The Other Shoe

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Since I can't say it any better, I begin with a quote from Professor Ludwig von Mises:

> "The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of voluntary abandonment of the further credit expansion, or later as a final and total catastrophe of the currency system involved."[i]

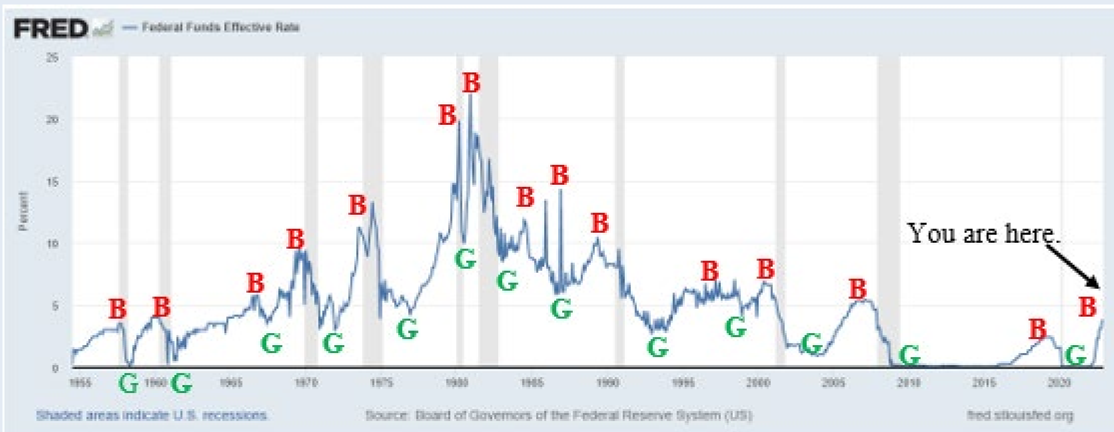
Mises wrote that back in the 1940's, and his insight could not fit the facts any better. Just a cursory look at the history of our "market cycles" proves that he was absolutely correct. Today, we are embarking upon the "voluntary abandonment of further credit expansion" as we've done so many times before—each time ushering in a market correction. What are the chances it will happen again?

The "final and total catastrophe of the currency system involved" has not yet occurred because the more tenable alternative thus far has been the "voluntary abandonment of further credit expansion" though, indeed, as Mises foretold, recessions and depressions followed. The Fed's "abandonment" of this current policy is threefold: One, raise interest rates. Two, stop the bond buying (money printing). Three, unwind the balance sheet (reverse the bond buying process).[ii]

To help illustrate Mises' point, take a close look at the chart of the Effective Fed Funds Rate on the following page. Note that the shaded areas indicate a recession—a bust. (In some cases, such as 1987, a bust may not fit the strict definition of "recession", so it is not shaded). Note that before every recession is the "abandonment" Mises spoke of, which I have labeled with a red "**B**" for "brakes." This is a raising of interest rates—an abandonment of easy credit.

Notice what happens just after every red **B**: a bust, just as Mises says. And before the red **B** (which is a rise in rates), there is a lowering of rates which indicates the beginning of the "quantitative easing" (lower rates = cheap money), which I have likewise indicated with a green "**G**" for "gas." Now take notice of what happens to the rates every time a recession occurs—more of the same—another artificial lowering of rates, creating yet again another boom-bust cycle.

Mises is right on. The Fed lowers rates to create a boom (G), a boom ensues. The Fed raises rates to control inflation (B), and then a bust strikes (recession), and then the Fed lowers rates again to create a boom (G). Every time, just like clockwork. Every "G" is followed by a "B" is followed by a recession (or bust) is followed by another "G", *ad infinitum*.



Where are we now? Well, we had our foot on the brakes after cruising so long without them and then Covid hit, so we slammed on the gas—pedal to the metal—which is why today we have such endemic inflation. Yes, unfortunately, it is here to stay. When has the price of stamps ever gone down? Never.

But that's beside the point. Since we now are breaking hard—as you can see from the steep angle of the recent hikes compared to, say, the angle of the rate hikes following 2005 and 2015—we have to wonder how far we can go before another stock market crash becomes imminent. You're probably saying, "What? The market has recovered already, or is well on the way to recovery." Au contraire mon ami. The other shoe is yet to drop.

You see, the rate increases you see occurring immediately around you are just the beginning. What the Fed never seems to understand is that the US economy is like an aircraft carrier group—it doesn't turn on a dime. Have you ever been on a cruise ship that thought they saw someone in the water—a life jacket or what not? Well, maritime law requires that we check it out if no other vessels are in the area. It literally takes hours for the ship to change course, turn around, go retrieve the empty life jacket, and then turn around yet again to get back on course. It is not as quick and easy as it might at first seem.

Likewise, it takes a while for rate changes to work their way through the economy.

Already we have seen mortgage rates jump, along with CD rates and money markets (though maybe not at *your* bank), but that is just the tip of the iceberg. The real effects of higher rates are just beginning to make their way to the market that really matters—the bond market. And here's why.

