Doucet Asset Management, LLC Quarterly Newsletter

January 2024
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The Goldilocks Economy-*Before the Three Bears*

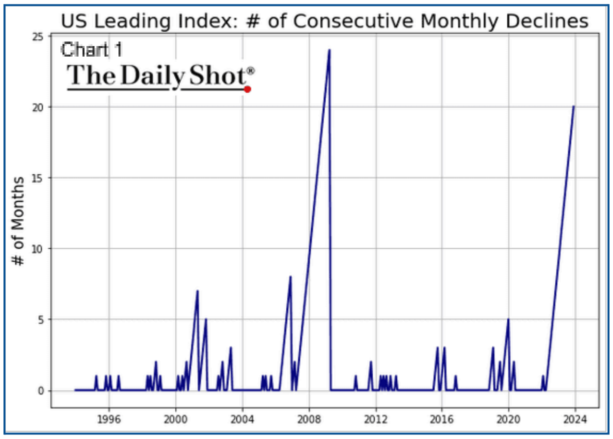
"I think the most likely outcome is that the economy will move forward toward a soft landing."
~Janet Yellen, President of the Federal Reserve Bank of San Francisco, October 30, 2007

"What we're seeing now I think we can describe as a soft landing, and my hope is that it will continue."
~Janet Yellen, Treasury Secretary, January 5, 2024

The first printed version of "The Three Bears" was written by English Poet, Robert Southey, in 1837. In Southey's version of the story, an uninvited elderly vagrant woman enters the home of the bear roommates who varied in size: large, medium and small. After breaking in, the heroine eats a perfect bowl of porridge, destroys a piece of furniture, takes a nap in a comfortable bed, and makes her escape through an open window. In the story's conclusion, Southey speculates the intruder might have been sent to a "House of Correction" for vagrancy or perhaps "broke her neck in the fall." The story was modified by different authors over the next several decades to make it more child-friendly. However, it was not until 1904 when the elderly trespasser was replaced by a blonde-haired juvenile delinquent by the name of Goldilocks. The three bear 'friends' were replaced by a less threatening bear 'family.' Perhaps the most significant change was in the moral of the story which went from one of law and order/crime and punishment to the less menacing theme of lack of respect for others' property can be overlooked if one discovers Goldilocks' "Just Right" List.

Wall Street has invoked the 'Goldilocks' name over the past 120 years to describe an economy that was 'not too hot and not too cold.' Recently, the Street insiders have focused on the economy's Goldilocks 'soft landing', and have tried to convince the investing public the Bears will not be returning home any time soon. This is a stark change from a year ago when 85% of economists surveyed by Bloomberg believed the US economy would slip into a recession in 2023. As it turns out, last year was perhaps the most anticipated recession that *never* happened. Interestingly, all of the ingredients were there that would foster most recessions. At the start of last year, the Leading Economic Indicators (LEI), an early indicator of significant turning points in an economic cycle, had been negative for 9 months straight (see Chart 1); corporate earnings were expected to be relatively flat in 2023; and the Fed was signaling multiple rate hikes and a continued unwind of their balance sheet for the next two and a half years - which together would adversely impact borrowing and jobs.

While Wall Street economists got these assumptions right, the anticipated economic Bears never quite made it home. The Fed continued hiking interest rates at the fastest pace in 40 years, the LEI continued to deteriorate (and have now been negative for over 20 months - see Chart 1) and S&P 500 corporate reported earnings are negative so far in 2023. However, both the markets and the economy were up more than almost anyone expected. GDP in the third quarter was up an eye-popping 5.2% and the S&P 500 was up over 24% (almost 12% on an equal-weighted basis). How did everyone get it so wrong in 2023?

