DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

Q4 2023

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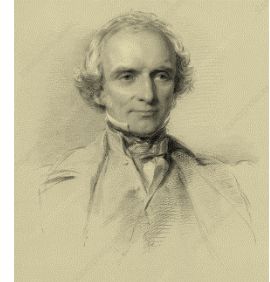
Fiscal & Monetary Policy: Medicine or Poison?

"Poisons and medicines are oftentimes the same substance given with different intents"
~ Peter Latham, English Physician & Educator July 1, 1789 – July 20, 1875



Mustard Gas is a condiment-smelling agent used during World War I that produced an assortment of maladies ranging from minor skin irritations to severe lung damage. Victims also suffered from a reduction in their white blood cell counts, making those effected more susceptible to diseases from germs and bacteria. But scientists discovered that a small dose of the gas could actually prove beneficial in killing cancer cells in lymph nodes. Dozens of studies followed that fortified the early findings. And by the end of World War II, the era of cancer chemotherapy had begun.

Like cancer chemotherapy, the goal of current monetary policy is to cause more *good* than *harm*. Administer high doses of interest rates to the economy and economic activity will slow and, in time, inflation can be eradicated. If the dosage is just right, a healthy or 'goldilocks' economy will survive. But if the dosage is too high, the economy will succumb to recession.

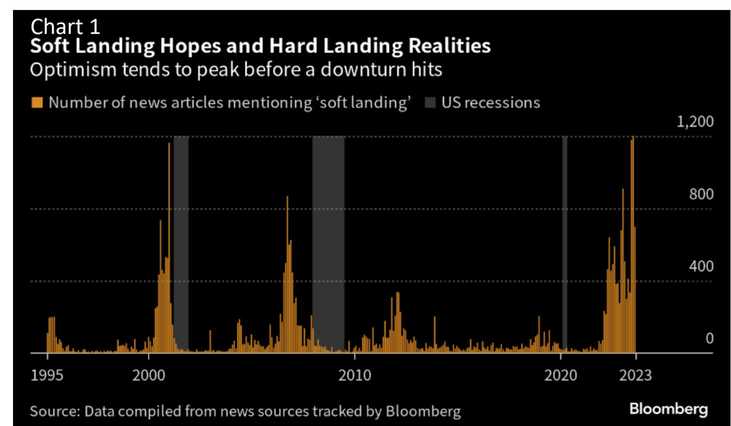
Finding the Right Balance

Over the past 19 months, the Federal Reserve has raised short-term interest rates by 525 basis points or 5.25% in its fight against inflation. While *monetary* policy has attempted to slow the economy, *fiscal* policy has provided the antidote to the Fed's inflationary cure. Unprecedented crisis-sized deficit government outlays have helped US GDP remain comfortably positive for the past several quarters, and have kept the most anticipated recession in history at bay…at least for now.

Despite the best efforts of Congress and the Treasury to overdose on spending, inflation has still managed to decline almost every month for the past 16 months. While both sides can claim they provided a cure for their ailing patient, there is still work to be done. Destructive agents like heightened oil prices, military conflicts abroad, and *anti-inflation* legislation will prove to be headwinds for the Fed in their fight against inflation.

Simultaneously, events like the resumption of student loan payments, tighter corporate credit, and *another* looming potential government shutdown will provide fiscal challenges which may make the hoped 'soft landing' in the economy difficult to achieve. What will be the outcome of these two opposing treatments, and how should investors position assets to keep their portfolios healthy?

