The Long & Short of It
Quarterly Newsletter
First Quarter 2024

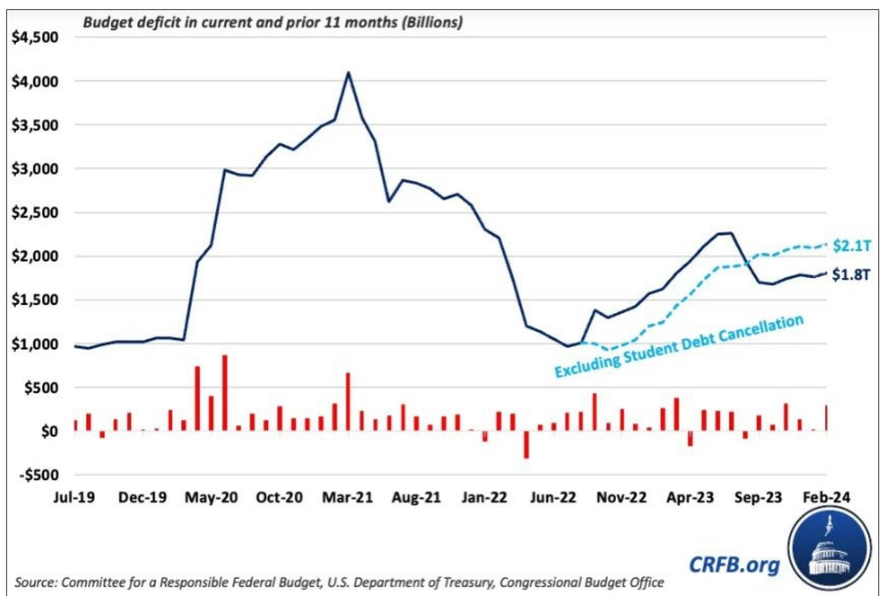
Aesop's Labels

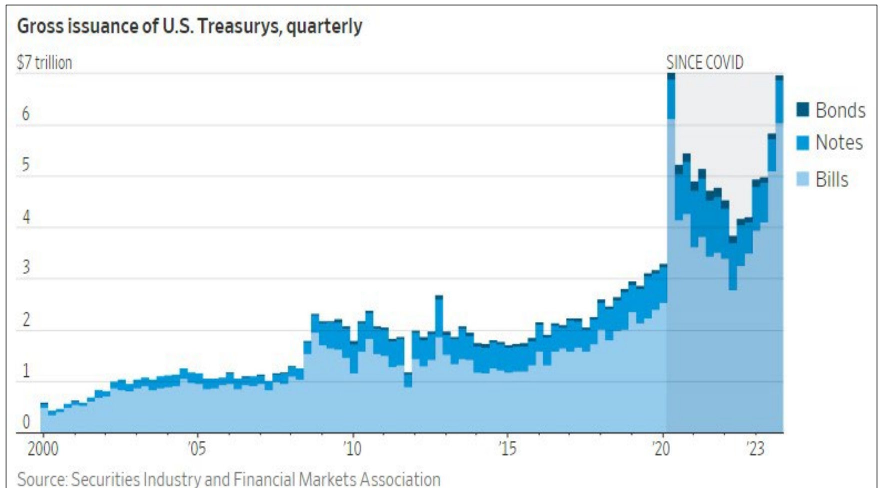
Investor expectations swung toward mania in the first quarter of 2024. Piling on to the heady results of 2023, the stock market rose about 10% in the last three months, bringing the 12-month result to about 33%. Rising interest rates kept pressure on bond prices. Yet it appears the investing public (and AI programs) expects a soft landing, a return to lower interest rates, few bankruptcies or credit problems, and continued unprecedented fiscal stimulus. Bullish consensus, measured in numerous ways, has rarely been so high.

A statistics professor with a delightfully dry sense of humor might say, "They may be right. [extra pause] But then again [very long pause], they may not." The future remains uncertain. Extrapolating recent history far into the future, investors can form expectations and move markets with only a loose attachment to long-term realities.

With all this in mind, monetary policy (the Tortoise), fiscal policy (the Hare), and investor expectations (the Boy who cried Wolf) will be the topics of discussion in this letter.

Part of the reason for this extraordinary ebullience is the unprecedented fiscal deficit spending that sustains what would otherwise be a slowing economy. (See chart to the right.) Much like Aesop's hare, fiscal policy takes off with a bang, quickly impacting the economy and diminishing in effect thereafter. The deficit ballooned during COVID-19, then fell for a brief time, but has been growing rapidly again since late-2022.





