



12/8/2023

AN UPDATE FROM PAUL DIETRICH

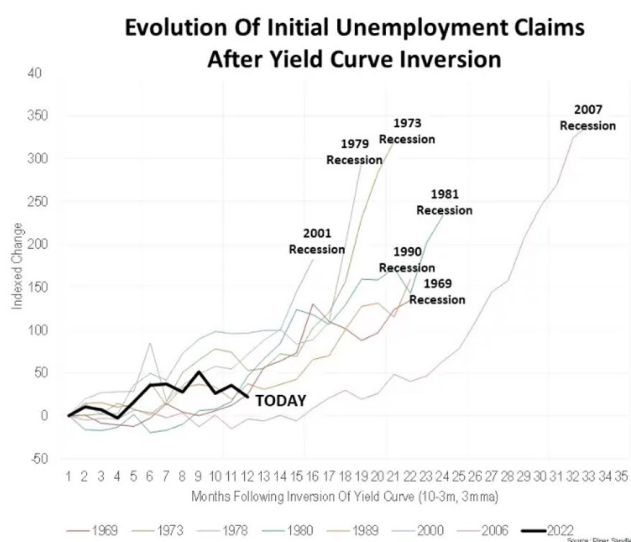
THE STOCK MARKET IS HISTORICALLY OVERVALUED AND COMPLETELY DISCONNECTED FROM A SLOWING ECONOMY

As we end 2023, we are beginning to see the classic economic and stock market *excesses, disconnects, and gaps* that always appear right before a bear market recession.

Historically, recession warnings, like the inverted yield curve and the *Conference Board's Composite of Leading Economic Indicators* signal a recession as an "early warning system" nine to 18 months in advance of the start of a recession.

Those recession signals were sounded in the *fourth quarter* of last year. We are now slightly over a year since those signals formally warned of an upcoming recession. This is still within the normal *time range* of these "signals leading to recession", considering the patterns established over the 100+ years that the Conference Board has tracked data since its founding by the U.S. government as an independent research institute,

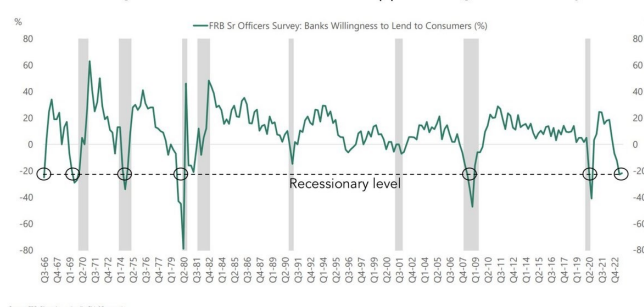
Here are the current cycle's numbers compared to prior inversions and recessions.



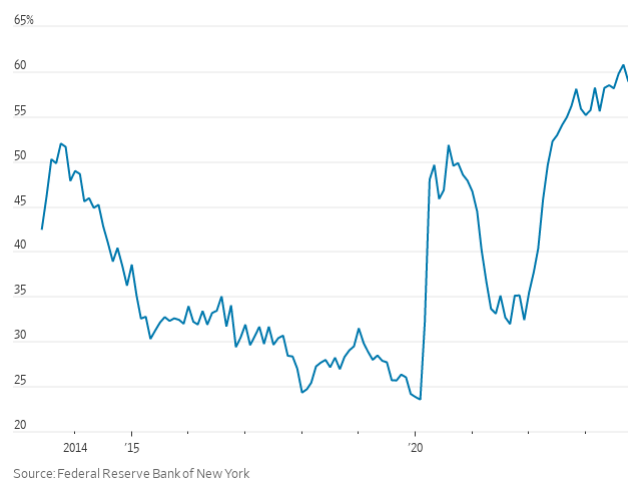
In addition to the *yield curve* and *employment indicators* above, other recession indicators continue to point to a

downturn ahead. One indicator is tightening lending standards from banks for both consumers and businesses.

Banks' Willingness To Lend To Consumers Approaching Recessionary Levels



Share of respondents who say it has gotten harder to obtain credit over the past year



After a 13-year bull market that started in 2009—the longest bull market in U.S. history—the historic business cycle is now rolling over from an expanding and growing U.S. economy to a contracting and slowing bear economy.

