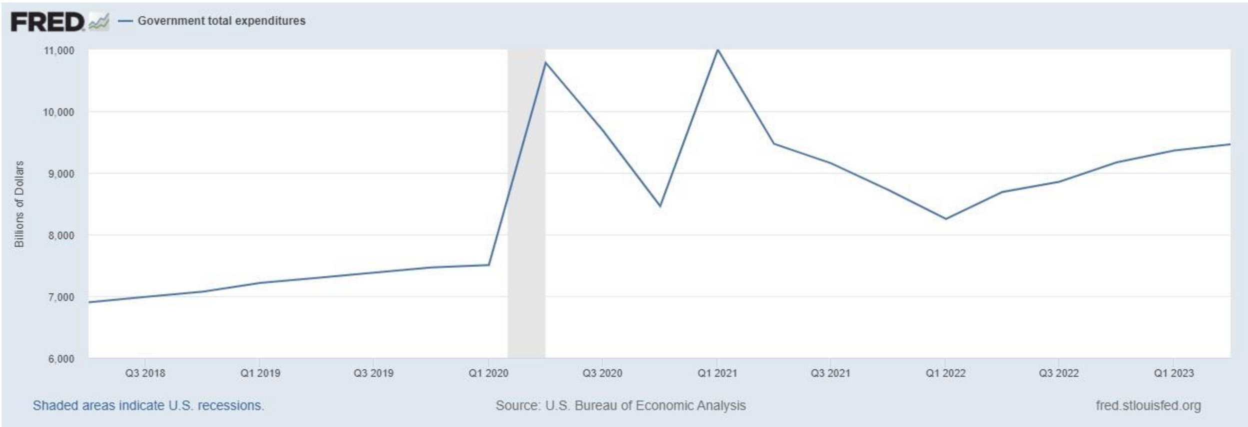
Mirage of an Oasis

Navigating the straits between runaway inflation and a recession

It is the *biggest* spending blowout of all time, accommodated by the *largest* expansion of the money supply of all time, leading to an *explosion* of inflation, followed by the *fastest increase* in interest rates of all time, now creating the *greatest* run up of deficits of all time. [1]

Traditional "sure thing" economic indicators have fallen by the wayside. A widely expected recession has yet to appear because Government spending deferred an economic slowdown and probably exacerbated the ultimate downturn.



Extraordinary, extravagant, and ill-designed Covid spending distorted the economy. **Spending has continued at emergency levels**. True, the US economy is very large, but so is the current budget deficit of over 5% per year. [2] The deficit, as a percentage of GDP is now higher than WWII levels!

[1] https://www.cbo.gov/publication/59377 The federal budget deficit was $1.6 trillion in the first 10 months of fiscal year 2023, the Congressional Budget Office estimates—more than twice the shortfall recorded during the same period last year. Revenues were 10 percent lower, and outlays were 10 percent higher from October through July than they were during the same period in fiscal year 2022.

[2] The federal deficit is projected to roughly double this year, as bigger interest payments and lower tax receipts widen the nation's spending imbalance despite robust overall economic growth.

The size of the deficit is already problematic, but less significant than the future course of the deficit. Higher real interest rates compensate for current inflation and future uncertainty created by the soaring deficit as well as reducing future growth potential.[3]

Some government spending is necessary, some is desirable. "Good" spending is devoted to legitimate central government functions and other amounts on "investments" that supply measurable returns. These obligations create a substantial current account deficit. That deficit can only be serviced and reduced by real growth in the private economy.

Non-essential spending financed by added borrowing must meet a substantially higher bar than the currently imposed. Far too much money is now spent on enormous boondoggles based on speculation, without a real cost benefit analysis. Genuine metrics and projections are needed for accountability, not the current pseudo-science and static economic analysis. Spending on programs and projects without measurable outcomes is an unaffordable luxury for an indebted government. The Congress uses continuing resolutions to avoid scrutiny and responsibility for their role in this excessive spending.

After the government's record spending in 2020 and 2021 to combat the impact of covid-19, the deficit dropped by the greatest amount ever in 2022, falling from close to $3 trillion to roughly $1 trillion. But rather than continue to fall to its pre-pandemic levels, the deficit then shot upward. Budget experts now project that it will probably rise to about $2 trillion for the fiscal year that ends Sept. 30, according to the Committee for a Responsible Federal Budget, a nonpartisan group that advocates for lower deficits.
https://www.washingtonpost.com/business/2023/09/03/us-debt-deficit-rises-interest-rate/

[3] https://www.frbsf.org/economic-research/publications/economic-letter/2023/september/does-monetary-policy-have-long-run-effects/

The country works like an economic entity – far larger and more complex – but still an economic entity running on a scale and in ways that are nearly incomprehensible. It is self-regulating, self-perpetuating, a super organism[4]. The response of the economy to the extreme fiscal and monetary policy is uncertain in nature and size – but the "largest of all time" predicate suggests an extreme outcome.

