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Economic and Market Commentary

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Just north of the Chesapeake Bay lies a smaller bay that was home to the Kechemeche Native American tribe, a branch of the Lenape Tribe. The Lenapes were the ones duped into selling Manhattan Island to the Dutch for 60 guilders worth of trinkets and goods. For hundreds and hundreds of years, the Kechemeches called this bay home.

Living off plentiful seafood like mussels, oysters and clams, these peaceful people prospered along the shores of what later was named Delaware Bay. Europeans first discovered this bucolic landscape in 1611, when Dutch sea captain Cornelius Jacobsen Mey explored the waters and claimed the area for New Amsterdam.

Over the next 200 plus years, the Kechemeches were pushed out (what a surprise), and the New Englanders moved in. The land took on the name of “Cape May” in the colony of New Jersey. Because of its white beaches, inviting climate and the ingenuity of the 19th century entrepreneurs, it became the first resort destination in America. Think of it as the Las Vegas of the first half of the 19th century.

Over the decades, the community matured. U.S. Navy facilities emerged along with beautiful architecture in the Victorian style. The community prospered through the decades, invested in its schools and public recreation facilities and capitalized on its equidistance from New York and Washington D.C.

Personalities

Over the years, Cape May, New Jersey, has birthed a myriad of people who entered the national stage. Quite an accomplishment for a community with a year-round population in the neighborhood of not much more than 4,000 people.

The playgrounds and schools of Cape May produced such notables as: Cliff Anderson, New York Giants football star in the 1950s; Eugene Grace, President of Bethlehem steel for 30 years; Jarena Lee, first Black female preacher of the African Methodist Episcopal Church back in 1819; and Louis Purnell, one of the original Tuskegee Airmen. These most accomplished individuals give you just a flavor of what a small and nurturing community is capable of for more than 300 years. But it doesn’t stop there. I’ve saved the most famous resident of Cape May for last. He was a young man named Paul.

Young Paul was a resilient kid having four older sisters to contend with. He was affable and well-liked by his school mates. His Mom, Alma, and Dad, Paul Sr., were children of hard-working German immigrants. Paul Sr. was the City Manager of Teaneck, New Jersey. He had a head for math and improved Teaneck's city finances tremendously in the 20 plus years he served in office. It became clear early on that Paul Jr. inherited his Dad's knowledge and instincts for government finance.

Paul Jr. Heads Off to Princeton

In high school, Paul was respected by his fellow students and faculty alike for his knowledge about politics and economics. When he was accepted to Princeton, it came as no surprise to anyone. His scholastic achievements at Princeton were impressive to say the least. In 1949, he graduated with honors from the Woodrow Wilson School of Public and International affairs.

If you haven't figured out by now who our young scholar was, this should be the final clue you need: his senior thesis was titled, "The Problems of Federal Reserve Policy Since World War II." Our young Paul's last name was Volcker, and he went on to become the Federal Reserve Chairman in August of 1979.

More than 25 years prior to this prestigious chairmanship appointment, Paul was declaring that "a swollen money supply presented a grave inflationary threat to the economy and that there was a need to bring this money supply under control if the disastrous effects of a sharp price rise were to be avoided."

In March of 1980, shortly after Volcker came to office, U.S. inflation rates peaked at 14.8 % . This was the time of the "misery index," consisting of double-digit unemployment, double-digit interest rates and double-digit inflation. Presidential candidate Ronald Reagan ran on a platform asking Americans, "Are you better off today than you were four years ago?" The answer was no, and Reagan won the election by a landslide. Although originally nominated by Democrat Jimmy Carter, Reagan reappointed Volcker because of his long-held belief that for an economy to flourish, inflation needed to be kept in check.

Paul Wasted No Time

The 1970s had been a turbulent time in American history. We had suffered a serious recession in 1973-1974. The Arab Oil Embargo of 1973 confirmed how dependent we were on foreign oil. Back then, the Vietnam War had ended, and veterans came home regrettably to a bitter welcome. In August of 1974, President Nixon resigned in disgrace. And by the late 70s, Americans were starting to believe that runaway inflation was here to stay.

