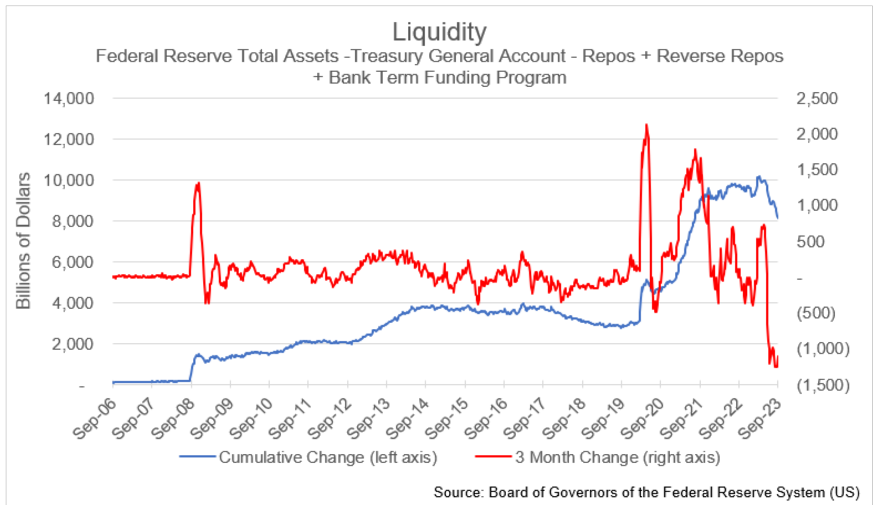
The Long & Short of It
Quarterly Newsletter
Third Quarter 2023

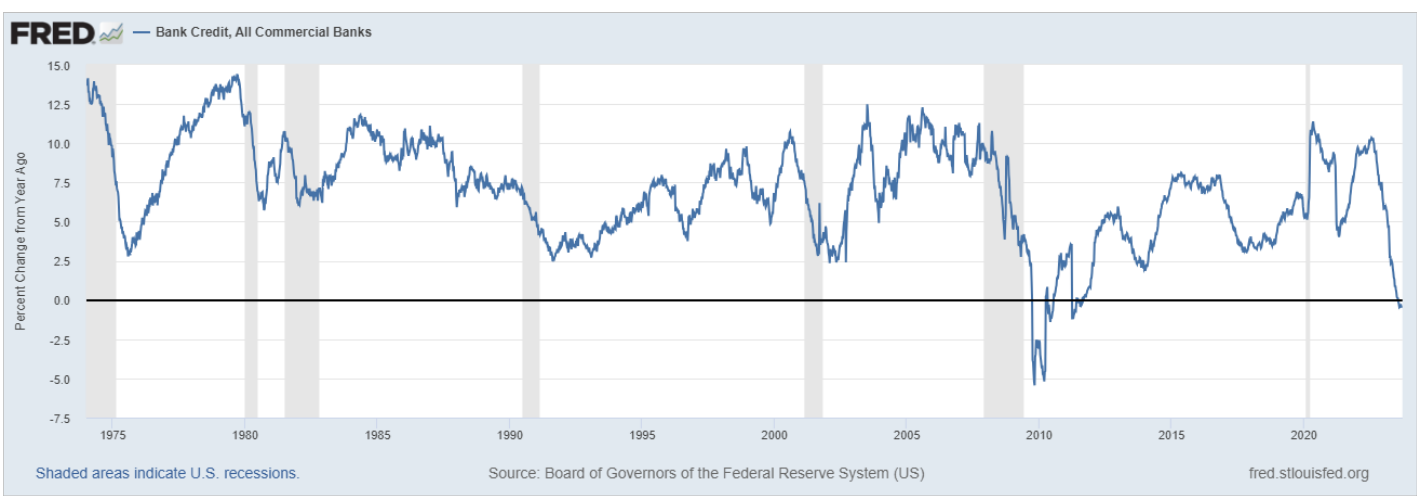
The Grand Tour

The pandemic led to unprecedented government spending, putting money into people's hands to alleviate suffering. Holed up in their houses and unable to travel the world, they spent the cash quickly, causing inflation. Though the Fed seems unable to draw this spendthrift journey to a close just yet, progress is being made. As a profligate youth's Grand Tour inevitably ends when the allowance runs dry, so too is the global economy's dizzying pandemic stimulus spree and resulting inflation reaching a finale.