Changing directions for the largest economy in the history of the world is like turning around an aircraft carrier. *It takes time.*

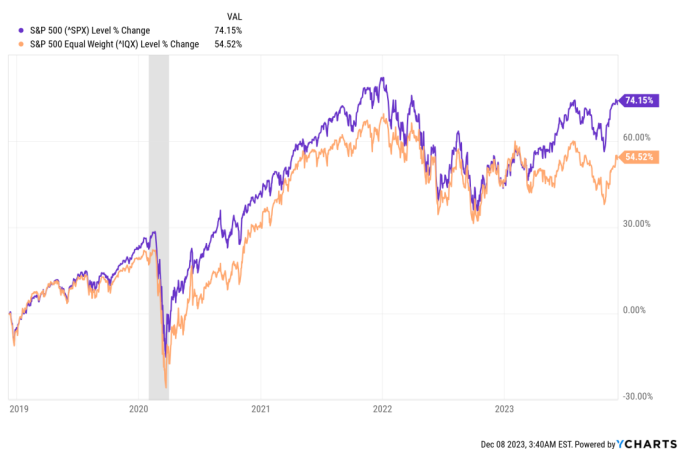
The Last Death Throes Of An Economy Rolling Over

Below are some of the classic signs we see right before every recession as it transitions from expansion to contraction.

- *Explosive stock market rallies*, like the almost 10% *S&P 500 Index* gain in November, are common right before almost all recessions formally start. Just look at the chart below. The shaded areas are actual recessions.



- In the stock market, the normal cap-weighted *S&P 500 Index* is up almost 20% year to date. At the same time, the average stock represented in the *S&P 500 Equal-Weighted Index* is deep in correction territory.
- Normally, when the stock market goes up, gold goes down. When gold goes up the stock market is usually declining. Right now, both gold and the stock market are climbing. That is another *disconnect* in the markets.

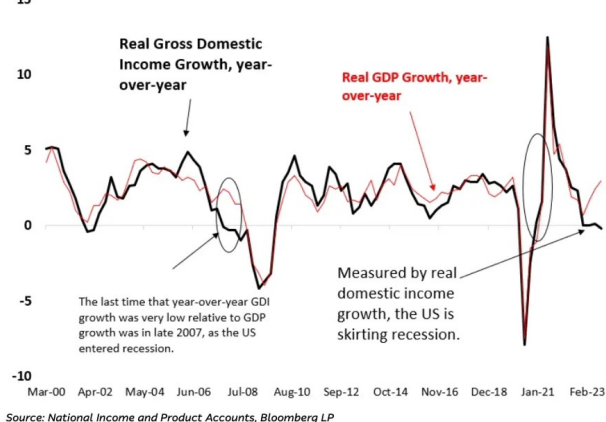


- The same thing is true for employment, the *Establishment Survey* showed ongoing gains in

nonfarm payrolls, and the companion *Household Survey* is highlighting serious cracks in the labor market, showing plunging full-time jobs through the second half of the year.

- The *Inverted Yield Curve* is the classic stock market disconnect that forecasts an upcoming recession when short-term bond yields are higher than long-term bond yields, which is opposite of the norm.
- There is also an unprecedented gap between real *Gross Domestic Product (GDP)* growth, which is signaling "no recession" and real *Gross Domestic Income (GDI)* growth, — the measure of total compensation given to production — *which is signaling a recession*. These two reports are normally almost the same. The gap between the two could explain why Americans feel poorly about the economy despite last quarter's robust GDP growth. These reports also suggest there is "*below-trend growth in real incomes, especially when considering the drawdown in household savings.*"

Figure 1 - US: GDP and GDI, Year-Over-Year Real Growth, through Q3 2023



Sky-High Valuations, Deteriorating Fundamentals & Poor Equity Market Math

The lags from the *Federal Reserve's* aggressive interest rate increases to 5.5% are slowly starting to kick in.

However, many investors are still embracing the "no-recession" view — pushing stocks higher on sentiment and momentum.

