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THE ONE-HANDED ECONOMIST

A Take on the Market Over the Next Twelve Months

August 2023

THE ONE-HANDED ECONOMIST

US President Harry Truman (1945-1953) is widely credited with saying "Give me a one-handed economist! All my economists say, 'on the one hand… [and then] on the other.'" The President wanted decisions, not discussions.

Our investors often ask us for our views on the economy and where the markets are headed next; which sectors (and sub-sectors) to invest in and which markets to avoid. And we know that they are looking for answers and opinions, and not just analysis.

For the impatient reader, here's our take: fed funds rate still have a way to go, they will be peak in the next 9-12 months and then decrease, marginally. The inflation is here to stay, and we just need to get used to "not 2%" target for the foreseeable future. The equities market will continue to do well, and unprofitable companies will continue to face headwinds in tapping the IPO market. In the venture world, vintage 2023 – 2024 will do much better than their predecessors given currently depressed valuations, even for high-quality companies.

And sometimes we do like to brag 😊: Check out our article from September 2022 (The Bullish Recession) when the world was quite certain of an impending recession and compare that to where we are now.

Not 2% – those days are gone.

Defining a monetary policy tightening is almost straightforward. Although the Fed has employed various instruments and intermediate targets throughout its history, its operations most of the time have focused on the federal funds rate (Bernanke and Blinder 1992)—the interest rate prevailing in the overnight lending market for uncollateralized bank reserves, where the lenders and borrowers are primarily depository institutions. When this interest rate rises by a sizable amount over a protracted period, that is a tightening cycle.
So far, the markets haven't acted like they are facing substantial friction from tighter policy. It simply has not been that hard for businesses to get access to capital this year, and particularly at fairly reasonable rates.

Most people would interpret higher rates as tighter policy, but you can't necessarily jump to that conclusion.

I just have a simple question for folks who disagree: If it were truly a tight monetary policy, why aren't the stocks depressed?

Equity markets demonstrated significant resilience in the first half of 2023 with the S&P 500 and NASDAQ rising 15.9% and 31.7%, respectively. The VIX Index declined 33.3% from 21.7 to 13.6, highlighting a decrease in market volatility compared to 2022 which saw an increase of 25.8%. The biotech sector recouped all of its Q1 losses during Q2 and now sits virtually flat on the year (XBI +0.2%).

Understanding whether financial conditions are tight or loose is challenging because a key variable is hidden from view. What matters isn't the absolute level of the Fed's target rate, but rather whether it is higher or lower than a hypothetical "natural" rate that would neither slow nor stimulate the economy.

Financial conditions only tighten when market interest rates rise firmly above the natural rate. The natural rate can't be measured directly, and it changes over time—rising when demographic or technological changes improve the economic outlook and falling when underlying prospects dim. If it has risen considerably over the past two years, it is plausible that the Fed hasn't tightened monetary policy as severely as its dramatic rate-hike campaign would suggest. *Natural rate has climbed sharply—pushed higher by the Fed's monetary stimulus during the pandemic—muting the effects of the Fed's 5-percentage points of rate increases over the last 18 months*[1].

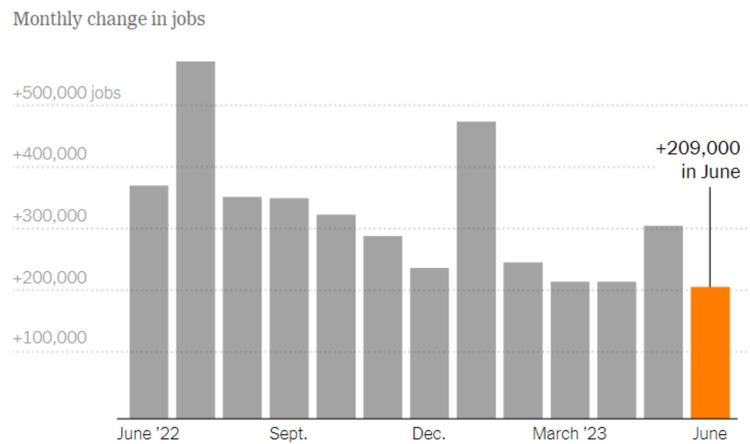
Continued Wage Pressures on Inflation

Why is inflation more important than unemployment?

If we can't explain it simply, then we don't understand it. So, for my 9-year-old, this is how I explain the importance of inflation: If the unemployment rate is 5%, it impacts 5% of the population. But uncontrolled inflation impacts 100% of the population, including that unemployed 5%.

"I was paying entry-level factory workers around $10 an hour in 2019, and now I can't get anyone to come in for an interview unless I offer at least $13 — so my labor dollars have gone up 30 percent, and that's not going to come back down,"

- Walt Rowen, the third-generation owner of Susquehanna Glass, a 113-year-old glassware business in Columbia, Pa.

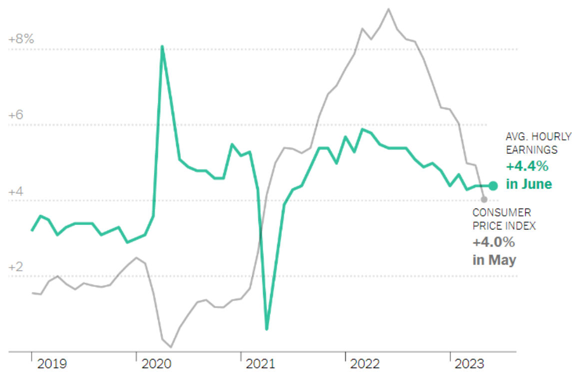


June 2023 was the 30th consecutive month of job growth, but the gain was down from a revised 306,000 in May and was the lowest since the streak began. Wages, as measured by average hourly earnings for workers, rose 0.4 percent from the previous month and 4.4 percent from June 2022. Those increases matched the May trend but exceeded expectations, a potential point of concern for Federal Reserve officials, who have tried to rein in wages and prices by ratcheting up interest rates.

