Thelma and Louise Redux

Jerome and Janet over the cliff?

The following are the Exclusive and Sole Opinions of the Author.[1]

Investment opportunities can occur in "real time" when short and intermediate term volatility disrupts theoretically linear and efficient markets. Yet there are also persistent price trends that can typically last from months to many years, hardly random in retrospect.

An investor may be able to add performance in this environment of disruptions and persistent trends. Many of these opportunities repeat over time – and this knowledge along with a long term, macroeconomic view are among the most important factors to achieve investment success.

The yield curve inversion is a significant disruption of the credit market creating opportunities.

"Forecasting future economic developments is a tricky business, but the term spread has a strikingly accurate record for forecasting recessions. ***Periods with an inverted yield curve are reliably followed by economic slowdowns and almost always by a recession."***[2]

[1] All opinions expressed by David S, Lerner in this newsletter are solely Lerner's opinions and do not reflect the opinions of Raymond James Financial, Inc. Lerner's opinions are based upon information he considers reliable. Raymond James Financial, Inc, does not warrant its completeness or accuracy and it should not be relied upon as such.

[2] https://www.frbsf.org/economic-research/wp-content/uploads/sites/4/el2018-07.pdf

The FED was determined to slow and reverse the inflation inflicted on the US economy. They would continue raising short term rates rapidly until unemployment rose – or some systematically important weak point in the financial system would break.

They succeeded again. Results are once again far worse than anything expected. A major bank run was triggered by a combination of tight money driven by FED policy, bad management by "woke" bankers, gross regulatory failure by the San Francisco FED and the FDIC[3] - and a loss of confidence in the monetary authorities. (Chairman Powell, Secretary Yellen, and FDIC Chair Martin Gruenberg.)

Banking/finance is not just another "sector" – every other sector is reliant on these companies to a greater or lesser degree. The

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[3] https://www.wsj.com/articles/fed-raised-concerns-about-svbs-risk-management-in-2019-4a1d802c?st=cvfu511hgie0iks&reflink=desktopwebshare_permalink Following the 2019 warning, the Fed informed SVB in 2020 that its system to control risk didn't meet the expectations for a large financial institution…Large banks that don't meet the Fed's expectations are supposed to take corrective action to fix the problems or potentially face enforcement actions…The bank's assets rose to $114 billon at the end of 2020, from about $70 billion in 2019, the year the Fed voiced its concerns. They nearly doubled from 2020 to the end of 2021 to about $209 billion, according to Federal Deposit Insurance Corp. data. The Fed's criticism of SVB's risk-management systems raises the question of "why were they allowed to double their size after that,"

problems in the banking system will almost certainly contribute to and magnify any economic contraction.[4]

Understanding the various elements of this financial fiasco requires a healthy dose of common sense and skepticism.

Common sense informs us that there are time lags at each step of crises resolution: recognizing a problem, adopting a solution and implementing a plan and monitoring the results. Success is achieved by applying the right policies in a timely fashion.

"….. policy lags can actually make stabilization policies destabilizing. That is, they can worsen the ups and downs of the business cycle…the stimulation might occur during the ensuing expansion, which can then overstimulate the economy and cause inflation.[5]

The economy was well into a vigorous recovery from the Covid pandemic by 2021. Regardless, the Biden administration enacted massive spending bills: The American Rescue Plan, The Infrastructure and Investment and Jobs Act, and the perversely named, Inflation Reduction Act. These maintained the profligate spending of the Covid emergency years, an extra $2 trillion over what might have been a baseline.

This spending was the primary impetus to runaway inflation, both the FED and Department of Treasury keeping rates far too low for

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[4] When banks' assets fall in value due to the increased chance of default, then their leverage—the ratio of liabilities to assets—spikes up sharply.
The rise in leverage increases the risk that banks will not pay households back in full in case there is a run on the bank. To prevent runs and therefore bankruptcy, banks strongly cut back on their lending by liquidating outstanding loans inefficiently and reducing new lending. In this way, banks are able to generate additional liquidity that could be used to pay back deposits and therefore prevent households from running on banks. However, the early liquidation of loans and the subsequent ending of the underlying investment projects causes aggregate investment and output to drop sharply. Through this mechanism, the model turns moderate adverse shocks into large macroeconomic effects. https://www.frbsf.org/economic-research/publications/economic-letter/2019/march/modeling-financial-crises/

[5] https://www.amosweb.com/cgiin/awb_nav.pl?s=wpd&c=dsp&k=policy+lags#:~:text=The%20three%20specific%20inside%20lags,can%20even%20destabilize%20the%20economy.

far too long. They knew what they were enabling, boasted about elevating and maintaining inflation above trend. Politics took precedence prudence.

The predictable inflation arrived, price increases quickly eclipsed the inflation targets and kept rising. The FED responded, raising interest rates. Inflation persisted. The FED continued to raise rates, increasing the pace, .75% - four times before slowing to .50 and then .25. Rates soared at an unprecedented pace in response.