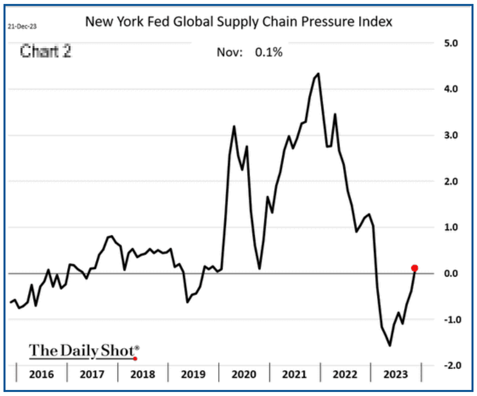

US Leading Index: # of Consecutive Monthly Declines

Why Did the Bears Hibernate in 2023?

The Goldilocks economy of 2023 was aided by three contributing factors that most economists failed to anticipate:

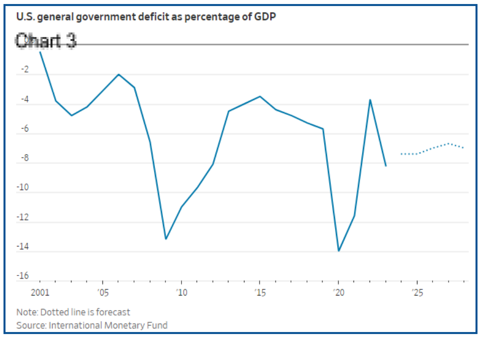
- **Supply disruptions *were* transitory after all**

Once supply chains normalized, supply and demand for goods matched once again and price increases moderated. As a result, inflation slowed on its own, suggesting that the most rapid rate hike regime in history may have been a bit overdone.


New York Fed Global Supply Chain Pressure Index

- **US government deficit spending**

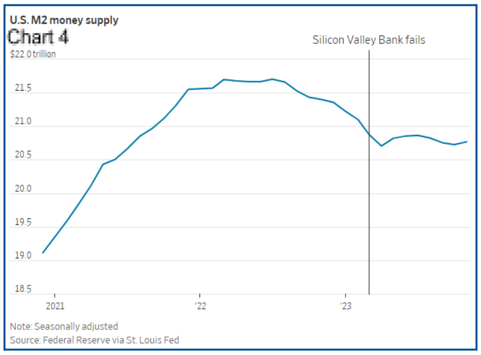
The government created an economic stimulus that potentially outweighed the Fed rate hikes and balance sheet reductions with almost $2 trillion in deficit spending. According to the International Monetary Fund, the US ran a deficit of about 8.2% of GDP in 2023. “That is by far the most of any developed country and a huge increase from 2022’s 3.7%.” [1]


U.S. general government deficit as percentage of GDP

Note: Dotted line is forecast
Source: International Monetary Fund

- **Fed tightening was neutralized**

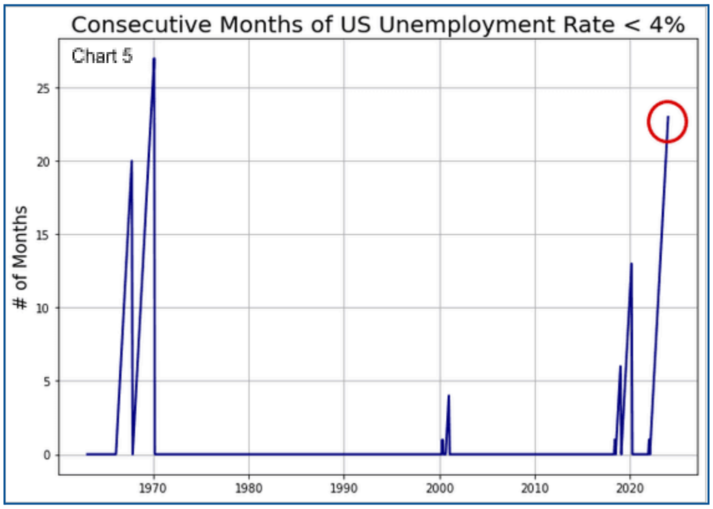
The Fed partially offset its own policy by injecting liquidity into the system early last year when it doled out huge sums of money on easy-lending terms to banks following the collapse of Silicon Valley Bank. As a result, the money supply stopped shrinking and, in essence, the Fed was no longer tightening policy, in terms of quantity of dollars, even though interest rates were rising along with the cost of money.


