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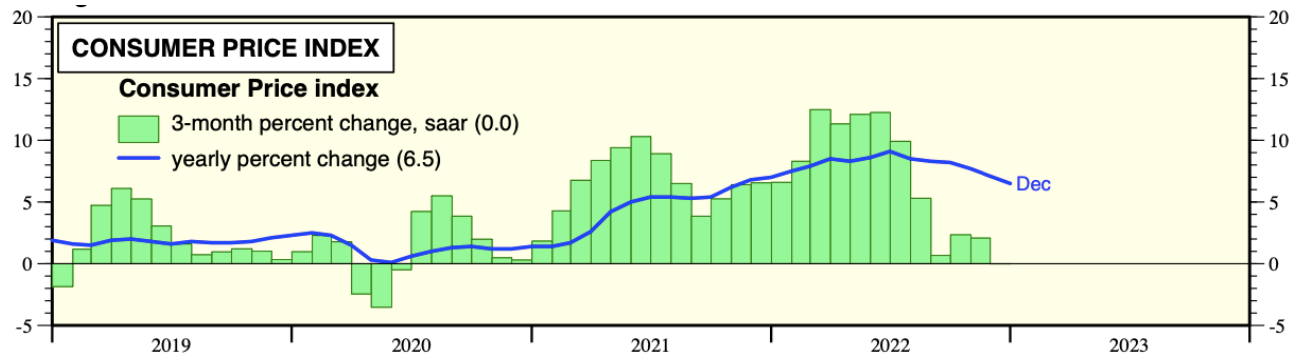
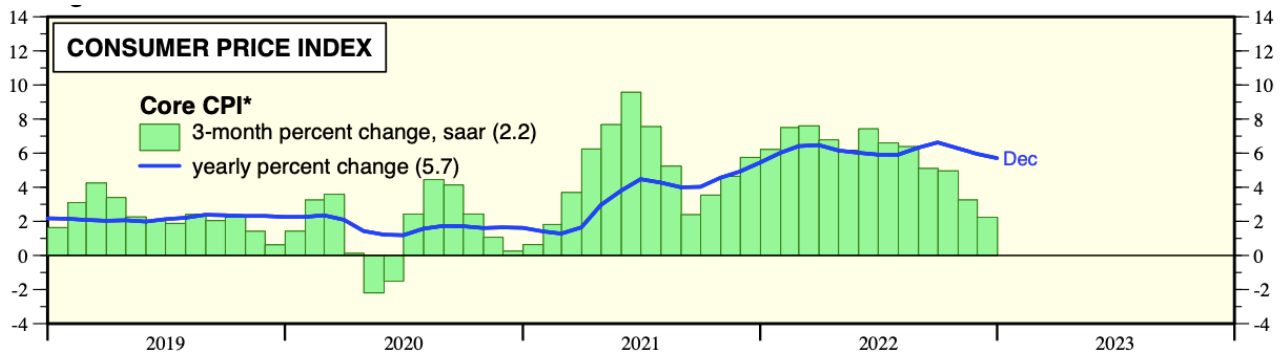
Brevity Series – Inflation Cooling

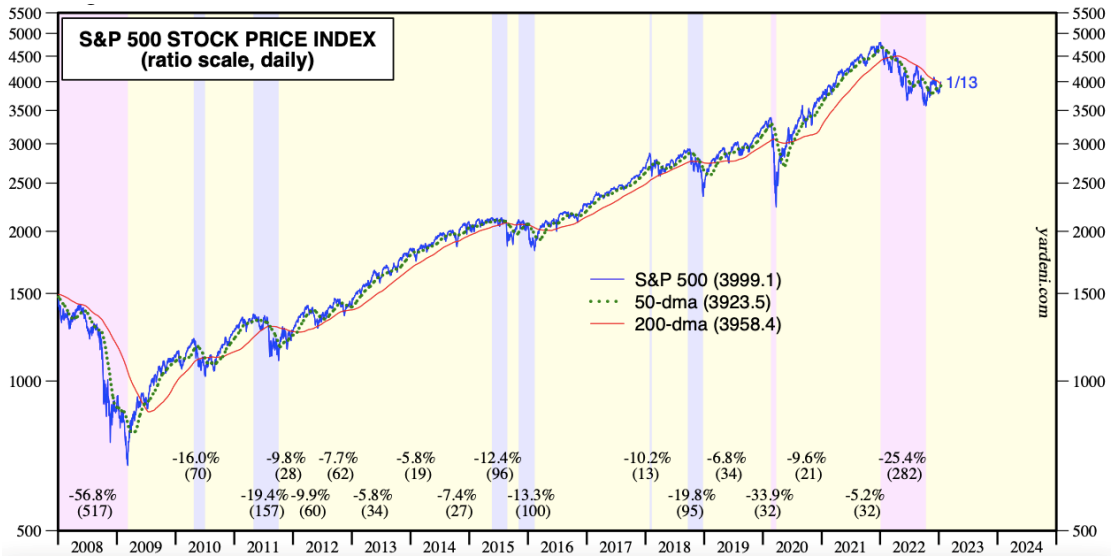
Last Thursday's CPI numbers were encouraging. Headline CPI dropped to 6.5% YOY. Even more encouraging was the 0% increase over the last 3 months. This marked 6 straight months of declining inflation and 8 months since headline CPI peaked at 9.1% in May of last year. Core inflation (excludes food and energy prices) dropped to 5.7%YOY. Inflation appears to be heading in the right direction.