To think that after a 13-year bull market, we will not see a normal cyclical bear market recession, is to believe that the business cycle has been miraculously repealed after over 400 years of historic stock market cyclical data. *They believe this time will be different. It never is.*

The Underlying Economy Is Not Healthy

I do not remember a time when consensus forecasts on ‘soft landings’ or a recession have had so much difficulty sticking for more than a few weeks to one dominant economic narrative.

A large number of analysts and economists [including myself] have been warning of a potential recession since signs began in late 2022 when the Fed started to aggressively raise interest rates to tame high inflation.

There is always the possibility that higher rates can cause overtightening financial conditions and push the economy into a recession.

Right now, the Fed rate hikes are already beginning to flash a number of warning signs across the economy.

Cracks Are Starting To Appear In Labor Markets

Job gains have slowed and unemployment claims are rising. Two years ago there were almost 12 million unfilled jobs. Last month that number dropped to 8.7 million.

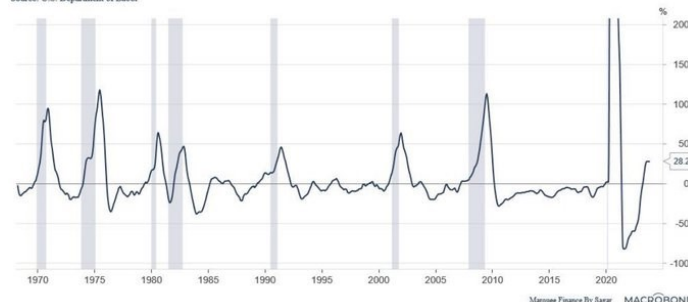
Labor Department data showed continuing claims for unemployment insurance rose to 1.93 million in the week ended Nov. 18. The figure has been climbing since

September 2023, suggesting out-of-work Americans are finding it more difficult to secure new employment.

The labor market has finally begun to soften, with continuing unemployment claims *jumping to recessionary levels*.

US Continuing Claims 3MMA (YoY% Change)

Source: U.S. Department of Labor



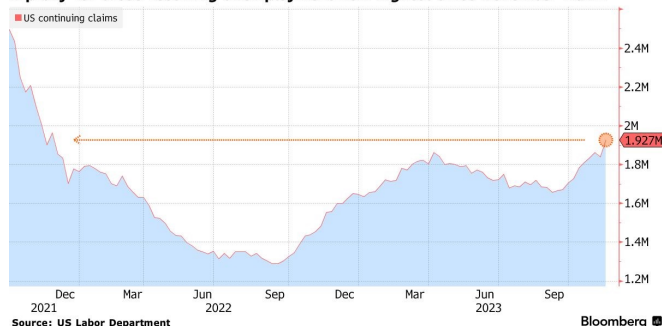
With employers scaling back hiring and wage growth decelerating, it's unclear how much longer the job market will underpin strong consumer spending.

Following peaks in past *Federal Reserve* hiking cycles, employment growth has historically slowed for another two years—meaning further slowing may be ahead.

Small businesses continue to be pessimistic on future hiring. Given that small businesses account for about 60% of all hires over the last three decades, this does not bode well for the labor market.

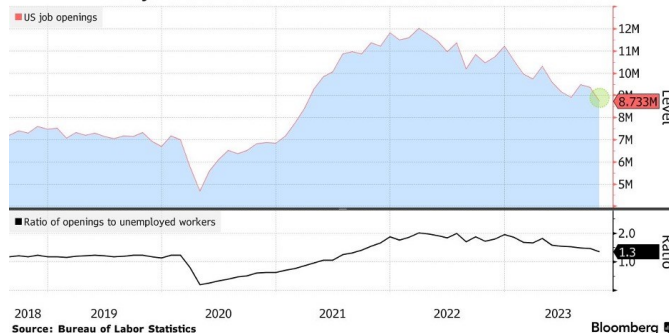
Continuing Applications for Jobless Benefits Surge

A proxy for those receiving unemployment now highest since November 2021



US Job Openings Dropped in October

Vacancies and key ratio fall to lowest levels since 2021



American Consumers Are Running Out Of Steam

While *Black Friday* sales may have posted record numbers, households have largely drawn down their excess savings from the pandemic, and monthly retail sales in October posted their first decline in seven months — a possible sign that a consumer-led slowdown is on the horizon.

