Behind the Markets with 314 Research: Outlook for economy, commodities, and real assets

Published July 31, 2023

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We recently had the opportunity to speak with Warren Pies, founder of 314 Research, on our Behind the Markets podcast about his views on the economy, commodities like gold and oil, and his quantitative modeling for the markets and asset allocation portfolios. Below are some highlights of the conversation:

- **Out of consensus calls:** 12 months ago, 314 Research wrote a report saying a 2 handle on the consumer price index (CPI) was possible, when inflation was 9%. It got very close to that number with the latest inflation report[1]. Their current out of consensus call is with regards to 2024 earnings expectations for the market that are currently expected to grow 9%. Warren's big picture concern for the markets is excess optimism and earnings expectations being too inflated with margins being a key risk. Warren pointed out that 70% of S&P 500 Index costs are wages, which are still growing. Interest expense is also rising. 100 basis points of margin compression would take down $20 of S&P 500 Index earnings per share (current estimates of $242)[2].
- **Will AI come to the rescue?** Warren's team will be producing a deep dive into the implications of AI from their machine learning expert, but he is skeptical this will impact 2024 earnings and productivity in a meaningful way. If anything, there might be a capital expenditure cost increase as firms invest for the future payoffs. Stay tuned to 314 research in August for more on the implications of AI.
- **Pushing back recession call:** Warren's team looks at housing as a key leading indicator for the economy. Warren's work shows leading into a recession, residential construction payrolls have dropped 8-10%. And the robust trends in housing starts and construction activity, with very little job losses in construction despite the increase in mortgage rate, implies the economy will stay resilient until at least Q2 of 2024.

- **Tactically bullish energy:** Warren walked us through his team's modeling of energy prices. He outlined his framework that evaluates factors like market technicals, positioning, inventories, and how the Singapore crack spreads are one of the key inputs he is watching for the future direction of oil prices.
  • **Fading recession trades:** One factor impacting oil prices was speculators piling on recession trades. Strong economic data caused some of those shorts to be taken off recently but there could be more of an unwind still to come. In Warren's view, to see more support for oil to get above $90 to $100 would be the fundamentals of the physical economy improving. This is where measures like the Singapore crack spreads (here Warren is watching to see if can get back above $20) reflects better demand for oil in Asia, particularly from China.
- **Gold bull:** Warren's models for gold paint upside potential to new highs. And what drives gold can vary based on different market regimes. His models rely on technicals as price can be a final arbiter of all assessments. But gold runs as an antithesis to the dollar – and given how the dollar has weakened recently, one might think gold should have rallied even more. But gold is also trading off a forward view of Fed policy. All of 314's gold model inputs look bullish, as of this conversation.
- **Stocks, bonds, and real assets:** One of the founding principles of 314 Research was a view investors would need to reintroduce inflation risk into portfolios by incorporating real assets into portfolios in a more dynamic way. Warren believes a longer-term change in correlations between stocks and bonds necessitates a new framework for long-term asset allocation. A 60/40 has revived from the dead this year, but alternatives like metals, energy, managed futures, and even bitcoin can be useful complements to hedge these inflation risks. This real asset model is one of the core features of the 314 research offering.

To listen to our full conversation with Warren Pies, go here.

[1] Source: https://www.bls.gov/cpi/

[2] Source: https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-eps-est.xlsx

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