July 2024

The More Things Change….

When the Federal Reserve began to raise interest rates in March of 2022, people were reminded of Milton Friedman's quote that monetary policies "operate with a long lag and with a lag that varies widely from time to time." How prescient. The ensuing rapid increase in interest rates was unable to eliminate this lag. Economic growth did not slow meaningfully, and the inflation rate continued to rise. In July 2023, the rate of inflation was moderating, and the Federal Reserve stopped raising rates. One year later, while still growing, the economy appears to be softening ever so slightly. Inflation, on the other hand, remains stubbornly above 3%.

Typically, as the Federal Reserve raises interest rates, demand for credit declines, which acts as a brake on the economy. This time, the monetary brake is being overridden by the fiscal gas pedal. A recent report by the Congressional Budget Office (CBO) revealed that the current budget deficit expectation for 2024 is approximately 7% of this year's gross domestic product (GDP). Not only is the deficit expanding this year, but according to the CBO, **assuming NO RECESSION until 2034,** the annual deficit will only decline to 5.5% in 2027 before moving up each year to 6.9% again in 2034. Since 1980, the annual budget deficit has only exceeded 5% during recessions and in their immediate aftermath. It is normal for these deficits to shrink during economic expansions as tax receipts increase while government welfare programs require fewer expenditures. The current projection is that even with a decade of uninterrupted 2% real GDP growth, the deficit will never fall below 5.5%. This level would usually be associated with the depths of a hard recession.

This continuous fiscal spending has put the Federal Reserve in an uncomfortable position. They need to decide which of their dual mandates is more important -- maximum employment or price stability? To date, they have attempted to thread a needle that served both masters. Starting with a historically low unemployment rate and an inflation rate still higher than they would like, their choices will become harder for the rest of this economic cycle.

With the Federal Reserve facing difficult choices, political uncertainty rising, and stock markets at all-time highs, it would be easy for investors to throw up their hands, head to the sidelines, and wait for a better entry point. We disagree.

The long-term workout of the excesses of the previous ultra-low interest rate environment will be resolved through time and occasionally sharp corrections in price. There will be further economic turmoil as credit availability is reduced and economic activity slows. These are normal parts of a business cycle. We continue to focus on investing in businesses that benefit from economic growth, possess pricing power, and generate significant cash flows that they can return to investors**.** Many of these stocks have not participated in the recent ebullient market performance, and as a result, we continue to find ways to deploy your capital prudently. This remains the core of our equity investment strategy. While many market participants are busy chasing the next great trade relying on technical analysis, fancy models describing total addressable markets, dot plots, and short-term forecasts, we have chosen to stick to what we know and understand. Once we find these businesses, the key to our client's long-term success in the equity market is not overpaying for them or holding them past the point of fair value.

While the equity market, represented by the S&P 500, has reached a new high 31 times this year, fixed-income markets have been volatile. Short-term interest rates appear to have peaked. The Federal Reserve has paused for nearly 12 months. Over the past 50 years, after the last rate hike, it has taken no more than fifteen months for the Federal Reserve to begin cutting interest rates. The average pause between rate hikes and rate cuts has been seven months. Once again, the long and variable lags make it difficult for the Fed to know when enough has been enough definitively. The consensus expectation currently is that since inflation is moderating, there will be no further interest rate hikes. This will allow the economy to experience a soft landing - possibly marked by a minor recession - which will allow the Fed to reduce interest rates stimulating the economy. That would be a wonderful outcome (some might even call it a fantasy). It should be noted that during 2022, the consensus was that rapid interest rate increases would cause a recession in 2023 and that the Federal Reserve would begin to cut interest rates. It is interesting that, in many regards, the current stock market rally started as a result of optimism powered by a belief in interest rate cuts that have yet to appear.

Despite short-term interest rates appearing to have peaked, the bond market remains unconvinced of the path forward for the economy. In a normal cycle, the next move would be a stimulating interest rate cut, which would gently push longer-term interest rates higher. This is not occurring today. Instead, rates have moved violently as if the bond market were a teeter-totter instead of a scale. For example, the 10-year treasury rate has traded at both 3.90% and 5.00% this year while it currently stands at 4.25%. With an entrenched consensus economic forecast discussed above, that sort of variability would not be expected.

This volatility is allowing us to reposition fixed-income portfolios on terms that we find exceedingly attractive. We have returned to an environment where we are able to construct multi-year corporate bond ladders with 5-6% coupons. The ability to ladder maturities, providing portfolio flexibility without giving up significant yield, is a scenario that does not often present itself. It affords us the ability to lock in substantial income without having to commit to a viewpoint on when rates will change or in which direction they will move. Additionally, the ability to earn 5% on cash provides us the flexibility to execute in both directions, as there is no longer a penalty for holding cash. Cash is not trash; it has once again become an asset that provides our clients optionality. It is no longer a naughty four-letter word!

In the midst of these uncertainties, it is important to remember **that the more things change, the more things stay the same**. Our simple belief is that over any reasonable timeframe, the economy and earnings grow, enabling equity markets to move higher. Patient investors ultimately are rewarded, though patience is tried at times. Financial markets will continue to allow individual investors to accumulate wealth and achieve their financial goals. Perhaps Benjamin Graham said it best, **"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavior discipline that are likely to get you where you want to go."** This is exactly the type of environment to achieve those goals.

Once you've put your plan in place, it is important to stay the course. As John Bogel, the late founder of the Vanguard Group stated, "Your success in investing will depend in part on your character and guts and in part on your ability to realize, at the height of ebullience and depth of despair alike, that this too shall pass." Both of these men are, in essence saying the same thing, investment success is driven more by the amount of time you are in the market and sticking to a plan than trying to time the market. When done in the context of an overall plan tailored to fit specific needs, this becomes an easier exercise. With changing opportunities in nearly all asset classes, now is a great time to revisit your plan and modify it if necessary.

As always, if you have any questions or simply want to catch up, please give us a call.

Enjoy the Summer!!