Massive waste of societal wealth has significant, long-term consequences.

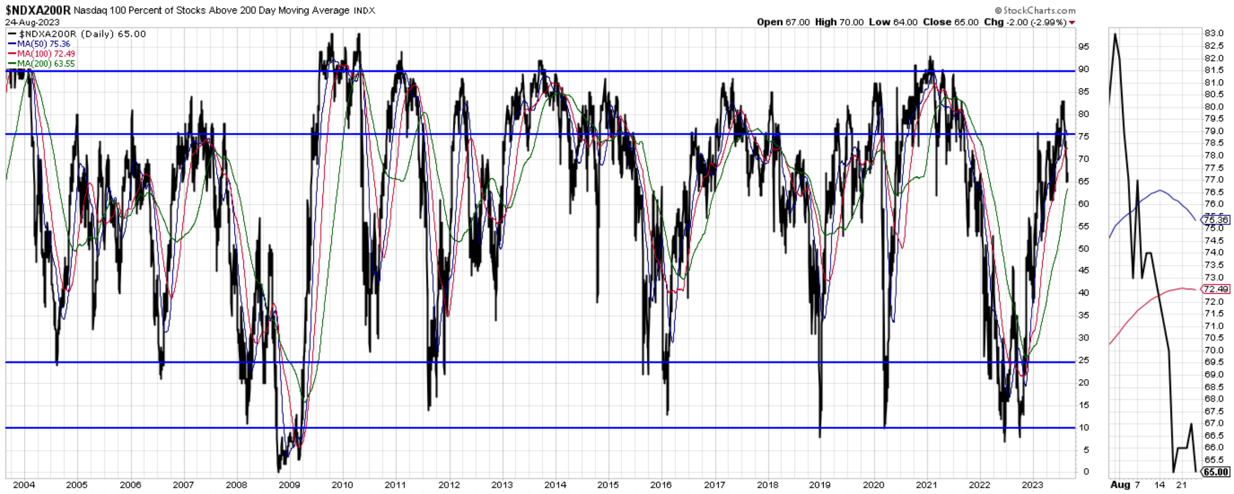
Regardless, stock market investors believe that central banks are omnipotent, able to control interest rates and business cycles. Sure, things can get messy – but not out of control. History suggests that this confidence is misplaced. When the drawdown of accumulated economic resources has reached an extreme, there is no longer any cushion for the impact of spending on inflation.

It's a Mad Magazine like "What me worry?" stock market rally.