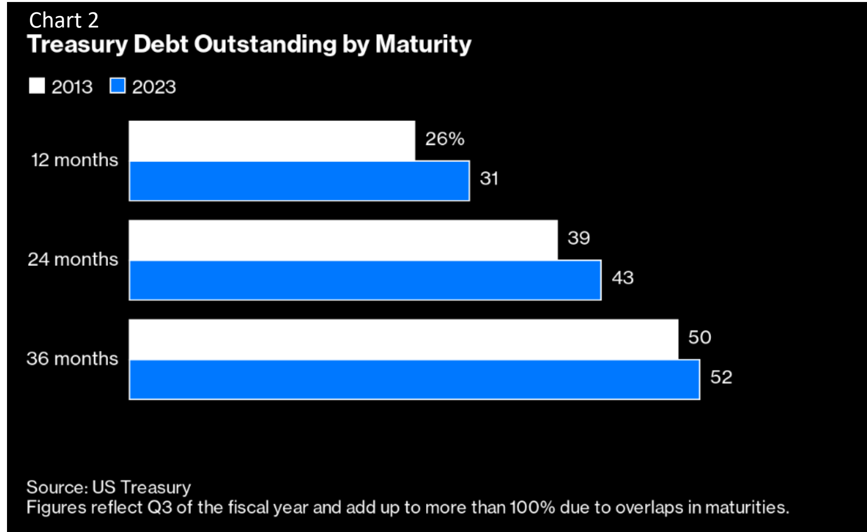
Fed Raises Rates Until Something Breaks

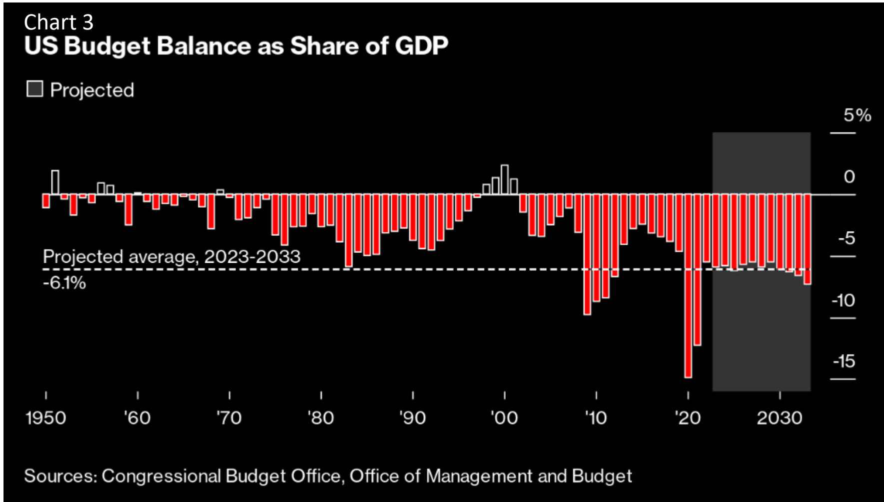


Since the 1970s, the Federal Reserve has only been able to avoid a recession following periods of rate hikes one time (1995). According to the famed economist Milton Friedman, the main reason the Fed raises rates for too long is monetary policy impacts the economy in "long and variable lags." In other words, it can take up to 18-24 months for rate hikes to completely cycle through an economy. This is just one reason why the Fed makes such notoriously bad (and very public) and ill-timed predictions about the economy. One particularly famous misdiagnosis was made by the current Treasury Secretary and former San Francisco Fed President Janet Yellin. Two months prior to the start of the Great Recession, she stated "the most likely outcome is that the economy

will move forward towards a soft landing." Unfortunately, Yellin was not alone in her overt optimism. As evidenced in Chart 1, with alarming regularity, soft landing calls peak before hard landings hit.

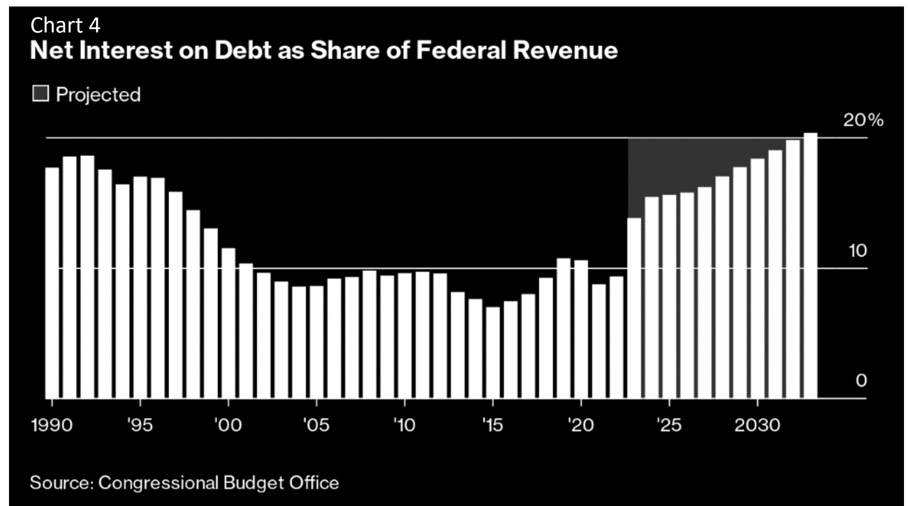
Any fiscal remedy administered by US politicians to grow the economy through deficit spending will be met with much more resistance in the future. Former forced buyers of US Treasuries have disappeared as Central Banks continue to raise interest rates and unwind their balance sheets. This buying slack has defaulted to discretionary yield buyers who have many choices where to deploy assets in this new era of higher interest rates. The timing could not be worse for the US Treasury as their short-term funding needs are…significant. According to Bloomberg (see Chart 2), despite interest rates that were near zero, maturities on Treasuries have gotten shorter in recent years, so that almost one-third of the national debt needs to be rolled over in the next 12-months.