If you do it by the numbers, it looks like this:

- August 1979. Paul Volcker becomes Chairman of the Federal Reserve Board. Seven months later, inflation peaks at 14.8%. When Volcker took office, the Federal Funds Rate was approximately 11.2%.

- By 1981, Volcker and his fellow Board members systematically raised the federal rate to a high of 21.5%.
- During this period unemployment rose to more than 10% and the country entered into a recession.
- High interest rates crushed industries like construction and farming. Who can forget the image of hundreds of American farmers driving their tractors down NW C Street in Washington D. C. in protest.
- By the second half of 1982, the Federal Reserve Board began lowering interest rates, and by 1983, inflation fell below 3%.

These actions, as Draconian as they appeared at the time, set American business and American equity markets on an upward trajectory that lasted almost 20 years without interruption.

Post Script: In late 1983, Paul Volcker received the U.S. Senate's John Heinz Award for the greatest public service by an elected or appointed official. Thus reinforcing the old adage that sometimes "Bitter medicine is the fastest cure."

A Quick and Brief Trip Back in Time

Long before the Roman Empire existed, Ancient Greece ruled much of Europe and Asia for the better part of one thousand years. The ancient Greeks gave us incredible architecture, epic poems the likes of Homer's, *The Iliad* and *The Odyssey*. Advances in math and astronomy blossomed. Plato founded the Academy, the first institution of higher learning.

The Greeks gave the world the concept of trial by jury. Alexander the Great conquered much of Asia including Persia and Egypt. Free standing sculpture developed under the Greeks. The concept of "Rule by the People," which we now know as democracy was founded by the Greeks. And as if all of these advances were not enough, the ancient Greeks invented the yo yo, the second oldest toy in the world after the doll.

Ancient Greece's accomplishments remain with us today, not just in architecture, art and politics, but in our everyday language. It's estimated that more than 150,000 words in English can trace their etymology back to ancient Greece, words like phobia, micro, philosophy, democracy, and the one we are most interested in today–dichotomy.

Dichotomy

The word dichotomy is actually the conjugation of two Greek words: Dikho (meaning two parts) and tomia (meaning cutting). By the 1600s, dichotomy, whose meaning refers to the division of something into two groups that are often mutually exclusive or contradictory, came to be known. You know what, that's exactly where we find ourselves today.

Think about it. Our equity markets have rallied at an unprecedented rate since the beginning of the year. Why? Layoffs, layoffs and more layoffs. We find ourselves in an environment where negative news drives the markets up. Higher layoffs great, unemployment up, great, housing prices decline, great.

You have to ask yourself in light of all this negative news, why have the equity markets rallied so dramatically since the beginning of the year? Answer: Layoffs, layoffs and more layoffs. (Thank goodness this reading is part two of a three-part series so that I can take the time to present the facts that will make sense.)

Today Alphabet announced 12,000 layoffs. Activist investors said, great. We want another 188,000 to meet our model. Alphabet has not been alone. Amazon, Microsoft, Apple, Sales Force along with numerous other mega cap tech companies have done the same. And what has the market thought of it? They are doing handstands. Last year's pariahs have been this year's market leaders: Microsoft, Apple, Alphabet, Nvidia to name a few.

So can you remember substantial layoffs leading to such up market gains? Personally, I can't, but I can understand it. Last year's villains, the large cap technology stocks, have regained investor confidence and are coming back with vigor. Why?

Here's Why

Big Tech, whether it be hardware, software, cloud or content have started and will continue a path of "right sizing." What does "right sizing" actually mean? It means layoffs plain and simple. When it's all said and done, we may see 1,000,000 layoffs in technology. Is it tragic? Only for those who can't find another position. But given the unemployment rate, those people will be in the definite minority. Simultaneously, Big Tech has already factored in lower growth (yet positive). The end of "cheap money" and the fact that the "new normal" will look much like the "old normal" did.

Old Normal vs New Normal–Not Much Difference

For the past 15 years or more, nominal interest rates have been near zero or less. What does nominal interest mean? It means you take the interest rate you're receiving by lending out money, and the yield you receive each year is less than the inflation rate. Net result, you're losing purchasing power.

