Who Benefits at the End of a Rate Hiking Cycle?

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Ed D'Agostino:

Hi, it's Ed D'Agostino from Mauldin Economics, and this week on Global Macro Update, my friend Sam Rines of Corbu Research joins us to talk about how to invest in the markets today.

It's always a pleasure. I'm really excited to talk to you about the markets because you've been so right this year. It's really impressive that you've dodged all the pitfalls that a lot of other economists have had. You coined a phrase. You coined a couple of phrases. First it was POV, price over volume, but now you've got something new. For the viewers that maybe haven't kept up with your and I conversations, could you maybe explain price over volume and then what you've moved on to, how you see the rotation happening in the economy?

Sam Rines:

Sure. About a year ago, a little over a year ago, one of the things that we began to notice at Corbu was this significant move by companies to choose price over volume. We call it POV. But this price-over-volume trend was everything from Pepsi and Coca-Cola to things like your everyday items at the grocery store. It was a pretty wide-ranging trend, restaurants included. Nearly everyone seemed to really want that pricing instead of volume. It makes a lot of sense. Price helps you maintain margins in an environment where you may not have the ability to pick up volume.

We began to see this happening in the first and second quarter of last year. What we suspected would happen as we came into the middle to latter part of 2023 was that this price over volume was going to begin to become price and margins. We call it PAM. One of the reasons that we call it PAM is Conagra, and Conagra was really the first one this earning season that really made it clear how much of this price was flowing into margin. PAM is one of the products that Conagra makes.

Price and margin, PAM, kind of made a lot of sense. But one of the curious things about this price and margin evolving from POV is that it's really powerful, and you've seen it from companies like Sherwin-Williams where they raise price, raise price, raise price consistently because input prices and labor costs were going higher. Then all of a sudden, their input costs began to decline, and they began to drop a lot of money to the bottom line. Their margins really began to expand because they didn't have to move their pricing at all.

They got a little bit of volume back. And all of a sudden, all of the pricing that they had put in to deal with those input costs began to flow to the bottom line. Our suspicion, that is turning out at least thus far this earning season to be true, is that this was going to be an era where companies attempted to hold the line on pricing for as long as possible and really capture those margins. That's really the essence of that price-over-volume trend beginning to evolve into a price-and-margin trend that could be a really powerful factor moving forward for markets.

Ed D'Agostino:

Why do you think it started? What do you think started the trend? Was it maybe a tight labor market, companies not able to get labor, so not able to produce as much, so they decided to just go for margin?

Sam Rines:

No. I really don't think it was so much on the labor front. I think it was that they had an excuse to increase prices. If all you hear about in the news is that gasoline prices are moving higher, supply chains are broken, et cetera, et cetera, it's awfully easy to, if you're a company, find an excuse to increase prices. We all know that there are fuel surcharges on trucking, there are fuel surcharges on shipping, et cetera, et cetera. It was basically that model and that idea of if the consumer's willing to take it, why not push that price and really not have to suffer too much on the volume front?

Most of the companies that you see pushing pretty significantly on price really haven't seen that significant of an effect on volumes. Once they had that excuse to increase prices, they did. And they found that as they increased prices, consumers were willing to take it. As long as the consumer's willing to take that price, companies are more than willing to increase price and continue to have a fairly attractive growth model. When those volumes come back, if they do come back in any significant way, that's going to again be margin enhancing.

It's kind of a get the easy margin with price, and then eventually down the line you continue to get margin via volume. It's going to be really interesting.

Ed D'Agostino:

I think I read in your last couple of notes to your readers that input prices are starting to go down, but that companies like Sherwin-Williams aren't passing that on to the customer. They're not lowering their prices. That has to be incredibly frustrating for someone like Jerome Powell.

Sam Rines:

It does, but at the same time, there's a difference between disinflation and deflation. The Federal Reserve doesn't want deflation outright. That'd be pretty bad in their thinking. But in terms of what they're doing, you're not seeing prices move lower. In fact, you're continuing to see price. Kimberly-Clark announced earnings today, and it was interesting. They had a significant amount of price. I think it was 9% pricing in the quarter.

You're not seeing prices go down. You're seeing a deceleration in how much price companies push through. That is what should be disconcerting to Jerome Powell is that you continue to have pricing being pushed. The idea that the input prices are declining is true. I mean, it's 100% true, but that's falling to the bottom line. It's not falling to the consumer.