Since COVID-19 broke out in early 2020, there has been an unprecedented surge in fiscal stimulus. SIFMA Research recently released *Research Quarterly, Fixed Income Markets – Outstanding for 4Q 2023*, reporting that debt outstanding in the US is by far the largest in the world, comprising about 40% of the $140 trillion total and more than double that of the next largest market, the European Union. About 60% of US debt ($26 trillion) is the outstanding marketable portion of US Treasury debt. As a result, **m*arketable US Treasury debt now makes up about a quarter of all global debt***. Another $7 trillion is "unmarketable" US treasury debt, which is not included in the chart.

In 2023, non-Treasury debt issued in the US grew by about 2%. Other debt around the globe grew by about 3%. US Treasury debt grew by over 10% to $2.6 trillion. The biggest borrower by far, the US government insists on growing at unsustainable rates that are 3-5x faster than the rest of the world and nearly twice as fast as US GDP growth. As the total debt outstanding explodes and debt comes due that will not be paid back, it must be rolled over and more new debt must be issued to replace it. The combination of deficit-related debt and rollover debt makes the US the unrivaled issuer of debt worldwide.

How much of our nominal 6% GDP growth in 2023 was directly caused by US Treasury issuance? Deficit spending (paid for by the issuance of Treasuries) impacts GDP at a 1:1 ratio as it is spent. If partly spent again in the same year, it can add more to GDP in what is called a multiplier effect.

In 2023, deficit spending ran at just over 6% of GDP, effectively accounting for all growth in the US economy. By contrast, 2023 inflation was only 3.4%, which suggests that without deficit spending to prop up the economy, GDP growth would have been negative after inflation. Growing Treasury debt at a slightly more reasonable rate of 3% of GDP would have likely still left the US in recession. Instead, Uncle Sam sent an extra $1 trillion to various people and programs. Without this excess, there would have been a 15% drop in federal spending. It is imprudent to borrow excessively, yet fiscal restraint continues to be wildly unpopular. The media howls “Austerity!” at anyone who mentions spending cuts or even a reduction of mandated rates of growth.

If Aesop could see the use of his and other metaphors today, would he be pleased? They are able to say so much in so few words. For instance, taken together, US government debt and spending have become both the “elephant in the room” and the “bull in a china shop” of financial markets worldwide. Although it is another story for another day, the Federal Reserve’s extraordinary efforts to maintain functioning markets covers up the fact that investors would normally reject such a scenario and send interest rates much higher. In doing so, the Fed ensures the public does not realize the emperor has no clothes.

And Along Comes the Tortoise…

One of the more difficult concepts for investors to grasp is the very tortoise-like nature of monetary policy. Once in motion, it takes 2-3 years to arrive. In March 2022, for the first time since the pandemic, the Fed began to tighten monetary policy through increases in interest rates. The bulk took place from May 2022 to December 2022, but there was a total of 11 increases over 17 months and an increase of 5%, the largest since Volker’s increases during 1978-1980.

Has the Fed stuck the soft landing? Not likely, but it is still too early to tell. As we mentioned in the January 2023 issue of *“The Long & Short of It,”* wide-ranging empirical research from Havranek and Rusnak shows an average transmission lag of 29 months. A prime example of this lag was the 2008 financial crisis. In April 2023, we reminded readers of the timeline for the stock market’s decline during this period:

> *“The Fed began raising the federal funds rate in July 2004 and stopped in July 2006. Roughly a year later in August 2007, the Fed pivoted and implemented a series of cuts to the federal funds rate. It took until early 2008 for the market to begin discounting the problems to come and until late 2009 before the economy exhibited the full impact.”*

In July 2023, we added:

