DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

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July 2022

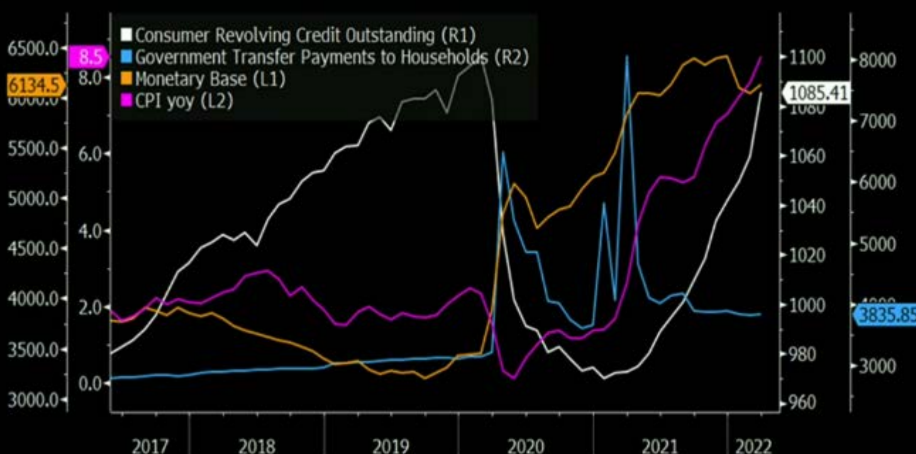
From "Whatever It Takes" to "Whenever It Breaks:" Navigating the Strait of Messina

"The best cure for high prices is high prices" Henry Clews, American Financier, 1836-1923

In Homer's *Odyssey*, Odysseus must steer his ship through the hazardous Strait of Messina. On one side of the narrow passage is Scylla, a multi-headed, man-eating beast perched on a cliff. Six men (one for each head of the monster) would be lost if the vessel traveled too close to the rock. On the other side is Charybdis, a monster transformed into a treacherous whirlpool which most assuredly would engulf the entire ship. Odysseus had a true dilemma which has been immortalized in the idiom "caught between a rock and a hard place."

Odysseus would recognize the Homeric dilemma the Federal Reserve finds themselves in today. If they continue to tighten monetary policy it will almost certainly help drive the economy into a rock (recession). If they reverse monetary policy to accommodate depressed financial markets and a flagging economy, they would most assuredly sail into a hard place (inflation) which already sits at a 41-year high. The Fed's journey might have been less treacherous had they acted when the economic winds were friendlier, but they were fooled into believing inflation was transitory. Today, there are signs inflation may have peaked in June just as the Fed has unfurled the sails of rapidly tightening monetary policy. However, forecasts may be calling for less accommodating skies on the CPI front and warning signs abound of a coming recession. Now that it appears the Fed is trading one tempest for another, which will they choose? Odysseus chose to lose 'only' six men, rather than risk losing the entire ship. Will the Fed steer the economy into a certain recession, or reverse course?

Chart 1: Tailwinds of Inflation

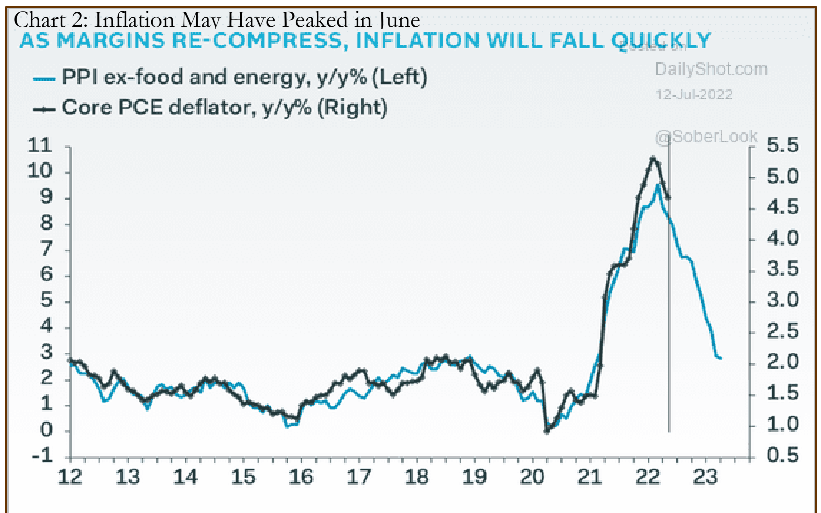


Inflation Storm Subsiding?

