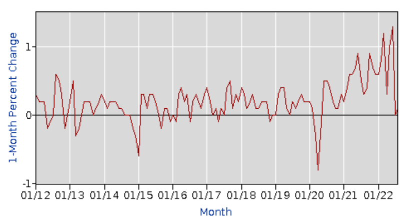
In the Pain Cave

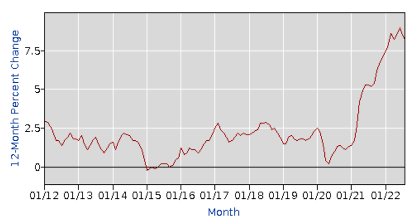
John M. Gustafson – 30 September 2022

"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions." - Seth Klarman

As the third calendar quarter skids to a halt in a volatile week, inflation continues to grab the headlines though the core cause is shifting around a bit of late. It is still demand-driven from the excessive amounts of liquidity injected during COVID, however the high cost of gas has moderated significantly and wage inflation has begun to drive the headlines.

Despite how things feel, as you can see from the charts I've added below, it does appear that things are beginning to top out in the near term. The graphic on the left shows month-over-month rates, which spiked for a few months earlier this year and have now settled down. The chart on the right shows year-over-year (the cumulative effect of those spikes) and it too has seemingly rolled over. Another old market saw states, "The cure for high prices is higher prices."





As mentioned in last quarter's note, the inflation issue was (is) caused directly by the multiple massive stimulus programs to stave off complete economic disaster during the COVID shutdowns and has been completely demand driven by consumer behavior. You can understand how this is occurring if you break things into segments of time.

We all recall when the early pandemic basically shut everything down for a couple of months in the middle of 2020. Trillions in stimulus programs were authorized and funded in five separate bills, absolutely flooding the economy with cash. (Deficit spending as a "last resort" by the Federal Government is the correct economic response in such situations – it's the reckless spending when things are going well that is the real problem long term.)

However, because of the supply chain issues caused by all the world's labor also sitting on the sidelines, the scarcity of everything and extra jingle in the jeans pushed people to say, "I want it now – of course I'll pay a little more."

The Federal Reserve is now talking now as if this is only in the 3rd inning of the inflation game and will do what is necessary, no matter what, in order to get things under control. They had to make such a harsh statement in order to counter the current rising expectations becoming the "norm." What I mean is, if everyone becomes used to above-historical inflation rates (i.e. > 2%-3%) and companies think they can simply raise prices and consumers will eat it without question (as car manufacturers have done recently) that becomes a more difficult economic problem, disconnected from actual demand.

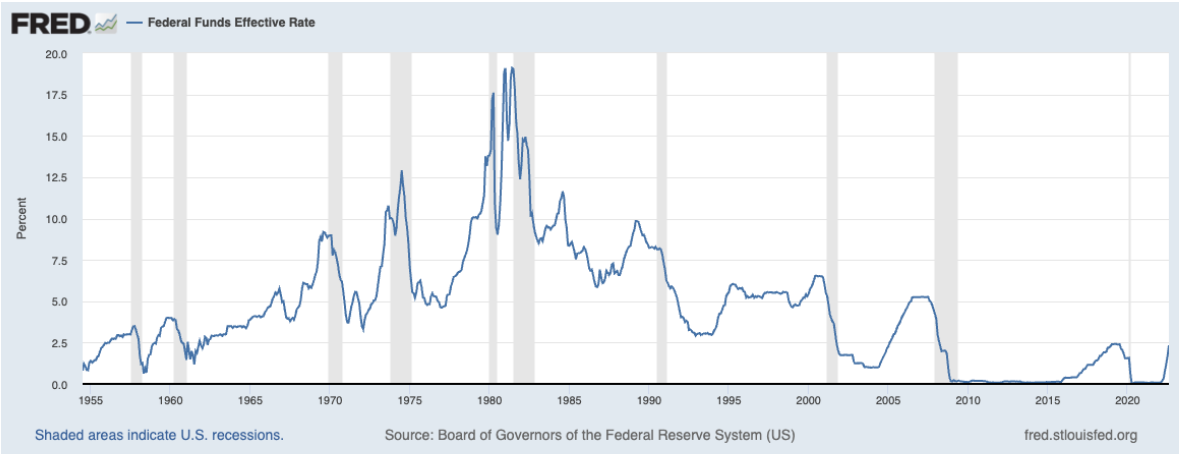
Think about it... Business news for years would quote companies complaining that "We can't raise wages – as soon as prices tick up to pay for them, consumers go elsewhere." Now that people have a pile of free money in their pockets, price-sensitivity is immunized. To a point... Folks complain about it, but they haven't yet changed back to their more traditional, historic (read: cheap) behavior.