This does not bode well for consumer spending going forward. A coming slowdown where consumers are weighed down by credit card debt is another factor pushing the U.S. economy into recession. That slowdown could come sometime in the first quarter of next year.

Many consumers are reaching their *credit limit on their cards*. Even for those with jobs, we could see a dramatic pullback in consumer spending after the holidays.

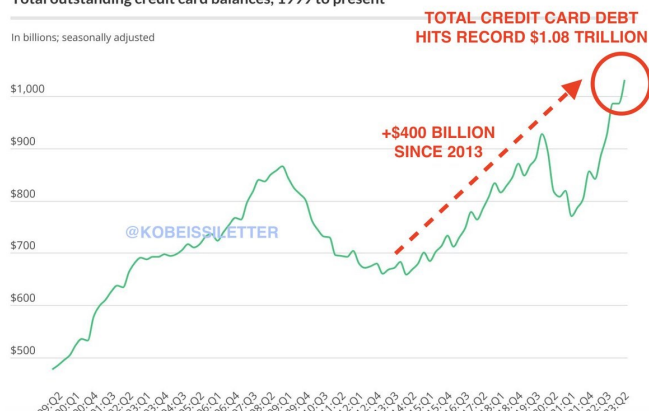
Consumer spending makes up about 70% of the U.S. economy. Historically, we have seen dramatic drops in consumer spending as individuals start to *reach their credit card limits*.

Credit Card & Other Consumer Debt

- Total credit card debt in the U.S. rose by \$48 billion in Q3 2023, to a record \$1.08 trillion.
- Meanwhile, interest rates on credit card debt are at a fresh record of 25% to 33%.
- The average consumer is now spending \$1,600/month on their credit card.
- Nearly 40% of U.S. households now have more credit card debt than savings.

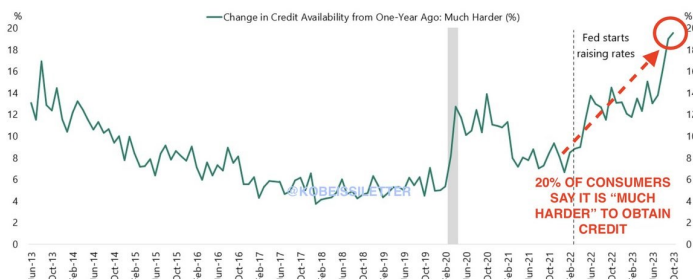
Total outstanding credit card balances, 1999 to present

In billions; seasonally adjusted



Source: Kobeissi Letter

- The average household has nearly \$10,000 in credit card debt.
- Inflation is sending many consumers into a debt spiral.
- A record 20% of consumers now say it is "much harder" to obtain credit. In other words, the number of consumers who believe it is harder to obtain credit has more than DOUBLED in 1.5 years.



Source: Kobeissi Letter

- As \$2 trillion in excess savings have been depleted and a long *Federal Reserve* rate pause is ahead, this will get worse.

- Credit card defaults were at 9.5% on the eve of the 2008 financial crisis. Today they are at 9.4% and rising.
- Nearly 1 in 5 car payments are now about \$1,000 per month. That is a record high. People are falling behind on car payments also.
- Retail shoppers are ringing the recession bells.
- Credit card debt and other forms of debt have fueled spending this holiday season. But how long can this really last? The era of "free" money is over.

The Stock Market Is Completely Disconnected From The Underlying Economy

Seven mega-cap, high-tech stocks, *Apple*, *Microsoft*, *Alphabet [Google]*, *Amazon*, *Nvidia*, *Tesla*, and *Meta [Facebook]*, have accounted for over 95% of the *S&P 500*'s gain this year.

These stocks, now referred to as the *S&P 7* or sometimes as the *Magnificent 7*, are the largest tech stocks in the *S&P 500*.