> *“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.”*

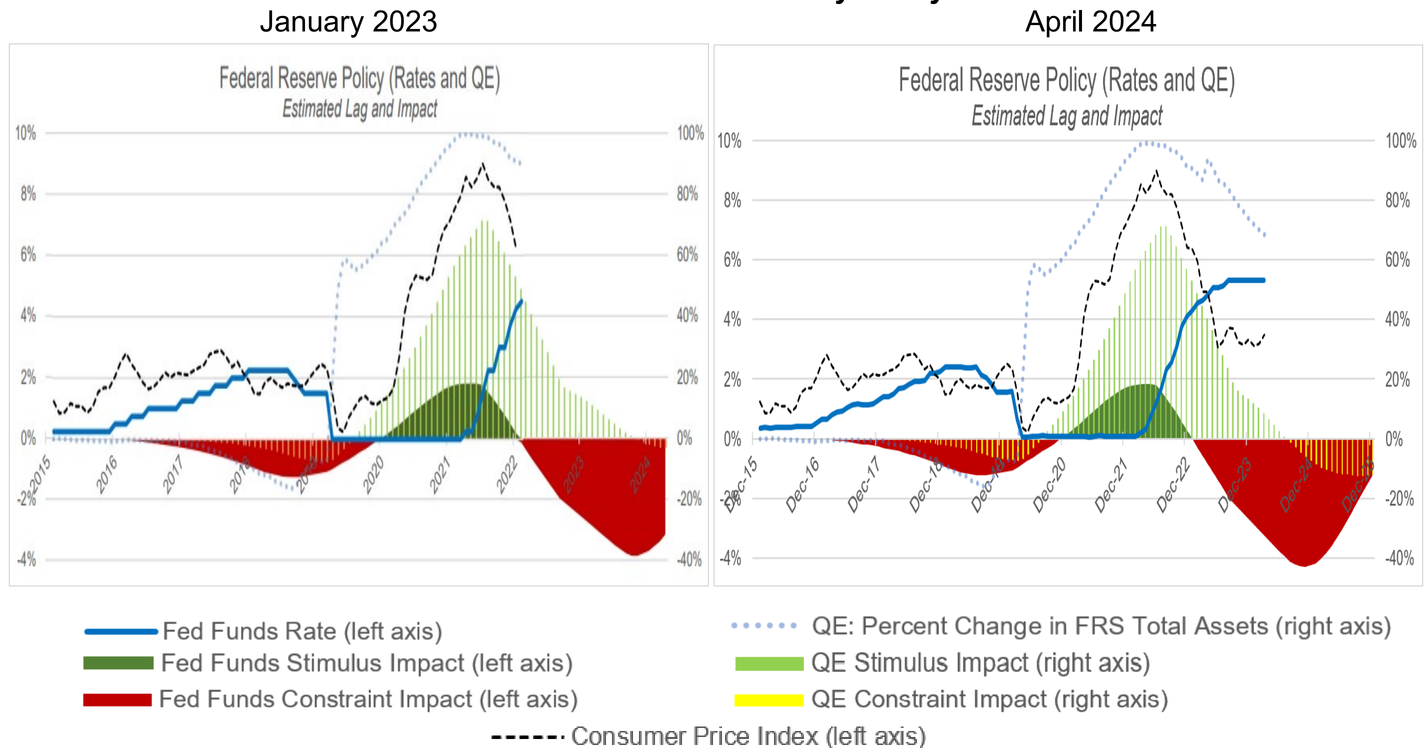
March 2024 marks 24 months since the Fed began gradually raising interest rates. Twenty-nine months after the major increases from May to December 2022 would land us from late 2024 to mid-2025 for maximum

monetary policy impact. It could take a bit longer because the US economy is among the most advanced in the world and the sheer size of the 2022 fiscal stimulus may prove sticky.

Of great interest would be whether the election brings any change to expectations for deficit spending in 2025. So much seems to hinge on this one factor. A reduction would be healthy for the long run but painful for nominal economic growth and likely a political failure.

We refer you to *"*The Slow Roll of Monetary Policy," which has been featured in *"The Long & Short of It"* all last year. It shows the slow and steady progression of monetary policy lag as it works through the economy and 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 below. (See our prior publications of this chart in previous quarterly letters.)

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.

Slow & Steady Achieves a Result

We trust the Fed will reach its mandated rate of inflation. It is just a matter of time. The bottom line is that while stocks are great for the long run, the government has become so large and dependent on its massive funding requirements that one must have a plan for dealing with the giant footprints left by government in today's markets. One option is to put your head in the sand and hope for the best. And while not ideal, passive investing is not the worst approach. Another tactic might be "runaway" go-to cash or more intermediate bonds, thereby placing even greater trust in the federal government's ability to protect the value of the dollar. However, that faith may one day prove to be misplaced.

At Robinson Value Management, we have spent the last 25 years researching how to opportunistically profit from macro factors that affect stock market returns. Although the sway of big government began to be noticeable in the 1950s, it has now become dominant and must be integrated into investment strategies. We look for ways to grow purchasing power while limiting the risk of its unrecoverable loss. Wanting to hold mostly stocks, we seek methods to mitigate systemic/stock market risk. In stock selection, this means industry leaders

with strong balance sheets, currently out of favor and selling at a discount to their historic multiples. At a macro level, it means identifying assets that exhibit low correlation to equities—especially in a crisis—and looking for patterns and fundamental/behavioral drivers that repeat, often with ties to the lumbering bureaucracy of our federal government.

If you are not actively adapting your investment process for today's managed economy, you may want to consider the implications of such an approach. We deeply appreciate our wonderful clients who embraced this journey with us over 25 years ago and welcome the opportunity to help new investors navigate the current stock market environment.

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