Ivory's Economic Outlook

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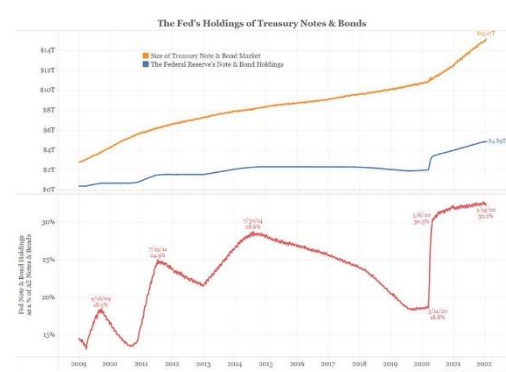
"If we had no winter, the spring would not be so pleasant".
Anne Bradstreet, Poet

On November 23, 1986, I found myself running down Beaver Stadium in State College Pennsylvania carrying a goal post after my beloved Nittany Lions beat the Pitt Panthers and qualified for that year's Fiesta Bowl. Weeks later we would prevail over the heavily favored Miami Hurricanes in thrilling fashion to win the national championship of college football.

What a semester that was! Penn State had 35,000 students on a campus that hosted a party every Saturday afternoon before the game, in the stands during the game, after the game had ended and was preceded by the parties on Friday night and the night before that. What a wonderful time to be alive. These conditions, however, did little to improve my academic standing.

Faced with a dwindling GPA I did the unthinkable and called my father during normal business hours to solicit moral support. This was a failed strategy because first, this was an era in American history when a child could not call their parents at work unless they had been hit by a car, arrested, or abducted by aliens, and second, my father did not believe in moral support. He fed you, clothed you, gave you shelter and an education. Everything else in his book was gravy.

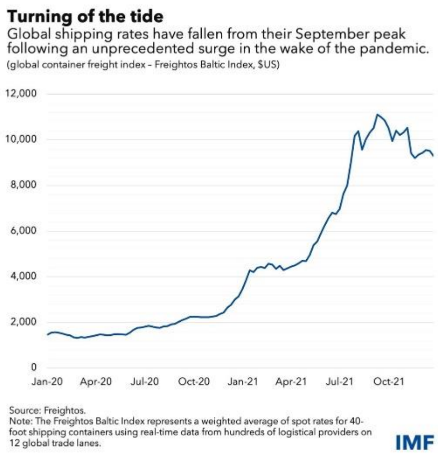
Nevertheless, I told him I was getting C's and D's and needed some direction. He responded by saying one of two things were happening: either I was studying or I was not studying. The broker of "no lies told" went on to suggest that if I wasn't studying I was wasting his money and if I was studying then maybe I'm not college material. He concluded his walk down old school lane by telling me to let him know if I was going back to school the next semester and then promptly hung up the phone.



Within an instant my father had removed the training wheels of life. Perhaps there was no other way to unhitch our two wagons but suffice it to say I finished all 134 credits within four years and moved out of my parent's house six months after graduation. It sure would have been nice to have had a Central Bank all these years share my father's no-nonsense approach; perhaps it would have prevented the codependency concerns we're facing today.

To be clear, the Fed has inflated asset prices for over a decade and now inflation has significantly reduced the purchasing power of consumers. To add context, the Federal Reserve creates money electronically and buys treasury bonds from the banks – the banks get the money, the Federal Reserve's balance sheet gets the bonds and the banks put the proceeds to work in the economy. When demand for bonds increase, bond prices go up, interest rates go down and that's how they lower interest rates to stimulate the economy.

Nobody's advocating for needless pain when Americans need a helping hand, but the Fed's balance sheet has grown from $1 trillion in 2008 to $4.5 trillion in 2014 to $8.7 trillion today. It has grown so large that it currently owns 32 percent of all treasury notes and treasury bonds[i]. The result is that 40 percent of our money supply has been created in the last 24 months[ii]. Call this reckless if you will, but it was all good in the hood when the champagne was flowing.