On a price-to-earnings (P/E) basis, the *S&P 7* are now as overvalued as many tech stocks were in the 2000 *Dot.com* bubble and the *Nifty Fifty* stock craze in 1972.

The *Nifty Fifty* was, to use a description employed by Wharton professor emeritus Jeremy Siegel, "a group of highflying growth stocks that soared in the early 1970s, only to come crashing to earth in the vicious 1973-74 bear market."

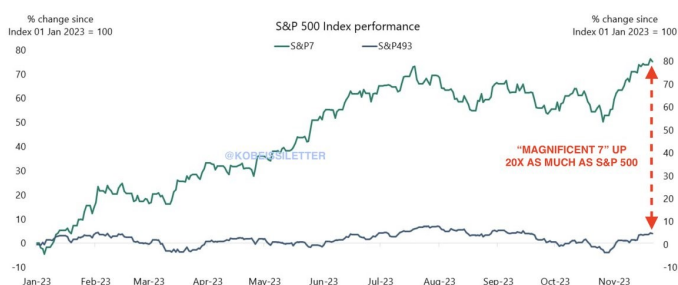
The P/E ratio on some components of the *S&P 7* is now more than DOUBLE the levels seen in those previous bubbles. For example, *Nvidia* has had a P/E ratio as high as 115x this year.

For context, without these seven companies, the *S&P 500* is up just 4%-5% this year.

S&P7	Trailing P/E	Tech bubble	March 2000 P/E	@KOBESSILETTER Nifty Fifty	1972 P/E
Meta	22	Intel	41	Coca-Cola	46
Amazon	68	Cisco	100	McDonald's	71
Apple	31	Dell	57	Texas Instruments	40
Google	25	Microsoft	51	IBM	36
Microsoft	36			Xerox	46
Nvidia	115			Polaroid	95
Tesla	75				
Average P/E ratio	53	Average P/E ratio	62	Average P/E ratio	56



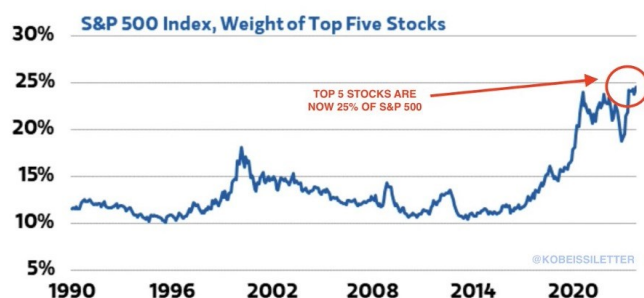
These charts show the *Magnificent 7* up 80% in 2023 while the remaining 493 stocks of the *S&P 500* are basically flat.



The *S&P 7* now make up almost 30% of the *S&P 500 Index*'s market capitalization. The other 493 stocks make up the other 70%. This concentration in a handful of tech stocks might be one of the riskiest and least diversified in *S&P 500 Index* history.

Those same seven stocks currently account for ~70% of the *Nasdaq*'s gain this year.

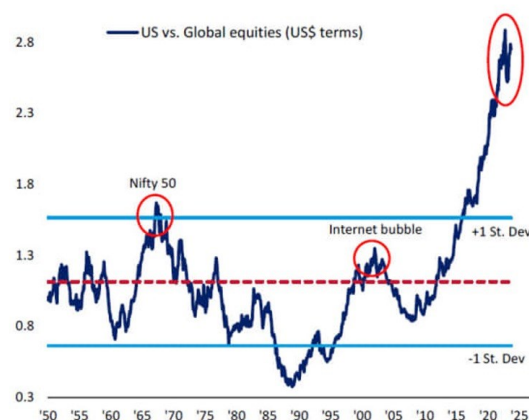
US Equity Concentration Is at a Record Level



These seven mega-cap tech stocks are currently surpassing *Small Cap Stocks* by the widest margin ever recorded in history, even exceeding the peak of the *Dot.com* bubble.

Exhibit 32: US is near extreme peaks vs. global equities, well exceeding the 60s/70s Nifty-50 and 2000s tech bubbles

US vs. World ex-US equities (relative price performance, USD)



Source: BofA Global Investment Strategy, Global Financial Data

Either the *S&P 7* are holding the U.S. economy together, or we are in extremely overbought territory.

