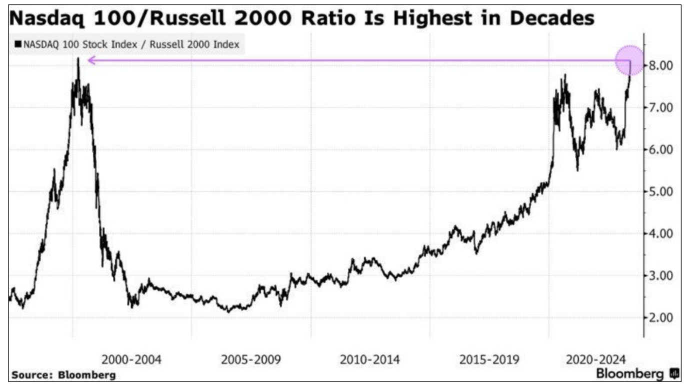
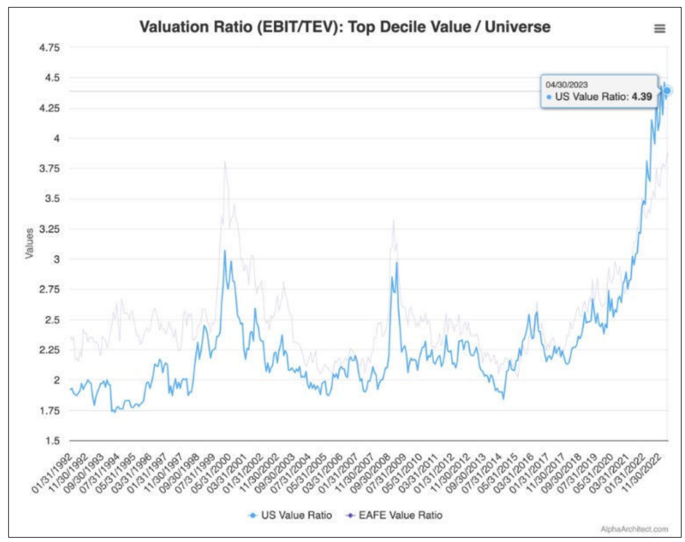
The Long & Short of It
Quarterly Newsletter
Second Quarter 2023

Bubbles, Babies, & Borrowing

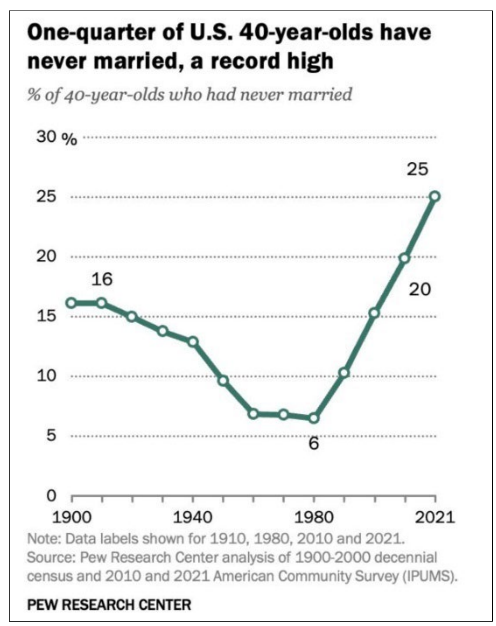


During the second quarter of 2023, inflation grudgingly continued to moderate. The stock market, still awash in liquidity, celebrated. Big tech initially led the way as expectations for future interest rates fell. Then ChatGPT kicked off another season for big tech as Wall Street decided artificial intelligence (AI) would result in the imminent transformation of the world. Déjà vu for those who watched the bubble formed in the late 1990s as the dot-com revolution seemed poised to change the world. Lack of infrastructure (a large-enough fiber-optic pipeline) slowed that rollout by a decade.



While some of the benefits of AI will take place rapidly and many of the optimistic AI visions will happen eventually, technological transformations are frequently more evolution than revolution. And although big tech may go higher before the bubble bursts, some constraint(s) unseen in this initial excitement will slow the trajectory of AI built into current pricing.

