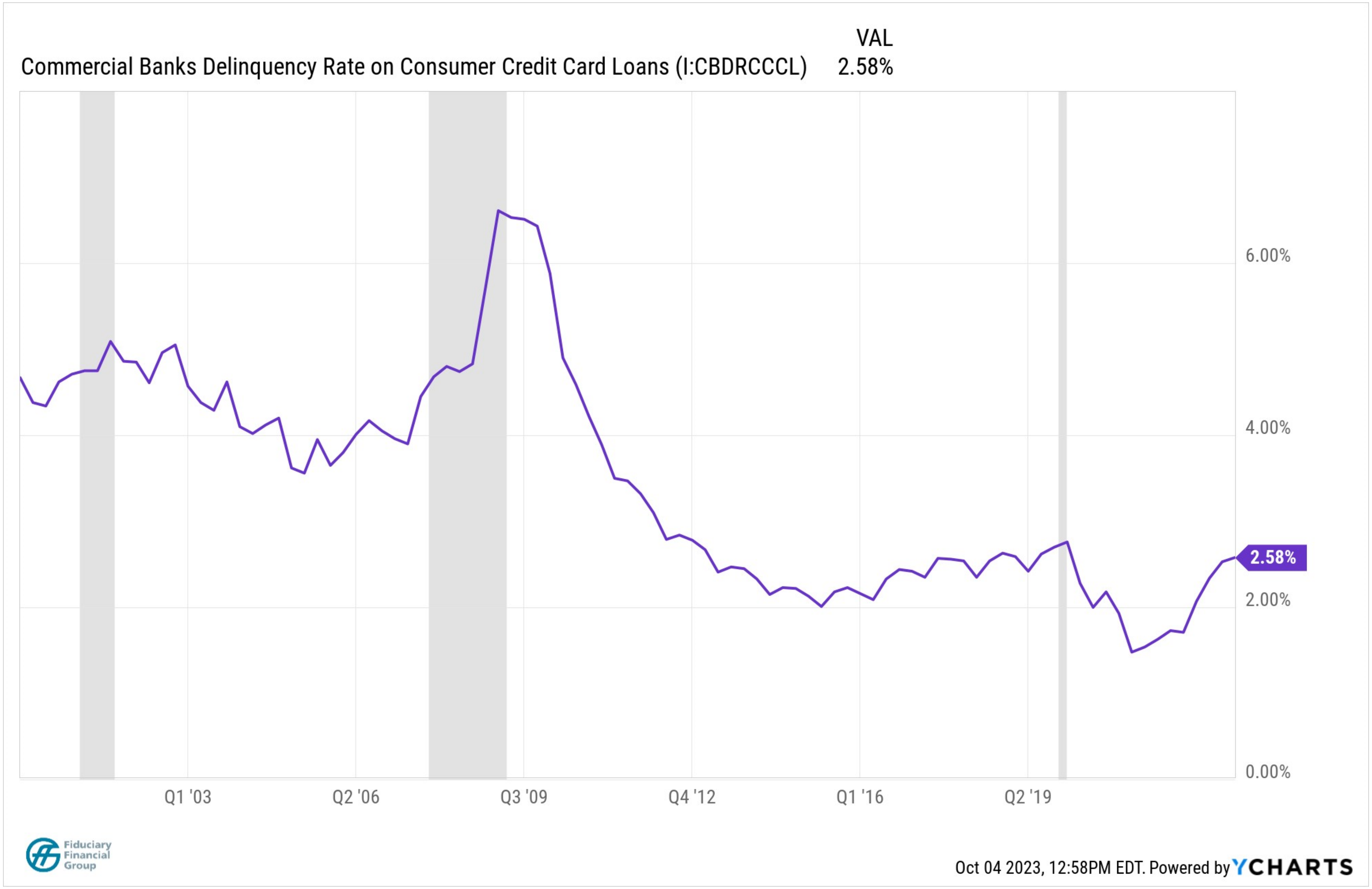
Economic Indicators

Delinquencies– Commercial Real Estate Loans (ex Farmland)