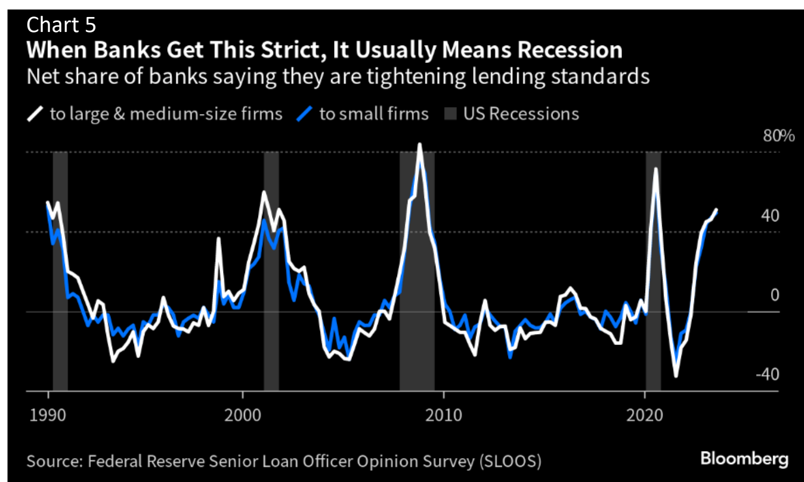


Funding this wall of government debt maturing over the next several years will prove challenging. According to the Congressional Budget Office, "deficit spending is expected to expand to roughly 6% of GDP this year and remain elevated for the next several years (See Chart 3). For context, in the six decades or so between the aftermath of World War II and the 2008 crash, the shortfall never reached that level."[1]

The interest payment on government debt is now roughly equivalent to the spending on the American military. According to the ***Washington Post***, US government's interest burden has doubled since the start of the pandemic from $380 billion to about $833 billion, or about 14% of total estimated tax revenue. The average yield on Treasury debt currently stands at about 3%...and its rising daily. The toxic mix of tight monetary policy and near-term funding needs will force interest costs on US government debt to rise significantly. John Ryding, Chief economist at Brean Capital, has attempted to quantify just how bad things could get if Congress does not get its fiscal house in order. Chart 4 helps to illustrate his point. He predicts "each percentage point increase in the federal budget deficit as a share of GDP will cause a 40-basis point increase in 10-year Treasury yields."

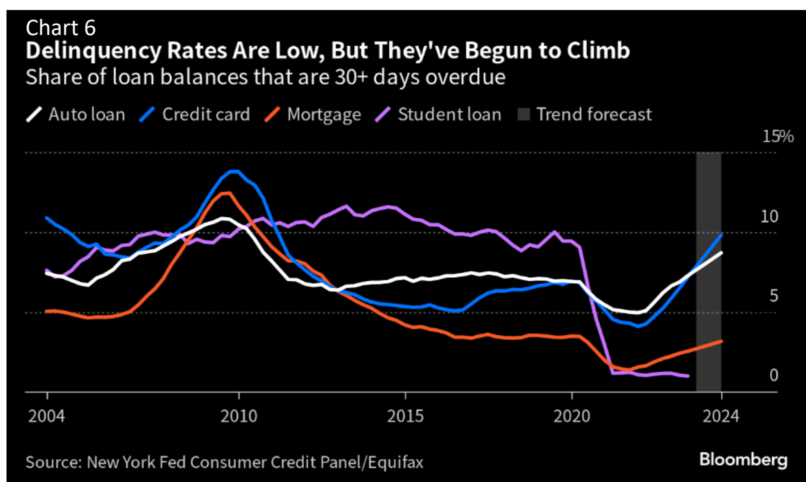


Economic milestones like tightening of bank lending and loan delinquencies augur ill for the economy and risk markets. In the past, when bank lending standards tighten, companies become starved of capital they need to fuel growth. Chart 5 shows the close relationship between tight lending standards and economic recessions. Businesses are already beginning to feel the effects. Corporate borrowing is anemic and will likely lead to weaker investment and hiring in the coming months.