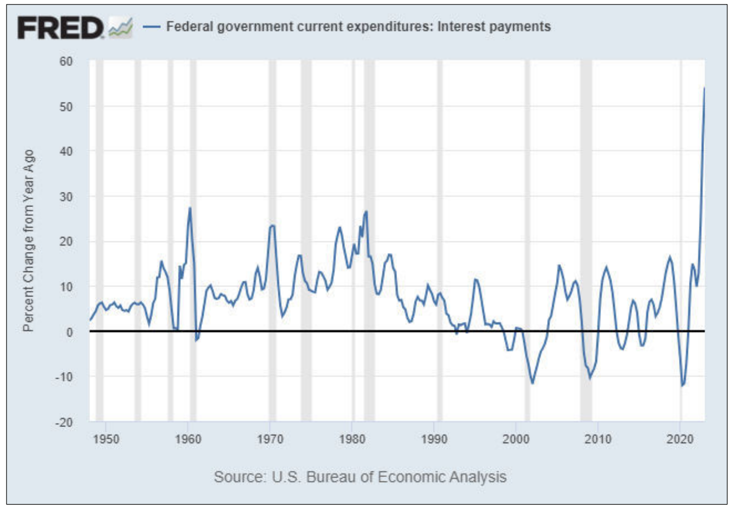
On average, the stocks of the 200 or so large-cap industry leaders we closely follow seem moderately-to-significantly overpriced, primarily due to perhaps unsustainably elevated interest rates. Moreover, the broader market does not seem cheap. Equity markets appear to be having a "calm before the storm" moment. In investing, calm feels like certainty, which is great for valuations, especially of those investments with widespread media coverage. The economy continues to grow, employment is strong, and too-hot inflation is finally quietly moderating. But the Federal Reserve is still tightening/raising interest rates. Although now at a slower pace, this episode is the largest tightening since the 1970s. Unlike the 70s, however, the US economy is less robust and rather fragile.



In the 70s, baby boomers were landing their first jobs, launching their families, and building houses, all activities that drove massive aggregate demand and economic growth. Today those same boomers are retiring, selling their second/vacation homes, and downsizing. The boomers remain the "pig in the python" as they had more brothers and sisters than children and their demographic continues to drive the economy. Their children (Gen X and Y) are not getting married and having children at the same rate. Pew recently reported that in 1980, 6% of 40-year-olds had never married. Today that number is 25%.

Demographics drive massive headwinds in the current economic environment. With slow growth comes low interest rates that facilitate borrowing. A large portion of the growth seen over the last 20 years has been due to the federal government's spending and expansion as facilitated by debt issuance and/or money printing. Moreover, the unprecedented flourish of debt added during COVID continues to keep the economy going even today. It is actually amazing the US did not have more inflation. Can you imagine the inflation that would have resulted from an inflation-adjusted $7B of deficit spending and Federal Reserve balance sheet growth in the 70s?

Debt: Delight, Debilitation, then Default



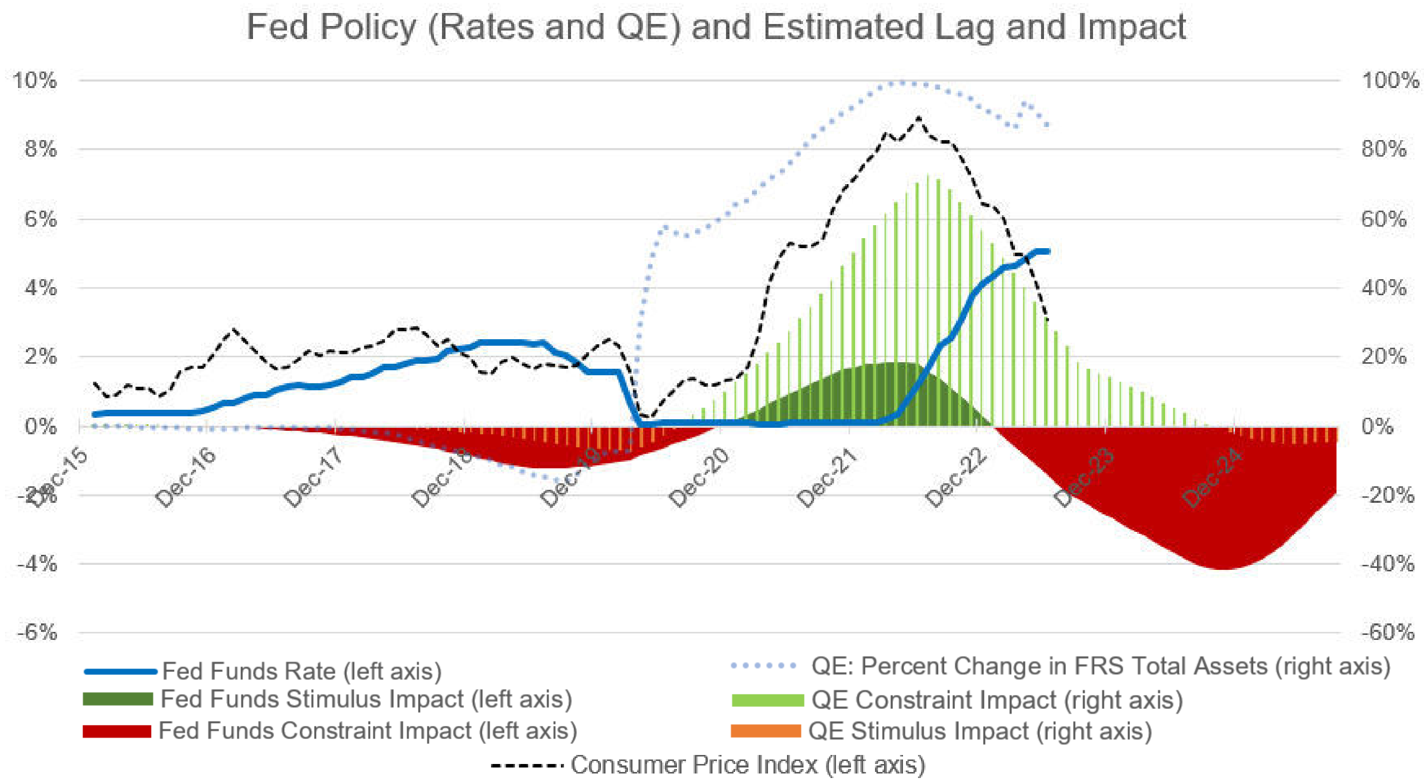
In today's aftermath, businesses and homeowners who borrowed 2-3 years ago through short-maturity or variable-rate loans at around 1-3% are facing refinancing and rate adjustments that bring their interest rates up to 5-7%. This kind of rapid doubling in debt expense is debilitating, sometimes bankrupting. Unfortunately, our federal government faces many of the same problems.

