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AN UPDATE FROM PAUL DIETRICH

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THE BOOM BEFORE THE BUST: DECODING THE MARKET SURGE BEFORE THE RECESSION

Despite the recent Gross Domestic Product (GDP) report, a strong jobs market report, and good consumer spending numbers, if you dig deep into the details of these reports, you will see that the underlying economy is slowing.

In just the past month, we have seen weaker headline job growth, a higher unemployment rate, and weaker wages.

What Does This Signal About Where We Are Now?

All the new reports are signaling a significant loss of economic momentum.

According to the U.S. Bureau of Economic Analysis (BEA), Gross Domestic Product (GDP) grew at 4.9% in the third quarter. That number can be expected to be revised down in future updates.

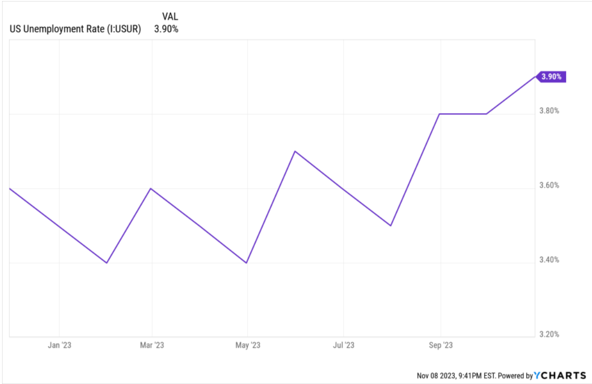
However, the Atlanta Federal Reserve, is now projecting a near stalling 1.2% GDP growth for the fourth quarter of this year.

If they are correct, you have to believe that employment will start to weaken and that is what we saw in the most recent unemployment numbers where the unemployment rate jumped to 3.9%.

Job Growth Is Slowing—The Economy Is Cooling

The October Jobs Report shows employers added the fewest jobs since June, while the unemployment rate rose. "Concerns about job cuts are rising for U.S. workers, reaching levels not seen since July 2020," according to *Glassdoor Data*. They report that employee confidence has hit a new low. They expect the job market to lose further momentum in 2024.

In the following chart, you can see the dramatic increase in the U.S. Unemployment Rate over the past year.



Consumer Spending Is Still Strong—But Unsustainable

Consumer spending accounts for over two-thirds of U.S. GDP. A strong consumer is therefore widely assumed to be the equivalent of a strong economy.

During Covid, the U.S. Government spent $6 trillion providing stimulus checks to people and businesses. After the lockdown, most people had excess savings and wanted to spend it.

After Covid subsided, Americans went on a spending spree. At first it came out of their excess Covid savings, and after that ran out, consumers kept on spending with their credit cards.

Just over two years ago, Americans had a record $2.1 trillion in excess savings. But now, excess household savings in the U.S. have fallen for 23 straight months.

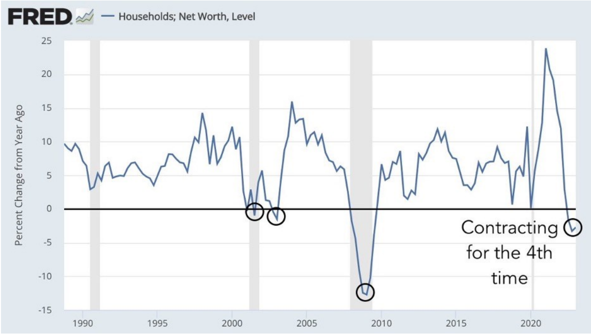
The San Francisco Fed estimates that remaining household savings will be depleted this quarter.

We went from handing out record levels of free stimulus money to borrowing record levels of debt.

Credit card debt hit a record level of $1.03 trillion last month.

We have now gone from a period of historically high savings to a period of historically low savings in just months.

Below is a chart of American Household Net Worth.