Can these stocks continue to carry the entire stock market? What happens when tech stocks pull back and the entire market is held up by them?

Will 'The Federal Reserve Cut Rates Soon' — Be Careful What You Wish For

Despite Federal Reserve officials continuing to state over and over again that "*rates will remain higher for longer*" and that they will not cut rates any time soon, many investors and analysts believe the Fed will start cutting interest rates from mid-2024 in an effort to prop up the economy.

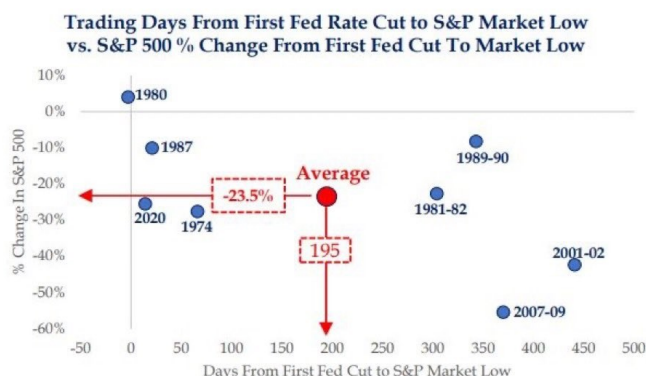
In normal bull markets, when interest rates fall, stocks tend to benefit because it becomes cheaper for listed companies to borrow, boosting their future cash flows.

But investors shouldn't count on the central bank lowering borrowing costs unless the U.S. economy falls into a severe recession—which may happen early next year.

The Fed almost never cuts rates during prosperous bull markets. Why should they?

The Fed typically starts cutting rates when there is a sharply slowing economy and rising unemployment—meaning a recession.

The chart below is a historical look at what happens to the *S&P 500* when the Fed pivots and starts cutting rates.



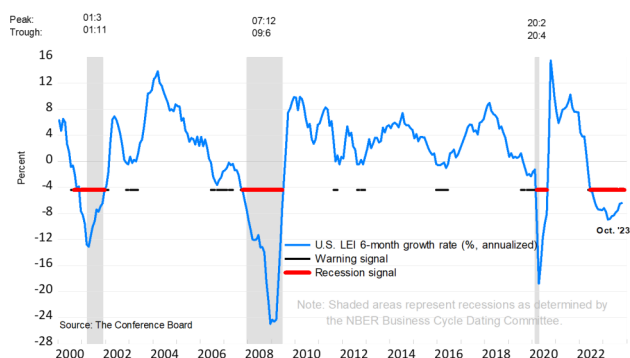
On average, the *S&P 500 Index* has fallen -23.5% over a period of 195 days from the first rate cut to the market low.

U.S. Leading Economic Indicators

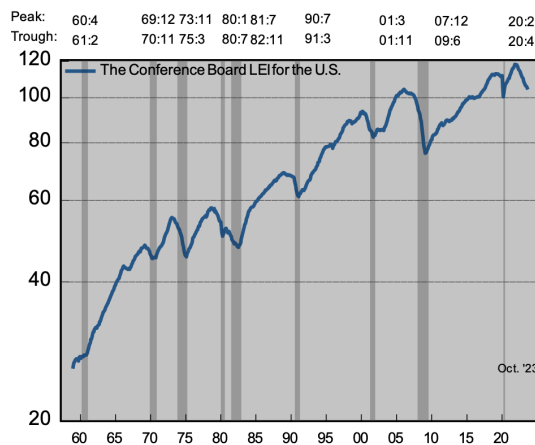
The *Conference Board Leading Economic Index[®] (LEI)* for the U.S. declined in October for the 19th consecutive month.

