The Long & Short of It
Quarterly Newsletter
Fourth Quarter 2023

Surprised by Goldilocks

C.S. Lewis would have been an astute market participant with his observation that the anticipation of perfection can be "as much happiness as is ever to be reached on earth." In the fourth quarter of 2023, the forward-looking stock market imagined the dual perfection of a soft landing and a Goldilocks economy. The resulting joy brought the S&P 500 to a total return of 11.7% during the quarter and 26.3% for the full year. Sadly, anticipation often holds greater happiness than the actual event.

It is as if Goldilocks has found her first bowl of porridge to be only a *little* too hot. Instead of moving to Mama Bear's bowl, Goldilocks chooses to stay and stir this one until it cools. All the while she imagines how delicious it will be when it reaches the perfect temperature. But she should not get too excited. By the time Goldilocks is halfway through her perfect bowl, she realizes it is cooling quickly and begins to fear the last several bites may be unappetizingly cold. She begins to rush through her meal only to experience indigestion. And then the Bears (aka bear market) arrive.

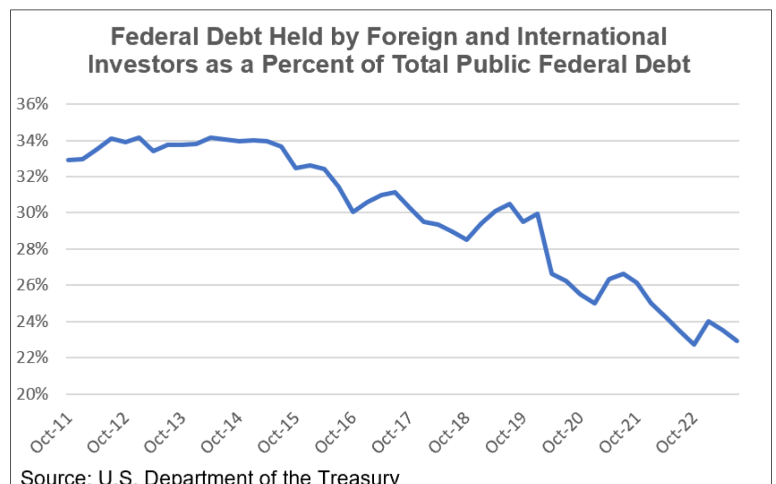
Analogies aside, in last quarter's letter we noted that "[T]he holidays are typically the best time to own stocks. If the slowing we anticipate begins incrementally this fall, the recent downturn could reverse for a period of time before the recession becomes evident." While the market's fourth quarter performance stood out, the S&P 500 is only back to the highs set in 2021. With 2022's 18.2% loss, the S&P 500 total return was only an accumulated 3.4% over the two years ending 2023. After 9.6% inflation is subtracted, the two-year accumulated real return of the S&P 500 drops to -6.5%, i.e., a 3.3% annualized loss of purchasing power.

Too Much?

Despite the stagnation, investor consensus is ebullient. The AAII Investor Sentiment survey read 52.92 on December 21, 2023. It has only surpassed that level in five months over the last ten years. Three of those times (December 2013, November 2014, January 2018) marked temporary market tops while two (November 2020, April 2021) were during the COVID money print-a-thon. There is no way to know how long that joy will last but valuations are now quite lofty.

In contrast to this positivity and as mentioned last quarter, it remains the case that "[t]he twin trends of declining bank credit and ballooning Treasury issuance may exacerbate recessionary dynamics" in 2024.

