

## Quarterly Economic and Market Comments March 31, 2023

The past six months have seen a big disconnect between what investors are thinking and saying and what they are actually doing. So much to worry about. The consensus among economists for some time that a recession in the U.S. and elsewhere is likely. In March, the second and third largest bank failures in U.S. history. Nine interest rate hikes of 475 basis points in a year by the Federal Reserve to the highest level since 2007. Growth in the U.S. money supply at its most negative since 1930. At its steepest point in the first quarter, the yield curve in the U.S. was the most inverted it has been since 1981. Four times the normal rate of volatility in 2-year U.S. Treasuries, exceeding the week Lehman failed in 2008 and 9/11 in 2001. The steepest 3-day drop in 2-year Treasury yields (since the 1987 stock market crash) after the Silicon Valley Bank failure. In one trading session, the entire Treasury curve moving from above to below their 200-day moving averages. Of course, this news backdrop has not gone unnoticed by investors. After all, 2022 saw the worst first six months for the American stock market since 1970, the worst six months for U.S. Treasury bonds since 1788, and the biggest quarterly decline ever in household net worth. In addition, the Ned Davis Poll of Investor Sentiment was in the extreme pessimism zone from April 2022 to January 2023, the second longest streak (after May 2008 to May 2009). Yet for all of the news and the concern, investors have shown little inclination to sell their stocks aggressively. At year end, institutional weighting in equities had fallen by a mere 3% and households remain heavily committed to equities, as do foreigners. Mutual fund cash levels are near historic lows and, indeed, adjusted for interest rates, are at record lows.

How is this possible? How come investors have not run for cover? There is no doubt more than one reason, but a big part of it is the tendency of investors to look in the rear-view mirror when making their investment decisions. So it was that investors in 1920, 1950, and 1980, after two decades of investment futility, were pessimistic, risk averse, and majorly underinvested in equities. In 1965 and 2000, it was just the reverse. Today, investors look back, not just at the past decade of strong U.S. stock market performance, but really at the past 40 years which encompasses the investment experience of most people. Buy and hold has been a winning strategy and specifically buying and holding the index since beating the index is tough and especially tough when the index is providing 10% annual returns.

However, what if the game has changed? What if we're closer to 1965 or 2000 than we are to 1950 or 1980 from an investment perspective. Current investor positioning suggests that's the case. Last quarter, we referenced Howard Marks who opines we are passing through the third "sea change" of his lengthy investment career. He observes, "If you grant that the environment is and may continue to be very different than what it was over the past 13 years - and most of the last 40 years - it should follow that investment strategies that worked over those periods may not be the ones that outperform in the years ahead." Among the factors that represented a big positive for equity investors from the early 1980s onward, Marks considers it "nearly impossible to overstate the influence of declining interest rates." Given that we have, over the past decade, experienced the lowest interest rates in human history and, given the increasing recognition that it has been a policy flop, it seems likely that the declining interest rate trend of the past 40 years is over. What the path of interest rates will be in the years ahead is obviously uncertain; however, today's 30-year mortgage rates in the U.S. of around 6.3%, which are having such a negative impact on housing, are roughly in line with the average

mortgage rate between 2000 and 2009 and compare with an average rate of 8.9%, 12.7%, and 8.1% in the 1970s, 1980s, and 1990s.

However, declining interest rates were not the only big positive for equities of the past 40 years that has taken a turn for the worse. A second important factor was good governance. This is something that we take for granted until it's not there and that investors ignore until, often suddenly, it becomes the most important thing. This is brought to mind as the U.S. faces the possibility that, in the upcoming 2024 election, the candidates for President will be two octogenarians whose approval ratings have wallowed below 50% and one of whom is facing 34 felony charges, a first in U.S. history for a President or ex-President. Of course, the lack of good governance in the U.S. goes way beyond Trump and Biden. The historian, Jon Meacham, among others, draws the analogy between the path the U.S. is on today and the 1850s. In a recent Gallup poll, Members of Congress were ranked lower in terms of honesty and ethical standards than telemarketers and used car salespeople. The Ederman Trust Barometer found six countries, one of which the U.S., were "severely polarized". The percent of Americans who have "no" or "very little" confidence in the news they see on T.V. has risen from 18% to 53% over the past 30 years. The federal budget deficit in the U.S. is greater in dollar terms than 93% of the world's economies (about the size of the Australian economy) and is larger than the deficit in 2009 during the Great Financial Crisis. No sensible conversation is taking place on the budget; instead, there is talk of not raising the debt ceiling and allowing the government to default. This brinkmanship has been seen before and a last-minute compromise seems likely, but confidence in a well-reasoned outcome must be considered as low as it has ever been. Of course, the U.S. is not the only country struggling to come up with a good fiscal plan. In its recent budget, Canada jettisoned its path to a balanced budget. Public debt for the world as a whole has risen from 60% of GDP in 2009 to 85% today. When it comes to leaders or ex-leaders being indicted, eyes turn to the paragon of democracy in the Middle East, Israel, where the Prime Minister's plans for judicial reform, thought by some to be, at least in part, self-serving, have led to record protests. Then there's France where the President used his authoritarian powers in the constitution to ram through very unpopular, albeit sensible, pension reform, leading to massive demonstrations. Lastly, in Britain, there have been six Prime Ministers over the past 15 years during which time real household incomes have stagnated. At least two of these individuals pushed the Brexit fantasy, partly as a result of which the U.K. is expected by the I.M.F. to be the one major economy to experience negative growth in 2023.