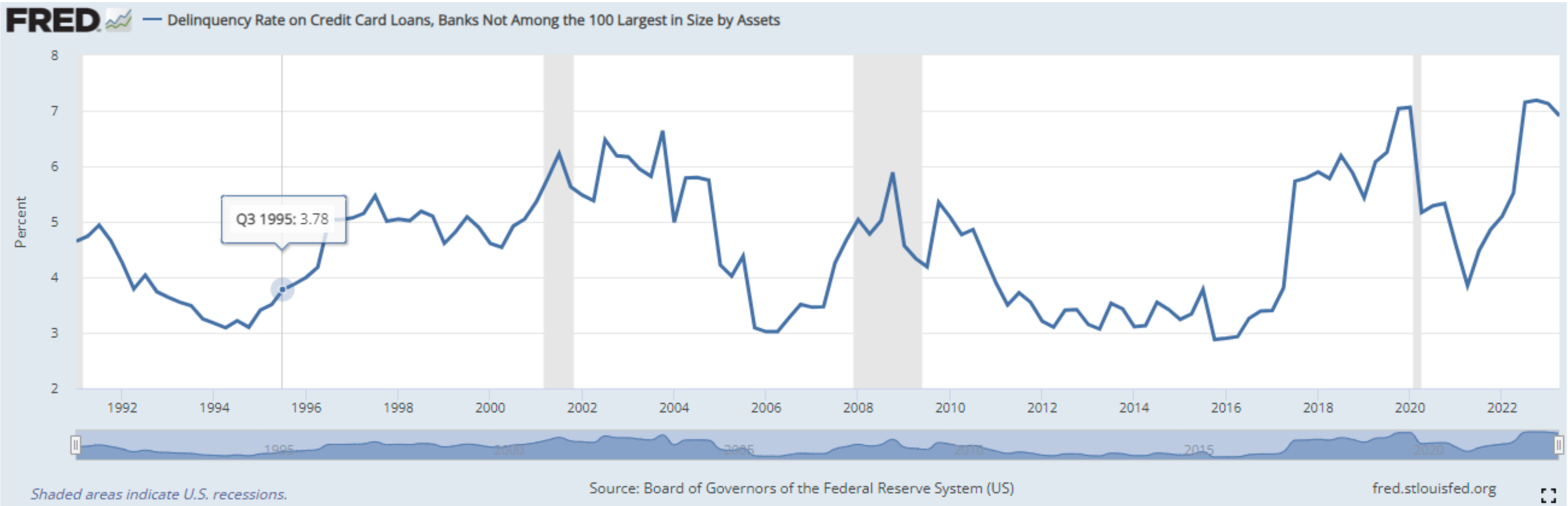
Economic Indicators

Delinquencies – Credit Cards



Economic Indicators

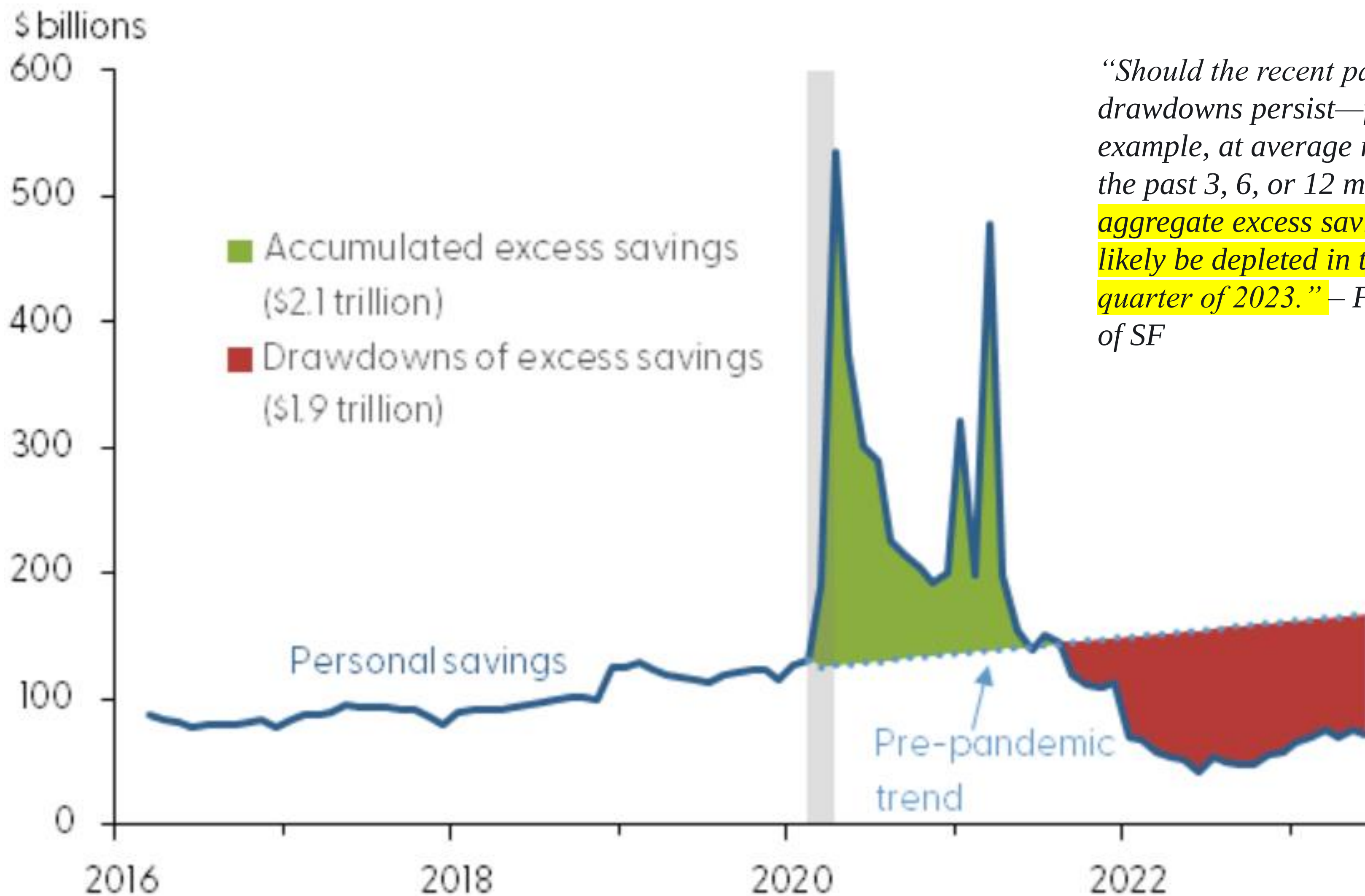
Delinquencies – Credit Cards at Banks Not Among Top 100 Largest in Size



7.2% delinquency rate @ Q4'22 *– Highest level seen since 1992 start of data*

Economic Indicators

Delinquencies– Will They Stay Low? **Unlikely.**



"Should the recent pace of drawdowns persist—for example, at average rates from the past 3, 6, or 12 months—aggregate excess savings would likely be depleted in the third quarter of 2023." – Fed Bank of SF

Source: Federal Reserve Bank of San Francisco

https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings/

Will we avoid a recession / hard landing…?