Simultaneously, Big Tech has recognized that slower growth lies ahead. Slower growth means time to cut back on the labor force, some say up to 20%. Talk about doing the Fed's work for them. (You want to lower inflation, put more people out of work. Sad but true. This is the stuff that profits are based on: fewer people, more machines, greater artificial intelligence equals a better bottom line.)

The High Wire Act

Most economists predict that the Federal Funds Rate will cap out in the five to five and one half per cent range, with unemployment numbers in the five to six per cent range. Neither needs to be recessionary or contractionary. So, what is the new normal going to look like? I'll guess (emphasis on semi-educated guess) a five per cent unemployment rate and a five per cent Federal

Funds Rate, neither of which are recessionary. From a historic perspective, they are in the norm. What's not in the norm? The 15-year period where interest rates have been at or near zero.

In my estimation, what's called for now is a measured approach in interest policy. Inflation has gone down for six consecutive months. Is that mission accomplished? Absolutely not, but don't lose sight of the fact that rising interest rates raise the cost of national debt. Net result, pain.

Go back to 1981. The entire national debt was less than one trillion dollars. Today, it's in excess of 31 trillion. That means every rise in interest rates (whether well intended or not) in relation to inflation means less money available for low income housing, Medicaid, disaster relief, etc. No need to go on. It's a high wire act to say the least.

Conclusion

As I've mentioned before, I'm glad this quarterly commentary, one I've done for more than 25 years, is only part two in a three-part series. Although it's not even the end of January at the time of this writing, equity markets are showing definite signs of life. Some of last year's biggest losers in mega-tech are already up 10% or more since the beginning of the year. Is a "soft landing" plausible? I believe so as long as partisan politics don't screw it up. More on that in a moment.

It's not unusual for humans to get turned around backwards and not even know it. Example: Using an unfamiliar freeway ramp and finding yourself going northbound when it was your intention to go southbound. In sailing, it's not uncommon when you have to tell a novice sailor who you want to pull in a sheet or line, no, "bring in the sheet in your other right hand."

Looking back over the past three years, that's exactly what happened to investors and the markets. To understand completely, one needs to be able to distinguish between a cyclical and a secular market.

During years 2020-2022, the world got things backwards. When Covid first hit in March of 2020, governments around the world started pumping money into the economy as they needed to do, and it made people feel flush with cash. Remember the PPP loans, unemployment benefits far higher than people were making before the pandemic? We saw super low interest rates, mortgages at less than three per cent and housing values skyrocketing. So, throughout 2020-2021, investors reacted like these things would go on and on. They mistook a cyclical market, one that has a short duration usually brought on by a temporary business trend, with a secular market, one that is driven by forces that will stay in place for many years. Investors and markets got it backwards, and equity prices soared.

Shortly after New Year 2022, the Federal Reserve Board said, wait a minute, inflation is getting out of hand, and we're going to start raising interest rates in a meaningful way. This was really a cyclical situation (remember how quickly Paul Volcker and his colleagues got inflation down below three per cent). Investors, however, treated it as a secular market that would be in place for many years. This drove down all markets, and in fact, punished the most successful and innovative companies, Big Tech the most.

I’m reminded of how great and innovative companies came out of the dot.com bust of March 2000–October 2002. The same thing happened after the 2008-2009 financial crisis. We are at a similar place in time now, with incredibly innovative companies making tremendous strides in artificial intelligence, semiconductors and biotechnology to just name a few sectors. That will continue, as long as big government and partisan politics don’t throw a wrench in the works.

Over the next several months, we are all going to hear a lot of heated debate over raising the debt ceiling. This is like an annual rite of passage for politicians who are known to shoot themselves in the foot. Back in 2011, when the debt ceiling needed to be raised, no bi-partisan efforts could prevail. The clock ran out, and the government started paying vendors with IOUs. This so enraged the credit rating services that they lowered the U. S government debt rating from Triple A to Double A. Not only was it a black eye to America, but it raised the cost for the U.S. to borrow money. We’ll be reading much about this issue in the coming months. This time let’s hope Washington learned from its previous mistakes. Once an increase is passed, the way to stabilized interest rates, sustainable growth, acceptable unemployment and an equities market that can distinguish between the cyclical and the secular can then take place. As always, with...

Very Best Regards,

Ray Lent
Enclosures
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