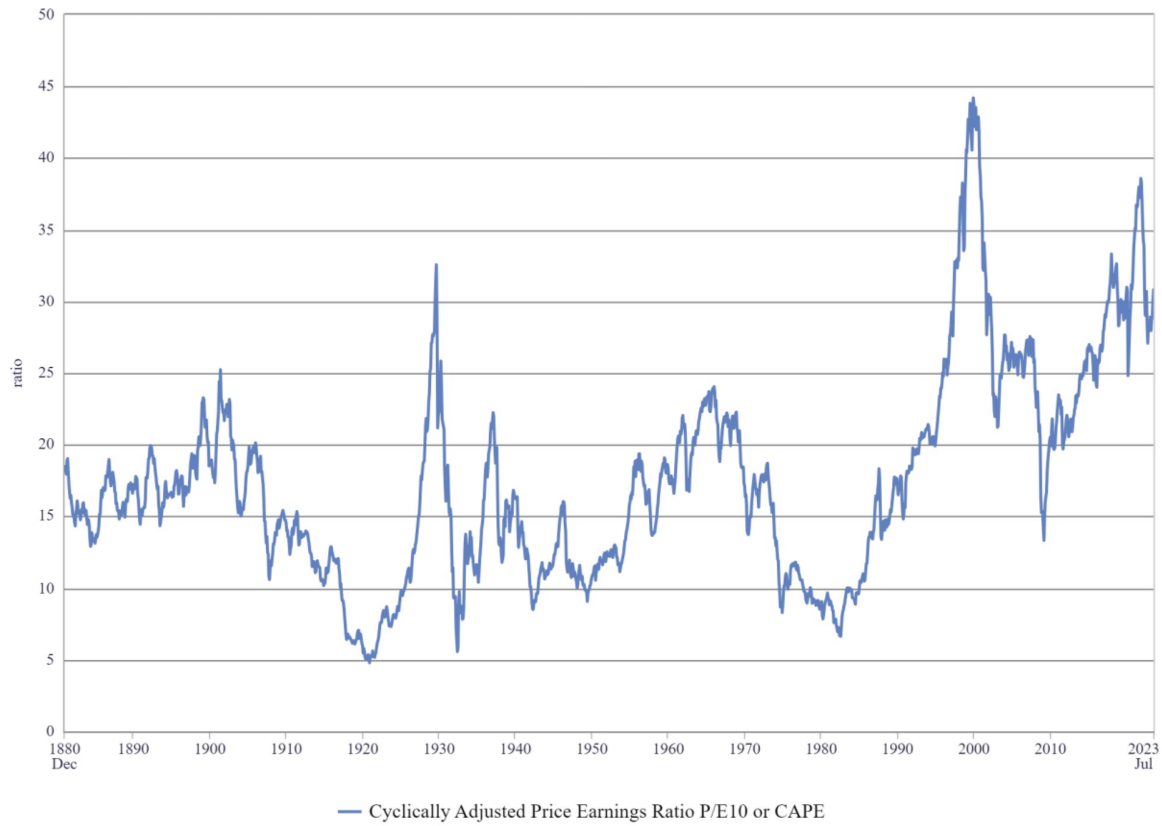
Equity markets have rallied,

and **stocks have moved into the expensive range**, back into the caution/avoid zone when over 75% of shares are above the 200-day moving average. Another measure of valuation – the CAPE ratio is again near all-time highs.[5]

https://en.wikipedia.org/wiki/Superorganism
[5] https://www.multpl.com/shiller-pe



Cyclically Adjusted Price Earnings Ratio P/E10 or CAPE



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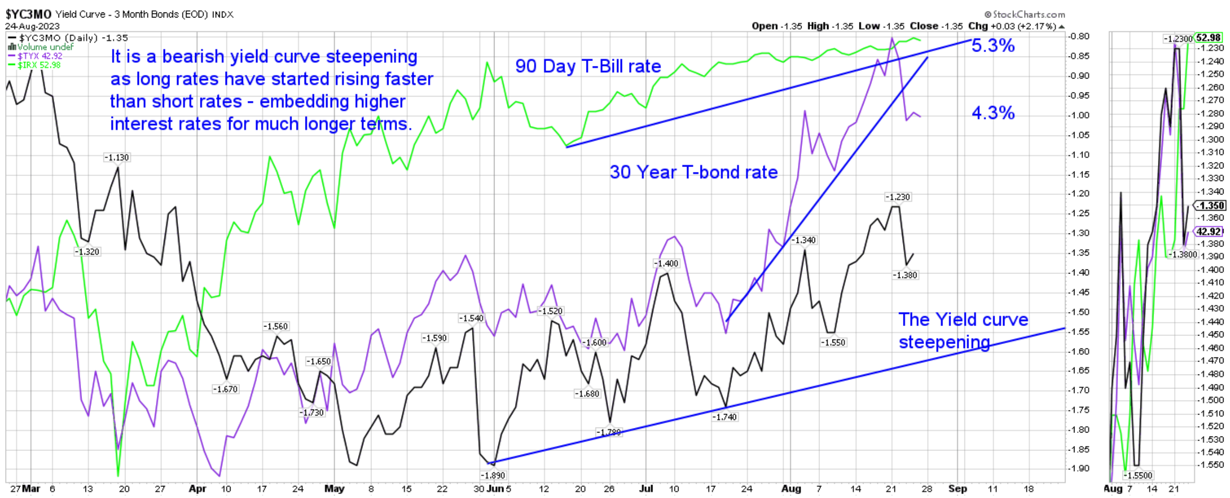
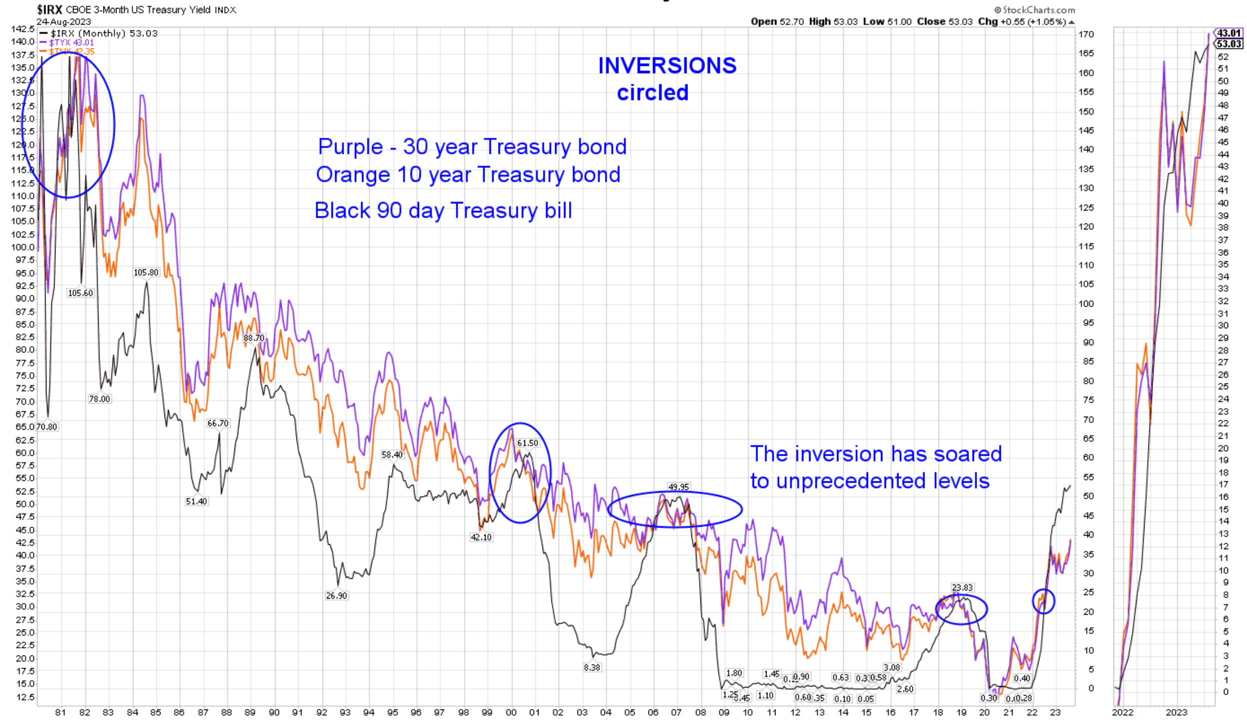
6 https://public.knoema.com/mbcuptg/online-data-from-robert-shiller-u-s-stock-market-data