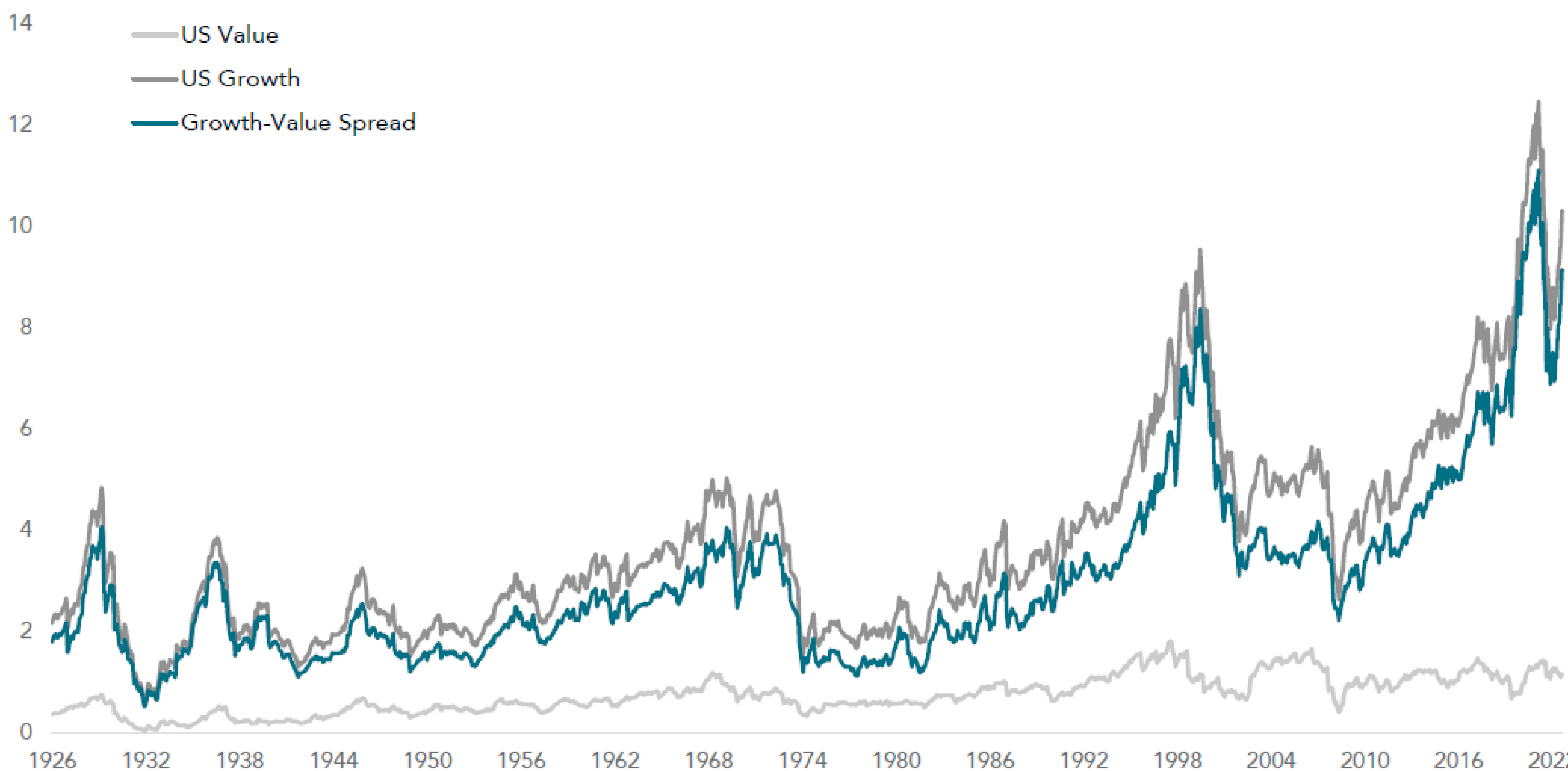
- The FED's record on achieving soft landings is weak at best when forced to fight inflation with restrictive monetary / interest rate policy.
- Leading economic indicators suggest we are in a recession already, or on the precipice of one.
- Delinquencies remain low, although they are rising, starting with credit cards / auto loans. These are LAGGING indicators.
- Unemployment remains low, although wage growth and job openings are stalling out (LAGGING indicators).
- The FED's public rhetoric suggests rates will remain elevated for at least another year.

… Likely not, so where are the investment opportunities?

Valuations (Stocks across US Styles)

By many metrics, we are pushing 2000 bubble valuations in growth-oriented US stocks which dominate most US index funds. Value stocks are priced near more "historically normal" levels. Dividend paying value stocks tend to outperform during inflationary periods.