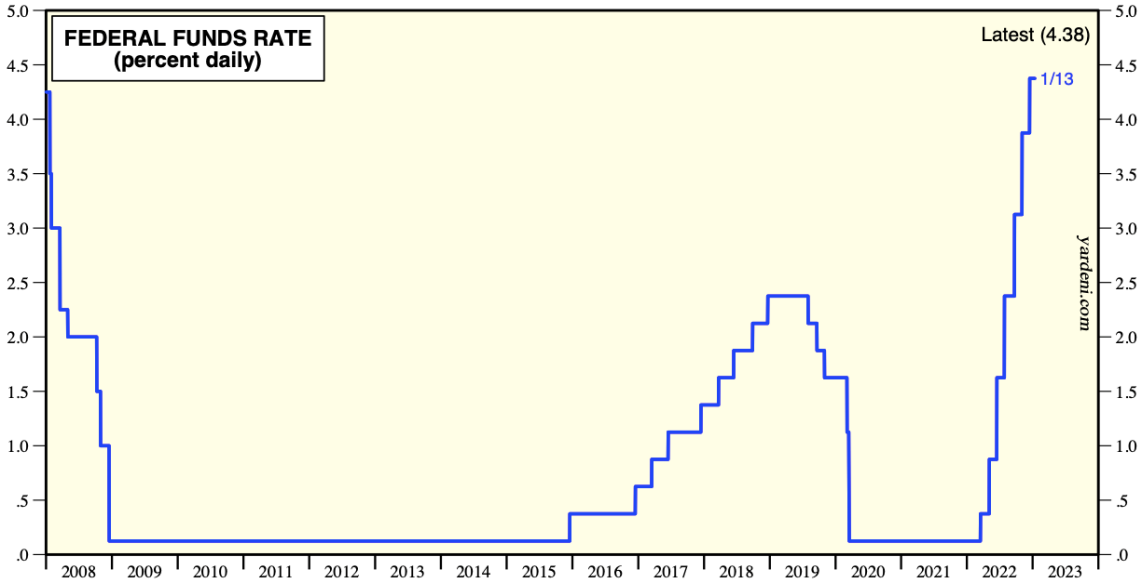


We viewed last week's inflation numbers as consistent with our thesis that elevated inflation rates aren't the result of systemic economic issues, but rather the result of too much monetary stimulus. We classified current inflation as *sugar-high* inflation, and our expectation is it will burn off without the need for the Fed to crash the economy (soft-landing scenario). The Bear argument has been that inflation is

systemic. Systemic inflation feeds off itself and creates an upward inflation spiral. Inflated consumer prices inflate wages, which further inflates consumer prices, which further inflates wages..... The only cure for systemic inflation is to crash the economy (hard-landing scenario) and stop the cycle. Since January 2022, the Bear's hard landing scenario has been a far more popular thesis than our soft landing scenario. It's certainly been the consensus view and stock markets reacted accordingly.