Ed D'Agostino:

You manage a portfolio. How do you factor in rates? What do you see the Federal Reserve doing moving forward? Do you think they're satisfied? Do you think it's going to be one more rate hike and then they're going to pause for an extended period of time? Or are you preparing for more and more hikes?

Sam Rines:

I wouldn't say more and more hikes. I would say you probably have two more hikes in the system. There's one coming this week and there will be another one at some point in the back half of this year is our thinking at the moment. It's for two reasons. One, inflation is somewhat sticky, particularly on the services front. You already had the easy deflation behind us in terms of goods. Services deflation tends to take a little bit longer. I would say two more hikes is the bogey at this point.

When you look at how strong the consumer is, I think that should be a little more disconcerting to the Federal Reserve than the current inflation rating. Those are going to be a little bouncy, but I would say you really need to have a consumer that is less willing to spend, less willing to really drive the economy, and maybe begin to pull back on the margins. When you look at how powerful the consumer has been over the last year, last year at this time, everyone was talking about a recession coming in the back half of 2022.

That did not happen. Now everybody is looking for the recession in '23, late '23, early '24. I would say the US consumer has continued to push the recession out. And unless you begin to see something really crack on the consumption front, it's really difficult to see the Fed begin to back off in any meaningful way. Skipping a meeting, hiking skipping a meeting, hiking seems to be the current cadence, and I think they're fairly comfortable with that. It's basically a 12.5 basis point hike every meeting.

It's just a slowing of 25 every meeting to 12.5. It's not an end to the rate hike cycle. But I would also say that interest rates really haven't done to the economy what we would have expected them to do. If you look at something like some of the housing ETFs, some of the housing names in the market, they're trading at one-year highs or very close to it in a number of cases. They're announcing killer earnings.

Again, they're seeing their input costs decline, particularly lumber costs on a year-over-year basis decline outright, but they're holding the line on home pricing and offering a couple of points as an incentive instead of a discount on the house. We like to make these big glorious headlines about these home builders having to give people points on their mortgage to get them in their house, but it's just a trading off of what the usual incentives were to begin with.

I think the usual suspects in a rate hike cycle haven't been the usual suspects this time around, and that should be much more disconcerting to the Fed and investors who are looking for a top in the rate cycle than anything else.

Ed D'Agostino:

What do you think it takes to get the consumer to stop spending? Is this normal? Are they still spending because they're still healthier than average? They have better cash than savings balances. Or do you think that there's been a change in the consumer? When you travel right now, I mean, everyone's out. Airports are full. Cities are packed. Restaurants are packed. It's the YOLO mentality it feels like. Has something changed with the consumer?

Sam Rines:

Well, everybody got a pay raise. I mean, everybody got a pay raise coming out of COVID. If you wanted to maintain your staffing levels, you had to give people pay increases. If you wanted to attract a worker, you had to give significant pay increases. People continue to see their wages move higher, their salaries move higher. If you're on Social Security, you got a 9% pay raise this year. You have a significant amount of, call it, wage gains that are flowing through the system that are...

They're helping the consumer. They're making the consumer feel better. When the consumer sees a 5 to 7% change in their wages and salary, they get pretty excited. They don't really care

that prices are moving up. Consumer confidence, particularly over the last month, has spiked, and you've seen call it a surprisingly happy consumer emerge. There's a lot of these underlying trends that I think aren't getting enough headlines. This isn't necessarily the new normal for the consumer.

It's the consumer catching up to what it would've done had COVID not been around. I don't think it's a new normal, but I think it's something to accept as a tailwind moving forward. Another thing that I would add is until you begin to see wages decelerate back to something normal, it's going to be very difficult to crack this consumer. The consumer's balance sheet returning to normal, but seeing a 5% nominal pay gain, that's going to keep the consumer moving. It doesn't really matter if their balance sheet goes back to normal, they'll spend from cash flow.

Ed D'Agostino:

Is it safe to assume then that you're still bullish on the markets and do you see any kind of rotation? Because a few weeks ago, everyone was talking about a big sector rotation, and then tech seems to have just bounced right back.