Compare the situation today with that of 40 years ago. Reagan in the U.S. was followed by Clinton. Thatcher by Blair. Mitterand by Chirac. Helmut Kohl was Chancellor of Germany for 16 years. These were leaders with their flaws, for sure, but they were able to generate reasonable support for reasonable policies that led to strong economic growth, a big increase in global trade, German reunification and European integration. This is the situation in the democracies. In Russia, Gorbachev presided over Glasnost and Perestroika, the dissolution of the Soviet Union, and the end of the Iron Curtain and the Cold War. His successor (after Yeltsin) has been issued an arrest warrant by the International Criminal Court. In China, 40 years ago Deng Xiaoping had taken over from Mao with the slogan, "To get rich is glorious" and the rest of the world welcomed China into the global community. The result was the Chinese economic miracle, stronger global growth, and reduced geopolitical tensions. Today, Xi Jinping has taken China in an authoritarian direction. Meanwhile, much of North America seems bent on a new Cold War as exemplified by the potential banning of Tik Tok, the number two app for U.S. teenagers and the number one social media news source for Gen Z. Adam Posen notes in the periodical, Foreign Policy, that the U.S. "has sought to take production away from others in a zero-sum way - explicitly from China and a bit more courteously from others". The recent cover of The Economist magazine notes: "America vs China - It's worse than you think." All of this has caused Ian Bremmer, head of a leading global political risk firm, to say we are in a "geopolitical recession".

So, the tailwind of falling interest rates appears to be over. The geopolitical landscape has taken a big turn for the worse. Population growth is becoming negative in many countries. Debt levels are much higher than they were. For these and other reasons, the world economy's potential growth in GDP, which slowed to 2.6% over the past decade from 3.5% the decade before, is now forecast by the World Bank to be only 2.2% in the decade ahead. What are the long-term positives, then, that continue to drive investors? One is technology, in particular the impact of artificial intelligence which could be huge. At the same time, there's a dark side to A.I. that has led some to propose a "pause", so it's unclear how things are going to unfold. The second feature of the past 40 years in which investors still have faith is the power and importance of central banks. This was on display in the first quarter which, in the spirit of Easter, could be summarized by the expression, "The last will be first, and the first last." After placing last in 2022 among the dozen asset classes monitored by Ned Davis Research, the technology-oriented Nasdaq Composite was the top asset benchmark in the first quarter. Conversely, commodities, which were first in 2022, finished last in the first quarter. The Energy sector, which posted its best performance on record in 2022 relative to the market as a whole, was the worst performer in the first quarter. The 150 best performing stocks in the S&P 500 in 2022 were, as a group, down in the first quarter; whereas, the 50 worst performers averaged a huge gain of 168%. The key event of the quarter was the collapse of Silicon Valley Bank on March 9<sup>th</sup>, the subsequent failure of Signature Bank, and the forced takeover in Switzerland of Credit Suisse by UBS. Throughout 2022, and even into the first quarter, rising interest rates were the main factor inordinately hurting growth stocks and long-dated Treasuries. The banking crisis in March caused markets to believe that the Federal Reserve would have to stop raising rates and the new concern, to the extent there was one, was credit. As a result, for the quarter, long-term Treasuries outperformed the rest of the fixed income space, in contrast to 2022. And, taking a page from the playbook of the past decade, growth stocks, in particular the so-called FANMAG stocks, dramatically outperformed the rest of the market. Indeed, just 4% of the S&P 500 stocks accounted for all the gains in the quarter. Nevertheless, on balance, it was the second consecutive positive three-month period for financial assets after the previous dismal nine months and led some to suggest that the bear market of 2022 was over and a new bull market was underway.