Price-to-book ratio, June 1926–June 2023



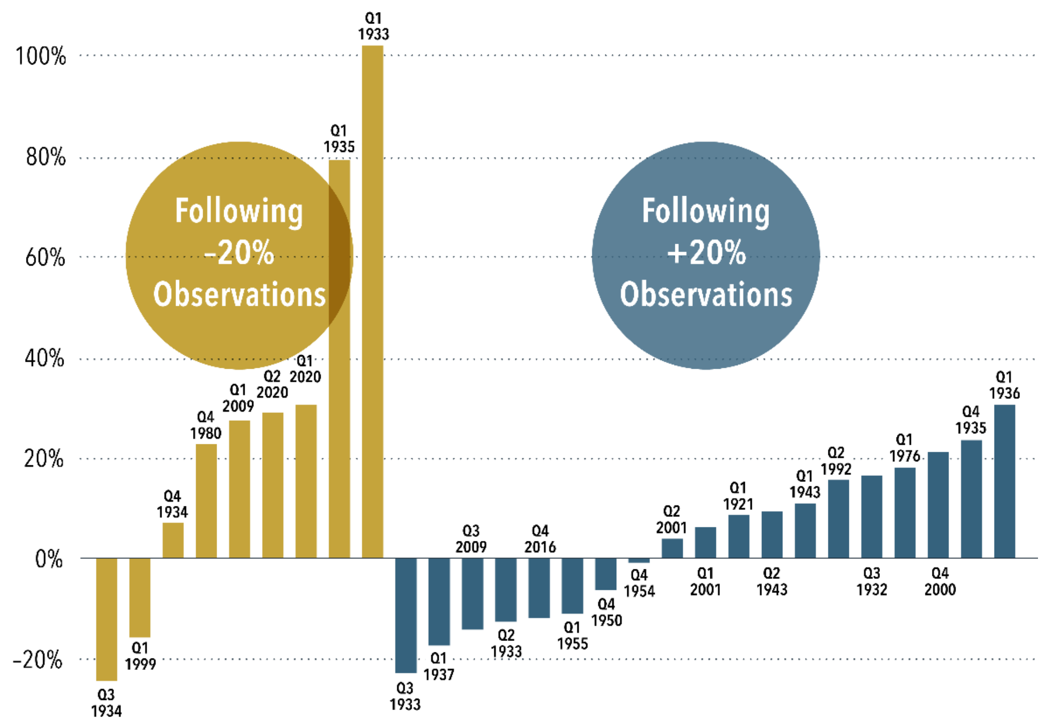
Value Stock Performance After Sub-Par Periods

(i.e. 1st Half 2023)

- The first half of 2023 marks the tenth time since 1926 that value stocks have underperformed growth stocks by more than 20 percentage points over a two-quarter period. Often, value has responded like the hero in an action movie, beating growth over the following four quarters in seven of the nine previous instances and averaging a cumulative outperformance of nearly 29 percentage points.
- The sample size may be small, but a positive average value premium following a large negative period is not too surprising. In fact, looking at the other side of the value performance distribution, there have been 19 two-quarter periods with the value premium exceeding positive 20%. In 11 of these, value outperformance continued over the next four quarters. The average premium across all 19 was 3.6%.
- It's notoriously challenging to find an indicator that consistently predicts negative value premiums. Regardless of value's recent performance, investors should expect positive value premiums going forward. That's a strong incentive for investors to maintain a disciplined stance to asset allocation, so they can capture the outperformance when value stocks deliver.

Comeback Kid

Cumulative return difference for value minus growth in US stocks over the four quarters following two-quarter periods during which value underperformed by –20% or outperformed by +20%.



Source: Dimensional Fund Advisors

Wes Crill, PhD

Valuations (Foreign Stocks)

