Ivory's Economic Outlook

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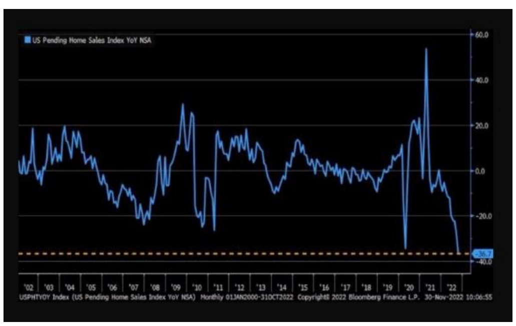
"I may be a senior, but so what? I'm still hot".
Betty White, Entertainer

My father's dementia may have gathered steam, but you can make the case that he would have made a great comedian if he had just given it some thought. Over the summer my mother hit her head and needed non-invasive brain surgery that required three weeks of rehab in the hospital. Day after day I would drive to Advent Health in Daytona Beach, FL with pops riding shotgun to visit my mom and consult with the doctors.

The problem was my dad would forget about our trips and began to suspect that his wife had run off with another man. Finally, he agreed that we had actually been to the hospital, although he declared that it wasn't his wife we had seen because in his words "that woman was old". This love-struck octogenarian then grabbed a picture of my mother from 1982 and stated emphatically "this is my woman, where the hell is she at?"

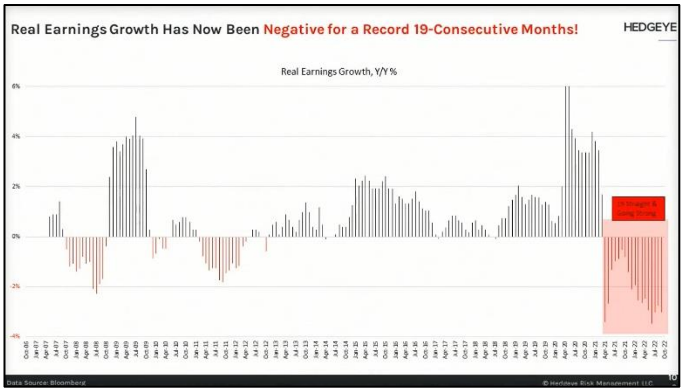


I explained to my dad that his wife isn't the same hottie she once was, and sadly, he's not exactly turning heads either. Suffice it to say it's hard to accept things as they are, to live in the present and not make decisions based on past realities that are no longer relevant. Last year investors kept grabbing scrapbooks from previous years wondering when the Federal Reserve would come to the rescue. Despite the overwhelming evidence that this is no short-term inconvenience, selling at the bottom still has its consequences.

The headlines may reminisce about last year's 19.1% decline in the S&P 500 after a late rally, but the Nasdaq dipped by 33% All the safe havens were seemingly in ER as even balanced portfolios with a 60/40 mix of diversified stocks and bonds declined by over 25%. The tools we successfully employed in the past simply didn't work which makes us wonder what to do in the face of new data.

Stock prices are a function of future cash-flow and corporate earnings. So how does the high cost of capital, high cost of living, high cost of labor and a significant decline in liquidity impact real earnings that have already declined for 19 straight months?[i] Narratives are a lazy man's crutch that include buying the dip, a Santal Claus rally, the Fed Put and pie charts. What matters more than anything else is the data.

A high cost of capital mitigates a business' ability to borrow money and expand operations. When interest rates go up, consumers need more money to buy the same house, car, or piece of capital equipment. Moreover, existing debt becomes more difficult to refinance which impedes growth and shrinks the bottom line. That's why pending home sales are down 37.9% year over year[ii] and used car prices are deteriorating. These conditions aren't just resigned to the middle class - the sale of luxury homes have sunk by the most on record[iii] and the consumption of luxury goods grew at .8% year over year in September 2022 versus 18% the year before[iv].

