

# Ivory's Economic Outlook

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*"Give a man a fish and he will eat for a day. Teach him how to fish, and he will sit in a boat and drink beer all day."*

George Carlin, Comedian

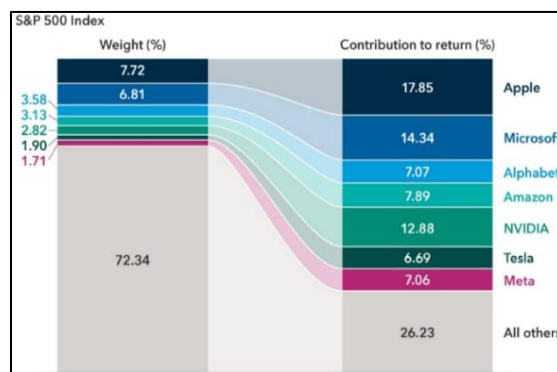
My roommate from college moved to northern New Jersey after we graduated and became somewhat of a fixture on my weathered \$150 futon and the microscopic one-bedroom Manhattan apartment that it occupied. He was starstruck by the Brooklyn brownstone parties my fraternity brothers would throw, the clubs we would get into for free because my childhood friend was a bouncer and the house music spots that wouldn't open until after midnight.

This was the pre-Rudy Giuliani anything goes Gotham City that hadn't quite gotten around to worrying about double parking or the safety of well-meaning tourists. That would come later. The late 1980's saw a city just 10 years removed from near bankruptcy and a sitting United States President telling the mismanaged metropolis, with hat in hand, to "Drop Dead".

It happened on Avenue C in the heart of Alphabet City just five blocks from my apartment at around 12:30 am while we waited on the sidewalk for a club called Choices to open. Out of nowhere a very determined young man was seen running down the street at top speed. He seemed to be a strong runner, and from what I could tell the beads of sweat on his forehead suggested they didn't have time to make their way down to the rest of his face, but that they eventually would.

The Lower East Side was in full effect. My friend from Maryland asked, "why is he running?" and I replied, "you'll see". We continued to socialize when several other very determined young men with baseball bats and chains were seen running in the same direction. My friend asked, "what's going on?" and I said, "you'll see". It couldn't have been more than a few minutes before we heard an ambulance and the sound of police sirens in hot pursuit. My old roommate (and best friend to this day) had all the information he needed, and I recall having a fabulous time well into the wee hours of night.

For the past year it has been apparent that corporate profits have been slowing, that the cost of capital is accelerating, and the economy is living on fumes. Nevertheless, in the wake of positive stock market returns, with all of us having a fabulous time, many advisors were asked if this was sustainable and we replied, "you'll see", even as we were enjoying the party ourselves. To the skeptical, the underbelly of double-digit returns was bereft of traditional valuation methods touted in our most esteemed and storied business schools. The discounted cash flow model, price earnings ratio, earnings before interest and taxes have all been abandoned in favor of mechanical order flows and derivatives that create demand for stocks.

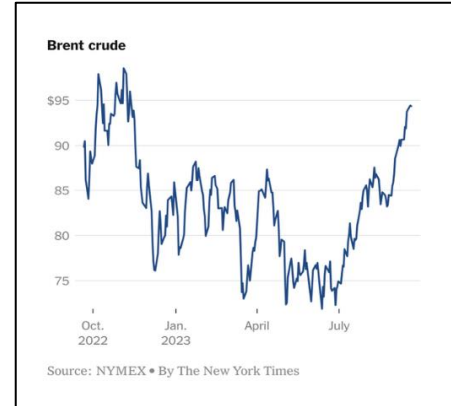


Source: FactSet. Weighted values for Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla and Meta as of June 30, 2023. Contribution to return calculated from January 2, 2023, to June 30, 2023.

On the surface, 28% of the S&P 500 weighting is represented by seven stocks that account for over 70% of the returns. Employees contribute \$464 billion to their defined contribution plans annually<sup>i</sup>, of which 73% goes to equities<sup>ii</sup>, and much of it to those seven stocks. To add context, defined contribution retirement accounts are valued at \$11 trillion<sup>iii</sup>. When a lot of money chases very few shares relative to the overall supply, those prices tend to go up disproportionately.

We also have a \$250 billion volatility control fund market<sup>iv</sup> where institutions and their passion for algorithmic investing are forced to buy or sell when volatility increases or declines. In this instance, it becomes a self-fulfilling prophecy that requires investors to have some participation in the market.