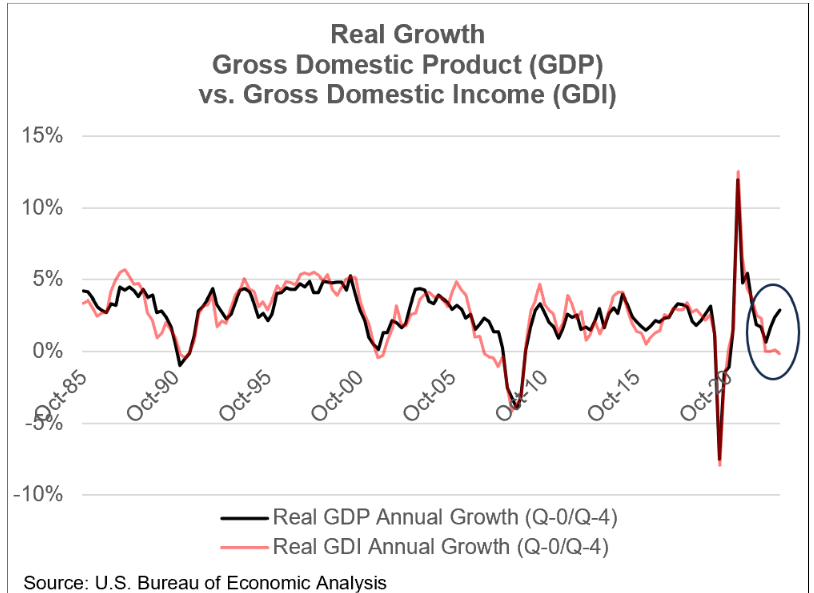
Treasury issuance continues at extraordinarily high levels and foreign buyers continue to purchase less of our sovereign debt each year (see table to the right). This affects the US's ability to run large deficits without inflationary repercussions.



Source: U.S. Department of the Treasury

Large deficits are exactly what has been fueling the economy as Congressional spending has been extraordinarily stimulative since early 2020. As James Fishback, CEO of Azoria Partners, said on Yahoo Finance, "We are running WWII-era deficit spending at a time where

unemployment is below 4%. In reality, Democrats and Republicans are part of the same party, which is spend more money that we don't have to buy things that we don't need."



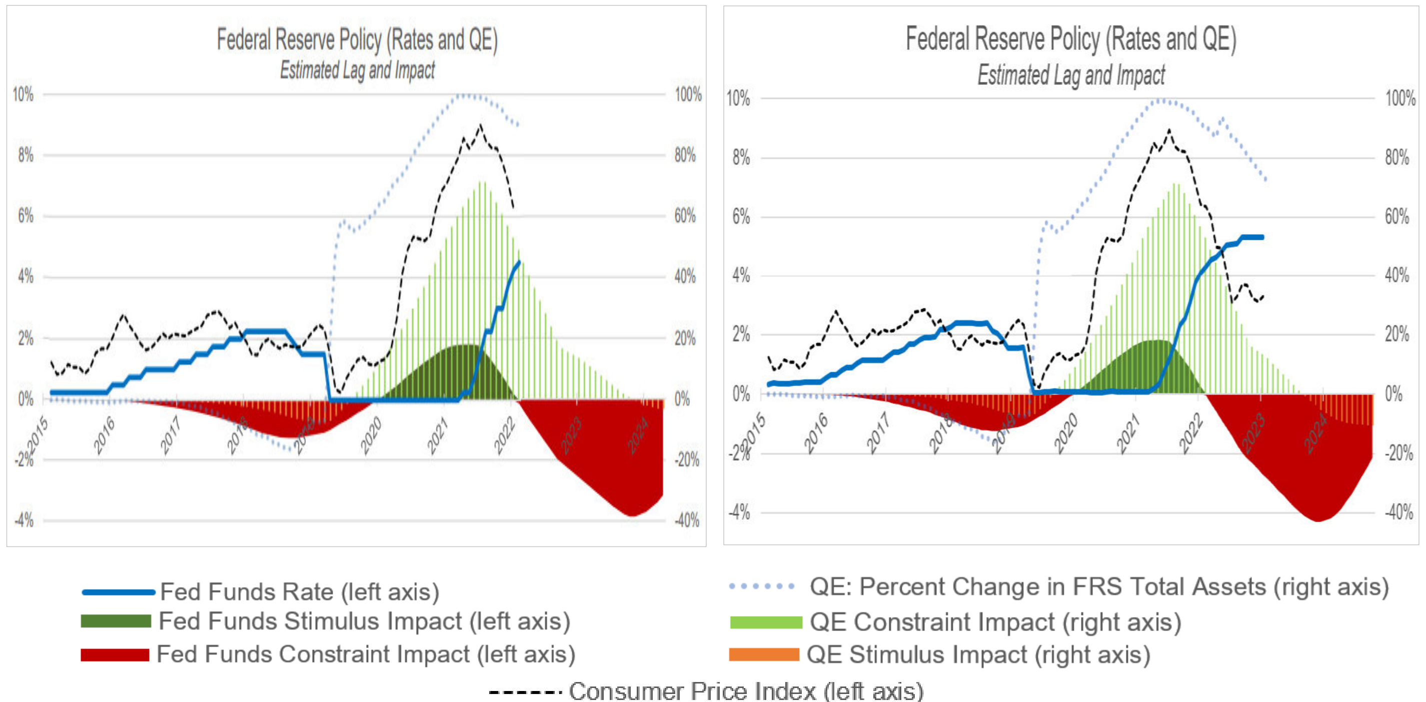
Too Little?

