April 2023
Volume 15, Issue 3

Sandpiper Capital

Gleanings

999 Waterside Dr #2600
Norfolk, VA 23510
(757) 679-9781

www.sandpiper-capital.com

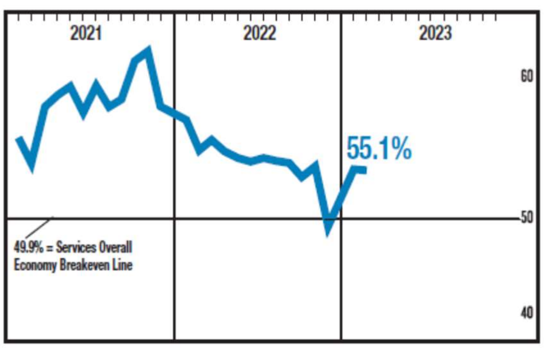
"Essentially, the markets are already looking forward to a Fed stimulated recovery even before we've had the recession."

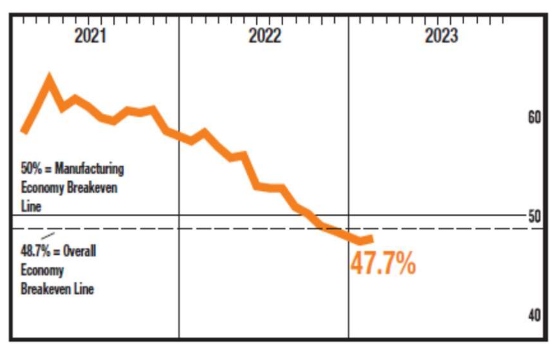
Market Returns Annually

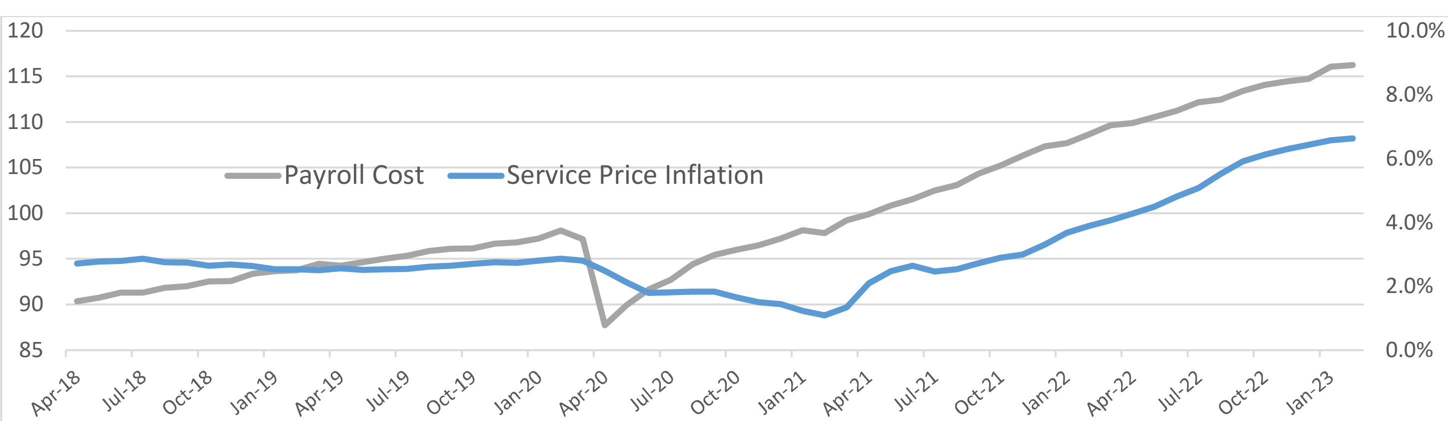
Index	2020	2021	2022	YTD
S&P 500	18.4	28.7	-18.3	4.3%
ML 1-5 yr Gov't/Corp	4.7	-.9	-5.5	1.0%
EAFE (Dev Fgn Mkts)	7.8	11.3	-14.4	-1.6%
Emerging Markets	18.5	-2.5	-20.9	-3.6%