U.S. M2 money supply

Note: Seasonally adjusted
Source: Federal Reserve via St. Louis Fed

Where Are the Bears Now?

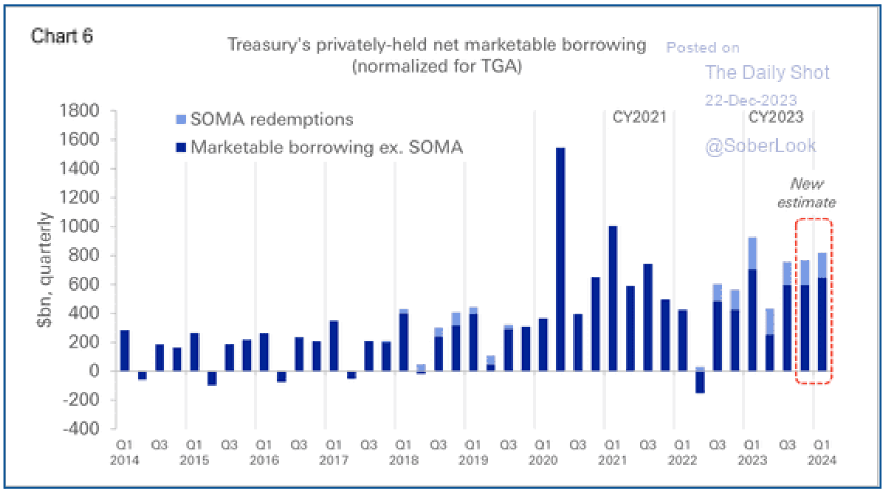
Can the combination of a neutral to dovish Fed, significant back-door government stimulus and normalizing inflation continue through 2024 and keep the Bears at bay? Consumers are still spending, jobs are plentiful and the Federal Reserve may have ended its aggressive cycle of interest rate hikes last summer. At least for now, the economy appears to be in the middle of a Goldilocks story of its own.



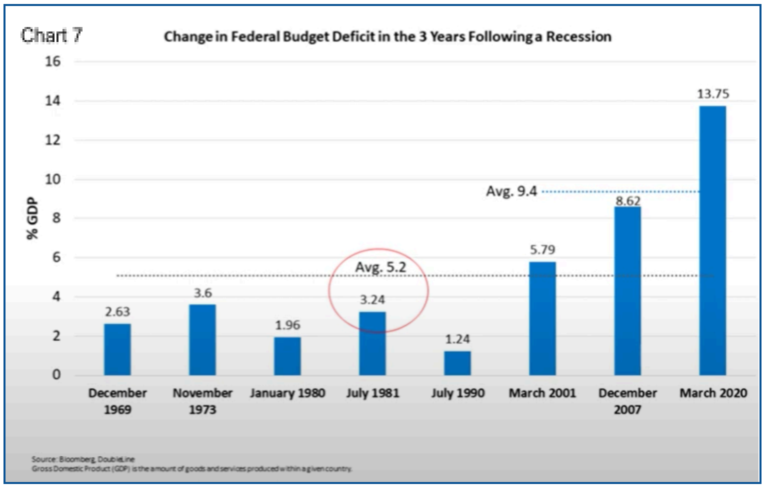
U.S. unemployment has been below 4% for almost two years, its longest stretch since the late 1960s. This is just part of the reason Wall Street is inundated with headlines of a soft landing. But the porridge isn't *just* right. Both markets and the economy are facing significant obstacles which may curb growth and impair returns. Contrary to good employment news, Leading Economic Indicators have only been this negative for this long one other time, around the start of the Great Financial Crisis (see Chart 1 again). This indicator has proven ineffective in predicting economic downturns in the past. Despite a decent employment report to start 2024, there are also "emerging signs of a softening labor market and sagging consumer confidence" according to Edna Curran of *Bloomberg Businessweek*. US households "are relying more heavily on plastic" and "credit card balances are now $154 billion higher than they were a year ago.'