Inflation has not been this high since the early days of the Reagan Administration. For the lion's share of the past 14 years, the Federal Reserve's unspoken motto has been "*Whatever it takes*" in response to mayday distress signals sent by the financial markets. Chart 1 helps illustrate just how monetary and fiscal policy responses to the Covid Crisis combined to create the largest increase in the money supply in US history. Now that the money supply is falling, inflation is showing signs that it may have peaked. A declining Core Producer Price Index (Core PPI) serves as an early sign that inflation may be waning. As evidenced by Chart 2, the PPI may have recently peaked and Core PCE will likely follow suit over the coming months.

> The Core PPI measures production costs which are passed on to retailers and consumers. Ultimately, they may appear later in inflation measures like the Consumer Price Index (CPI) or the Fed's preferred method, Core Personal Consumption Expenditures (Core PCE) Index. Generally speaking, the Core PPI will ebb or flow before the CPI.

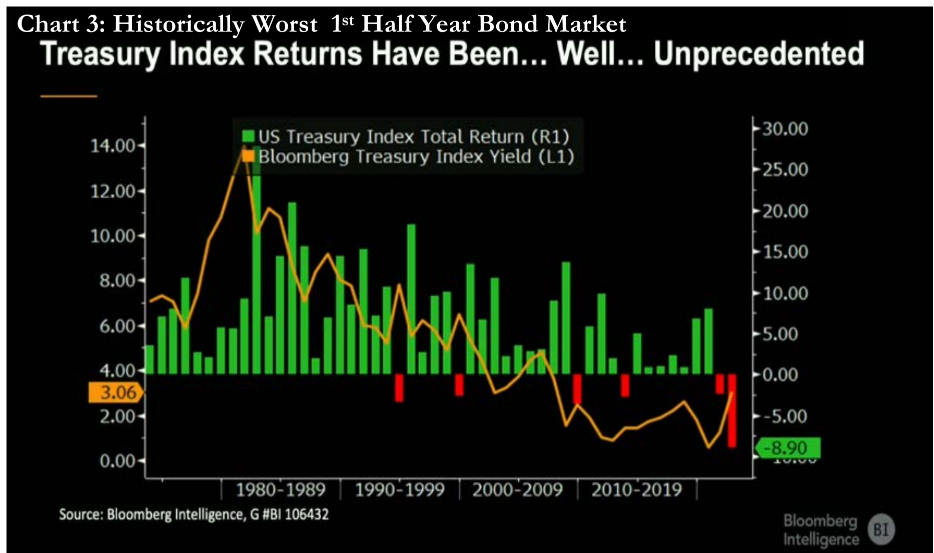
Chart 2: Inflation May Have Peaked in June



Bond Market Shipwrecked

The market response to the tightening of fiscal policy would make even Charybdis envious! Interest rates on the 10-year Treasury bond have gone from a low yield of .5% two years ago to a recent high of 3.47% in mid-June. In the first half of 2022, the US bond market was down the most since George Washington was first elected President in 1788 and could experience its second consecutive down year for the first time ever. But while the Fed is still in its incipient stages of fighting inflation and unwinding historical monetary stimulus, the dark clouds of a coming recession are on the horizon. The question now on the minds of investors is will the Fed continue its "full speed ahead" into tightening if the financial markets continue to worsen, earning the new motto "*Until it breaks*?"

Chart 3: Historically Worst 1st Half Year Bond Market

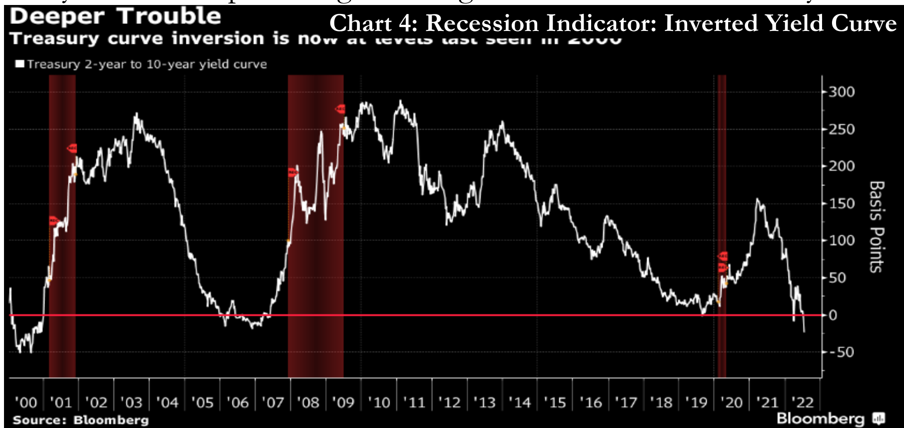


Is a Recession on the Horizon?