This rapid increase in rates is flowing through the economy, negative economic outcomes are spreading.

"Alternatively, the impact of contractionary monetary policy designed to reduce inflation created during an expansion might not occur until the onset of an subsequent contraction. In both cases, the resulting policy is not counter-cyclical, but pro-cyclical. The policies reinforce and thus destabilize the business cycle.[6]

The economy is weakening, decelerating as real interest rates bite. The depth and duration of decline is unknowable but should become clearer soon.

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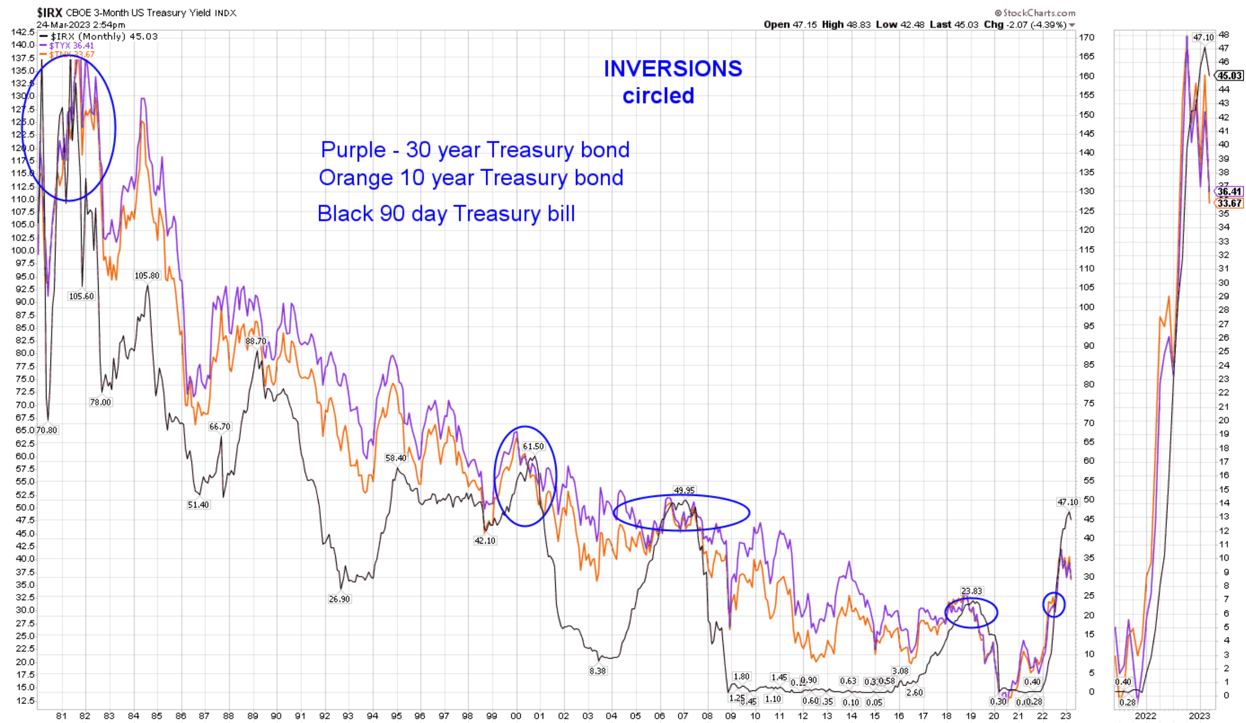
6 https://www.amosweb.com/cgiin/awb_nav.pl?s=wpd&c=dsp&k=policy+lags#:~:text=The%20three%20specific%20inside%20lags,can%20even%20destabilize%20the%20economy.

Tying it all together

Equities do not yet price seem to discount a significant recession. P.E. ratios remain above average, based on trailing earnings. Earnings could fall dramatically in a recession, leaving valuations highly uncertain.

The outlook for fixed income is clearer. Eventually rates will fall, the likely decline will be significant and should persist. The decline, based on past episodes should be rapid.



For bank balance sheets the decline can't come too soon. The size and slope of the price decline in the 30-year treasury bond is unprecedented. A competent central banker would know and care that the banking system could not accommodate such rapid change.

<u>Banks, or other financial institutions overly exposed to this price decline may only avoid insolvency by regulatory forbearance or financial support until interest rates stabilize and fall</u>. The accounting fictions underlying modern banking are only honored when depositors are confident in the system and the regulators. The distinction between assets held for sale and those held to maturity becomes irrelevant when you are seen to be insolvent.

The Treasury, the FED and the FDIC are the central authorities at the center of this storm. I believe many concerned with this banking crises share my opinions that the FED has forfeited their authority by repeated displays of incompetence, the politicized FDIC is discredited, their regulatory failure is egregious, that the Treasury Secretary is not a forceful or convincing leader.

The damage to investor confidence is large and unresolved. Personal assurances, speeches or ad hoc policy solutions cannot fix the problem.

From my perspective, Declining interest rates are <u>the exclusive remedy</u> when you can't trust the words and intentions.