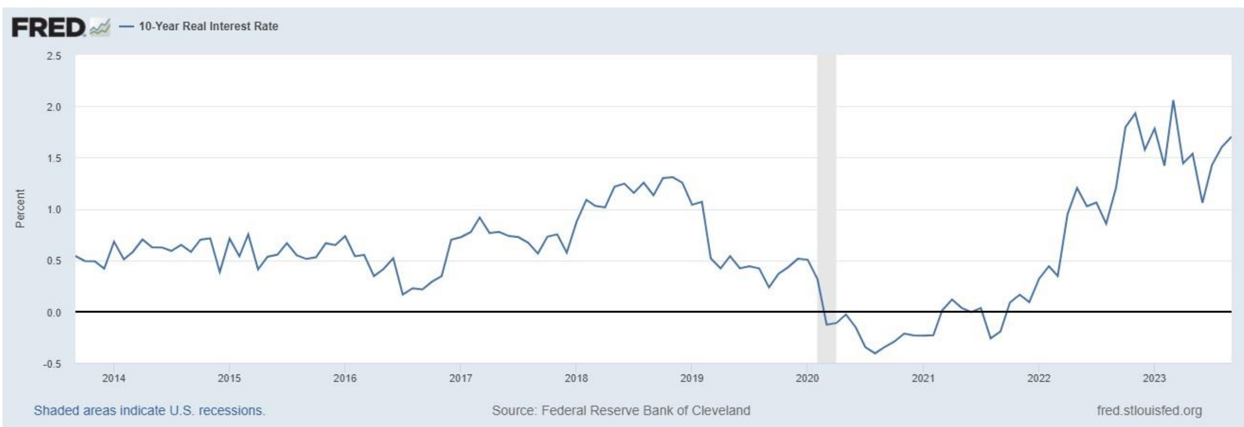
The **yield curve has flattened slightly, but it is a bearish steepening** – long term rates have moved higher compared to short term rates, the curve is still deeply inverted.



Greatest of all times accurately describes the interest rate increase of the last two years.



The rapid increase in yields has now surpassed the earnings yield of stocks. Simply put – short term treasury debt at 5+% promises a higher and certain return than stock earnings yield at slightly more than 4%, an unusual occurrence. Not a definitive sell signal, but it suggests stocks are expensive relative to bonds.



Real rates have been higher, much higher in the past– but **the recent move has broken the long term down trend**. Higher interest rates for longer have traditionally been poison for the stock markets. Anticipation of an imminent peak in interest rates and then a rapid decline still resonates loudly in the market, consistent with a faith that inflation has been "whipped." I believe investors are prematurely discounting the effects of the sharp interest rate increases.

A Temporary Reprieve

The massive budget deficit is indisputable evidence of a sick economy. Powell and Yellen cannot honestly deny the growing debt bomb, so they dissemble a transition to a stable economic future. That future fades farther into the distance as the deficit grows so large *that the prospective benefits of this spending exceed any possible recovery*.