The fact that investors were shocked by the sudden demise of Silicon Valley Bank and Signature Bank brings to mind a football coach's observation in an athletic context, "Everybody's surprised every time this stuff happens. It surprises me that everybody gets surprised because every year there are surprises. The most surprising thing would be if there weren't any surprises." In fact, the current economic and market cycle is just following the typical pattern of the past 50 years, not to mention the past 200 years. It starts with overly easy monetary conditions leading to excessive speculation and rising consumer prices. The monetary authorities rush to tighten credit. But how much? They don't know, so they tighten until something "breaks", telling them that they have done enough. At this point, however, the die is cast. A recession is underway or inevitable. Interest rates start to fall and a new cycle is born. Rinse and repeat. In 1970, it was the bankruptcy of Penn Central Railroad; in 1974, Franklin National Bank; in 1982, it was a 50% collapse in the price of silver in one day and an emerging market debt crisis; in 1984, the bankruptcy of Continental Illinois Bank; in 1987, the Wall Street crash; in 1990, The Savings and Loan Crisis; in 1998, Long Term Capital Management and the Asian currency crisis. And on it goes. Of course, the story line is always that the economic fallout pursuant to this financial crisis is the result of credit being too tight and interest rates that were too high. In fact, the villain is always – and this was certainly true in 1929 – the speculation and easy credit conditions that preceded the monetary tightening phase. As it happens, the Federal Reserve Bank of San Francisco has just published a study entitled, "Loose Monetary Policy and Financial Instability". They conclude that "a loose (monetary) stance over an extended period of time leads to increased financial fragility several years down the line. Policymakers (need to) weigh the potential short run gains of loose

monetary policy against potentially adverse medium-term consequences. Such policies increase the risk of financial crises and thus the risk of high social, political, and economic costs.”

Today, we have probably had our financial crisis for this cycle, although sometimes there is more than one. As a result, we are probably at or near the end of the rising interest rate regime of the past year. A final 0.25% rate hike by the U.S. Federal Reserve in May is considered a coin toss by the markets which are pricing in a relentless decline in the Fed Funds rate to less than 3% in late 2024. This is partly a result of the banking crisis, but also the waning of inflationary pressures. U.S. producer price inflation peaked at 11.7% in March 2022 and is now at 4.6%, its lowest since March 2021. The year-over-year increase in the Federal Reserve’s favourite inflationary gauge has retreated to its lowest level since September 2021. The New York Fed’s global supply chain pressure index has moved into negative territory for the first time since Covid, illustrating the extent to which inflation in the goods sector has abated. Service sector inflation is “stickier”, but even here there are signs that the trend is down. Discounts at auto dealers are at their highest level in a year. Rental rates on apartments are up 2.6% year-over-year, the lowest since April 2021, and this is before a ton of new apartment supply hits the market. Office vacancy rates are near record highs, implying lower rents ahead.

Markets are loving the prospect of lower interest rates, but what about the recession that has been expected for so many months that it has been dubbed the “Godot” recession. While anything is possible, the odds are it is still coming. Over the past 60 years, the yield on 3-month U.S. T-bills has exceeded the yield on 10-year Treasuries eight times. Every time a recession followed. The spread today is the most in two decades. The University of Chicago’s Booth Business School looked at 16 post-World War Two episodes of inflation-fighting rate hikes across four developed economies. Their conclusion? “There is no post-1950 precedent for a sizeable central-bank-induced disinflation that does not entail substantial economic sacrifice or recession.” Then there’s the credit crunch. Even before SVB and Signature, only 25% of small businesses reported being able to obtain the financing they required, 10% less than what was experienced in the summer of 2008. Over the past 35 years, when the percentage of banks tightening credit exceeded 40%, it was a recession. In the first quarter, 45% of U.S. banks reported tighter lending practices and it’s no doubt higher now. Another indicator with a perfect track record of calling recessions over the past 55 years is the spread between how consumers feel about their situation currently as against their expectations for the future. The last time this indicator was as negative as today was in February 2001 and the recession started in March. Deutsche Bank’s recession probability model pegs the likelihood of a U.S. recession at 90% which, over the past 50 years, has always proven accurate. Rarely, if ever, have the datapoints been so unanimous in pointing towards an economic contraction. It’s so obvious that contrarians everywhere are left to wonder, “What’s wrong with this picture?” There is, in fact, one indicator with a perfect track record that suggests a different outcome – U.S. stock prices, which fell in 2022, but rose in the first quarter of this year. In the 11 previous instances since 1950 when the S&P 500 fell the previous year and then rose in the first three months of the next year, over the rest of the year the index rose every time by a median 11.2%.

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