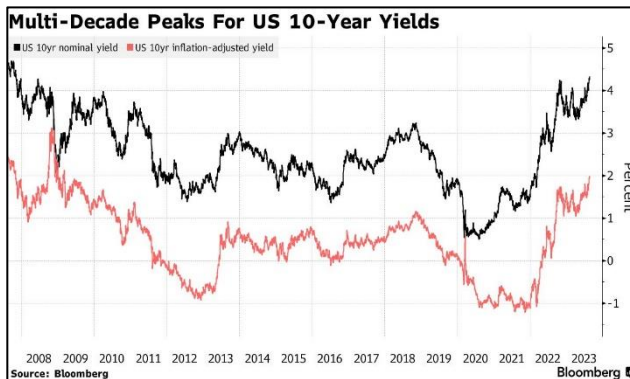
This behavior has created favorable outcomes, and there's no way to time the expiration date. Instead, you weigh the odds of something coming to pass. In this sense, portfolio managers have become odds makers and getting better over time doesn't mean always getting things right in the future. That's called perfection, and no one in this business is perfect.



If anything, I not only missed the impact of mechanical order flows described earlier, but how the Employee Retention Credits would affect GDP. These are remnants of the COVID stimulus plan that paid businesses as much as \$26,000 for every employee they retained. By March 2022 they accounted for \$26 billion of the \$5 trillion COVID stimulus<sup>v</sup>, but because they got extended, they had grown to \$220 billion through September of 2023 and \$95 billion of that was just this year<sup>vi</sup>. It's a great deal if you can get it, but the gettin' has gotten bad because the IRS recently stopped processing applications.

This game of musical chairs is fine until it isn't because it can work in reverse. For instance, when workers are confident in their financial well-being, they will increase retirement plan contributions. Unfortunately, when oil, rent and food prices increase they might just reduce those contributions, or worse yet, increase hardship withdrawals by 36%<sup>vii</sup>. Moreover, it was recently reported that one volatility control fund is expected to sell either half or all of its \$2 billion stock allocation if the market moves lower than the current levels<sup>viii</sup>. These are not predictions, just data points one would use to measure the probability of a subsequent result.

How did it all come down to this? It turns out that according to Open Secrets, 12,000 lobbyists spent \$3.7 billion to influence public policy on the Federal level in 2021 and during COVID we found out that American businesses operated like many of their customers - check to check. Not only did they need a lifeline, but so did their customers who were strapped for cash.



Congress is used to bailing out the banks and corporate interests because that inflates financial asset prices that benefits the donors who keep them employed. This time they were naive enough to give money to the people who really needed it, to lots of people who didn't need it, and to some people who didn't even ask for it. Lo and behold, their constituents spent every dime and caused inflation. Now everyone must pay the price, whether that's in the form of dairy products or nest eggs, we just don't know when it'll happen.

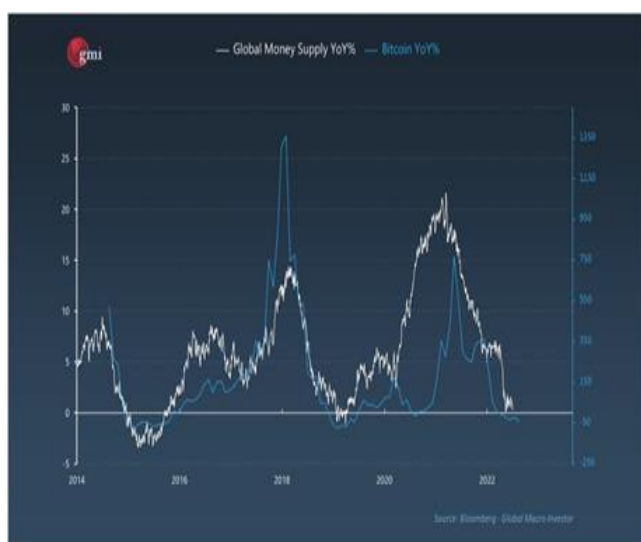
In 1970 Lockheed Martin was not only the nation's largest defense contractor, but it was essentially bankrupt after blowing through \$400 million in bank loans. The book "The Creature from Jekyll Island" explains that management, stockholders, and labor unions descended upon Washington and told politicians that without a bailout 31,000 jobs and untold economic growth would disappear.

The answer was a \$250 million government bailout that put the company 60% deeper into debt. It also meant that Congress had to steer contracts to the company to make the loan look more pleasing to the taxpayers' eyes because they would pay for it with higher taxes and the loss of their purchasing power. If socialism only works until you run out of other people's money, then you'd better create a central bank that never runs dry.

For every action, however, there is a reaction. We all assumed that interest rates would either decline or remain the same once the Federal Reserve paused interest rate hikes in September, but the opposite occurred. In fact, the interest on the 10-year treasury bond increased to as high as 5% from the 4.36% level it was at when the Fed made its announcement last month. For context, it was .65% just three years ago. The central bank has essentially lost control of a bond market that is now the true arbiter of interest rates. Something isn't everything but everything is something.