The corporate bond market represents debt that is owed by corporations. All those corporations that comprise the Dow Jones Industrial Average, the S&P 500, and the NASDAQ have outstanding bond issues. What does that mean? Think of it as an adjustable mortgage on your house. How much of your house is mortgaged? If it's a lot, and then the interest rate on that portion of your house triples, or quadruples, you stand to spend a lot more money on interest every month. What if you owe more than your house is worth?

Take a company that you know. It's a very large company and you would certainly know it if I mentioned it. There's a good chance you are a customer. In some ways, this company is attractive because its earnings, relative to the price of the stock, are nice. It has a low P/E ratio of near 8, and the dividend yield is paying around 7%. The company is large, with over $326 billion in assets. BUT, the company also has $286 billion in debt, mostly in the form of bonds (debentures). Right now, the company is still enjoying the low rates of the bonds it sold in the past—but not for long.

As bonds mature—and they are maturing every month—they are rolled into new bond issues. Do you think the new bonds will be paying the same interest rate as the old bonds? No. In some cases, they will be paying significantly more. This is good for the bond holder receiving the higher interest rate of course, but not so great for the company paying the interest.

Where will the money come from to pay the new higher interest rates? That's right, earnings of course. And if money is diverted from earnings to pay higher debt service what happens to profits? Right again. They drop. And what is one of the key contributors to a stock's price? You're on a roll— that's right—profits!

So higher rates mean higher debt service costs which mean less profit which translates to lower stock prices. Any questions? I knew you were going to ask that. No, I don't know exactly when it will happen—no one does, least of all the Fed. It's an aircraft carrier group, remember? It won't be tomorrow, it won't be next month, but it may very likely be next year.

Since we don't want to invest heavily in stocks right now, the higher interest rates have opened up other opportunities. We have invested a significant portion of our "safe money" in something called T-bills. These are 2-month treasuries which we are able to buy directly from the Treasury and have no price fluctuation, unlike the TIPS. Currently, we are earning about 4% (annualized) on these T-bills and we plan to simply roll them every two months as the Fed continues to raise rates. This is a great place to park dormant cash.

On November 30, the Fed indicated that it would be reducing the rate of interest rate hikes—meaning that instead of raising rates by .75% they will raise them by .50% each meeting—but they are still going to be raising rates. Yet that's not all they're doing. They are also literally destroying money in the reverse fashion of how they created it—by buying created treasuries with created money.

> "Over a three-month period, the Fed has been letting $47.5 billion worth of assets every 30 days roll off its massive near-$9 trillion bond portfolio, more formally known as the balance sheet. But starting in September, the Fed kicked the process up a notch, doubling how many Treasury and mortgage-backed securities it's rolling off to $95 billion."[iii]

So in addition to no more new money, we are now destroying money at almost $100 billion per month. And I absolutely support this—that much money never should have been created to begin with. Less money in circulation is the only way to truly curb inflation. But as Mises and history have pointed out, there is an adjustment period that is often painful.

Just like a drug addict, the longer you've been on a drug the harder it will be to get off it. And indeed, it will. But it's the only way to save "the currency system involved." This pain is often referred to by economists as "a credit event."

We are truly in uncharted territory here, and we all agree that there is more chance of downward pressure than upward momentum. *(If you don't agree with that basic sentiment, then let's talk.)*

So let me reiterate our plan:

1. We do not want to overexpose ourselves to equities as rates continue to rise.
2. While we are waiting for the Fed to finish raising rates, we will continue to roll our safe money into 2-month T-bills yielding about 4% and increasing with time.
3. We are patiently waiting for an entry point in stocks which will come when the market drops significantly, after which the Fed will start dropping rates.
4. Once the Fed has plateaued or indicated that rate hikes are over, we will go out longer term on our treasuries—perhaps 7-10 years or even longer.
5. After stock prices have dropped enough, we will selectively return to our normal asset allocation, which means buy back into stocks.

Just as a reminder of our motivations, our only loyalty is to our clients, and we have a legal fiduciary duty to put our clients' interests first—even ahead of our own. This is easy because the better our clients do, the better we do, and vice versa. AND because we feel like you are a part of our family—and indeed you are.

Someone reached out to me recently and said they found us on Nextdoor.com. She said that several clients had said very nice things about us on the site. I didn't even know we were on that site but apparently several of you do. I want to take a moment thank you for your kind words. It really means a lot!

As always, if you have questions or concerns, all you have to do is reach out to me at kevin@magellanplanning.com or 404-257-8811. There is no question that is stupid or silly, and I'd love to hear from you.

Very Truly Yours,

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[i] *Human Action: A Treatise on Economics*. Ludwig von Mises, 1949.
[ii] https://www.cnbc.com/2022/01/06/the-fed-is-scaring-markets-with-the-triple-threat-of-policy-tightening.html
[iii] https://www.bankrate.com/banking/federal-reserve/how-shrinking-fed-balance-sheet-impacts-your-finances/