In the third quarter of 2023, a bit over a year after the rapid rise in the federal funds rate, Mr. Market has surveyed the world around him and blinked. He is running out of money but remains far from home. For his journey home, he is facing (our top-10 list) a sharp rise in the 10-year US Treasury yield to above 4.5%, credit card debt spiking higher as savings from COVID-related handouts finally run out, higher crude oil prices, mixed economic data, student loan payments restarting, an extended pullback in technology stocks, a major strike by the United Auto Workers, and a potential government shutdown. After solid performance in the first half of the year, the S&P 500 dropped 3.3% in the third quarter, coming to rest 6.5% below the July 31 closing high.



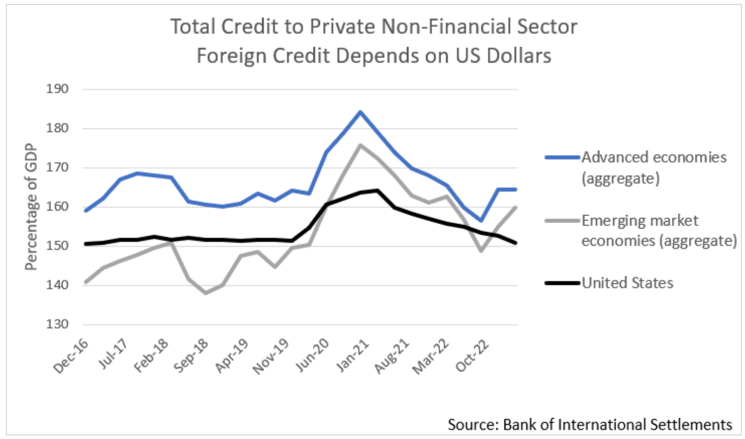
Despite the Fed's serious steps to slow things down, not much of its work showed up in our measure of liquidity until summer 2023. We are now seeing a dramatic unprecedented decline in liquidity. But fiscal policy (budget deficit) is not showing a serious corrective direction, which is likely part of the reason why long-maturity bond interest rates continue higher.



When the Fed raised rates and signaled "higher for longer," aggregate expectations for economic activity fell and loan demand weakened. It is rare to see this phenomenon so extensively before a crisis actually occurs. The combination of weaker loan demand and tighter supply had a rapid impact on the rate of credit creation for consumers and businesses, turning negative for the only other time except *after* the Global Financial Crisis in 2008-2009. Typically the largest declines in credit creation tend to happen later, in the middle of, or even after a recession has ended.

In No Cents Abroad

In his 1869 travel book *The Innocents Abroad*, Mark Twain takes his own grand tour, frequently commenting on the eager acceptance of dollars abroad. Reserve status has made the dollar even more attractive. We liken global money supply dynamics to water in a bathroom, with the US being the tub and the rest of the world being the floor. Our excess brings loads of liquidity abroad. But if we even just stop the overflow, the floor dries up. Foreign credit, very sensitive to US monetary policy, was down significantly from its 2021 highs by the end of 2022. In 2023, the impacts of US monetary policy on credit creation shown above have grave implications for foreign credit, numbers we will not see for months. The international financial market has become levered to what we are seeing domestically.



Making it Home

Can America bring its journey to an end without a nasty outcome? Can the Fed negotiate a soft landing? After the last Fed meeting on September 20, chair Jerome Powell stated that a soft landing is the primary objective but he would not go so far as to call it a baseline expectation.

Yet the media continues to hold out hope for a scenario where inflation is tamed through a cyclical slowdown in economic growth without entering recession. On CNBC the morning of September 20, *Wall Street Journal* reporter Nick Timiraos likened the emotions about the prospects of a soft landing to one's feelings during a Hail Mary pass in football.

> "At this point in the cycle, when people think the Fed is done raising interest rates, the economy looks OK. You don't quite know yet if the Fed has done enough to put it into a downturn, and so there is a lot of optimism about a soft landing. It is like a Hail Mary football pass, right? When the ball is in the air, a lot has to go right and a lot can go wrong for the receiver to take that ball in the end zone, but you think, 'Maybe this time it's going to work out.'"