There are early warning signs to help determine if a recession is just around the bend. Some of these include an inverted yield curve, a decline in consumer confidence, a drop in leading economic indicators (LEI), a bear market in stocks, and rising unemployment.

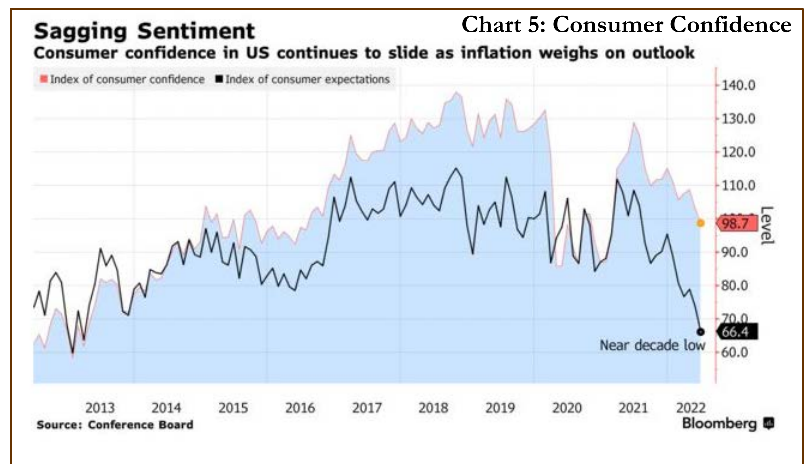
Recession Indicator: Inverted Yield Curve

According to Certified Financial Planner Melissa Cox, a negatively sloped or "inverted yield curve has been very effective in predicting a coming economic recession." Why? She believes "long term bonds yield more than short term bonds in a healthy economy to compensate investors for additional inflation risk." However, she says, a negatively sloped yield curve suggests demand for credit is dissipating and a recession may be on the horizon in "the next 6 to 18 months." The yield curve inversion between the 2- and 10-year Treasury bonds hit the worst level since 2006 and now stands at about 22 basis points.

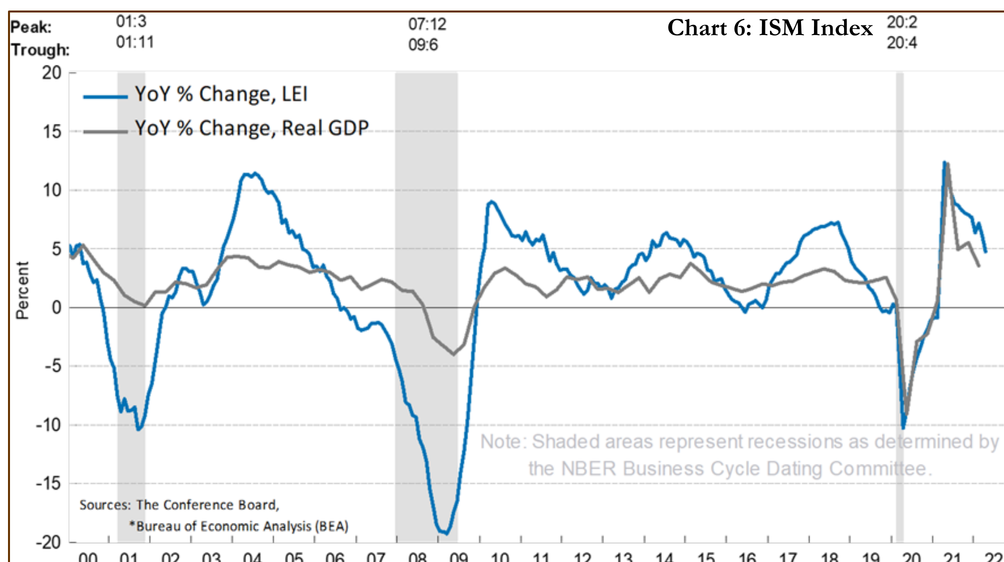


Recession Indicator: Consumer Confidence

In a recent Bloomberg news report, Olivia Rockeman reported that consumer sentiment dropped to its lowest level in nearly a decade as "Americans grew more downbeat about the economy, labor markets and income." History shows that consumer confidence has been at its lowest point just prior to, and in the midst of, recessionary periods. The index rises when consumers regain confidence in the economy, which portends increased consumer spending and thus economic growth.