Despite significant fiscal stimulus this year and Gross Domestic Product (GDP) rising, the economy is not running hot. Gross Domestic Income (GDI), which measures total economic activity from the income side, has entered a recession with a negative result for the third quarter of 2023. The difference between GDP and GDI is now the largest on record (please see chart).

Which will prove predictive, GDP or GDI? With monetary policy still very tight, we bet on GDI. Looking back, the times GDI has turned from positive to negative since 1970 were in 3Q 1974, 1Q 1980 and 1Q 1982 (catching both sides of the double dip), 1Q 1991, 4Q 2001, 3Q 2007 (well earlier than GDP), and 2Q 2020. A rather amazing record.

In investigating where inflation may go, we look to changes in Fed Funds and liquidity from one to three years ago that drive money supply. We refer you to "The Slow Roll of Monetary Policy," which has been featured in *The Long & Short of It* all year long. It shows the slow and steady progression of the monetary policy lag as it

The Slow Roll of Monetary Policy



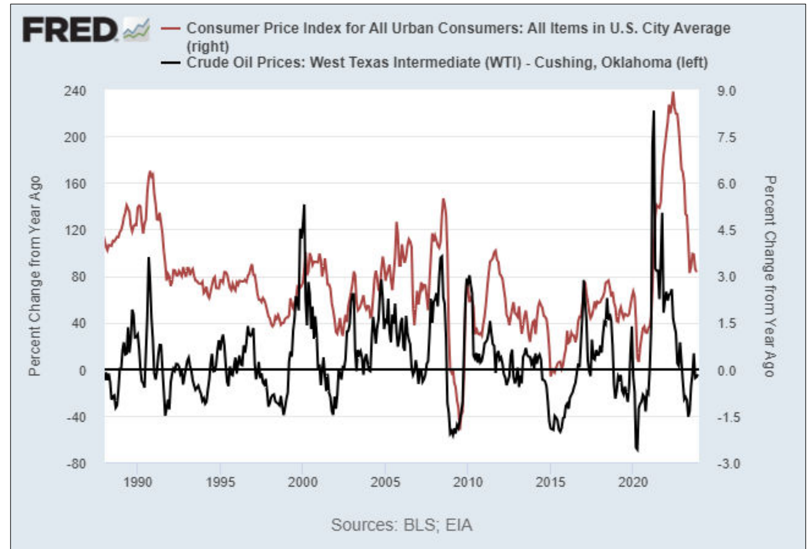
Sources: US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in US City Average Seasonally Adjusted [CPIAUCSL], Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL],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