Curing the Disease but Killing the Patient

Consumers are also beginning to feel the pinch This summer saw Americans splurge on a wave of hit entertainment ranging from "Barbie" and "Oppenheimer" movies to Beyonce and Taylor Swift concerts. According to Bloomberg, these blockbuster entertainment events "added a remarkable $8.5 billion to the economy." But excess savings ins rapidly dissipating and delinquencies on credit cards are on the rise. Auto loans are following suit as most were made since the start of the Covid era when there was a significant supply/demand imbalance and auto prices were artificially high. Now many of those loans are underwater and auto loan delinquencies are also rising.



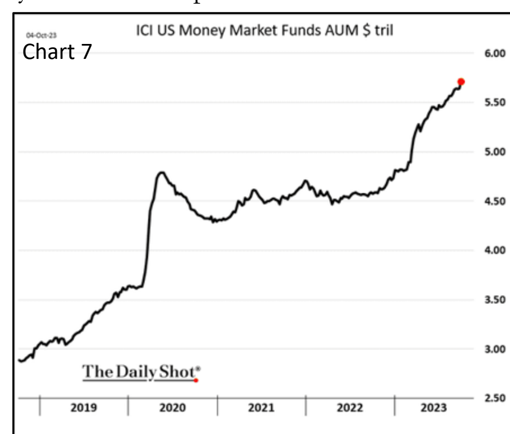
In sharp contrast to autos and credit cards, delinquencies on student loans and mortgages are near historic lows. However, it is important to point out that there are historic events that have caused these mismatched circumstances. Student loans enjoyed a three-year moratorium on payments which was lifted September 1st. Most home mortgages are experiencing such positive credit history because they are "in the money and have lower rates" so the expectation is those loans will remain healthy much longer.

Financial Market Response

Historic moves in fiscal and monetary policy have resulted in equally historic moves in some financial markets.

Bonds

Perhaps most notably, according to Bank of America, the US Treasury market has experienced its worst selloff since before George Washington was first elected president. The bank recently traced US bond market returns all the way to 1787. What they determined is there has never been an extended period of losses for this long in any period of time in US history. So far, the combination of yields and a slowing economy has yet to compel investors to rush into this asset class. The pain suffered in the debt markets and investors the lack of conviction to buy longer bonds has helped to underscore the growing angst Wall Street has about the current state of government finances.