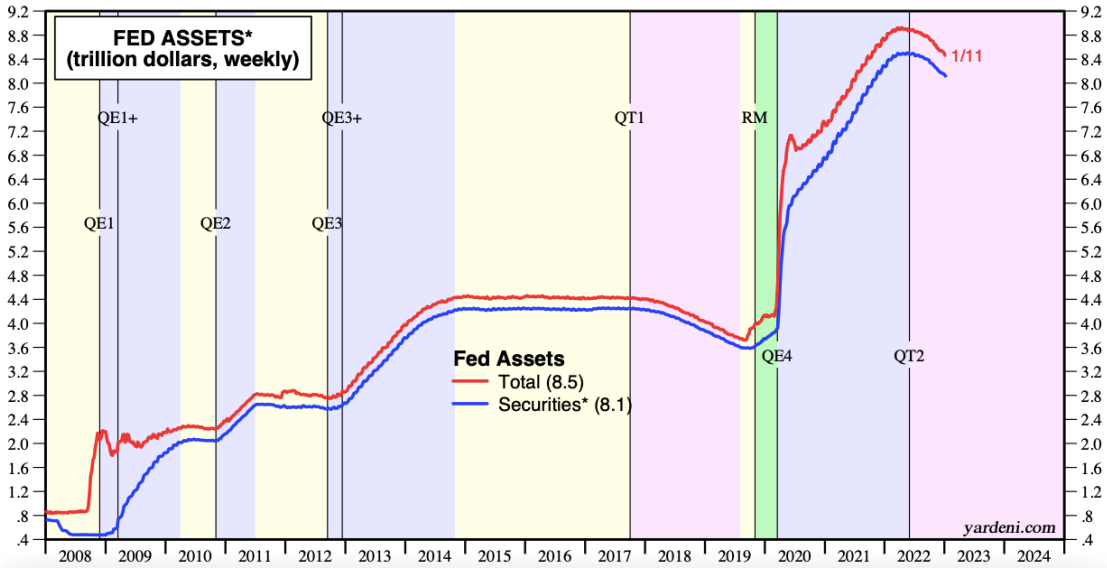
After peaking on January 3rd of last year, the S&P 500 sold off 25.4% over 282 days in anticipation of a hard landing. The S&P 500 bottomed, at least for now, in October of last year. We expect that bottom to hold. The S&P 500 is up 12% since the October lows, but still remains 16% below its record high. We expect stocks will continue to move higher in 2023, however, we also anticipate much higher-than-usual volatility levels will continue. We don't expect volatility to normalize until the Federal Reserve officially pauses its rate hikes.



Most recently, the Fed dropped its rate hikes from 75bps to 50bps. The consensus is that they will now drop to 25bp rate hikes. It is expected that the Fed will enact three more rate hikes of 25bps before pausing its tightening policy. We think monetary policy is already restrictive enough and that inflation will significantly recede during 2023 even without more rate hikes. We acknowledge the Fed doesn't care about our opinion.

With all this inflation talk it's easy to overlook that we are entering earnings season. It's early, but so far so good. Solid corporate earnings aren't getting the credit they deserve for the recent positive stock market performance. Encouraging inflation numbers are stealing the headlines. Our forecast is for Core Inflation to continue dropping and end 2023 closer to 3% than 4%. Our current year-end point forecast for Core CPI is 3.3%. We are concerned even that is too high.

We are going to make one more forecast before wrapping up. By 2025 The Fed will once again be undershooting its 2% inflation target and concerned that inflation is too low. The systemic deflationary forces (technology and globalization) that were in place before incredible amounts of liquidity were injected into the economy under the cover of pandemic relief are still in place.



As this liquidity burns off, achieving a 2% inflation rate will once again become a challenge.

Professor MMFS's not-so-quick tutorial - Several of you have emailed us or asked us during conversations to better explain what we are referring to when we talk about quantitative easing and tightening. The chart above does a good job of illustrating quantitative easing/tightening. Prior to the

2008 credit crisis, the Fed only controlled short-term interest rates. They did so by increasing or decreasing the Fed Funds Rate we referenced earlier in this commentary. Although many have argued, including us, that controlling long-term interest rates is outside of the Fed's charter, the Fed disagreed and deemed it a necessary monetary tool. When the Fed wants to lower long-term interest rates, they go into the open market and purchase bonds. This increases the demand for bonds and decreases the supply, which in turn pushes bond prices higher and long-term interest rates lower. This practice is called quantitative easing.

In addition to lowering long-term interest rates, quantitative easing also increases the money supply. When the Fed purchases bonds, it does not have actual money set aside for this purpose. Rather, it creates this money by expanding its balance sheet. It effectively gives itself a loan. The Fed puts a liability on its balance sheet to offset its bond purchases.

In the above chart, notice the sharp increase in Fed assets as they started purchasing bonds (quantitative easing). The Fed purchased roughly $5.7 trillion worth of bonds before stopping its purchases near the end of 2021.

The Fed is now starting to shrink its balance sheet. Most everyone seems comfortable calling this quantitative tightening. We've often mentioned that we disagree with this terminology. Quantitative tightening would be the Fed selling the bonds they previously purchased back into the marketplace. That's not what they are doing. They are simply not repurchasing bonds that mature off their balance sheet. That is why the decrease in Fed assets is so gradual. It will take decades for all these bonds to mature. That is why we refer to this current period as *quantitative nothing* and not *quantitative tightening*.

As always, we appreciate your questions and feedback. It helps us to better understand how we can improve and clarify how we communicate.

Have a wonderful day,
The MMFS Team

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