Economics vs Politics

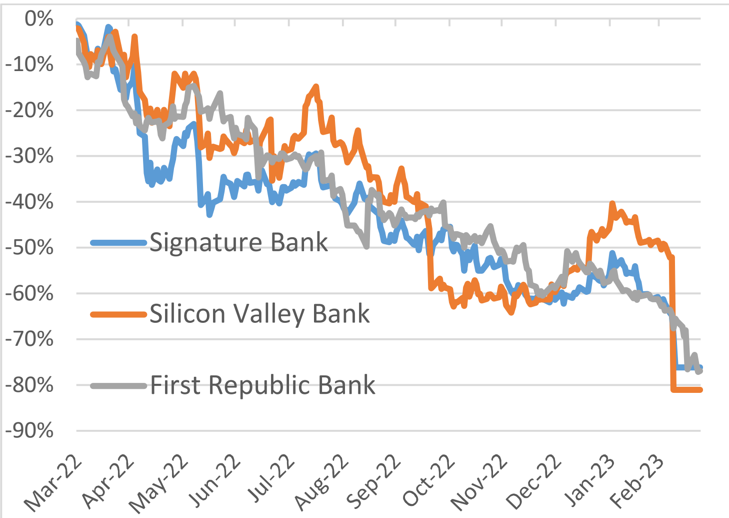
While the Federal Reserve professes independence from political pressures in its objective of fostering stability in the country's economy and banking system, it hasn't been immune to the influence of the cultural transformation in the U.S over the last five decades where deregulation, reduced corporate tax rates and industry consolidation have moved from the wish lists of corporate lobbyists to the accepted wisdom that the country's growth and prosperity depends upon the unfettered growth and prosperity of its businesses. From the excesses of the sub-prime loan programs leading to the Great Recession to the gross mismanagement of Silicon Valley Bank, there has been abundant evidence that Central Bank policy is to provide as much cheap money as possible and then stand aside until the cost of not intervening threatens the viability of the economy. It's no surprise then, that as in 2019, which is the last time that the Federal Reserve raised rates to cool inflation, the markets fully expect that they will cut rates as soon as the economy starts to cool. (In August of 2019, inflation was above the 2% target and increasing but manufacturing had been signaling a slowdown when the Fed dropped rates three times in three months.) Essentially, the markets are already looking forward to a Fed stimulated recovery even before we've had the recession. Here's why there is risk to that outlook. While the economic indicators for the manufacturing side of the economy have moved towards recessionary levels, the service economy (78% of the total) is still strong. Higher rates do affect consumers' likelihood to buy a new car, not-so-much their desire to go out for dinner. The post-pandemic demand for services has far outstripped the supply of willing service workers, increasing labor costs (number of workers x's hours worked x's hourly rate) as well as service price inflation. While the rates of growth are both slowing, we are years away from 2%.