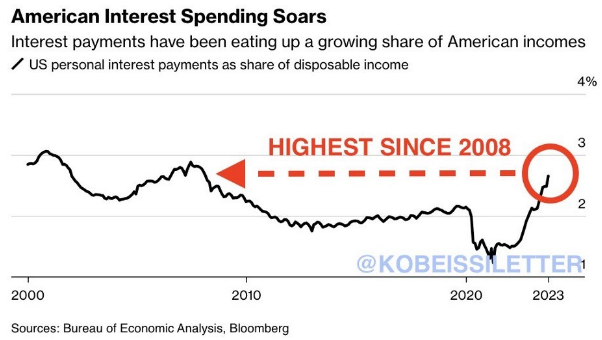


Consumer Debt Delinquencies Are Surging

- Delinquencies on auto loans, credit cards and consumer loans just hit their highest levels since 2012.
- Delinquency rates over 30-days are up six straight quarters, on track for the longest streak since 2008.
- As both rates and prices rise rapidly, delinquency rates are skyrocketing.
- The average new car now costs $48,300, up from $37,700 just four years ago.
- The average used car is now selling for an alarming $27,000.
- Last month, student loan payments on $1.6 trillion of debt have now resumed.
- People are "fighting" inflation with debt they can't afford.
- This is what retail sales data looks like when you print $6 trillion and hand it out.
- For the past nine months in a row year-over-year real retail sales growth has been declining. Many consumers have switched spending patterns to focus on services, like restaurants, air travel, cruises, hotels, and Taylor Swift concert tickets.

American Interest Payments Soar

- In just one year, the average interest rate on credit card debt has gone from 14% to usurious rates of 25% to 30%.
- New car loan rates went from 4% to 8% while used car loan rates are at 12%+.
- Mortgage rates are almost at 8%, up from 2.7% in 2021.
- Americans are now spending 2.7% of their disposable income on interest, the highest since 2008.
- In 2021, Americans were spending just 1.2% of disposable income on interest.
- Americans will soon be spending 4-5% of their income on interest.
- The era of "free" money is over.



[SOURCE: The Kobeissi Letter]

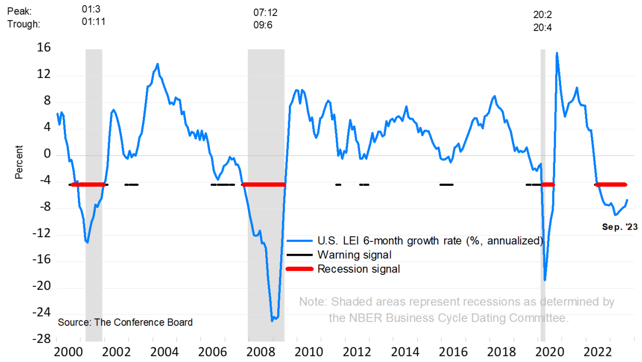
The U.S. Now Holds This Much In Personal Debt

- Record $17.1 trillion in household debt
- Record $12.0 trillion in mortgages
- Record $1.6 trillion in auto loans
- Record $1.6 trillion in student loans
- Record $1.03 trillion in credit card debt
- Total mortgage debt is now more than double the 2006 peak.
- New data from the Fed shows the total number of credit card accounts is still rising quickly.
- For the first time in history, the U.S. is set to cross over 600 million credit card accounts. That would mean ~2.3 credit card accounts per U.S. adult.

- Meanwhile, the average American now has $7,300 in credit card debt.

Many consumers are comfortable with more debt because they currently have a job.

Why This Matters: As unemployment rates continue to increase, this level of debt is unsustainable. Something will break soon. Consumer spending on everything will slow dramatically. That's almost the definition of a recession.



Why Hasn't The Recession Come As Analysts Predicted?

If you look at all the major elements of the U.S. economy from the decline in U.S. manufacturing, the increase in unemployment rates, the rise of credit card debt and student loans in consumer spending, the high mortgage interest rates on housing and commercial real estate refinancing, the impact of world oil prices and an ever-increasing U.S. government debt caused by politicians continuing to spend trillions of dollars we don't have — our economic future looks bleak.