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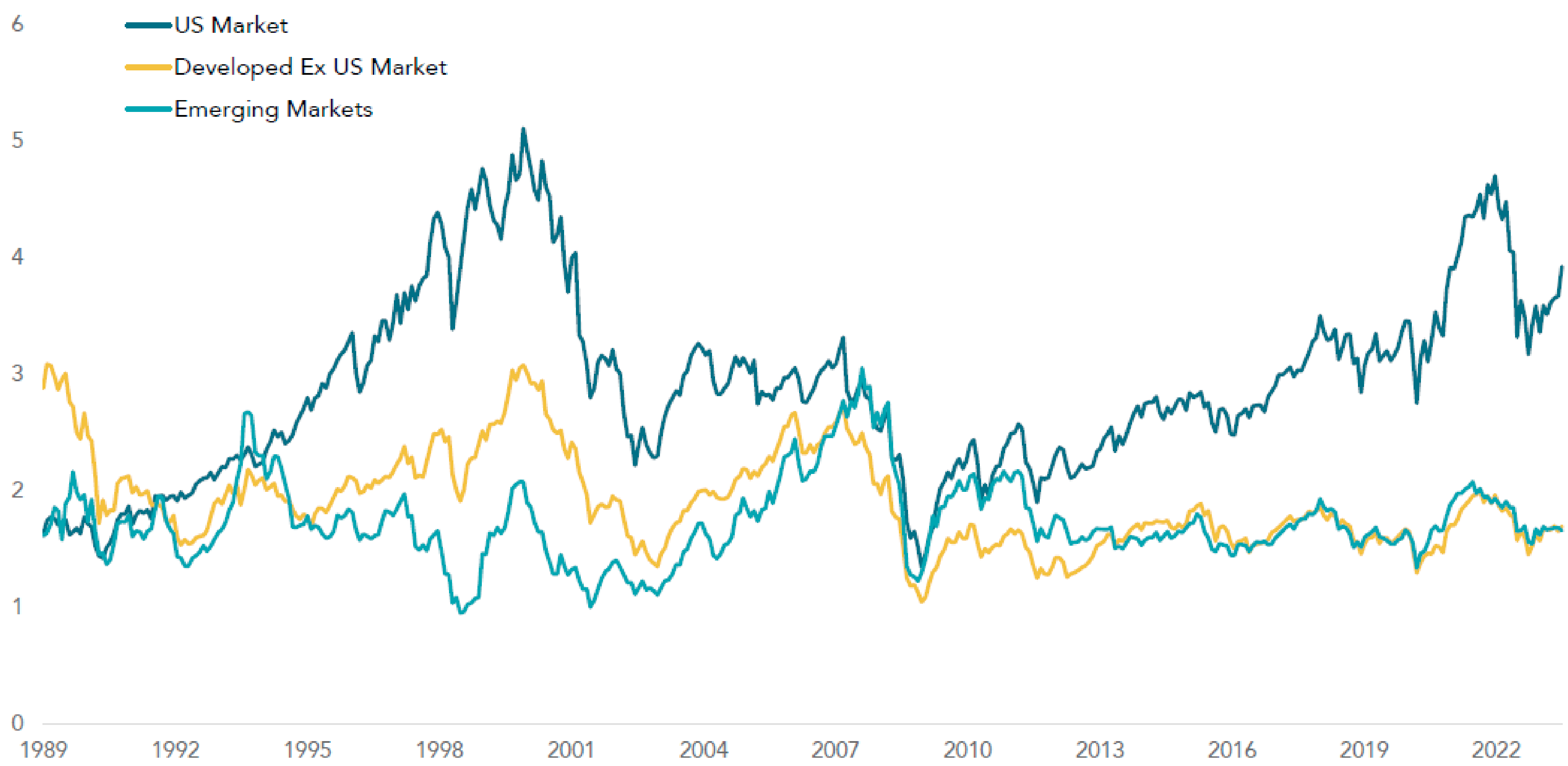
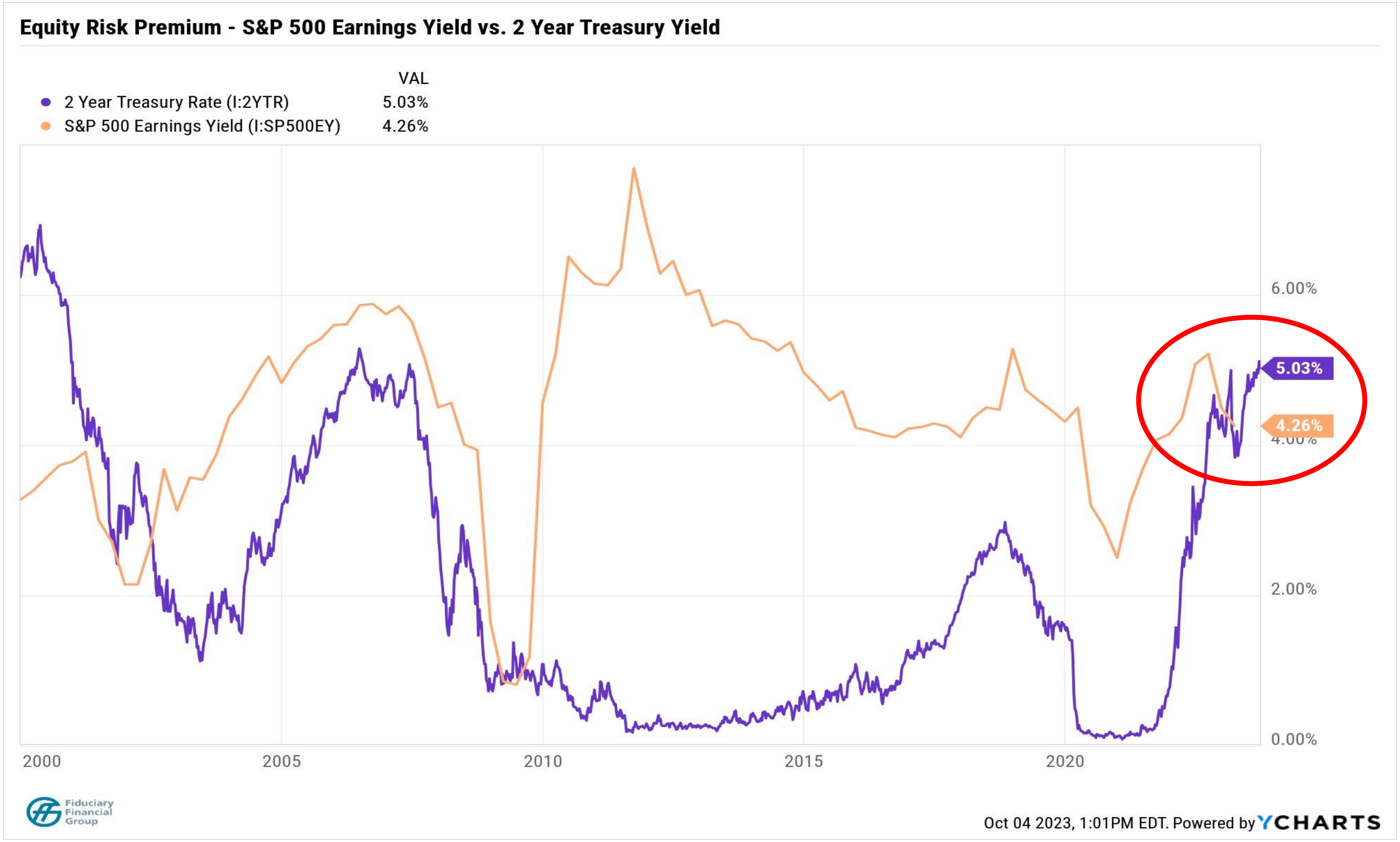
Foreign stocks, while generally discounted vs US counterparts, trade at very low-price tags, even on a relative basis vs most other times in history. The last time this happened was in 2000. For the next 10 years, foreign stock market index returns trounced US markets.

