the advisor

Winter 2023

A Journey

"If Stupidity got us into this mess, then why can't it get us out?"

Will Rogers

These quarterly missives often concern journeys into the future. The way is always uncertain, the destination opaque. What may help guide us forward is an awareness of where we have been. With driving, the rearview mirror is incredibly useful for manoeuvring a vehicle - but to rely on it solely for steering is dangerous and stupid.

Since the financial crisis of 2007 - 2009, investors have dealt with the distortions created by Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) separating the financial markets from economic fundamentals. Today's markets are not moved by economic fundamentals but are driven by liquidity, momentum and short-term emotions. For the last fifteen years, investors have become inured to this environment and expect, after the steepest rise in interest rates in decades, a return to "normal".

Currently, there is a broad willingness amongst investors to buy bonds in anticipation of the US Federal Reserve resuming accommodative measures. Expectations for coming rate cuts rely on the premise that core inflation will continue to smoothly decelerate - and that may indeed be the case. The bond and stock markets have priced in six rate cuts in 2024 while, on December 13th, the US Federal Reserve signalled only three cuts. Bear in mind that lower inflation and lower interest rates point to slowing economic growth and to lower corporate profits, which are inconsistent with forecasts for new market highs.

The effects of monetary policy typically lag the economy by about twelve to eighteen months. This means that markets have not yet fully digested many of the Fed interest rate hikes. If we assume a twelve-month lag, 150 basis points still have to be discounted; assuming an eighteen-month lag about 450 bps. In other words, it is still too early to determine how rising interest rates have affected the economy. We will probably only know in the second half of 2024.

Over the past eighteen months it has become increasingly difficult for companies to refinance since the rates are far higher than what they were accustomed to. Many companies' debt goes back to when money was cheap, so only a portion of it will be refinanced at current rates. It takes time for debts to mature, which is one of the reasons why monetary policy has a delayed effect on the economy.

Over US $1.5 trillion worth of debt will come due in the next two years. As much as 60% of this debt will be for investment-grade companies while, at least for 2024, speculative-grade companies will face smaller refinancing amounts. The debts coming due originated when the Fed Funds Rate was close to zero; today this debt is being refinanced in double digits for the most distressed companies. Obviously, paying more interest has a negative impact on corporate income statements and on earnings.[1]

Years of yield-chasing and rising leverage have rendered markets vulnerable to a sudden shock. Presently, valuations are near the most extreme in history making many stocks especially risky. The fact that the rate of inflation is decelerating is stoking the markets. A recession no longer seems imminent, which is what usually occurs right before one happens: no one expects it. To believe that inflation will be contained without paying any cost is naive. As mentioned, most of the rate hikes have not yet been discounted by businesses and households, and by the time the first rate cut takes place, it may be too late.

Easy money does nothing for stocks unless investors treat safe, liquid assets (such as T-Bills) as being inferior to risk assets. During the 2007 - 2009 crisis, the S&P500 collapsed by 55% while the Fed eased aggressively the whole way down. It is during the easing that recessions become visible.

"Since 1970, there have been nine instances in which the Fed significantly cut the Fed Funds rate. *The average maximum drawdown from the start of each rate reduction period to the market trough was 27.5%.* The three most recent episodes saw larger-than-average drawdowns. Of the six other experiences, only one, 1974-1977, saw a drawdown worse than the average."[2] (See chart next page)

Meanwhile in Congress, the debt

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A Journey (cont'd)