Reality is not the same as the *"Happy Talk Analysts"* you see every day in the financial press where they are asked to comment in 30-seconds on the state of the U.S. economy.

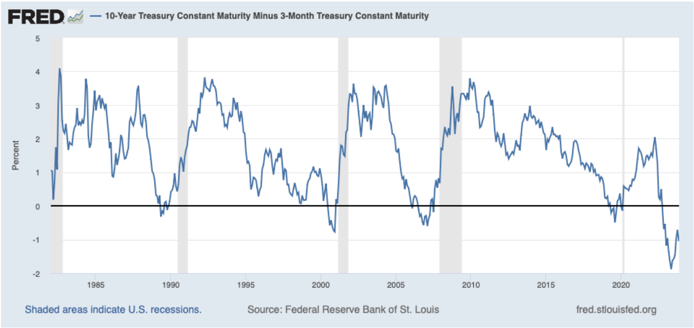
I think many economists who lost patience with their own recession calls, because it didn't happen within the first six months of their talking about it, are going to be putting that call back over the next four or five months.

Most Wall Street analysts are unaware or were sleeping during their college economics course when they were taught that the Conference Board's Composite of Leading Economic Indicators and the 10-month-3-month Inverted Treasury Yield Curve are both leading indicators that signal recessions nine to 18 months in advance of a recession.

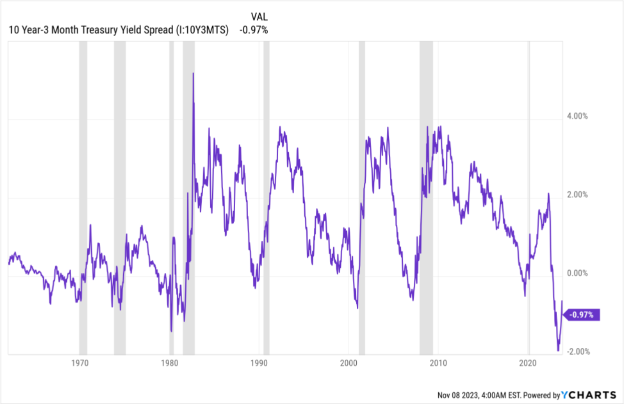
Both leading indicators have historically been relied upon to accurately predict and signal in advance, an upcoming recession.

The Conference Board's Composite of Leading Economic Indicators signaled a recession in late September 2022. On average, the signal is an advance warning nine to twelve months in advance of a recession. As of now, in early November 2023, it is currently six weeks beyond the 12-month signal.

The 10-month-3-month Inverted Treasury Yield Curve signaled a recession when it inverted below zero on the chart below on October 27, 2022, approximately a month after the Leading Economic Indicators flashed a recession signal. On average, the inverted yield curve recession signal gives an advance warning of 12 to 18 months in advance of a recession. As of early November 2023, it is currently still within the early warning range.



If you look carefully at a chart of the Treasury Yield Curve over the past 50+ years, with the shaded areas showing recessions, you will see that when the yield curve inverts by going below zero that is the recession signal, it always starts to *disinvert* (go up) right before the recession historically starts. On the far right of the chart you will see that *disinversion* happening right now.



A Lesson For Investors

Most of the Wall Street analysts you see in the financial press are experts on the history and technical indicators of the U.S. and global stock markets. But very few have seriously studied the history of the underlying macro economy. It is important for investors to understand that the stock market and the underlying economy are very different. They are NOT the same.

If you have ever taken an Economics 101 class in college, you learn on the first day that almost any event on television can make the stock market go up or down in the short term. But in the long term, the stock market ALWAYS follows the directional trend of the underlying economy.