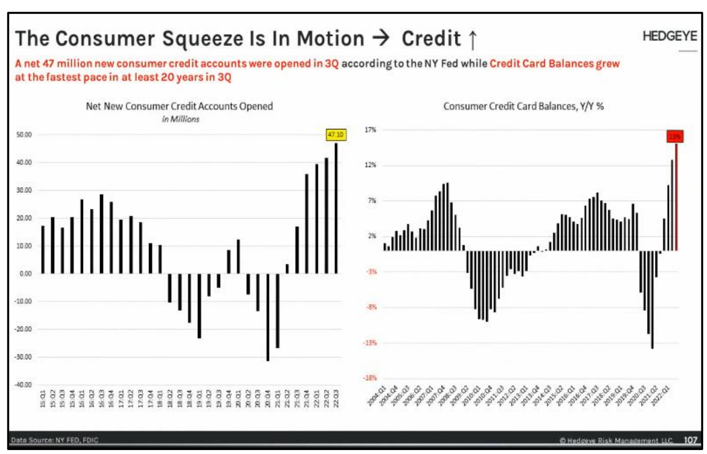


Consumer spending is 70% of our economy and the consumer is tapped out from higher prices. Lo and behold, 47 million new consumer credit accounts were opened in the 3rd quarter[v], the savings rate is lower than it was during the pandemic[vi] and credit card balances went up 15%[vii], the fastest pace in 20 years. All the households who wanted to live like a rock star suddenly realized that playing the guitar is harder than it looks, except this time they borrowed money to buy the instruments.

These numbers alone would be troubling if the liquidity hadn't declined. When the Fed creates money out of thin air with low interest rates and the government facilitates stimulus programs, the economy is awash in currency because the banks are more prone to lend and the consumers get a check directly from the government. That dynamic has reversed with the money supply declining at the fastest pace ever as defined by M2 (bank deposits, cash, and money markets)[viii]. For instance, commercial bank deposit growth is negative for the first time in 30 years, having increased by $700 billion in 2020, $350 billion in 2021 and declining by $370 billion in 2022[ix]. In other news, G4 balance sheets fell by $2.6 trillion year over year[x].

The Seattle Seahawks were driving down the field in Super Bowl XLIX when they found themselves on the Patriot's one yard line down by four points with only a few seconds left in the big game. During their emphatic march down the field, they had successfully run the ball. Then the craziest thing happened. Faced with a 2nd and goal the Seahawks decided to throw it, got intercepted and lost the game. Immediately the fans and experts alike questioned the play call. After all, why not dance with the girl who brought you to the party and hand it off to your running back?

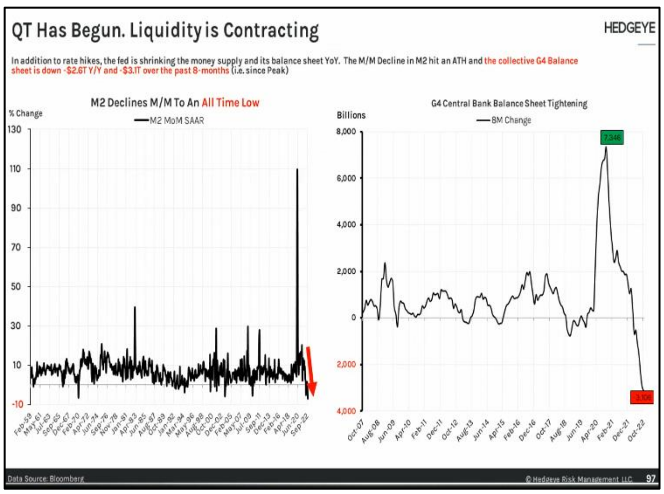
It turns out the coach made the right decision. During that season only 1% of all passes in the NFL from the one-yard line had been intercepted. Moreover, it was 2nd down and they only had one time out left that would allow them to stop the clock. If they ran the ball and didn't score, they would have to use their last time out because the clock keeps running on a run play. An incomplete pass, however, stops the clock. By passing the ball the Seahawks were all but guaranteed the ability to have three plays (with the option of a run or a pass) instead of two plays and could do so with a low probability of turning the ball over.



The decision was correct even if the outcome was unfavorable. Annie Dukes explains in "Thinking in Bets" that decisions should be judged based on the process and not the outcome, that if a man shows 17 at the blackjack table and draws a 4 he has made an error in judgement because the odds of a favorable outcome were low. Over time that player will likely lose money. In this instance, the Seahawks showed 11 and drew a 3.

Investors have been seasoned to believe that a rebound is imminent once inflation moderates and the Fed cuts rates. One would have to believe that after CPI grew from 2.6% to 9.1%, the Fed would cut interest rates because inflation falls back to (oh, I don't know) 6%, even though inflation would still be more than twice as high as it was two years ago. While on one hand the rate of inflation has declined, things still cost a helluva lot more than they did a couple of years ago. How exactly would the market respond to a Federal Reserve hiking rates and then doing nothing when investors expect a pivot? If your guess is as good as mine, let's make it an educated one.