Our federal government's interest expense is now 19.3% of receipts, up from 13.5% one year ago. Its $31.5T debt is now 1.2x the size of our gross national product and has an average maturity of 5.2 years. This means that, on average, about $750B must be refinanced each quarter. In doing so, the interest rate rises from approximately 1.9%-3.0% currently paid on outstanding notes and bonds to 3.8%-5.5% for newly issued notes and bonds. In addition, another roughly $350B of new issuance takes place each quarter just to fund the current deficit. Interest paid on each new issuance is an entirely new expense for Congress.

So roughly $1.1T of federal debt issuance is required each quarter, i.e., approaching $1B each week—all in a non-recessionary environment! The approximate 2.0% increase in the interest rate paid on the $750B in refinanced debt, plus 4.5% on the $350B of new debt, results in approximately $30B in additional interest payments each quarter and thereafter. For perspective, continuing in this way for merely two years would raise the interest payments on federal debt by nearly $1T annually, an amount equal to more than half of all discretionary spending by Congress ($1.7T in 2022).

This debilitating growth in interest service expense is already happening. The Bureau of Economic Analysis reported that from the first quarters of 2022 to 2023, interest payments by the federal government rose from an annual rate of $603B to $929B, a $325B increase. This was a 54% rise in one year, increasing the average interest rate paid on federal debt from 2.10% to 3.01%. As long as interest rates hold here or decline, the eventual damage to the budget in the near future should peak at about $500B annually. It is a profound imposition, illustrative of the fragility of our government's functioning and our economic stability.

We continue our visual depiction of monetary policy lags and their actual and projected impacts. (See our last and prior quarterly letter). We have updated it here and will continue to track it through this economic cycle.



Sources: US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in US City Average Seasonally Adjusted [CPIAUCSL], Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], and Federal Funds Target Range - Lower Limit [DFEDTARL], all retrieved from FRED, Federal Reserve Bank of St. Louis.

The rapid monetary policy tightening that took place in summer 2022 should begin to have a deeper impact in the second half of 2023. In May, our internal measures of economic liquidity turned down rapidly. As described earlier, the initial result of slowing inflation is seen as positive and will remain so until fear of slowing too much takes hold. It should be an exciting and then possibly hazardous second half of the year for the markets.

Company selection remains at the forefront of our investment approach. However, the government's growing influence demands that portfolios be shaped by a solid understanding of the politically driven macroeconomy and its impact on asset classes, especially during a crisis. The tune may change each year, but the rhythm of the federal government and its bureaucratic and ever-increasing influence on markets continues. While "stocks for the long run" remains as true as ever, for over 25 years Robinson Value Management has creatively sought to mitigate equity risk in ways more effective and less damaging to returns than simply an "industry standard" allocation to fixed income. We remain laser-focused on protecting and growing our clients' purchasing power in these uncertain times.

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