



Let's Take a Step Back

The stock and bond markets had a solid November, with the S&P posting its second consecutive monthly gain, +5.59% for the month and the Aggregate Bond Index + 4.7%.ⁱ A month-end rally was fueled by Federal Reserve Chairman Jerome Powell suggesting that the Federal Reserve Board of Governors ["Fed"] was prepared to mitigate the recent 75 basis point interest rate hikes that have characterized the last four interest rate hikes this year (June through November.) With the slower pace of the Consumer Price Index ["CPI"] increases last month, Powell's statement indicates that the Fed is actually monitoring and responding to data. A thinking man's approach, this allows the recent Fed tightening actions to cascade through the economy with their inherent time lags.

The economy appears to be holding up relatively well in spite of the rate increases intended to combat inflation. The most recent Institute of Supply Management data indicate that business activity and new orders data remain in expansion mode, while the Prices Paid Index was lower, albeit still at elevated levels.ⁱⁱ There are anecdotal indications of companies preparing for slowing economic growth, such as recent layoffs at PepsiCo and Morgan Stanley, while Capital Expenditure budgets in industries other than semiconductors and communications services are expanding. There are rumblings that the inversion of the yield curve (shorter-term rates higher than longer-term rates) is becoming less about whether the Fed will keep raising rates and more about the market anticipating slower economic growth and therefore less demand for financing. The advent of higher interest rates and a soft equity market has resulted in a dramatic fall-off in Initial Public Offerings of stock with the dollar volume of financing down 93% versus a record 2021 and investment-grade bond issuance down 28% versus a year ago.ⁱⁱⁱ Consequently, access to growth capital is more constrained than it has been.

We find ourselves in a convoluted world, where so-called "bad" economic news is, in fact, deemed positive as it suggests the need for the Fed to continue tightening is abating. At some point, the media will shift their perspective to legitimate concern over the economy.

In our quest to conquer the "Dark Knight" of Uncertainty, entire industries have been built around extrapolating historical data, interlaced with myriad assumptions, to forecast what lay ahead. Recently, media outlets have focused on the prospects for the timing and severity of a recession. The National Bureau of Economic Research ["NBER"] Business Cycle Dating Committee—the official recession scorekeeper—defines a recession as ***"a significant decline in economic activity that is spread across the economy and that lasts more than a few months."***^{iv} Further, because the NBER relies on government statistics which are typically reported with some delay, a "recession" cannot be identified until after the fact. Big psychological difference between a "slow-down" and a "recession"!

History affords us learning opportunities and today's economic and market conditions are no exception. If one examines past stock market behavior and recessions, there is ample evidence that severe supply shocks have had an outsized impact on economic recessions^v. Conventional neo-classical economic theory assumes inflation is a result of outsized demand for goods or services. This same theoretical construct assumes that Prices rise to induce additional Output, which eventually thereby fills consumer



demand and price stability returns to a more normal level. There's just one problem with this 'model' – it assumes producers *can* increase output. When there is a supply constraint, price goes up, but output is unable to increase and therefore TOTAL OUTPUT actually declines. More money chasing fewer goods.

Now, stir into the recipe a very healthy dose of monetary stimulus in the form of Covid payments and you have even more money chasing fewer goods AND the services sector of the economy (restaurants, travel, etc.) took a nosedive while we were all quarantined. This resulted in even more demand for the constrained supply of goods.

If you have followed my logic, then it should come as no surprise that there are certain parallels to the early 1970s when oil shocks hammered the economy after excessive government spending under President Nixon and President Johnson's "Guns and Butter" fiscal policy. The de-linking of the U.S. dollar from the gold standard facilitated more expansionary monetary growth. On-again/off-again monetary policy (at a time when the Fed's independence from government policy was questionable) exacerbated the runaway inflation inherited by Presidents Ford and Carter, which was eventually brought under control in dramatic fashion by Fed Chairman Paul Volcker's October 1979 "Saturday Night Special".^{vi}

I am NOT suggesting we are heading for anything as dramatic as these periods in our history; rather, I am highlighting how cataclysmic supply shocks, exacerbated by excess money supply growth led to rapid inflation. Volcker literally put his foot on the economy's throat, inducing a major recession that lasted from July 1981 to November 1982.