There are no absolutes; we are best served living by probabilities. With consumers becoming increasingly indebted and less able to pay top price for goods and services, the likelihood of a slowing economy goes up. Similarly, as businesses tighten their belt in response to refinancing risk and compromised margins, employees have historically been the unwitting targets of cost saving efforts. The Employment Cost Index is currently at a historically high level of 5% on a year over basis when compared to what is normally 3%[xi]. The layoffs haven't really begun in earnest. Finally, the negative liquidity means there's less money to support global debt markets that have gone parabolic.



The United States currently owes $31.4 trillion in debt of which $24.5 trillion is owed to the public and $6.9 trillion is intragovernmental debt that includes money Uncle Sam borrowed from the social security trust fund a long time ago. According to the Treasury Borrowing Advisory Committee, 29% of the publicly owned debt, or a touch under $7 trillion, must be refinanced in fiscal year 2023 at higher rates[xii]. To add context, in just the last year interest on the 2-year note has increased from .55% to 4.33%, the 10-year note went from 1.725% to 3.64% and the 30-year bond from 1.75% to 3.74%.

If borrowing costs on only the publicly owned debt grows by 1.75%, that's over $120 billion every year in additional interest payments which represents more than 15% of our military budget. Please note that these figures are for one year – roughly 75% of the publicly held debt must be restructured over the next three years[xiii]. The Fed, if it's smart, must tank the economy just to keep the yields down. This is just one of the many unknown risks developed countries took when they financially engineered economic growth with artificially low interest rates for a quarter century. The $1.4 trillion private debt market that's illiquid, mispriced and largely owned by pensions is another. To the extent that economic pain forces the Fed to ease too soon, stocks could very well take off like a rocket in the short term. In the long-term, in the face of mounting debt and an unwillingness to batten down the hatches, U.S. debt and the dollar may no longer be seen in the same light.

The point I'm trying to make is the data suggests a strong likelihood of a volatile market the first half of the year because the Fed is unlikely to return the punch bowl as corporate profits suffer (or so we should hope), but anything can happen. In this environment we would want to own gold, cash, utilities, and consumer staples, but with money markets paying 4% even the defensive stock positions must be reconsidered. Under normal conditions we would also own bonds, but last year that was the equivalent of throwing the ball on the one-yard line. That being said, I would anticipate that as things go from catastrophic to bad, by the middle of the year it will be good for markets and investors can resume an aggressive posture. We'll see how it plays out. In the meantime, let's take the safe road unless there's an attractive opportunity.

On Christmas Eve my dad had a hypoglycemia attack because his blood sugar was too low. It happened because he's the James Bond of raiding the pantry when my mother turns her back, sneaking snacks and sodas that he shouldn't eat only to lack an appetite for dinner. While he was in the hospital he told the doctor that we were trying to kill him because we won't let him drink Coca-Cola. The doctor explained that he's a diabetic and soda was bad for him.

He asked the doctor if he was in the hospital for low blood sugar or high blood sugar. When the doctor said it was for low blood sugar my father asked if soda had high sugar or low sugar. Satisfied with the response pops dropped the mic by saying "exactly, drinking soda keeps me out of the damn hospital".

We can make up all kinds of stories to convince ourselves of one thing or another. In the end what gives us the best odds of success is following a repeatable process with an understanding that sometimes the best laid plans go awry. Hang in there; our greatest fears rarely ever happen. We're not out of the woods yet, but at least we have a map.

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[i] *Bloomberg Research*
[ii] *The National Association of Realtors*
[iii] *Redfin*
[iv] *Bloomberg Research/HedgEye Research*
[v] *NY Federal Reserve/FDIC*
[vi] *Federal Reserve*
[vii] *NY Federal Reserve/FDIC*
[viii] *St. Louis Federal Reserve*
[ix] *NY Federal Reserve/FDIC*
[x] *Bloomberg Research/HedgEye Research*
[xi] *Bureau of Labor Statistics*
[xii] *Fed interest rate hikes just made national debt a lot more expensive; Washington Post; 6/27/22*
[xiii] *U.S. Department of Treasury*