Unfortunately, there are close to no successful soft landings and the ones that have occurred have seen the Fed stimulating early, not engaging in "higher for longer" late in the cycle as it is doing now.

By the Way, How Are Things Back Home?

Projections indicate the federal budget deficit could exceed $2 trillion by 2025 even without a recession. But in the case of a recession, outstanding Treasury debt is likely to increase at a remarkable pace, rising to unprecedented levels above annual GDP as debt issuance will likely exceed what the global market can bear. This massive financing need may already be starting to overwhelm investor demand as long bond rates have been rising rapidly. Sooner than anticipated, the Fed may have to go back to quantitative easing (QE). Who knows how the market will react to a new round of QE?

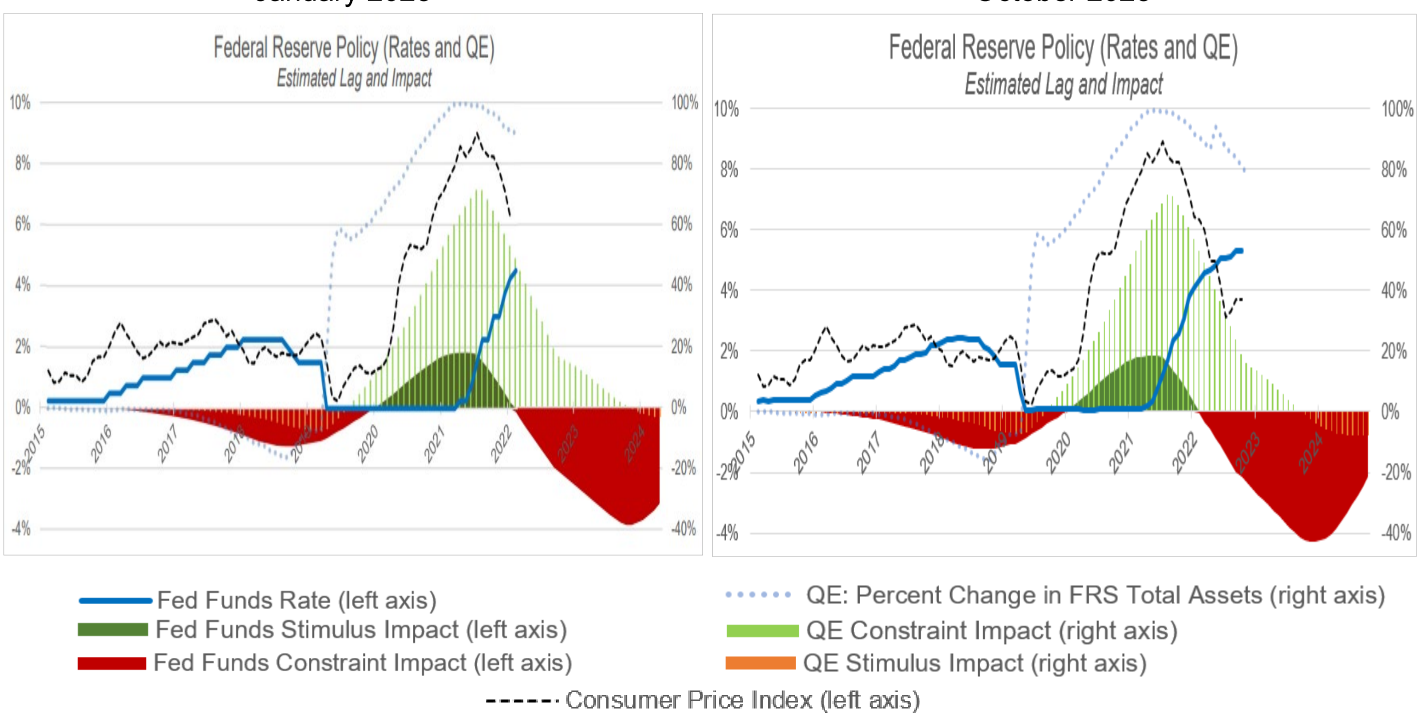
This interconnectedness of financial markets is displaying the long-term challenges of increased debt issuance, rising debt levels, and higher rates' impact on fixed income, equity, and the economy. The glut of Treasury bonds available is driving bond prices lower and longer-term yields up. Shorter-maturity yields remain anchored for now, as the Fed does not want to bring all lending to an end but just have it continue at a slower pace. The Fed believes they have done enough, but bond vigilantes watching the large post-pandemic deficits balloon are not buying the Fed's stance. The resulting challenge is that the yield curve steepens, the term structure portion of monetary policy becomes more accommodative, and banks become more willing to lend. The Fed may soon feel it must raise rates still further to stay ahead of increases in the longer portion of the rate curve, thus risking a severe recession. Interest rate volatility is increasing, creating challenges for fixed income investing. Stock markets face headwinds from higher discount rates applied to earnings. Lofty equity valuations are beginning to correct toward historical price-to-earnings averages.