For what it's worth, the timing of higher interest rates is not good. Uncle Sam's debt is expected to double in 30 years<sup>ix</sup> and he'll spend \$10 trillion on just the interest payments alone over the next 10 years<sup>x</sup>. Any good bookie would tell you that there's a chance of something going woefully wrong and that singles and doubles are much better than swinging for the fences, especially when the low interest rate security blanket has been removed.

Nothing has suffered the consequences of higher rates and a hawkish Fed more than bitcoin. It seems like just yesterday the crypto currency enthusiasts were counting chickens weeks before they were scheduled to hatch. Bitcoin might be quite the swindle, but there is mounting evidence that it is a response to the systemic financial engineering orchestrated by the Fed. A cursory analysis of recent price movement suggests that it mirrors the liquidity either created or eliminated by the global central banks. For instance, in response to COVID the Federal Reserve grew the money supply by 40% with the European Union hot on its tail growing its own money supply by 22%<sup>xi</sup>. Fiat currency, in the midst of becoming even more abundant, was being exchanged for something that had a cap in supply of 21 million coins.



We now understand all too well that this dramatic increase in liquidity stoked inflation and the Fed responded by engaging in quantitative tightening that led to a historic decline in the money supply. The very same dynamic that led to bitcoin's price appreciation had been turned upside down. That of course created a precipitous decline in bitcoin. Once the rate at which the Fed reduced liquidity declined, bitcoin saw quite the rebound in 2023. The takeaway is that bitcoin may become a hedge against the Fed's history of debasing our currency and the reduction of our purchasing power in the process. As is the case with all new asset classes, however, we'll know more over time.

It's only marginally helpful to know how the movie ends if you don't know how long it will last. The traditional safe havens with a slowing economy will not work in this environment because high interest rates don't bode well for consumer staples, real estate, bonds, and utility stocks. To the extent that oil prices are accelerating we should own energy stocks, although the volatility of oil has increased, and we'll have to walk lightly in that regard.

There will always be a core of stocks you hold for the long term like family members who can disrupt a Thanksgiving dinner every now and then but are well meaning and have proven reliable over time. Japan's economy seemed to be one of the few countries that was still growing until it recently slowed down. Gold is traditionally a safe haven, although it has not responded well to higher interest rates and a stronger U.S. dollar, so the jury is still out on precious metals, the conflict in the Middle East notwithstanding.

Americans of every socio-economic class have directly or indirectly benefited from rampant deficit spending, even if the most vulnerable will be the first to suffer the consequences. The data shows that the median household income is \$70,734<sup>xii</sup>, student loan payments have resumed, and credit card debt has reached \$1 trillion<sup>xiii</sup>. Among households using SNAP, half are eating less, over 30% are visiting food pantries, and 30% are relying on family and friends for meals<sup>xiv</sup>. These demographics, both the poor and the middle class, were protected by the low cost of capital and absence of inflation. Now they are being crushed by this stunning turn of events. Oh, don't mind me; I'm just counting my blessings like I'm in accounting class.

I want you to imagine a child in his/her 30's who has become co-dependent on their parents for financial support. On the surface they are a model of success, but over time their own parents will exhaust their resources and the time approaches when that child will have to live on their own two feet. When that happens is anybody's best guess, but the odds are that the children will find the experience unsettling.

It's not my imagination (or yours). It's rough out there for a lot of Americans that the economy relies on to fuel its bottom line.

Play the odds.

You'll see.

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<sup>i</sup> Department of Labor

<sup>ii</sup> Vanguard: How America Saves 2022

<sup>iii</sup> Vanguard: How America Saves 2022

<sup>iv</sup> Deutsche Bank

<sup>v</sup> Where \$5 Trillion in Pandemic Stimulus Money Went; New York Times; 3/11/2022

<sup>vi</sup> Inside a Sales Army Turning a Tax Break Into a Modern-Day Gold Rush; Wall Street Journal; 9/4/2023

<sup>vii</sup> Americans are pulling money out of their 401(k) plans at an alarming rate; CNN; 8/8/2023

<sup>viii</sup> The S&P 500 just hit a key level. That could trigger a big shift in this \$2 billion ETF; CNBC; 10/23/2023

<sup>ix</sup> Peter G Peterson Foundation

<sup>x</sup> Federal budget deficit expected to nearly double to around \$2 trillion, government watchdog says; CNN; 9/6/2023

<sup>xi</sup> More Money Supply, More Problems; Northern Trust; 7/15/2022

<sup>xii</sup> Census Bureau

<sup>xiii</sup> Credit card balances jumped in the second quarter and are above \$1 trillion for the first time: CNBC; 8/8/2023

<sup>xiv</sup> Food Insecurity Remains Elevated After Pandemic-Era Benefits End; Bloomberg; 9/27/2023