It is the mirage of an oasis.

Modern Monetary Theory[7] was the modus operandi at the FED, if not the "official" policy.

The price increases caused by increasing the money supply by 30% are mostly permanent. Some effects are swift, consumers facing prices for example, other responses take time to develop Wage push inflation has now increased.[8] Increased strike activity is associated with the multi-year inflation. "Large" wage increase demands in recent major union contracts – a response to higher prices and declining living standards are even more aggressive because of a regime in D.C.[9]

Higher financing costs as debt is refinanced will also contribute to inflation.

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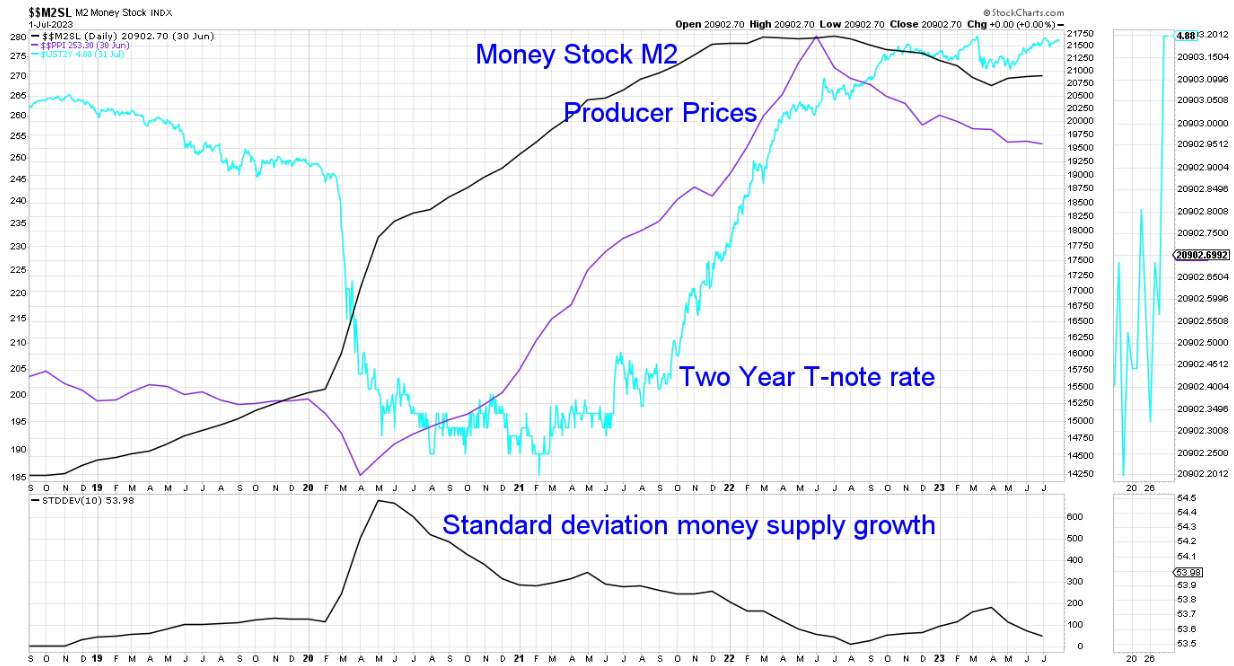
[7] MMT is used in policy debates to argue for such progressive legislation as universal healthcare and other public programs for which governments claim to not have enough money to fund. ….The central idea of modern monetary theory is that governments with a fiat currency system under their control can and should print (or create with a few keystrokes in today's digital age) as much money as they need to spend because they cannot go broke or be insolvent unless a political decision to do so is taken.https://www.investopedia.com/modern-monetary-theory-mmt-4588060

[8]

Wages and salaries increased 4.7 percent for the 12-month period ending in June 2023 and 3.2 percent a year ago. Benefit costs increased 5.2 percent for the 12-month period ending in June 2023. The prior year increase was 3.6 percent. (See tables A, 7, 11, and 12.)Jul 28, 2023
https://www.bls.gov/news.release/eci.nr0.htm#:~:text=Wages%20and%20salaries%20increased%204.7,%2C%2011%2C%20and%2012.)

[9] https://www.wsj.com/economy/jobs/unions-flex-power-when-workers-are-in-short-supply-ff4ab076?st=vxvct5fl1uplpzs&reflink=desktopwebshare_permalink

The “war on fossil fuels” has created market shortages that can only get worse, another impetus to a resumption of inflation.