This 19-month streak was only exceeded in the 2008 recession period and 1974 recession period.

territory in October,” said Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board. *“Among the leading indicators, deteriorating consumers’ expectations for business conditions, lower ISM[®] Index of New Orders, falling equities, and tighter credit conditions drove the index’s most recent decline. After a pause in September, the LEI resumed signaling a recession in the near term. The Conference Board expects elevated inflation, high interest rates, and contracting consumer spending—due to depleting pandemic saving and mandatory student loan repayments—to tip the US economy into a very short recession. We forecast that real GDP will expand by just 0.8 percent in 2024.”*



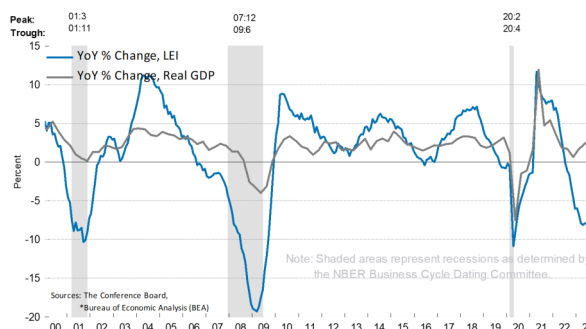
U.S. Composite Economic Indexes (2016=100)



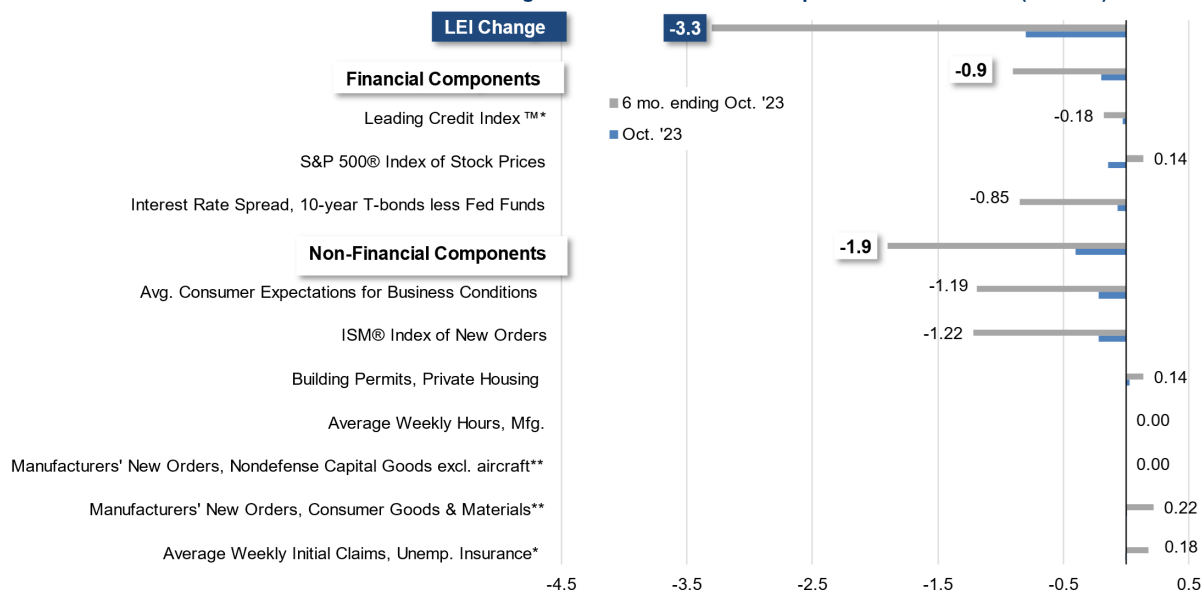
The *Conference Board* marks a recession trigger when the growth rate of the LEI falls below -4.5%.

The growth rate in October fell to -7.3% which marked the 13th consecutive month when the LEI formally signaled a recession.

According to the Conference Board press release, *“The US LEI trajectory remained negative, and its six- and twelve-month growth rates also held in negative*



The Conference Board Leading Economic Index® and Component Contributions (Percent)



Source: The Conference Board
 * Inverted series; a negative change in this component makes a positive contribution.
 ** Statistical Imputation
 LEI change might not equal sum of its contributions due to application of trend adjustment factor

U.S. LEADING ECONOMIC INDICATORS (DECEMBER 2023)

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

The updated monthly table on the previous page 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.

Paul Dietrich, Chief Investment Strategist, B. Riley Wealth

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*.

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