Price-to-book ratio, June 1989–June 2023



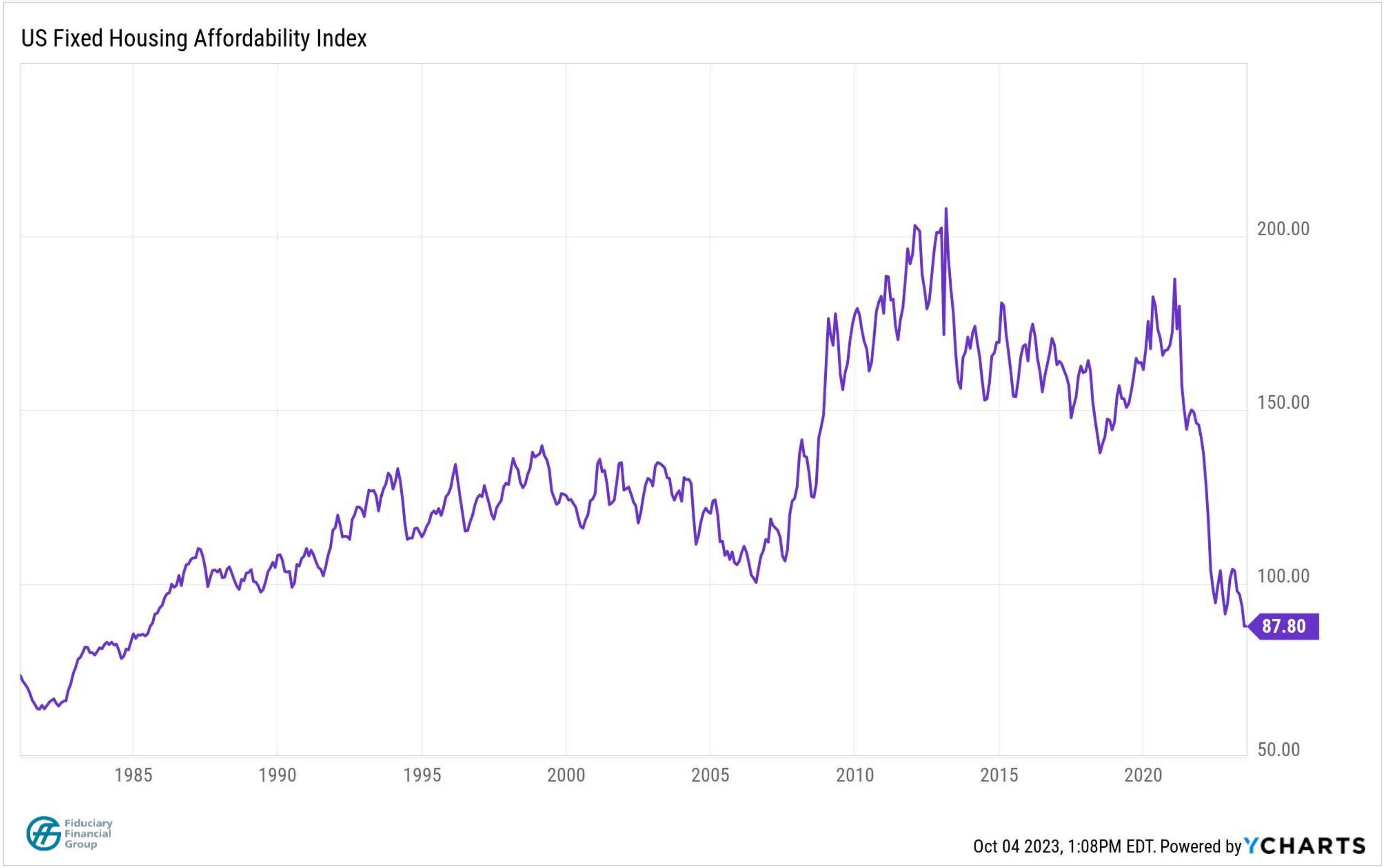
Valuations (US Stocks vs. US Bonds)

Investors are getting paid very poorly for the risks they are taking in US Stocks, particularly with heightened recession risk and a hawkish FED.