It's too bad it has come to this and we have to try and squash consumer confidence, but that is directly related to the fact the Fed got behind the curve and waited too long to begin to raise rates. Time will tell if the jawboning & posturing works, but one thing I'm confident of is that once they signal they are finished raising rates there will likely be a significant rally.

"The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate." - Benjamin Graham

My thoughts along these lines are from experience early in my investment career. 1994 to be exact... The tax and budget legislation passed after the first Gulf War had begun to work and the economy was quickly growing out of a minor recession (not fast enough for Bush 41) and the Fed under Chaiman Greenspan was forced to take aggressive actions. They raised rates 6 times in 8 months – most 50bps per meeting – and the moment they signaled they had finished, the market took off. Granted, that FRB was early to the party, removing the punch bowl of cheap dollars before inflation got out of control, but that is the reality. Just because people like Rand Paul and Bernie Sanders complain about the Federal Reserve doesn't mean that the global market participants don't trust them.

The next chart should give a little visualization to history. As you can see, we have now only returned to where short-term rates were set prior to COVID. The Fed hit the gas immediately and went a little too far prior to applying the brakes. They have now done so more aggressively than any time outside of the early 80's. It's not necessarily the level of rates but the pace of the change that slows things quickly (because of the previously discussed sentiment shift) - the Powell FRB has shown that they are perfectly comfortable being more aggressive in both directions than almost any time in the past.



A lot of that has to do with the transparency that has increased in the past decade. The Chairman holds an actual press conference after every meeting, whereas in the past all we would see are a bland set of meeting minutes that would be parsed and interpreted. Now, the press can get clear answers to what people want to know – adding to the "jawboning" capabilities of the board to enhance their monetary tools.

"We don't have to be smarter than the rest. We have to be more disciplined than the rest." - Warren Buffett

What do I believe will happen and will position accordingly to capture? It appears that we are at a point where we're going to have to slow the economy back to levels we saw for most of the last decade. I still remember the constant complaints in the media from about 2010 onward whining, "we're not growing fast enough." It's not a recession – there is growth – but it will increase the rate of unemployment slightly (because aggressive job growth planning slows) and people "feel" bad after experiencing substantial, quick expansion. And the media will continue to pound the negative message... But, it is growth – not recession – and should allow things to stabilize.

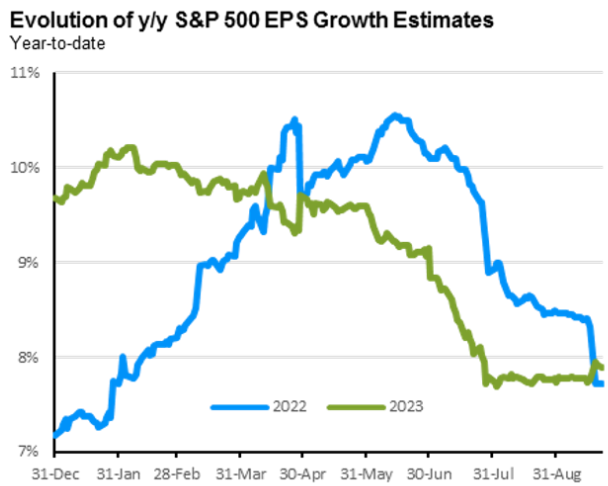
Also, as we pointed out in the last quarterly note, people are still not behaving as negatively as they claim to feel. Despite the constant barrage of negative news, the falling markets and whatnot, the monthly economic numbers show that consumers are still buying homes and cars, shopping online and in general comfortable spending money. Are they spending at the blistering pace they did last year up until just a couple of months ago? Not close – which will also help the inflation figures. (and may be why we have seen the inflation charts earlier in this note rolling over) I hate to keep beating this drum but it's the truth – slow(er) growth is NOT "recession."