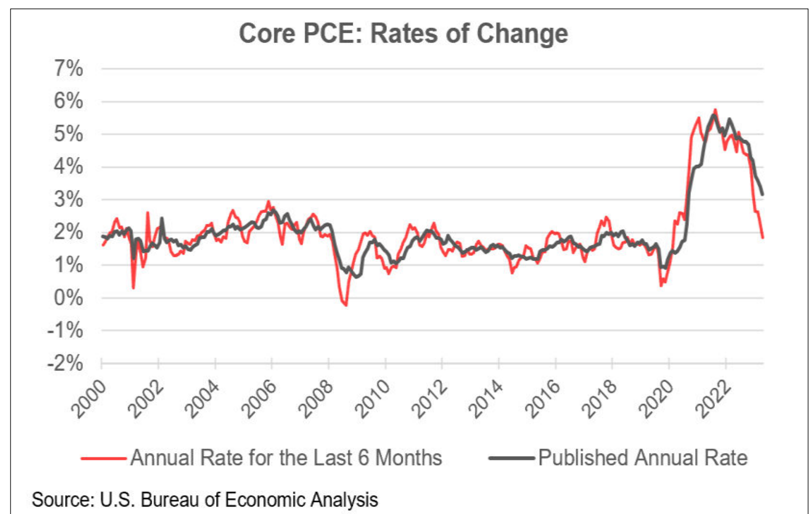
drives inflation. We continue this visual depiction of monetary policy lags and their actual and projected impacts by showing our January 2023 chart as well as the most recent chart. (See our prior publications of this chart in previous quarterly letters.)

Finally, although there is much debate about where inflation is going, one of the best leading indicators for inflation over the next year is the price of crude oil. A large move in the price of crude affects manufacturing, packaging, and transportation costs across the economy. The chart on the right suggests that inflation should continue to moderate until something drives crude oil higher.

The Bears

By keeping monetary policy tight, the Fed seems to be living in the past and risking economic contraction but it may not be able to change. From a purely economic point of view, with the known lag to monetary policy and Core Personal Consumption Expenditures (PCE) running below its 2% target for the last six months, it seems strange that the Federal Reserve keeps monetary policy so tight. Recognizing that today's Fed is very active and vocal, it also appears to be more subject to political pressures than in the past.





It is difficult for the Fed to fully incorporate monetary policy lags into current and ongoing policy because it is judged in the media daily based on each day's outcome. For example, imagine if the Fed raised interest rates dramatically in early 2021 when the COVID vaccines first arrived—while many people were still suffering greatly from the disease and much uncertainty remained. The Fed would have been condemned as heartless to raise interest rates at that time. Yet the impact would have taken place in the future when it was truly needed and likely reduced the painful, extraordinary inflation that followed.

Now, in an election year, efforts to undo the tightening before any evidence of a hard landing would be seen by many as politically motivated. Pressure will be applied and inflation fears used to warn against a repeat of the 1970s. If the wars continue to escalate, those inflationary fears could be well founded and crude oil will lead the way higher. If inflation continues to wane, then recession looks likely. Our concern is that before 2024 draws to a close, we will long for the pre-1970s inscrutable, nearly silent, stable Federal Reserve. While the Fed of that era was often criticized for its slow response to a problem, it was not usually viewed as the *cause* of the problem.

Although the market historically averages low double-digit returns, years in that range are rare. More often there are large gains or large losses. In 2024, the potential for both an extraordinary rise and a steep fall in the

stock market will be high, making any efforts at market timing either very rewarding or very painful. Investors will need to be extra careful not to buy into great strength or sell into great weakness.

Just Right

We are most grateful for our clients, their efforts to live good lives and their votes of confidence, especially in these interesting times. We wish everyone a successful, fulfilling, and profitable 2024. May your New Year be "just right": filled with pleasant shelter, healthy food, and a safe place of rest from any bears.

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