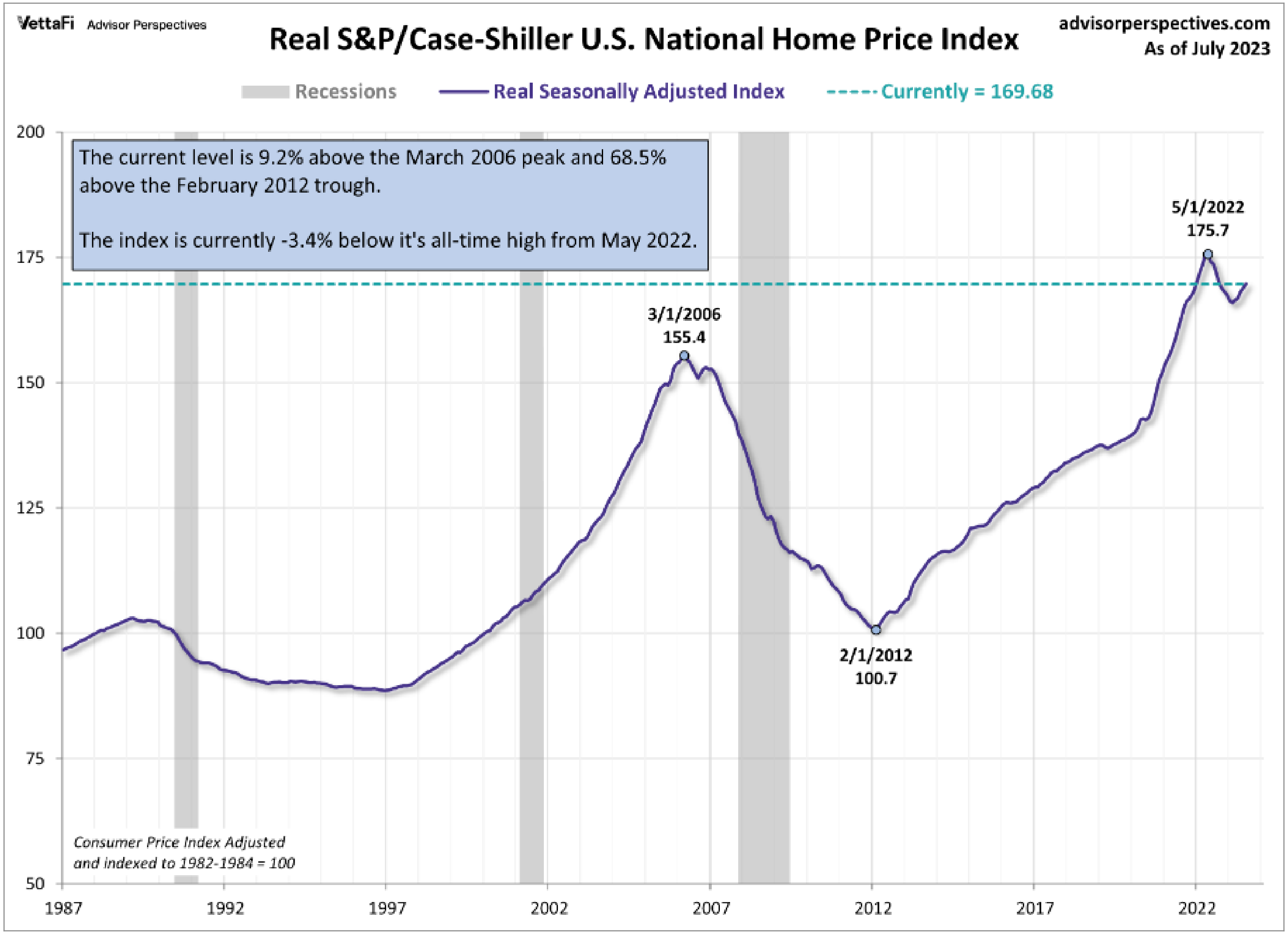
Valuations (Real Estate)

Homes haven’t been this **un**affordable since 1985.



Valuations (Real Estate)

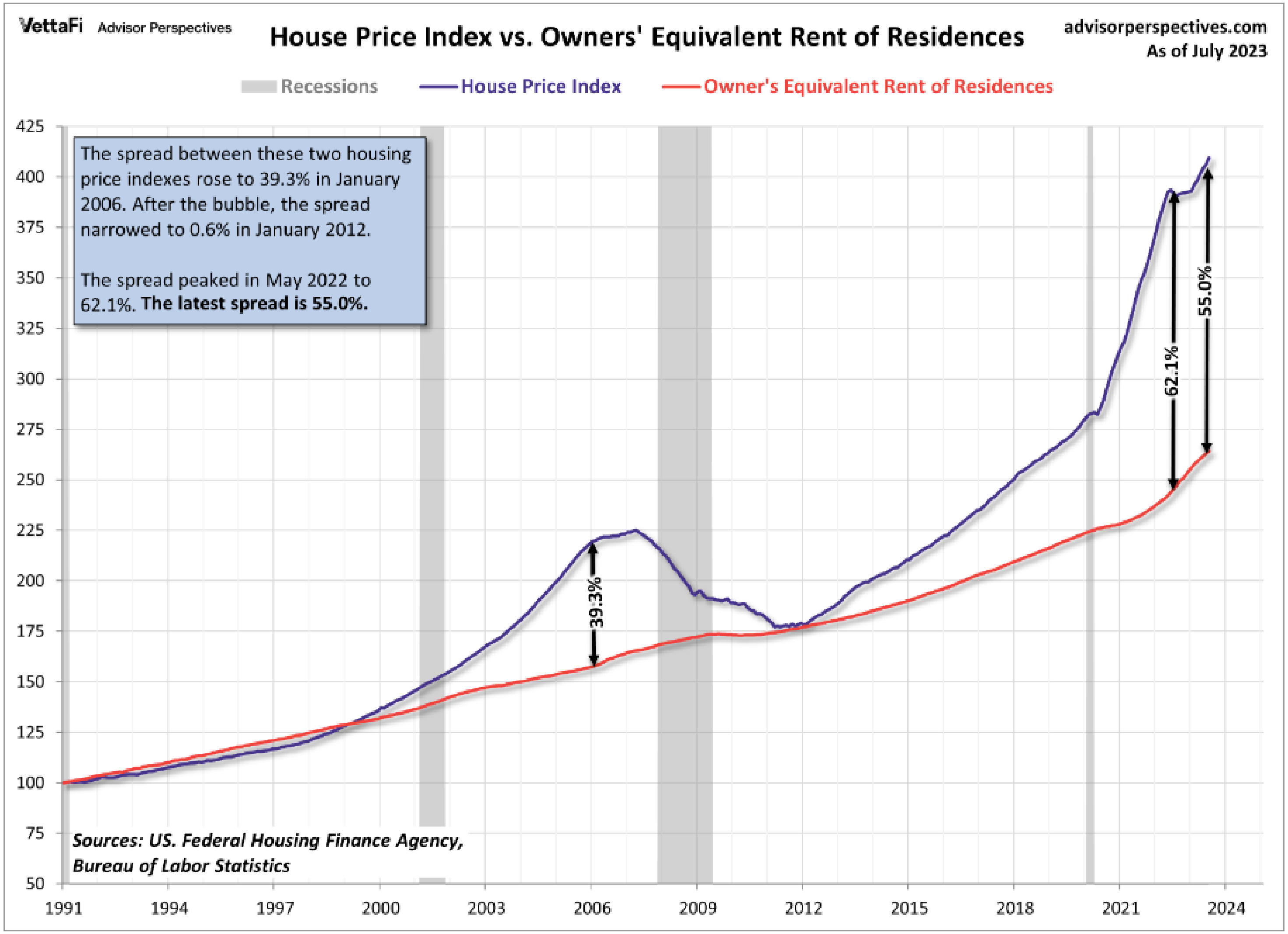
Adjusting for inflation, home prices now sit well above 2006 peak levels.



