The Big Picture:

Here are two years of Consumer Price Index inflation numbers: 8.4% and 14.4%. Is this the CPI for 2022 and an estimate for 2023? or the results from 1978 and 1979, in the era of raging inflation? Nope, they are from 1946 and 1947! The CEO of one of our portfolio holdings, Stifel Financial, brought this to our attention. The old saying is that Generals are inclined to fight a new war as they had the previous one; the Calvary versus tanks, repeating rifles versus machine guns. The point being that maybe the tools the Federal Reserve employs today being reminiscent of the 1970's are not the correct ones for this episode. The current Chair of the Fed, Jay Powell, keeps reverently referring to Paul Volker, the vaunted Fed Chair from 1979-1987, who crushed the rampant and unanchored inflation of 1970's decade. The 1946-1947 inflation experience was the result of a flood of returning soldiers from World War II. That war(s) ended in one week in August 1945; it's over, everyone go home! At the same time the industrial might of the U. S. was dedicated to the war effort – building airplanes, ships, weapons. The Ford Motor Company did not produce a new line of passenger cars until *1949.* But returning veterans and reunited families wanted toasters, refrigerators, automobiles, TV's, new homes, etc. That period is therefore characterized by a demand driven economy where supplies of what citizens wanted were either unavailable or in short supply. The consequence of course was inflation where that which was available was bid higher.

Sound familiar? COVID-19 saw the U. S. economy come to screeching halt in March of 2020 as it locked-down for well over a year, and then some depending on your state or geography. The U. S. Government through programs like the forgivable loans of The Payroll Protection Program, extended and enhanced unemployment benefits, outright distributions of money under the CARES Act, rent payment abatements, and the multi-trillion-dollar American Recovery Act plus other COVID relief programs flooded a shut-in society with money. Some of these programs were very valuable and a genuine lifeline for many, so there is no value judgement here. In this same time frame industry also shut down, supply lines closed, many businesses, especially small businesses such as restaurants and the like permanently closed, car rental companies sold their fleets, airlines moth-balled their planes and furloughed crews, cruise ship companies were continually on the brink of failure. At one point *the price of oil went negative*; "I can't store any more unused oil; I'll pay you to take it off my hands."

As the economy opened up, really very quickly, when COVID policies were dropped or liberalized, a society with $4 trillion in savings was released to spend it, but with scant availability for many things, even the basics. Shortages in the U.S. where historically everything was available, in whatever color you wanted, or however many you wanted, and on demand, had never been in question! The response to the attendant inflation related to this mismatch of demand and supply has been to target the *demand side* of this imbalance with the most rapid tightening via higher interest rates and collapsing money supply (M-2) in the history of the Fed; "we need to create more unemployment to staunch demand to tamp inflation!". The problem is that *it is a supply problem*! Could this have equilibrated on its own? I doubt it, but maybe they could have employed different tools. We have the Federal Reserve that we have, but I fear, like the Generals mentioned in my opening, they are looking at the '70's experience for today's policies. They might make another policy mistake as they attempt to cure the first policy error of cheap and easy money for far too long. Thirty-year mortgages, only 13 months ago, September 2021, were available at 2.625% and today they are knocking on 7%! I do hear voting Fed members like Charles

Evans and Lael Brainard speak about taking a breather to assess the consequences of their current actions.

There is considerable discussion about the possibility of a recession. We covered that a little in our second quarter letter. An inverted yield curve, as we have now, has the goal of bringing investment funds from the long-term into the short-term, in essence “benching” capital investment projects. Today a two-year U. S. Treasury yields ~4.3%, to go out 10 years yields 3.9% - which one would you want? The sum of two down quarters of GDP, an oil shock like the two in the ‘70’s, an inverted yield curve, plus the traditional lag time of 9 to 18 months for tight monetary policy to take effect, to me, makes a recession a certainty in 2023. Many commodities have already rolled over from oil, to lumber, wheat, “dry” shipping indices, and even the 3 years out inflation expectation has fallen to 2.9%.

Now for a little good news from historical data. According to *The Wall Street Journal,* in the past 80 years, in mid-term election years, there has never been a fourth quarter that did not rally. From Strategas Partners, the S&P 500 has advanced in every 12-month period following a mid-term election since 1942! Of course, there are always exceptions, but….

Thank you,

Doug

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