Against this background, the recent surge in inflation shows that the FED can no longer suppress interest rates and shape the yield curve without immediate consequences.[10]

Actions that directly or indirectly support growing deficit spending cause an almost immediate increase in inflation. Progress on inflation stalled after recent interventions in the banking crises, early this year. The bail out of these “special” banks was a fiasco for many reasons. The responses were ad hoc, unprofessional.[11] Regulatory incompetence, irregular procedures at the FED, the Treasury and particularly the FDIC **required** a massive intervention to assuage market fears and staunch an out of control run on many “regular” banks. It was a much more consequential and much closer call

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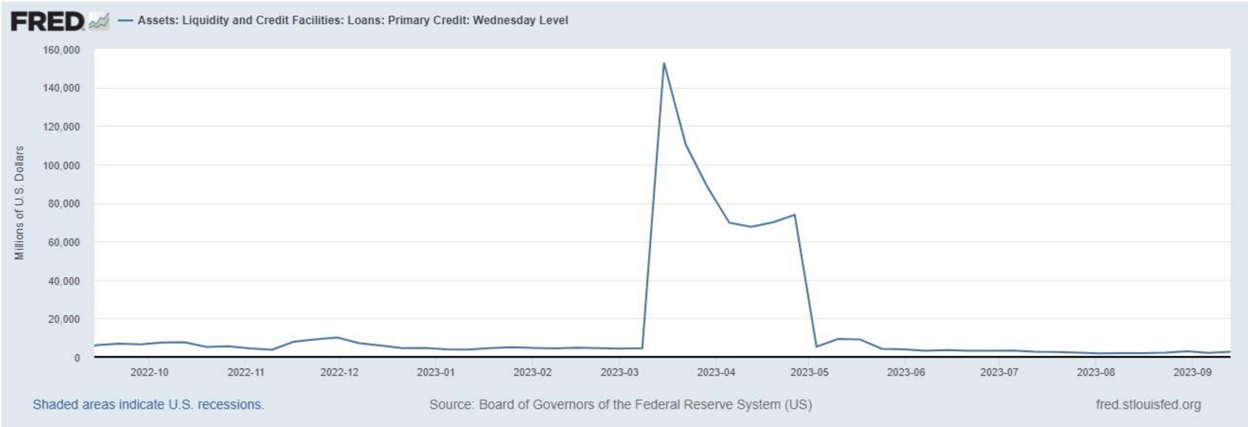
10 https://www.investopedia.com/terms/c/crowdingouteffect.asp#:~:text=The%20crowding%20out%20effect%20is%20a%20theory%20that%20suggests%20that,revenue%20for%20its%20own%20spending.

11 https://www.nytimes.com/2023/05/01/business/first-republic-jpmorgan-fdic.html?smid=url-share

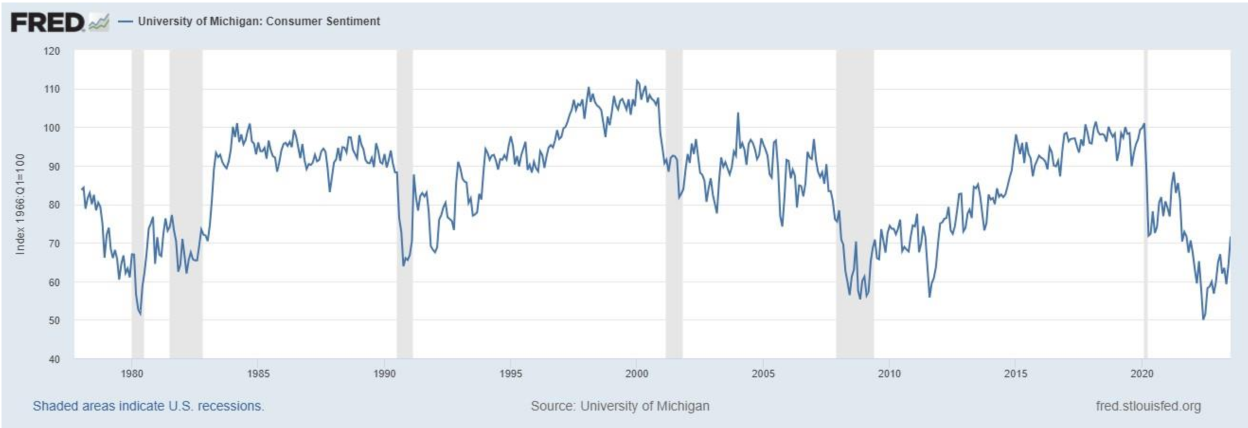
than most investors understand. Banks cannot prosper, must struggle to survive when the yield curve is steeply inverted, so the problem remains.



Increases in the money supply produce inflation – whether bailing out the banks or the extravagant Covid spending.