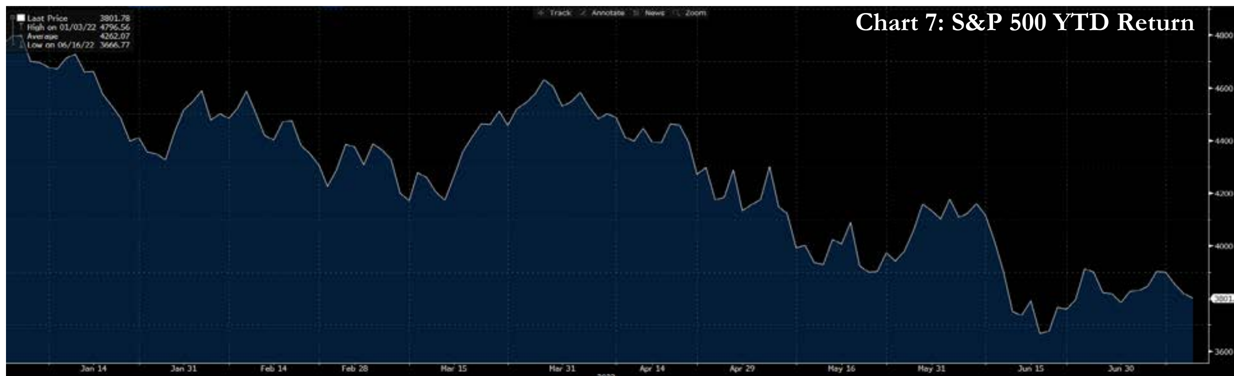
Recession Indicator: Leading Economic Indicator (LEI)



The Conference Board Leading Economic Index (LEI) is intended to help forecast future economic activity. The Index includes items like weekly unemployment claims, Institute for Supply Management Index of new orders, and consumer expectations. While the Index is near historic highs, it does suggest "tighter monetary policy is poised to dampen economic growth even further," according to Senior Director of Economic Research at the Conference Board, Ataman Ozyildirim.

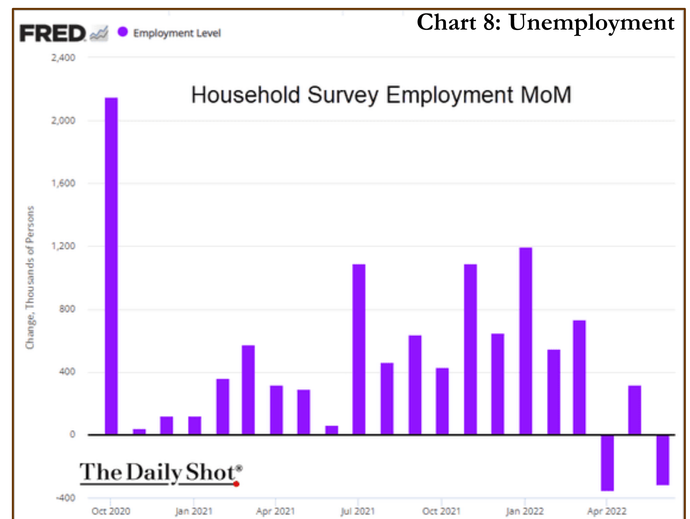
Recession Indicator: Sudden Stock Market Decline

The S&P 500 finished the first half of 2022 in bear territory or down more than 20%. The Index has not fallen this much by the mid-point of the year since the US went off of the gold standard in 1971.