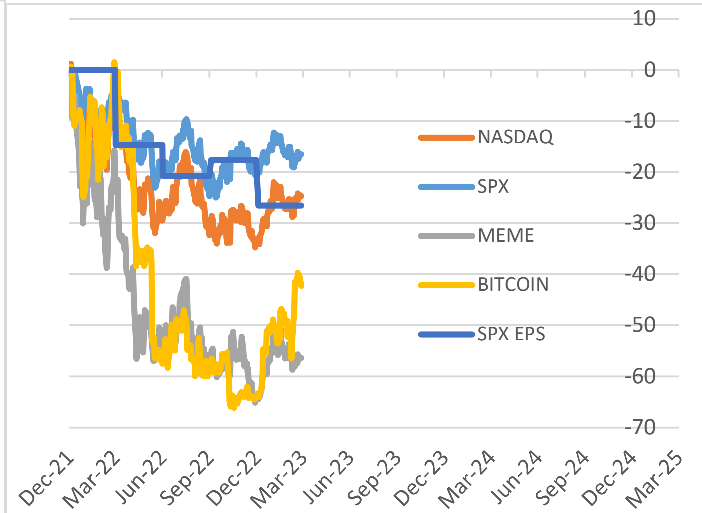




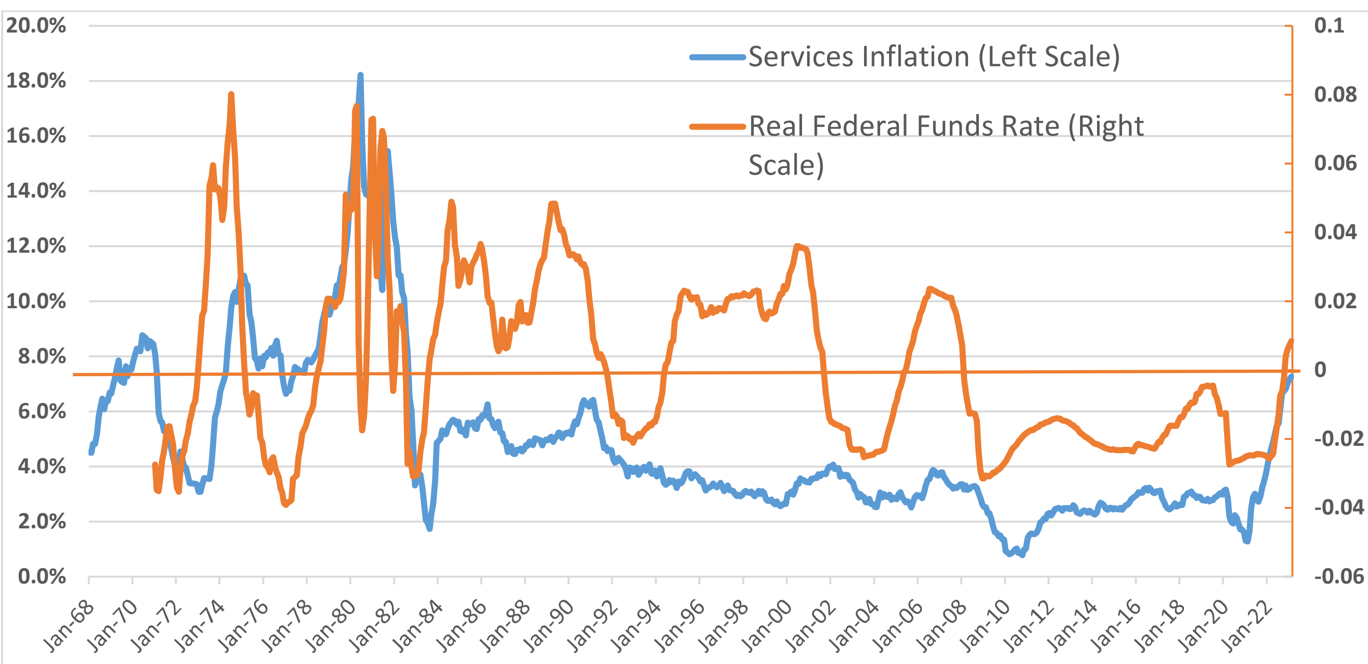


The increase in interest rates that has slowed the manufacturing economy has also exposed the weaknesses of those financial institutions that had become too reliant on cheap money to fund their growth. As long as you only have to pay a fraction of a per cent on your deposits, you can afford to make loans without much regard to their quality, duration or diversification. Incredibly, some institutions were surprised when the cost of money returned to more normal levels, assuming that government subsidized growth would go on forever. In spite of the multi-billion dollar government bailouts, the markets have reacted positively to the news as they were one more sign of the Central Bank's support of business. Most market participants seem to agree that a drop in rates to more accommodative levels is also in store.





The challenge for the Federal Reserve is the long lag time between rate changes and the desired effect. In the chart below, the solid orange line that originates in the right-hand scale at 0% is the point where short term interest rates are more than long term inflation rates. We just only recently entered into anything that could be called a restrictive level. In past cycles, the average time between when rates became restrictive and service employment peaked was three years. The average time between the peak of service employment and the peak of service inflation was a little over a year. To see any progress in inflation then, the Federal Reserve will need to keep rates at this level or higher for a number of years, not months. Optimism on the timing of the next rate drop is pessimism on controlling inflation.



Tom Lukic