A dim outlook

The consumer rules America. They are unhappy. Some more very negative sentiment readings.[12]



[12] The research discussed above suggests that today's consumer confidence does give a meaningful clue as to the economy's strength, both in the present and the future. https://www.stlouisfed.org/publications/regional-economist/april-2003/consumer-confidence-surveys-do-they-boost-forecasters-confidence

Consumer attitudes reflect prices stabilizing at an inflated level, resulting in a *permanent* decline in their standard of living. This impoverishment extends to all but the wealthy, the politically connected, and the power elites and special interests fare much better.

Resentment is building, "Rich Men North of Richmond" is clearly an anthem resonating with millions.[13] The viral nature of the video is another sign of the emergence of a new "Counterculture."

Censorious scolds, second and third generation iterations of their parents, are the last vestiges of what was the counterculture revolution of the 1960s. That period of expression has run its course, devolving into pedantic nonsense.

Just as populist movements can drive markets, so can events. Several economic contractions and adverse stock market events have coincided with significant social and political upheaval.

Elections have consequences.

The greatest cage match of modern American political history is underway. It is a unique time in the history of the Nation, a painful embarrassing mess for patriots on both sides. The leading nominees are both nasty men, serial liars and probably criminals.

Both are easy to dislike, to put it mildly.

Reasonable people might differ about which is the worst scoundrel. It is an argument without merit – the conduct of both men is unacceptable.

Biden is implicated in suspicious behaviors by voluminous evidence, that if true are well defined crimes. Trump is an uncouth bruiser. Unlike the President's case, far more is proven in the Trump record, however the materiality is in dispute. The "law" is being applied and enforced in new and unique ways. That distinction may well resolve the issue if either man is still standing by election day.

It is inconceivable that either could be the candidate of their party or be elected President. Yet November 2024 is approaching rapidly.

Another candidate or candidates may come to the forefront. A President Harris seeking reelection is a possibility. The possibility of a satisfying 2024 election outcome seems as remote as a soft landing.

[13] https://www.youtube.com/watch?v=sqSA-SY5Hro

Perhaps Mr. Market sees another outcome, indifferent to the current jostling.

OUTLOOK

"Three years before the deadly collapse of the Champlain Towers South condominium complex near Miami, a consultant found alarming evidence of "major structural damage" to the concrete slab below the pool deck and "abundant" cracking and crumbling of the columns, beams and walls of the parking garage under the 13-story building.

The engineer's report helped shape plans for a multimillion-dollar repair project that was set to get underway soon — more than two and a half years after the building managers were warned — but the building suffered a catastrophic collapse in the middle of the night on Thursday, crushing sleeping residents in a massive heap of debris."[14]

Long clear structural flaws were kicked down the road until the collapse occurred. Just as gravity eventually led to the collapse of the Towers, the US economy is at risk.

It may be possible to navigate the straits between Scylla and Charybdis. On one side: higher interest rates and a slow or no growth economy, the other: inflation and an unknown economic future. Historical precedents are not encouraging.

MORE CONFUSION

The equity index price charts reflect expectations of a soft landing for the economy. The out performance is unusually concentrated on large growth stocks. The market capitalization weighted S&P 500 has substantially outperformed the equal weighted alternative, as well as small and mid-cap companies. This contrasts with the historical norm –reflecting the weaker credit posture of most companies compared to the mega capitalization technology companies.

The resolution of this disparate performance will decide the next phase for the equity markets.

[14] https://www.nytimes.com/2021/06/26/us/miami-building-collapse-investigation.html?unlocked_article_code=wMzdJGkrZ2NTng-4iASsWYU_aGM-PTs8Temj6sKwi4-bQBTGXT1SQ90mOfmiDeT80_FHrNi-iVJshvL2ByRyHl_btwnKqfcGlOmviz6tlZMTXWuT_aNo2Ea1FntEjBDYRH5AG_QHvm7vXg5Ox-_EK_kscYRopkvEAr1xz-0BukQ1y6APAgSK52c2-3JfRh3mH7a1DXkjX4A-Lc9P_UHdNFidxNxxFS0tRJJt-mbv4aDKsWJAz6xvqJ4FIKsFpf_fag2f2Z5Kih_GalzPV6tTK-zsyNN2WZ_kJ-qLObatvaUg-fHL34otJQJNAsUzYsPZd7bat34GnbrQqh-6bGASIZtlxmMuTX6A4ok&smid=url-share

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CONCLUSION

It is the *biggest* spending blowout of all time, accommodated by the *largest* expansion of the money supply of all time, leading to an *explosion* of inflation, followed by the *fastest increase* in interest rates of all time, now creating the *greatest* run up of deficits of all time. [15]

Wasteful deficit spending has led to exploding budget deficits. This spending exhausted the slack in the economy. It led to a large increase in the money supply that led to explosive, unsustainable price inflation.

Federal spending funded by huge money supply increases cause inflation is the new mantra, replacing Modern Monetary Theory, for the moment.