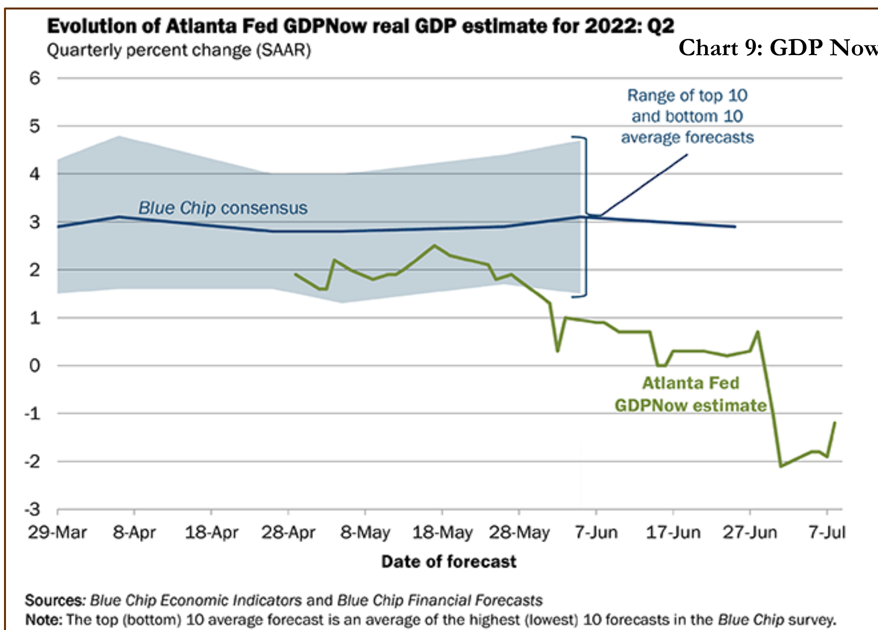
Recession Indicator: Unemployment

Job gains have been strong and are now on par with pre-covid levels at an unemployment rate of 3.6%. But the Bureau of Economic Analysis (BEA), in a recent survey, points to a potential crack in an otherwise hot labor market. Consumer expectations now suggest an increasing number of respondents believe the US unemployment rate will rise over the next year, especially for college graduates.



Conclusions: Navigating the Strait of Messina

The Atlanta Federal Reserve now predicts the US will experience its second down quarter in a row and the US economy has unofficially entered a technical recession. However, it is important to note that the economy still grew well over 7% during the second quarter but real GDP was negative due to inflation that averaged over 8.5% in the same period. Also, employment is near a pre-pandemic high with a 3.6% current unemployment rate so economists will be reluctant to declare a recession until more economic indicators turn negative.



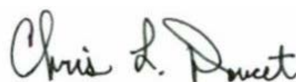
If the Fed continues to fight inflation until their mandated 2% is within reach, it is highly unlikely the US will not fall into an economic recession. While it is clear the economy is at or near peak inflation, even when inflation does decline, high prices will likely plateau before trending lower to the Fed's mandated rate of 2%.

The investing mantra that served investors well over the past 14 years is "Don't fight the Fed." Investors have

become conditioned to buy the dips because the Fed will provide liquidity to the markets when markets swoon … until now. If the Fed's mantra has been "*Whatever it takes*" to support the financial markets since the Great Recession, it has probably changed recently to "*Whenever it breaks*" the back of inflation. The Fed has raised short term rates about half of what the market expects at this point and they have not even begun to reduce their almost $9 trillion balance sheet. Given the headwinds from monetary policy and a slowing economy, the resulting simple math does not support stocks at their current 19.5 times trailing earnings and 17 times future earnings. This equation is exacerbated by a 3% 10-year Treasury bond competing for investing dollars. Over the past four months, earnings estimates are relatively unchanged. But the US dollar has screamed higher, economic data is slowing, debit card transactions have declined and a plethora of other signs abound to help illustrate that business is less vibrant than it was 120 days ago. Earnings in stocks and margins are historically well above trend which will not be sustainable if the US enters an economic slowdown or recession.

Given the scenario of a Fed who will likely remain hawkish for too long (or at least longer than the market expects), the investor perception of cash has evolved over the past few months from "trash" to a very valuable asset. Liquidity will give investors an opportunity to redeploy cash into good quality stocks in the near future at prices that reflect lower earnings estimates and a more challenged, less liquid market. If the Fed stays true to its new mandate, it is highly likely the US economy heads into a full-blown recession. Much like Odysseus, the Fed certainly does find itself between a 'rock and a hard place."

Sincerely,



Chris L. Doucet, CEO

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