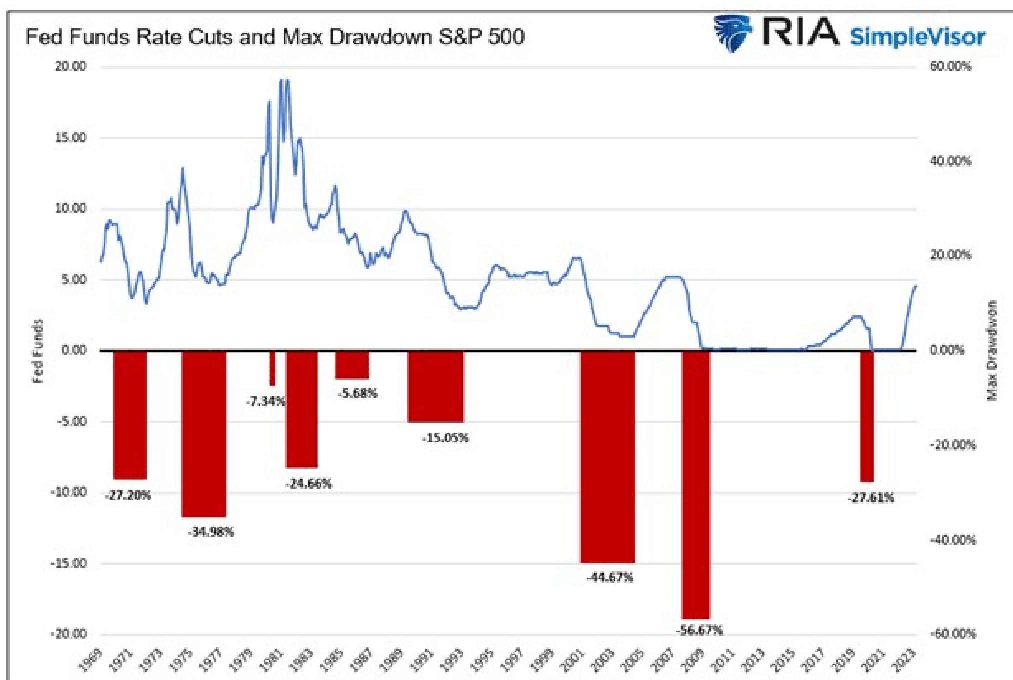
ceiling brinkmanship is pushing America towards a debt default. Incontinent spending has seen federal debt balloon, closing in on $34 trillion or 122% of GDP. The government has a soaring interest-rate bill which will become an increasing strain on the volume and velocity of reserves in the system, worsening headwinds for risk assets and for the economy. By abandoning "higher for longer", the Fed has enabled interest-rate costs to fall - but only by exacerbating future inflation risks.

Due to residual supply chain disruptions, tight labour markets and wage demands, corporate down-sizing and near-shoring, food and energy volatility, inflation is likely to remain elevated and sticky Consequently, American bond yields may not fall as much as the markets currently anticipate. In addition, the Fed may not be able to deliver rate cuts as deep as forecast because the US Dollar is weakening, and cuts will only accelerate that weakness.

In August 2020, the Fed adopted a new monetary policy framework called Flexible Average Inflation Targeting (FAIT) to keep inflation close to 2 percent. This framework came under intense scrutiny for its failure to prevent the 2021–2023 inflation surge. We do not hear much about FAIT these days. Back then the Fed was willing to "let inflation run hot" in line with their policy. Will they now be willing to "let inflation run cold" to achieve their target? That seems unlikely. The amount of debt in the system means it cannot be repaid in constant dollars. It can only be addressed by default or by inflation. The Fed will choose the latter.

"Central bankers who fix interest rates by reference to changes in an index of consumer prices are setting themselves up for failure."[3] A natural rate of interest, that balances demand for savings with supply, is not necessarily revealed by the presence of inflation or deflation. What is needed is less active monetary policy interventions to allow for the discovery of a true rate of interest.

The result would be a new era of normalised real (i.e. after inflation) interest rates, somewhere around 2% - 3%. This would have profound implications for how the global economy might behave. Real interest rates in this range would prove beneficial for economic growth – restoring the primacy of a market driven economy over central banks' policy distortions. "By forcing businesses to invest in real stuff to generate real returns, and households to budget on the basis borrowed money has consequences as a result of real interest rates, over the medium-term the global economy will rationalise and revert to growth. The transition will hurt but the outcome is a rational market."[4] Normalised rates would cause over-levered "Zombie" companies to fail, unemployment to spike, and households to budget for limited discretionary spending.



However, these negative effects might be offset. Home prices might return to more affordable levels, while stocks could revert to sensible valuations. There would be new corporate investment in plant and equipment to enhance productivity. The world would adapt to changed supply chains, and to productivity gains expected from technology. Free markets should not be underestimated.

Perhaps our journey's objective should not lie with making predictions at all. Most of the time things are getting better anyways, but sometimes things go awry. Portfolio resilience is thus something to pay attention to. It is the deviations from the expected where opportunities might lie. Portfolios should be constructed to be resilient to the divergences, not fragile to them.

For fifteen years the Fed has been steering the economy while looking in the rearview mirror. Investors should not risk following the same strategy. Looking in the rearview mirror today, what you see receding into the background *was* "normal".

Ahead *is* the new normal.

Sources:

1. Eugenio Catone, "S&P500: Why 2024 Could Be the Worst Year Since 2008", Seeking Alpha, 4 Dec. 2023
2. Lance Roberts, "Sell Cash, Buy Stocks as Powell Pivots", RealInvestmentAdvice.com, 19 Dec. 2023
3. Edward Chancellor, The Price of Time, Allen Lane publishing, 2022, page 312
4. Bill Blain, "Interest Rate Scenario", Morning Porridge, 30 Nov. 2023
5. Chart this page, Lance Roberts, "Sell Cash, Buy Stocks as Powell Pivots", RealInvestmentAdvice.com, 19 Dec. 2023

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