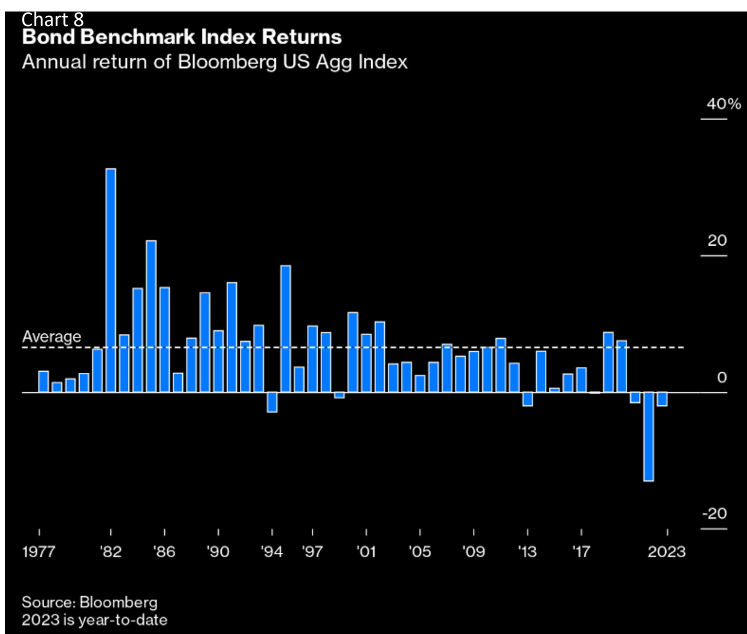


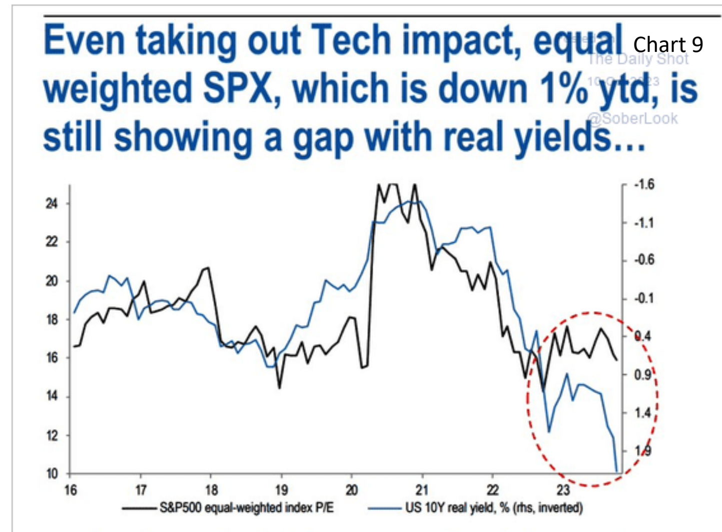
Cash

While investors have avoided bonds, they have plowed a record amount of cash into T-bills and money market accounts. In just 19 short months, the rise in short-term yields from zero to over 5% and the era of "cash is trash" has ended.

Stocks

2022 losses in stocks have been followed up by a lackluster year for *most* equities. The "Magnificent Seven" stocks (Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla, Meta Platforms) have been the driver for outsized returns in the NASDAQ and the S&P 500 so far this year. But the S&P 500 Equal Weighted Index is down more than 1% so far in 2023 and Dow Jones Industrial Average is barely positive. What is interesting, as evidenced by Chart 9, is even when you take out expensive large tech stocks, real yields seem to suggest the equal weighted market might still be pricey compared to bonds.

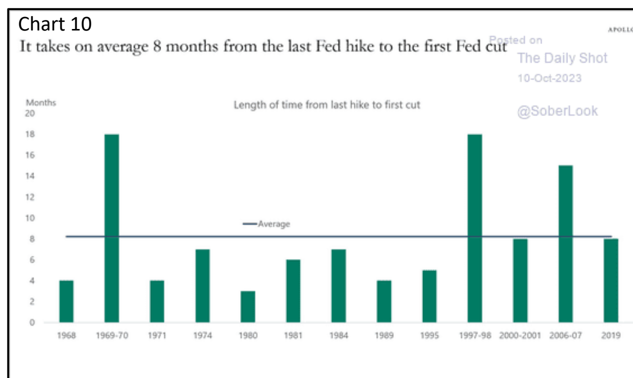




The Treasury & Fed Will Overprescribe

The Treasury and the Fed have been working in opposition to each other for months now, administering competing medicines to accomplish two completely different goals. Fiscal policy has involved using the government credit card to super charge the economy which has added to the inflation equation. On the other hand, the Fed has raised short-term interest rates by more than any time in the past 40 years in an attempt to slow down this same economy and eliminate the inflation in the process.

What happens next? It is hard to see exactly how fiscal and monetary policy will change much from this point. The problem now is it is hard to see exactly how fiscal and monetary prescriptions can change much from here. Government spending will likely stay elevated for longer and the Fed must remain hawkish and leave rates elevated as dovish comments on actions of actions on the part of the Fed are met with surges in optimism.



While economic realities suggest not much will change in monetary and fiscal policy in the coming weeks, leading economic indicators still signal a recession is in the oft but timing is still uncertain. The Fed "Dot Plot" suggests rate cuts will start coming fast and furiously some time in 2024. Historically, as indicated by Chart 10, the average time from the last rate hike until the first rate cut is around 8 months. If these symptoms are accurate, investors should begin rolling out of money market accounts and start investing in bonds with longer maturities. In this scenario, stocks will be under more pressure going forward and bonds will represent a better risk-return outcome in the coming months. One thing is certain, the last thing Congress and the Fed want to see is the economy (and the equity markets) to feel an inordinate amount of pain. As a result, they will remain on call ready to overprescribe fiscal or monetary medicine if the need arises.

Sincerely,

Chris L. Doucet

Chris Doucet

Footnotes:
[1] Source: Bloomberg Businessweek, "How Much Debt Is Too Much Debt?", edited by Cristina Lindblad, pp.22-24

Amin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
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