The slowdown ahead, due to the credit contraction, may be significant in the end. With monetary policy constrained by public debt concerns, the Fed may be unable to provide sufficient stimulus. This could force deeper economic contraction and higher unemployment. If the Fed is able to provide sufficient stimulus, the result may be a much larger round of inflation, though with low real growth. In summary, declining bank credit growth and surging Treasury issuance are both likely to dampen market performance and slow the economy.

We continue our visual depiction of monetary policy lags and their actual and projected impacts showing our January 2023 chart as well as the most recent. (See our second, and third publications of this chart in prior quarterly letters.) We will continue to track it through this economic cycle.

The Slow Roll of Monetary Policy

January 2023 October 2023



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 solid dark red/green wave represents an estimate of the timing and scale of impact for monetary policy as determined by the federal funds rate. The bars represent an estimate of the timing and scale of impact for monetary policy as determined by the Federal Reserve's balance sheet, i.e., quantitative easing and tightening. Given the scale of monetary stimulus during the pandemic, it is remarkable the resulting inflation was not worse. Assuming a typical 1- to 3-year lag for monetary policy, the tightening that took place in summer 2022 should now, finally, begin to have a deeper impact.

Grand Tours Will Continue

Young people went on grand tours and economic cycles existed long before any of us were born. Some were solid and productive, some spectacular, and others near disastrous. Downturns can make for challenging moments, but the world carries on despite claims to the contrary by those selling media space. The public sees inflation numbers that are old due to the six-month lag created by the way rents are calculated. Non-rent inflation (excluding rent of shelter) was reported at 2.3% in August. The Fed will eventually succeed but we expect it will succeed too much, driving inflation too low and overshooting the target.

The most important choices facing investors are not related to predicting whether the recession will happen but how to be positioned for whatever reality arrives. Markets reflect expectations, so if expectations are elevated and hoping for a Hail Mary to work, wise investors should make some incremental adjustments to be ready for the coming shift in those expectations. The key here is "adjustments" as the future is always uncertain. In addition, the holidays are typically the best time to own stocks. If the slowing we anticipate begins incrementally this fall, the recent downturn could reverse for a period of time before the recession becomes evident.

With the Fed braking for over a year and liquidity dropping significantly since May 2023, the economy has remained robust due to extraodinary amounts of pandemic-related stimulus. Yet already, government tax revenues fail to keep up as government expenses spike from higher interest payments, inflation adjustments to Social Security, and increased infrastructure spending. As the government continues to expand, the potential deficit expansion will likely put serious strain on the US Treasury market and supply will surely overwhelm demand. How the Fed and the markets respond to this reality is the next most interesting thing for which investors must be ready.

The twin trends of declining bank credit and ballooning Treasury issuance may exacerbate recessionary dynamics. Macro-oriented risk management may be helpful as asset classes face heightened volatility, liquidity shortages, and disorderly repricing scenarios. **For all the declines in liquidity, absence of lending, rate increases, and talk of "higher for longer," know that the market is not convinced the Fed has succeeded until long-term interest rates are declining.** As we concluded in last quarter's letter, "It should be an exciting and then possibly hazardous second half of the year for the markets."

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