If the economy's underlying directional trend is up—then the stock market will go up. If the economy's underlying directional trend is down—then the stock market will go down. If the economy's underlying directional trend is going sideways—then the stock market will trend sideways. This is one of the most important lessons any investor can learn from old economics classes.

Soft Landing: Repealing A History Of Over 400 Years of Business Cycles

When the recession didn't come as early as many analysts expected, (even though the signals are still within their historical average time frames,) they started to talk once again about the elusive "soft landing ."

After the steep stock market losses in September and October, the financial press was back to talking about the impending recession. No one was talking about a soft landing or a new bull market.

This was at a time when stock indexes were giving back most of their performance gains since the bear market rally started in March of this year. As of the last week of October, the Dow Jones Industrial Average Index was negative year-to-date, having given back all its performance gains from earlier in the year.

As the stock market has temporarily corrected up over the past few weeks, many analysts are starting to resurrect the soft landing story.

Contrary to what the Federal Reserve has publicly stated, many analysts now believe that if the Fed stops raising rates (*Note the Fed says rate increases are still on the table*), and if they start cutting rates in June 2024 (*Note the Fed says rates will be higher for longer until 2025*), and we continue to see a weaker economy and lower inflation, maybe we could have soft landing.

There seem to be a lot of wishes and maybes in their predictions.

How Serious Can You Take These "Soft Landing" Predictions?

Since World War II, the U.S. economy has had many bouts of inflation. But only once, in 1994, has the Fed accomplished a soft landing, but the inflation it tried to subdue was hardly significant by today's standards.

In that year, The Fed brought the Core Consumer Price Index (Core CPI) down from 5% inflation in three years in 1991 to 2.6% in 1994.

But in 1994, it must be remembered the economy was in the midst of a bull market—not an economic slowdown. The Leading Economic Indicators and the Treasury Yield Curve had not inverted, and neither had formally signaled a recession. In terms of comparison to today, there is little economic similarity.

In February 1994, then Fed Chair Alan Greenspan started raising interest rates and ultimately steered core CPI inflation to 2.1% from 2.9%. A 0.8% reduction isn't on the scale of the task that the Fed now faces, with core inflation having peaked at 6.6% in September 2022 and currently at 4.1%, it is still over double the Fed's target of 2%.

According to the International Monetary Fund (IMF), they examined more than 100 examples of inflation in 56 countries since the oil shocks of the 1970s and found that in only 60% of those cases was inflation brought down over five years. To get to 2% inflation now, Fed Chair Jerome Powell will have to keep his foot on the brake and likely let the U.S. economy go into recession.

Today, we are also looking at rising oil prices because of Russian sanctions, Saudi production cuts, and wars in Ukraine and the Middle East that threaten to drive inflation higher while reducing growth by slowing discretionary spending. This kind of "stagflationary" shock is the opposite of what you want if you're trying to engineer a soft landing.

To believe we will not eventually have a recession after the most serious Fed rate hikes and tightening cycle since 1981 is simply not credible.

With over 411 years of stock market data from when the first modern stock markets were established in Holland and the U.K., we know there are only two cycles in the real economy.

The first is a bull market where everything in the economy is expanding. Historically, these bull market cycles last 6 to 10 years.

They are always immediately followed by a bear market recession, where the economy is slowing and contracting. Historically, these bear market recessions last, on average, 9 months to two years.

Since the summer of 2009, when the Great Recession formally ended, we have all lived through a 13-year bull market.

If you don't believe that after the longest bull market in U.S. history we are due for a bear market recession, you must believe that 411 years of alternating bull and bear market cycles have somehow been repealed. *This time must be different!*

Why Can't The Recession Hurry Up & Get Here?

Back in early 2007 I was regularly appearing on both CNBC and Fox Business News, and talking about the recent recession signals and how I was transitioning my clients to a more defensive investment portfolio.

I remember in late 2007 being asked by one program host, "When is this recession that you have been talking about for a year finally coming?" The Great Recession formally started a few weeks later in December of 2007.