Today, we have confronted similar major supply disruption over the past 3 years, which has fueled inflation. Further weighing on extraordinary excess costs during 2021 for such things as lumber, asphalt, steel, etc., higher interest rates have stemmed housing demand, throwing the homebuilding sector into a recession, but "second-level" supply chain issues that constrained availability of appliances and autos and contributed to higher transportation costs. Easing of these constraints will help normalize these sectors. Consumer goods, so much in demand during covid, experienced a subsequent glut of inventory, promptly forcing retailers to take major mark-downs, reducing their profit margins. Airlines, travel services and restaurants are again experiencing modest rebounds after their near-death experience. What we have here is a rolling recession, impacting specific industries at different times, amidst a generally inflationary environment. A very different scenario compared with the 1970s and 1980s or the financial crisis of 2008. It is noteworthy that inflation took a breather under President Ford in the mid-1970s. Not because of the "Whip Inflation Now" campaign (remember those buttons?), but because the supply shocks ran their course and disappeared.^{vii}

Geo-political uncertainty continues to influence. China's "Zero Covid" lock-downs impact global trade in a major way. When will these restrictions be lifted to allow manufacturing and consumption to resume? How will Russia's intervention in Ukraine continue to impact the global energy markets and food supplies? China remains covetous of Taiwan and North Korea seems determined to demonstrate its entire military arsenal monthly. These considerations remain a weight on the financial markets.

Readers of previous Grist from the Mill missives will know my opinion of forecasts is poor at best. It is more advisable to evaluate the current economic/business cycle, assess how investors are responding and prepare for what comes next. The Fed is not finished raising rates and any immediate "pivot" (a word I have come to despise!) leading up to an election year presents huge political risk (recall Nixon and the



1972 election which he won with the able assistance of Arthur Burns).^{viii} Supply disruptions are easing, but it is likely that the ramifications will roll through the economic sectors as secondary effects trickle through. Over the past 90 years (since 1932) there have been 5 occurrences of consecutive negative annual returns.^{ix} Such occurrences represent rough spots along the journey, and my expectations for 2023 are a tad more constructive than that. Hunker down, emphasize higher-quality stocks and shorter-term bonds while we work through this portion of the cycle. Think binoculars, not microscope! Stay focused on your goals and ignore the noise.

Wishing you all the best for the Holiday Season!

Jim

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ⁱ www.standardandpoors.com/indices

ⁱⁱ First Trust Advisors L.P. DATAWATCH 12.5.2022 <https://www.ftportfolios.com/Commentary/EconomicResearch/2022/12/5/the-ism-non-manufacturing-index-increased-to-56.5-in-november>

ⁱⁱⁱ <https://www.reuters.com/markets/ipo-market-nearly-paused-exchange-leaders-expect-2023-boost-2022-12-02/>; First Trust Advisors L.P. *Talking Points* December 2022;

ⁱⁱⁱ *How Do Economists Determine Whether the Economy Is in a Recession?*, The White House, July 21, 2022 <https://www.whitehouse.gov/cea/written-materials/2022/07/21/how-do-economists-determine-whether-the-economy-is-in-a-recession/>

^v *A Monetary and Fiscal History of the United States 1961-2021*, Blinder, Alan, Princeton University Press 2022 pp 86,88

^{vi} Since the late 1960s, the nation had experienced a trend of rising prices as inflation began creeping upward from annual rates that were previously less than 2 percent for several years. In 1973, the Federal Reserve tightened policy to address an increase in inflation rates. However, in the face of higher unemployment, the Fed eased its policy before inflation had been fully contained. The year-over-year inflation rate bottomed out at 5 percent in December 1976 before moving higher once again..... During a rare [press conference](#) on the evening of October 6, 1979, the Saturday before Columbus Day, [Fed Chairman Paul] Volcker announced the results of an unscheduled FOMC meeting held earlier that day.... "By emphasizing the supply of reserves and constraining the growth of the money supply through the reserve mechanism, we think we can get firmer control over the growth in money supply in a shorter period of time," Volcker told the assembled reporters.... Previously, the Fed had conducted policy by targeting growth rates for the money supply and by keeping the federal funds rate within a narrow range that was believed to be consistent with the monetary growth objectives.... However, as the Board of Governors noted in its Annual Report for 1979, "It was felt this procedure had become less reliable in an environment of rapid and variable inflation."

As a result of the new focus and the restrictive targets set for the money supply, the federal funds rate reached a record high of 20 percent in late 1980. <https://www.federalreservehistory.org/essays/anti-inflation-measures>

^{vii} *A Monetary and Fiscal History of the United States 1961-2021*, Blinder, Alan, Princeton University Press, 2022, p 90

^{viii} *A Monetary and Fiscal History of the United States 1961-2021*, Blinder, Alan, Princeton University Press, 2022, pp 60-68

^{ix} <https://www.stern.nyu.edu/~adamodar/pc/datasets/histretSP.xls>