Government Debt *Bear*ing Down on Goldilocks Economy

The U.S.Treasury is close to maxing out its credit card. This is a problem for the economy. According to Haver Analytics, government spending was 68% of real GDP in the first quarter of last year alone. As evidenced by Chart 6 , the government continues to spend at levels only seen in the past during Covid, significant economic downturns, and wartime. This level of government spending is not sustainable.



A key element to any soft landing will be the Treasury's ability to continue to finance its deficit spending. But this is only part of the problem. Doubleline Funds suggests government spending is exacerbated by the fact that about $17 trillion in U.S. government debt comes due over the next three years. So, the U.S. needs to finance a 'bear' necessity of $6 to $7 trillion in bonds per annum just to stay afloat. The cost to service this debt is now on par with the amount budgeted annually for the military…and rising! The average interest rate on the current Treasury portfolio is 3.17%. With prevailing rates ranging from 3.97% to 5.38% on new issue Treasuries, interest costs will continue to rise substantially in the coming years unless yields drop precipitously.

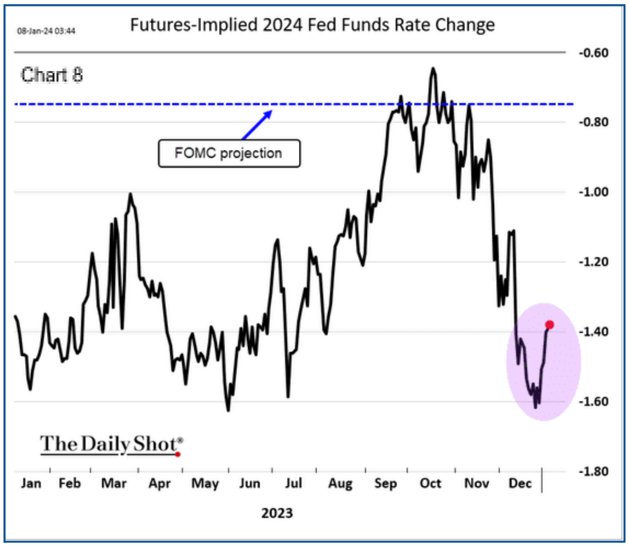


Source: Bloomberg, DoubleLine
Gross Domestic Product (GDP) is the amount of goods and services produced within a given country.

The funding problem will become significantly more apparent during the next economic downturn. In recessions, spending as a percentage of GDP rises because of a combination of lower tax revenues and higher absolute government spending to support unemployment payments, higher food stamp participation, and other government programs. Chart 7 from Doubleline Funds helps illustrate that deficit spending as a percentage of GDP has actually averaged about 9.4% over the past three U.S. recessions.

Too Hot, Too Cold, or Just Right?

One does not need to be smarter than the average bear to understand that it is not likely that any of these issues will be ameliorated in an election year. Market multiples have expanded and bond yields have come down over the past several months with the belief that the Federal Reserve will cut rates by 150 basis points next year, employment will remain strong, and a recession will be avoided. It would certainly be a fairy tale ending if all three of these events could happen at one time, but that is highly unlikely. Just in case the Goldilocks scenario does not work out for the economy and markets in 2024, it might make sense to take a little porridge off of the table in case the three bears come home earlier than expected.



Sincerely,

Chris L. Doucet

Chris Doucet

Footnotes:

[1] Wall Street Journal, James Mackintosh, December 29, 2023, "How I, and Everyone Else, Got 2023 So Wrong.

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.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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