[1] Scott Sumner, a monetary economist

The year-over-year gain in wages exceeded that of prices for the first time since 2021

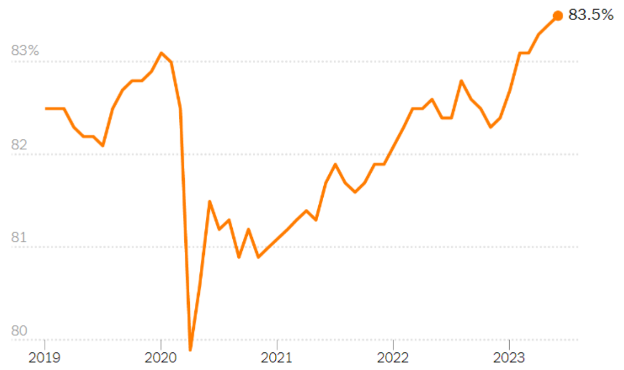
Year-over-year percentage change in earnings vs. inflation



Note: Earnings data is seasonally adjusted. • Source: Bureau of Labor Statistics • By Ella Koeze

Prime-age participation in the labor force continued to rise in June

Share of people ages 24 to 54 in the labor force

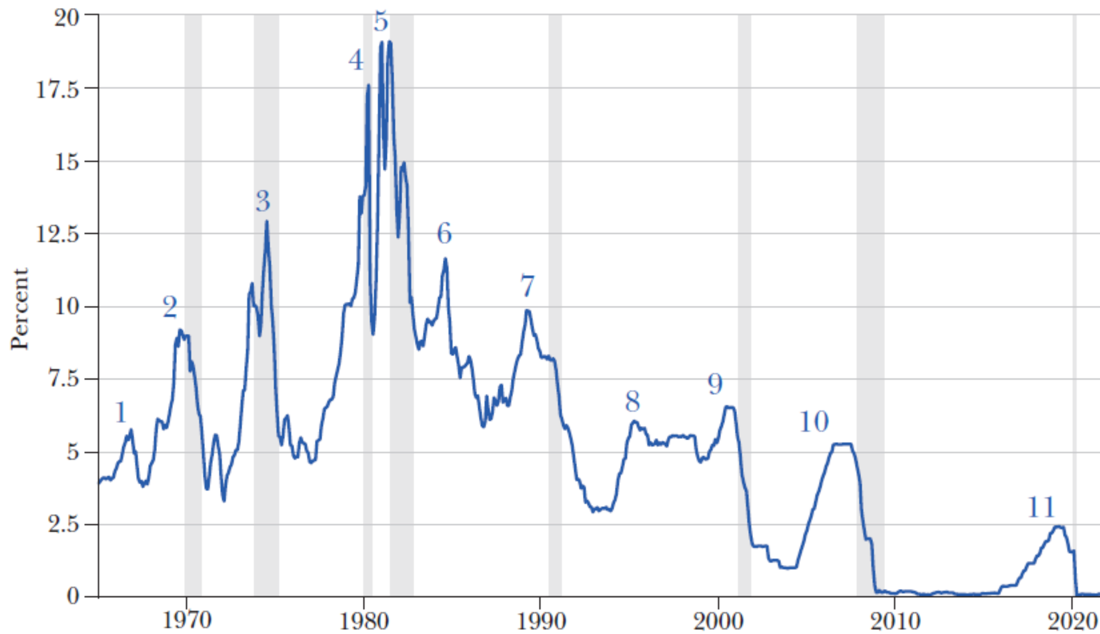


Note: Data is seasonally adjusted. • Source: Bureau of Labor Statistics • By Ella Koeze

For a year or more, worries about an impending recession have dominated discussions about the economy. Most economists expected a recession to hit the United States by now — in part because of the rapid escalation of interest rates. But the dampening effect of higher rates has confronted the robust income and spending of many households and the staying power of businesses — both buttressed by emergency pandemic support from Congress and the Fed. Though families, business managers and investors alike have had to contend with the frustrating realities of inflation and economic uncertainty, growth has continued, almost defiantly.

So where do we go from here?
If the equity markets are robust while the fed continues monetary tightening, we can only imagine what the markets will do once the fed stops. The only question is whether the fed will stop later this year or early next year. That is not an easy answer because we don't believe the labor market is cooling off any time soon. And so long as people get their paychecks, they will spend. Which means inflation will not stop, nor will the Fed. So, we'll just need to get used to higher rates for the foreseeable future.

The Effective Federal Funds Rate, 1965–2021



Source: Board of Governors of the Federal Reserve System

While the above chart may not have a direct relevant to our near-term (NTM) outlook, let's not forget that 7+% rates were not that uncommon 4 decades ago 😊

Nevertheless, there is a newfound wisdom in the public and in the private markets that value profitability over growth. Regardless of the strong economic indicators, we believe that investors have learnt from their mistakes. While many of the older vintage funds are still licking their wounds (some privately, some publicly), the upcoming class of 2023 – 2024 is poised to benefit from that newfound wisdom. And given the outlook for public equities, we believe the IPO floodgates will open in the near future, which means that many private investments now will see additional exit opportunities at higher valuations. The only catch is that the companies will need to have a real business model with current profitability or near-term profitability.