Could the Fed take it too far and overshoot to show that they aren't "behind the curve?" Of course, although this seems to be why they are talking so aggressively as to what they could do. We may see the recent slowing become a mild recession – as long as it's shallow and the Fed then signals a pause in their actions, it's not the worst outcome.

The reality is that we know inflation will be subdued – Paul Volker proved that theory in the early 80's - killing inflation is easier than jump-starting a no-growth economy. (Ask Japan) The next FRB meeting isn't until early November, so there is ample time to measure the current effects of their aggressive actions before more may be triggered.

"It is better to be roughly right than precisely wrong." - John Maynard Keynes

With all of this negative information out there – and the current year's market performance where EVERY asset class is down – how can anything be seen as positive? Look at this chart:



If you look closely, the graphic shows how analysts went from wildly optimistic to back down to earth rather quickly. Clearly, once inflation took hold and was no longer believed to be "transient," estimates of earnings growth in the 10%+ range were clearly far too high. And it's not simply because growth will be slowed, it is because suddenly fixed income (bonds) once again become a legitimate return vehicle in portfolios and not simply a stable place to park non-equity exposure.

Even with these large estimate adjustments, the current and near future expectations remain at a significant level, north of 7%, both for 2022 and 2023. Couple that with the fact that stocks have corrected into Bear Market territory a few days ago (For the second time this year) the downside remaining has been somewhat minimized from here.

"The four most dangerous words in investing are: 'this time it's different.'" – Sir John Templeton

So, despite the fact that rates are not wildly out of historical norms, earnings still show promise based on current economic data. There are clearly significant headwinds that remain, although not many of them are new.

One of the biggest problems we've observed over the past several years – and often commented about in these notes – is the relationship between immigration and unemployment. There has been an almost complete halt on immigration of all forms in the country over the past few years, especially during the initial months of the pandemic. And it remains a fact that the U.S. has more current job openings than we have people looking for work.

This means that any economic growth will naturally be slowed and is in itself inflationary, based on the rise in wages to lure people from one place of work to another. Lack of human capital is the same as not having enough component parts for your finished product – it currently has its own supply chain issues. And unlike food & energy prices that can swing wildly based on supply changes, this type of inflation sticks around and becomes a component of all base costs if the problem isn't rectified.

"With a good perspective on history, we can have a better understanding of the past and present, and thus a clear vision of the future." — Carlos Slim Helu

Finally, everyone claims to love small businesses – politicians, the media, the general public, etc. - and we all should, small businesses currently make up 44% of American economic output. However, one significant problem that has been talked about ad nauseum for most of my life has only gotten worse as the Baby Boomers have aged. Because Americans only receive healthcare insurance via their jobs, and the costs continue to skyrocket, most small businesses can't afford to offer health insurance for their employees.

This is a significant competitive disadvantage that certainly stifles innovation and keeps the playing field tilted toward large corporations who already have significant economic advantages. It's great to see Intel moving to a rural area here in Ohio to build chips that we will no longer have to buy from China or Taiwan, but it seems a little ironic that many of the devices we take for granted now began as ideas by brilliant people working out of their homes. That can still occur, but it is much more difficult than ever before, simply because of the skyrocketing cost of privatized healthcare. (With no end in sight as our population ages.)

I don't want to go off the rails on socialized medicine and things of that nature at this point. I'm merely giving an historical example as to some of the issues facing our economy – hampering potential growth - that have been ignored to the point where that is seemingly no longer an option. Stay tuned...

Thank you as always for your trust, friendship and your business. If you need anything, as always, I am merely a phone call or email away.

Cheers!