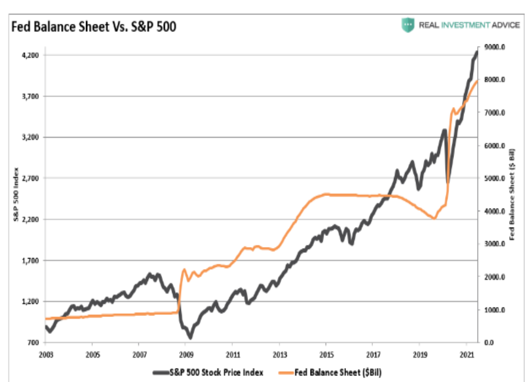


Likewise, low interest rates have made it easier for companies to borrow money, leading experts to label anywhere from two[iii] to 20 percent[iv] of all publicly traded domestic U.S. companies as zombie firms depending on who you ask. These are entities with no viable business model and only survive because they can borrow more money to stay afloat. Regardless of the true number, you'll recall that when COVID shut the economy down the government had to rescue countless Fortune 500 companies who couldn't survive 30 days without revenue. Inexpensive capital also paved the way for 100 percent of net new purchases of stock since 2008 being the result of stock buybacks[v] because companies could borrow money on the cheap and create demand for shares that boost stock prices. Nobody is cheating, they're just maximizing returns within the confines of the law.

In fact, our entire economy is now built to optimize stock prices. The supply chain gets a bad rap for inflation, but this is due in part to "just in time" supply chains where companies refuse to tie up capital in inventory. This meant that once COVID curtailed shipments there were a lot of companies with no reserves to sell. Worse yet, many of the small manufacturers that serviced retailers went out of business because ordering goods that wouldn't be immediately sold hurts earnings and those who survived had incredible pricing power when business resumed. Couple that with shipping containers that tripled their price[vi] with loose monetary policy and one grandiose stimulus package after another and you get 6.8 percent year over year inflation[vii].

These extraordinary measures by the Fed to prevent widespread economic pain worked like a charm, yet even a casual observer can see the remarkable resemblance the trajectory the Fed's balance sheet has with the S&P 500's. The two charts are almost in lockstep, one pushing the other along it's merry way. Lo and behold all the manufactured money has caused inflation and since Main Street votes and Wall Street has better lobbyists the Federal Reserve is trying to thread a needle as narrow as gun barrels to thwart rising prices.

The central bank has been so instrumental in supporting asset prices that any hint of a change in Fed policy impacts the market. The one thing I believe to be true is that inflation and economic growth have peaked on a rate of change basis and the Fed is tightening into a slowdown. I'm not saying inflation and GDP will reverse, they're just not going up as fast. With this as the backdrop, the same behavior that created higher stock prices and inflation - the dramatic increase in the money supply, the artificially low rates that led to stock buybacks and zombie companies - is about to be unwound at what may be the worst possible time.



The book “Never Split the Difference” is a fascinating examination of how to successfully negotiate during a crisis. Written by top FBI negotiator Chris Voss it explains that getting somebody to say the word “no” gives them a sense of control. Another method is to say no without actually saying no. On one occasion a politician’s aunt had been kidnapped by assailants who demanded $150,000 as ransom. Instead of engaging in a back and forth the nephew was instructed to respond to the demand by saying “how am I supposed to do that?”.

When the kidnappers made another threat against the aunt the nephew responded “I’m sorry, but how are we supposed to pay if you’re going to hurt her”, a subtle way of questioning the kidnapper’s fairness. It also brought up the aunt’s death which was the one thing they had to avoid if they wanted to collect any money. Ultimately the nephew offered a strange number that gave the impression he counted every last dollar and that came to $4,751. Then he threw in a portable CD player that the kidnappers didn’t need to create the illusion that there was no more money available. Six hours later his aunt was home.

The Federal Reserve is on the wrong side of these negotiations with a market that repeatedly asks “how are we supposed to do this?”. The Fed tried to raise rates and trim the balance sheet in the 4th quarter of 2018 and the market dropped 15 percent in the month of December alone. That simple reminder of how addicted the market was to easy money was enough to make the Fed change its mind and go back to business as usual.