Given the $6 trillion in Covid stimulus payments to so many people and businesses, and the Biden infrastructure spending, it should not be surprising that those excess savings may have pushed out the recession later than normal.

We've seen this before. In 2006–2007, consumer spending pushed out the start of the Great Recession as a result of all the extra cash extended to borrowers because of mortgage equity withdrawals and cash flow refinancing that were the last vestiges of the housing bubble.

Remember when you could borrow 125% of the value of your home and you didn't even have to have a job to pay it back? Do you remember how that worked out?

A Soft Landing May Just Be The Rollover Period Between The Economic Expansion Phase To The Contraction Phase Of The Business Cycle

Since the economy was in a bull market and there were no recession signals in 1994, you can't call that a real "soft landing."

Most analysts and financial press use the term "soft landing" as an alternative to experiencing an actual recession and negative contraction of the economy.

But if you think about the rollover period—which often takes a year or more—for the economy to slowly transition or bridge from a bull market expansionary cycle to a bear market recessionary contraction phase of the business cycle, I could agree that we have been in a temporary "soft landing" over the past year.

The Warren Buffett Indicator

Over the past few months, the legendary investor Warren Buffett has been selling stocks and raising cash. He now is holding an all-time record high of $157.2 billion in short-term treasuries and cash alternatives.

Even after the recent stock market correction, he believes the stock market today is massively overvalued. How does he know that?

Warren Buffett invented his own stock market indicator, commonly called the "Buffett Indicator."

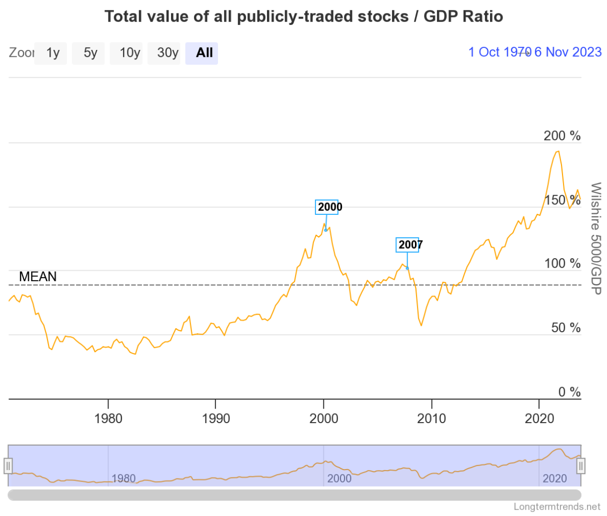
The Buffett Indicator is currently ringing alarm bells for

Buffett's investment firm, Berkshire Hathaway.

Over the years, he has said that the Buffett Indicator was "probably the best single measure of where stock market valuations stand at any given moment."

The indicator takes the 5000 stocks in the Wilshire 5000 Index, which is just about every stock traded in the United States, and divides it by the latest estimate of quarterly Gross Domestic Product (GDP). This gauge essentially takes the total stock market capitalization of all actively traded U.S. stocks and divides it by the size of the national economy.

The indicator is now above every extreme reading prior to the beginnings of past recessions like 2000 and 2007.



A couple of months ago it hit an historic high and was almost 200% above the mean stock market valuation, but the current reading of almost 159% is still one of the highest readings on record.

Buffett wrote in a *Fortune Magazine* article in 2001 that when the indicator soared during the dot-com bubble, it was a *"very strong warning signal"* of an impending stock market crash.

He suggested that stocks would be cheap at a 70% or 80% reading, and offer fair value at 100%, but it would be *"playing with fire"* to buy when the gauge was around where it is now at 159%.

Putting The Recession In Perspective: When Will The Recession Finally End?

Historically, the stock market bottoms before the recession ends. Typically, the market bottoms in 'capitulation selling' (remember March 9, 2009?) about 70% through the actual recession.