Source: https://www.advisorperspectives.com/dshort/updates/2023/09/26/s-p-case-shiller-home-price-index-continues-to-trend-upward-in-july

Valuations (Real Estate)

Since COVID, renting has never been more attractive vs. owning when comparing the costs borne by renters vs. owners of the same properties.



Source: https://www.advisorperspectives.com/dshort/updates/2023/09/26/house-price-index-fhfa-rises-july-2023

Conclusions

- **Don’t fight the FED**. For a decade+, soft monetary policy boosted asset prices (stocks, bonds, real estate). That era is behind us and higher rates with FED balance sheet tightening present a major headwind for asset prices looking forward.

- **Don’t get wooed by glimpses of a soft landing.** A credit event and/or spike in unemployment rates is still likely before the FED eases interest rate & monetary policy. These events have historically been required to bring inflation “all the way down”. Coupling this with the fact that household excess savings have been zeroed out in Q3’23 further supports major credit events being imminent.

- **US stocks (particularly growth stocks that dominate index fund weightings) remain VERY elevated while foreign marker equities are nearing “bargain territory”.** We are encouraging our clients to emphasize value stocks and foreign stocks. Further, we promote holding excess liquid assets, particularly while short-term treasury yields are north of 5% and the equity risk premium is NEGATIVE.

- **Purchasing residential real estate in this climate is difficult to rationalize.** While every deal and every market must be assessed individually, we are generally averse to direct investments in residential real estate right now given mortgage rates & affordability, home valuations, and rent vs. own statistics.

- **Distressed asset sales are common amidst “credit events” (i.e., major business failures, spikes in consumer debt delinquencies).** Institutions with superior deal flow, low leverage on current holdings, and access to financing have competitive advantages to capitalize on these circumstances.
  - Specifically, we see opportunities among our partnerships with institutional real estate managers who possess these characteristics above, AND who are vertically integrated with in-house leasing, acquisition, development, and property management functions.

Footnotes

- **Slides 5, 6, 8-10, 12, 13, 17-19, 26, & 27** are graphs pulled direct from FFG's Y-Charts terminal.
- **Slide 7** - Federal Open Market Committee, Summary of Economic Projections - September 20, 2023, 4 of 17. federalreserve.gov.
- **Slide 16** - Clearbridge Investments. (2023, October 1). U.S. Economy: Anatomy of a Recession. Franklintempletonme.com. https://www.franklintempletonme.com/our-funds/themes/anatomy-of-recession
- **Slide 20** - St. Louis Federal Reserve. (2023, August 21). Delinquency rate on credit card loans, banks not among the 100 largest in size by assets. FRED. https://fred.stlouisfed.org/series/DRCCLOBN
- **Slide 21 -** Abdelrahman, H., & Oliveira, L. E. (2023, August 16). Excess no more? dwindling pandemic savings. San Francisco Fed. https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings
- **Slide 23 & 25** - Dimensional Fund Advisors. (2023, July 1). Historical Valuations: Price-to-book ratio through June 2023. Retrieved October 4, 2023.
- **Slide 24** - Dimensional Fund Advisors. (2023, October 1). Quarterly Market Review / When Value Delivers. Retrieved October 4, 2023.
- **Slide 28 -** Nash, J. (2023, September 26). S&P Case-Shiller Home Price Index: Continues to trend upward in July ... advisorperspectives.com. https://www.advisorperspectives.com/dshort/updates/2023/09/26/s-p-case-shiller-home-price-index-continues-to-trend-upward-in-july
- **Slide 29 -** Nash, J. (2023, September 26). FHFA House Price Index Rises 0.8% in July. advisorperspectives.com. https://www.advisorperspectives.com/dshort/updates/2023/09/26/house-price-index-fhfa-rises-july-2023