It’s much easier to fix a wayward child than a broken man. This was always going to be a difficult transition. In the aftermath of the Fed’s December 2021 announcement that they would take the punchbowl away our celebrated stock market responded in kind and sold off. So now what? Should investors react according to what would happen if the Fed has the intestinal fortitude to follow through or bet that they’ll reverse course like usual and print more money to keep the markets happy? Those who make the wrong choice face being on the opposite side of a fast market while trying to straddle both possibilities guarantees that you’ll be partially wrong. Call me chicken but I don’t like getting run over and neither do you, so instead we straddle the fence until we know for sure.

It's hard enough managing risks presented by changing business cycles and macro-economic events, but this is an entirely different animal. When the growth rate of both the economy and inflation decelerate at the same time, certain asset classes such as utilities, consumer staples, health care, gold, and long-term bonds historically outperform on a relative basis. Were it not for the guessing game these names would have a bigger role the portfolio.

				% of members with:			
Index	YTD return	Index maximum drawdown from YTD high	Average member drawdown from YTD high	Positive YTD return	At least -10% drawdown from YTD high	At least -20% drawdown from 52w high	At least -50% drawdown from 52w high
S&P 500	-9%	-10%	-12%	23%	60%	49%	2%
NASDAQ	-15%	-16%	-20%	17%	71%	76%	46%
Russell 2000	-14%	-15%	-20%	13%	79%	82%	34%

Source: Charles Schwab, Bloomberg, as of 1/27/2022. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. Past performance is no guarantee of future results. Some members excluded from year-to-date return columnsgiven additions to indices were after January2022.

Crypto currencies are responding to the Fed tightening as well because there will only be 21 million bitcoins ever produced and that creates scarcity. When you buy bitcoin you are exchanging something in abundance (a dollar) for something that has a capped supply (bitcoin). When the Fed increases the money supply, that's good for bitcoin. When they reduce liquidity, that of course is bad for bitcoin. If you believe they will stop creating money out of thin air long-term with a $30 trillion national debt and 70 million retiring baby boomers, you should be bearish on bitcoin long-term. If something that drops 50 percent is too volatile, you should know that 46 percent of Nasdaq stocks as of this writing are down over 50 percent from their all-time highs and a widely held popular company recently tanked 23 percent in a single day. This game has more angles than a 10th grade trigonometry exam.

My tenant has moved out of my apartment in New York and with my son out of college I've decided to spend more time in the city. This requires some elbow grease to sand down the walls and prime before painting. I have to swap out lighting fixtures and change the bathroom vanity and update the kitchen. As luck would have it I ran out of materials during the last trip and had to walk eight blocks to a hardware store because parking in Manhattan is not an option.

It was the first time I had walked around the Lower East Side in quite a while and I was astonished at the changes in my old neighborhood. The bodegas became hipster hangout spots, holes in walls with strong drinks in plastic cups are now lounges, the illegal drug trade transitioned to a CVS. All of this got me thinking about some of the kids I grew up with who didn't have the father I did, who didn't know that food service contracts and $10 a day ankle bracelet charges would turn prisons into a booming business. I couldn't help but wonder if they had known those scales were weighing corporate profits and not narcotics, that they were the product and not the pusher, would they have done anything different? Would they have at least attempted to get C's on a college campus with 35,000 kids?

The Federal Reserve has repeatedly taken the easy way out and inflated the price of financial assets for over a decade and now the inflation police are knocking on the door. It seems the middle class is tired of witnessing the value of their hard-earned money being stolen and they want their block back. Things would have been so much easier to navigate if our elected officials and central bankers had taken the training wheels off and unhitched the economy's wagon from the smoke and mirrors that has dominated much of our recent history. This ain't Armageddon, it's just messy.

There's an old saying in cards that if "you think long you think wrong". Good thing I'm not playing cards; this set up demands all of my attention.

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[i] *Bloomberg*
[ii] *Inflation has Fed critics pointing to spike in money supply; Washington Post; 2/6/2022*
[iii] *U.S. Zombie Firms: How Many and How Consequential?; Federal Reserve; 7/30/2021*
[iv] *Deutsche Bank*
[v] *If Companies Aren't Buying Their Own Stock, Who Is?; Wall Street Journal; 6/2/2020*
[vi] *Higher Shipping Costs Are Here to Stay, Sparking Price Increases, Bloomberg, April 12, 2021*
[vii] *Inflation surged 6.8% in November, even more than expected, to fastest rate since 1982; 12/10/2021*