Sam Rines:

I wouldn't say that I'm overly bullish on equity markets at the moment from a call it a top-line S&P 500-type number, but I am fairly bullish on the ability of equities to push higher, particularly in different pockets. I think if you really go down and dig down into the sector-by-sector level, you can find some pretty interesting stuff underneath the surface. For instance, if I told you that housing would be the big winner in a Fed rate hike cycle, you would've thought I was insane.

But the question is, as you begin to approach the end, or at least you know you're in the call it the slow Fed, not the fast Fed phase, the question is, who does that benefit and who benefits when you eventually get to the end of the rate hike cycle? I would say you're beginning to see some movement on the industrial side, particularly some of the Caterpillar, Deere type companies. You're beginning to see a real bounce back in the shipping companies that have really been left for dead, the J.B. Hunts of the world and the like.

We're in a shipping recession and J.B. Hunt's pretty close to a one-year high. I think there's a lot of things underneath the surface that are, saying maybe the economy isn't as bad as we thought. Maybe the end of the destocking cycle is at least able to be seen by some of these companies, and maybe you can begin to have green shoots in places where it's been pretty negative. As soon as you begin to have some cracks in the services side of the economy, maybe manufacturing bounces back.

I think that's going to really catch some people off guard that the services economy really powered us through a manufacturing recession. And if, all of a sudden, services begin to slow back to some normality and manufacturing begins to pick back up, that's going to catch a lot of people wrong-footed. I would be looking at the industrials. I'd be looking at some of the places that are a little boring in terms of investing. I wouldn't necessarily be all over the AI craze. Is AI good? Yes. Is AI great? Yes, but I wouldn't necessarily be putting all my eggs into that basket. I would really be spreading it out into some of those sectors that have really been under pressure as we've moved through the first half of 2023, looking at what does the end of the destocking cycle look like? What does call it a return to normal after COVID look like?

Ed D'Agostino:

How about energy, Sam? Because I know going back to last summer when you and I were together in Maine visiting our friend David Kotok, you were pretty bullish long term on oil and gas. How do you feel today?

Sam Rines:

I'm still bullish longer term. I do think that you're beginning to see the effects of a much more restrained oil patch. The oil patch for the majority of its history, particularly in Texas, has not been call it capital curative. It's burned a lot of cash. But what you're beginning to see are companies really looking at cash flow over poking holes in the ground. That is beginning to have some consequences. Those consequences that you're seeing what looks to be kind of a top in Permian production near term.

You're beginning to see some signs that maybe you're having a little bit of a tightness, particularly in the US oil market. I think that is really something that can continue. Assuming that you begin to have a manufacturing call it comeback, you begin to have some infrastructure building, and the US consumer goes back to normal but continues to drive. You continue to have some people go into the office. All of these are things that are going to require oil and energy.

I think you're going to consistently have at least pretty normalized demand and you're unlikely to have a significant increase in supply anytime soon.

Ed D'Agostino:

Any other sectors that you might want to highlight? Real estate, for example. How about commercial real estate, which that's a giant blob with lots of things in it? But what are your thoughts in general?

Sam Rines:

There's this really interesting bank, and this is a big rabbit hole, so thank you for bringing this up. There's this little bank called Bank of Hope, and it has this great presentation every quarter. It's one of the ones I like to look at because they break it down and they break down their CRE pretty nicely. They break down everything into these little buckets. Something that is interesting to me is we kind of say, commercial real estate is in trouble office, blah, blah, blah. But in reality, it's very, very specific to offices people don't want to go back to. That's really what it is.

When we talk about CRE, there's an awful lot of dentist's office, doctor's office. Those are things that it's really hard to do an exam from when you're not there. It's really hard to get your teeth cleaned if you're not there. These are places that are going to be occupied. They're going to get paid as long as the business is viable, and going to the dentist and going to the doctor tends to be something you do even in a downturn. While I would say that I wouldn't really want to be exposed to a high-rise, I don't think it's all that bad for all real estate.

I went through a lot of the real estate investment trust earnings reports, and the difference between the earnings reports of people who own New York City high-rises, Boston high-rises, whatever it might be in terms of office and the tone of an industrial property operator is wild. I mean, you would think that Armageddon was coming if you read the CRE guys and office guys, and you would think everything was booming if you just read the industrial side. I do think that there's a significant difference in what's being demanded and how it's being demanded in terms of property.

