October 13, 2023

Higher for Longer Act 2

Dear Investor:

After hiking rates by 0.25% in July, the Fed decided to pause for the second time at their recent September meeting. Most everyone was hoping for this, and I think it was a good decision. We have come a long way very fast, and the heavy lifting is behind us now. I think the Fed can afford the luxury of moving a little more slowly and carefully. That said, the release of the Fed Dot Plot and their latest projections have put the market on the back foot. Without going into a detailed review of the numbers, the dot plot is suggesting that rates will be higher over the next two years than was recently forecast in June. There is also a distinct possibility of one more rate hike this year, which could come in either November or December. There are no cuts forecast for this year, and a smaller range of potential cuts the next two years. Thus, higher for longer, than was previously thought. The reason for the shift in outlook is that unemployment has been lower than expected, and the GDP has been substantially higher than expected. Overall, the economy has been doing pretty well this year.

The resilience in the economy is coming primarily from the consumer. There are a few reasons for this that I see discussed frequently. I mentioned the current mortgage situation in my last letter. Although rates on a new mortgage can easily be over 7%, the data show that half of all current 30-year mortgages are below 3.25%, and two-thirds are below 4.2%. This means that people with these low interest mortgages have little incentive to move unless they have a life style change. It has also led to a drop of over 15% in existing home sales. There are a lot of consumers in this position, and they are dodging one of the biggest effects that higher interest generally has on slowing down the economy. Another issue that I've mentioned before is excess savings. Famed bond investor Bill Gross said, "we threw trillions of dollars out of a helicopter". How much money do consumers still have from all the pandemic programs that has not been spent yet? There is a lot of debate on this question, and a fairly wide range of conclusions. I've reviewed two different Federal Reserve studies, and they both lead to the conclusion that the extra savings are gone. The study from the Federal Reserve Bank of New York illustrated clearly that the economy has been being propped up by this extra money for the last two years. If others are right and some of this money is still left, I would be very comfortable suggesting that it will run out as we move into 2024. When all the "helicopter money" is behind, I believe we will see what the true earning power of the economy is in 2024. There's a very good chance that things will slow down.

Many have been calling for a recession for almost 18 months now. The recession never came, and some have given up on it as the economy has kept moving forward. I think the points I mentioned above are a large part of the reason. Also, wage increases were very good last year which added some buying power back to consumers. Higher rates certainly could push us into a recession in the months ahead. Inflation has continued on its downward trend, and that's very good news. Putting together the recent reports on PCE inflation and the CPI, we see that inflation over the last 12 months is right around 4%. Readings from the last three months are even lower. That's a huge improvement from the recent high of 9%, but still a long way from 2%. Several of the smart people I listen to think it will be quite difficult to get from here down to the 2% target without a recession of some duration. As rates stay high and inflation drops, the real interest rate is increasing. Higher real rates will eventually have a much bigger effect as corporations, commercial property owners, and Uncle Sam have to refinance their debts. Higher real rates are a definite headwind for the stock market. This leads us back to the question of can the Fed balance this whole thing and lead us to a soft landing? No one can answer that, but it would be great if they could.

I have no intention of trying to predict if we will have a recession in the next year or two, but I would like to add some context to the feared "R" word. According to Wikipedia, we have had 48 recessions, give or take a few, since we were under the Articles of Confederation. It's a very interesting list to review if you like history, as I do. As an example: our very first was the Panic of 1785, which lasted until 1788. It ended the business boom that followed the American Revolution and the victory at Yorktown. Many others were associated with financial crises and banking panics. In more current times, from the Great Depression until now, there have been 15 recessions. The latest was in the spring of 2020, due to the Covid pandemic. My point in bringing this up is that recessions are an unavoidable fact of economic life. There are many reasons for them, but it generally boils down to human behavior. We are emotional people and the fear of loss, or desire for gain, usually drive things to extremes. We end up with booms and busts of various types. One of the reasons we have the Federal Reserve is an attempt to smooth out these cycles and cushion us from the worst outcomes. I'll leave you to your own opinion as to how well that has worked. If you are in the camp that the role of the Fed has been helpful, we still have to recognize that they cannot prevent these cycles from happening. Just think of the Great Recession that we went through over ten years ago. The Fed was unable to prevent it, and many put much of the blame on them for the bank regulators not doing their job.

Our success as investors is not based on our ability to predict recessions or even avoid them. We certainly do make adjustments in our portfolios due to the outlook and many other factors, but generally speaking, we have to stay in the game during recessions if we want to be successful. The current outlook is that SP 500 earnings will increase over 10% next year. That would be very welcome but there is certainly no guarantee that it will happen. What does seem certain to me is that the Fed has a lot of room to stimulate the economy if it does slow down too much. Hopefully this would lead to a short or shallow recession if we do have one.   Please contact us anytime to discuss your portfolio.

Best Regards,

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