A significant interest rate decline and bond price recovery has probably begun. The FED has no alternative but to relent in their crusade to crush demand. The "terminal rate" and date for interest

increases may well have arrived, below projections and months sooner than expected.

Rate declines have been rapid after reaching the terminal rate in past episodes. Area pattern analysis suggests the target yield for the ten-year bond, if (when) the top pattern completes, is 2.5%. Trends appear in retrospect – interest rates may well have peaked in October 2022.

Conclusions

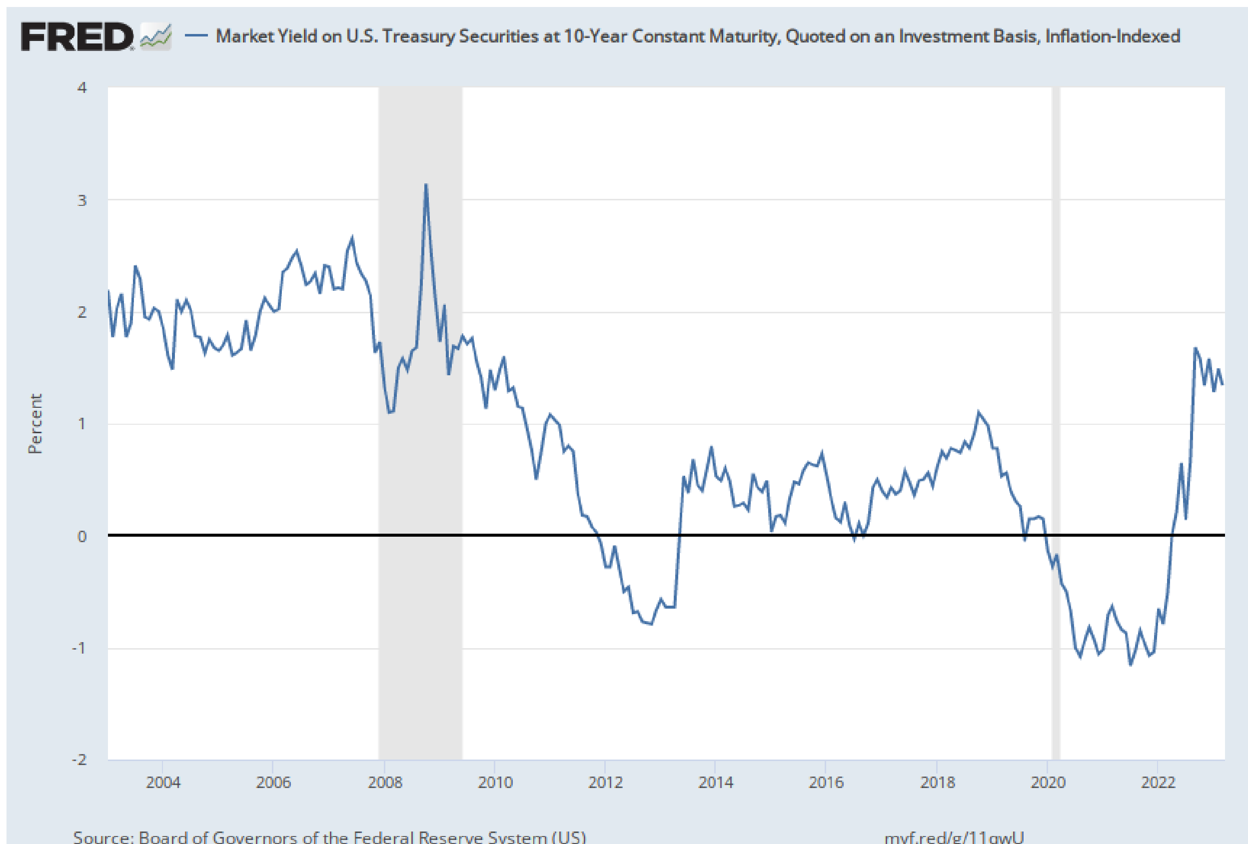
In my opinion:

1.**Economic data is less reliable than previous eras, beyond the Covid dislocation.**
2.The Federal Reserve Board has failed to maintain a steady monetary policy. Way too easy for way too long, followed by an abrupt reversal, becoming too tight, far too fast.
3.<u>The economy has reached the tipping point.</u> Real interest rates brought about by tight money are slowing/reversing growth. The bank runs are symptomatic of significant financial dislocation that will continue and worsen.

4. Equities appear to me to be expensive based on average price earnings multiples applied to declining earnings. 15 X $200 results in an S&P target of 3,000 – compared to the current 4,000 level. The CAPE Cyclically Adjusted Price Earnings ratio (left scale) has recently declined but is still 21.

https://www.multpl.com/s-p-500-pe-ratio

5. Income investments are attractively priced compared to projected inflation rates. Real Interest rates are positive and heading toward historically high levels. Real interest rates are as high as at the depths of the great recession in 2008. These real rates may move even higher, as inflation fades.



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