Since recessions generally last 9 to 18 months, if the recession were to begin during the third quarter of 2023, a nine-month recession could see a stock market bottom during the first quarter of 2024. If this turns out to be an 18-month recession, we could see a market bottom in the summer of 2024.

The good news is that this recession is not the world's end. Because of the strong jobs market, this is not 2008. Yes, revenues will be off. Earnings will be off. The U.S. economy will slow because of inflation and Fed rate increases, resulting in a good old-fashioned earnings recession with inflation.

With patience, we will get through this.

While I still expect the S&P 500 Index to trade down to the 3200 level, representing a potential downside of about -25% from now, I also expect an eventual recovery sometime in early 2024 through the third quarter of next year.

Investors Need To Be Patient—And Realistic

As an analyst, I am not a permanent Bull or Bear. I am neither optimistic nor pessimistic.

I look at the facts and data and see where I am now within the larger business economic cycle.

We are entering into a global recession and a contracting business economic cycle.

It is time to be defensive in your investing. Don't take any risks. Hunker down and try to preserve all the capital you have.

Acting appropriately to what you are facing is like battening down the hatches during a storm or hurricane. This is just common sense.

These are natural economic cycles like the day follows night, and spring follows winter.

Investors need to take a deep breath and realize they are living through a natural cycle that has played out for hundreds of years in world economies and stock markets.

When Should We Get Back Into The Stock Market?

The leading economic indicators will show us when the next bull market is starting.

The table below provides current data on the two major composites of U.S. leading economic indicators and their composite indicator components. I've included a column to show the trailing 12-month directional trends and whether each is currently declining, plateauing, or recovering.

This updated monthly table shows investors the long-term directional trends of the significant composites and individual indicator components of the leading economic indicators.

On a personal note: As an investment manager, I have relied on this table through three previous recessions and will do so again in this upcoming fourth recession. It has never let me down.

I have been managing investment strategies for over 25 years and through three recessions, not counting the one that will start this year. I have benefited most from dispassionately focusing on data based not on the stock market but on the underlying U.S. and global economy. The data is what it is.

The good news is, at some point, when the U.S. leading economic indicators start to turn up again—as they always do—I expect that as I retire my defensive investment strategies and let my offensive strategies take the field once again, my investments will be worth more as the economy recovers and corporate America resumes another expansionary path.

U.S. LEADING ECONOMIC INDICATORS (NOVEMBER 2023)

Source: YCharts

U.S. Leading Economic Indicators	Trailing 12-Month Directional Trend	Declining / Plateauing / Recovering
Conference Board Composite of Leading Economic Indicators	Recession Signal	Declining
ECRI Composite of Weekly Leading Index	Recession Signal	Declining
Major Leading Economic Indicator Components		
10 Year-3 Month Treasury Yield Spread	Directional Trend Down	Declining
US ISM Manufacturing New Orders Index	Directional Trend Down	Declining
US ISM Services New Orders Index	Directional Trend Down	Declining
S&P 500 Real Price	Directional Trend Down	Declining
US Index of Consumer Expectations	Directional Trend Down	Declining
US 4-Week Moving Average of Initial Claims for Unemployment Insurance	Directional Trend Down	Declining
US Consumer Goods New Orders	Directional Trend Down	Declining
US Construction Materials and Supplies New Orders	Directional Trend Down	Declining
US Manufacturing Average Weekly Hours	Directional Trend Down	Declining
US Manufacturing New Orders	Directional Trend Down	Declining
US Nondefense Capital Goods Excluding Aircraft New Orders MoM	Directional Trend Down	Declining
US Building Permits (SAAR)	Directional Trend Down	Declining
US Weekly Economic Index (NSA)	Directional Trend Down	Declining

> **Only in America do you find a kid wearing $150 sneakers, drinking a $5 cup of coffee, texting on their $1000 cell phone complaining on social media that he is oppressed and that capitalism has failed him!**

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as an on-air commentator and contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*