But at the same time, if you have an office building in a place that nobody wants to go back to, you're going to be in trouble. The question is, is office buildings and call it the work-from-home movement really going to break the overall property market? I think those predictions are a little overblown. I just don't think it's going to be that big a deal. We tend to figure out what to do with things rather quickly. And frankly, it's not like the home mortgage industry. I don't think it can bring Wall Street to its knees. It can certainly hurt a lot, but I don't think it can be devastating.

I would also point out that the other property types that are pretty interesting typically are cell towers. You would think with all of us on our cell phones working from home, et cetera, those would be booming. But at the same time, AT&T and Verizon haven't exactly had the best of all worlds lately. They're actually delaying the 5G rollout, which is hitting the tower companies pretty hard.

I think there's a lot of dispersion within real estate and the real estate investment trust world that you really have to pay attention to in order to understand what's really going on. If you think that you can just short REITs and be okay, I think that's a pretty dangerous thing to think.

Ed D'Agostino:

Well said. That was a great explainer. You have a new product or a new offering out with our friends over at WisdomTree, a model portfolio. Can you tell me a little bit about what that is, what is a model portfolio, and how can you access it?

Sam Rines:

Sure. A model portfolio is a portfolio of ETFs designed to capture Corbu's thematic thinking around markets and how we think a portfolio would be best positioned for this environment. It's a portfolio of WisdomTree ETFs designed around our themes and our ideas. Those three themes being re-regionalization. I think we can all kind of look around us and say there's a significant amount of manufacturing that is either coming back to the US, coming to Mexico. It's coming closer in.

If there's one thing that COVID really did, it has taught us that you do not want to have your supply chain an ocean apart and in a part of the world that you really don't know how the policies are going to evolve and whether or not you're going to be able to build and supply your product. That's the first largest call it theme in the portfolio. And that encompasses our thinking about US markets, particularly equities and how we structure that. The second theme and the second largest in the portfolio is allies, the return of the allies.

Getting a little bit of a Star Wars vibe there, but the idea being that for a long time it was a pretty simple business operation. You just built a factory in China. It was cheaper. You brought it back to the US and you took a spread. That has really ended, and you're going to have to have a much more significant base, both of manufacturing and of intellectual property, based within the allies. Those are both allies in terms of economics, but also in terms of what we're seeing between Russia and Ukraine.

The final theme is from the Fed's POV playing on the price over volume and how we're thinking about that. That's framing our, at least currently framing, our outlook for fixed income, which is we do really like the positioning of call it one-to seven-year-type Treasuries and corporates. If you're going to have a very slow-moving Fed from here, it's worth capturing some of that yield. If you do have some hiccup, the Fed is going to cut and it's going to cut significantly. And that's an easy way to have some exposure there and to have call it a hedge with a 5% give or take yield on it.

That's our thinking and that's the way that we frame our portfolio and provide research around it and constantly thinking about whether or not the themes need to evolve, the positionings need to evolve, and whether there is some pending change. We have something called the back book of ideas. It's the back burner where something isn't necessarily ready to be a theme, it's

not ready to be an investment, it's not ready to go into the portfolio, but it's something we're really paying attention to.

It's something that could really alter the outlook either for the returns of the portfolio, the returns of the overall theme, and really get a handle on what's going on there. In this case, that would be the destocking cycle and how we're thinking about that is in the back book and thinking about how that would alter, really, the outlook for either the return of the allies, re-regionalization and how we would restructure some of the investments under there if we begin to realize that as occurring and actual.

Ed D'Agostino:

Sam, when you say destocking, you're talking about companies moving out their excess inventory and getting back to a more normal inventory level. Is that correct?

Sam Rines:

When we came out of COVID, a lot of companies, a lot of retailers in particular, massively over-ordered. It was a tremendous trend. It took a long time to work through that inventory. Whether you're a wholesaler or retailer, you tended to have an elevated level of inventory. That's why it was so good for goods at the beginning. That's taken a while to work through, and now you're beginning to see some signs that maybe that process is over.

As you sell those products down, you destock. And at some point, you need to reorder to either maintain a decent level of inventory or to restock back to something that makes you comfortable that you can capture sales. As we approach call it the holiday season in particular, it's going to be really interesting whether we begin to hear more stories of either the end of the destocking cycle or the beginning of a restocking cycle.

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