Monetary policy has reversed course sharply, fiscal policy remains in full on stimulus mode, on automatic. (Continuing resolutions)

A credit crunch, because of the mismatch on the balance sheets of financial institutions and credit quality deterioration is occurring at the same time as “crowding out” – as the Government borrowing increases. As a consequence, the yield curve is experiencing a bearish flattening, as long-term rates increase versus short term rates. No way out!

Equities compete for investment dollars. High interest rates exceeding stock earnings yield are unusual and tip the scales on allocation towards yield.

Investing

Elevated market risk is usually accompanied by a wide dispersion of valuations among and within asset classes. The worse things appear, the better the investment opportunities. These can culminate in a “magic moment” (actually a few days or even months) when fears overwhelm

[15] https://www.cbo.gov/publication/59377 The federal budget deficit was $1.6 trillion in the first 10 months of fiscal year 2023, the Congressional Budget Office estimates—more than twice the shortfall recorded during the same period last year. Revenues were 10 percent lower, and outlays were 10 percent higher from October through July than they were during the same period in fiscal year 2022.

reason and assets are auctioned off at fire sale prices. It can and frequently does occur across most asset classes.

It is impossible to pick a bottom, the best one can do is conclude that valuations are low enough to warrant investment. Investors would do well to understand that a balanced portfolio has returned perhaps 8% over the long term. Significant performance variance is caused by sequence risk – which investors can seek to minimize.

The value of many cyclical stocks, interest sensitive sectors, e.g., financials, real estate, utilities, and special situations are becoming attractive.

“Fixed” income offers real interest rate returns not seen in decades.

Energy is still under owned and inexpensive on most measures. The outperformance of the sector is likely to continue as terminal valuations become more reasonable and portfolio managers try to catch up in the performance derby.

The Ursa Major is about to resume. Support levels are at or near the October 2022 lows. The next down leg should be steep, carrying prices down another 10-25%.

A patient and prepared investor has a greater likelihood of success. A massive markdown and clearance sales are underway. When fear rules the market, bargains abound. Excess confidence is a sell side opportunity; buyers should focus on valuation, fundamentals, and tangible returns. Buying near the lows is possible, buying at the lows is sheer luck.

Casual bettors should be very wary of parlay bets. While these bets can promise huge payouts, they are risky and are not an investment strategy.[16]

There are 11 S&P 500 market sectors. The recent performance spread has been significant. Comparing the short-term performance to the long term

[16] https://www.investopedia.com/parlay-bet-5217711

suggests that the depressed sectors are becoming compelling, e.g., real estate and financials. The market leadership, not so much.

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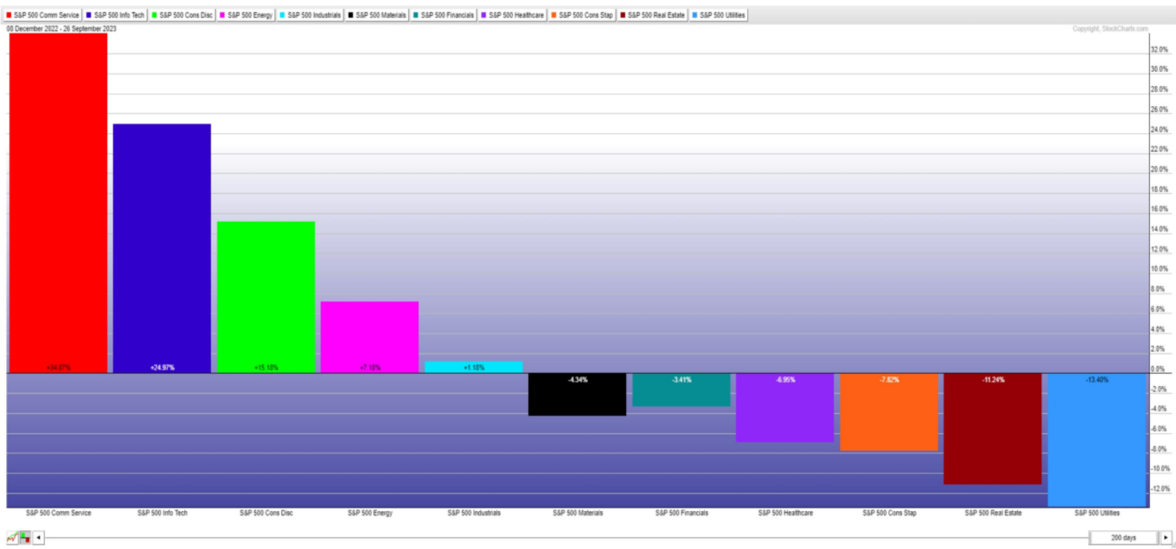

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