May 30,2023
Dow: 33,042

Stuck in the Middle With You

We refer to the title of a 1973 hit song by Stealers Wheel. This has to be the way Jerome Powell, or any Federal Reserve Chair, feels at turning points in the rate cycle. "Clowns to the left of me, jokers to my right, here I am, stuck in the middle with you." Catchy lyrics; and at the beginning and ends of rate cycles, it is usually most difficult to build consensus. Powell is truly stuck in the middle, or he has to stake out a position that becomes the middle in order to develop consensus.

For the last few weeks, it felt as if a pause was the clear consensus, but the equity market has moved to new highs and economic reports have been somewhat resilient. There may well be a pause at the June meeting, but markets are now expecting another increase at the late July meeting. We hope this isn't so as the M2 measure of money supply is shrinking at an unprecedented rate. Supply and demand governs many market relationships and is a key source of market discipline. From 2020 through 2022, the economy was flooded with cash through many government programs designed to support the economy. These programs worked, but there was no return to normal. Many stimulative government programs continued into 2023. The money supply ballooned during this period, and inflation followed. We don't disagree with the implementation of these large stimulus programs, but it now seems unusual to believe that the inflation would be temporary if the stimulus that caused it isn't promptly removed from the system when the economic danger passes.

As we have pointed out before, over the next seven weeks, we will get two more inflation reports that should move the trailing year inflation numbers into the mid 3% range. If the Fed truly believes that their policy operates with a lag, they should pause. Inflation rates dropped to the mid 3's in the third quarter of 2022, and they have maintained those levels as the Fed has continued to increase their policy rate. The economy has remained resilient as the Fed has raised rates and moved nearer the end of their tightening cycle. Last year we talked about this being our best-case scenario, and so far, it has played out.

Although the Fed policy rate has increased three times this year, Treasury yields at two-year maturities and beyond have barely budged, resulting in positive year-to-date returns for fixed income investors. Long rates have moved off their lows, implying a reduced risk of an imminent recession. As first quarter earnings season has concluded, fear of an imminent downturn in profits has also receded, and total

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returns of most equity indices are soundly higher. While the S&P 500 Index is up over 10% for the year, 100% of the return can be attributed to just eight of the largest stocks with only 28% of stocks outperforming the Index return.

Stuck in the middle with you is also an apt description of the current relationship between the Speaker of the House Kevin McCarthy and President Biden. They have spent a good deal of time together over the last few weeks - how can that not be a good thing? Most of the reporting on the debt ceiling has been incorrect and borderline dangerous. Treasury Secretary Janet Yellen recently said that in the event the debt ceiling isn't raised, "We have to default on some obligation, whether it's Treasuries or payments to Social Security recipients" - this is irresponsible. A late payment made by the government to anyone or any entity other than a debtholder is not a default, it is a late payment. If a company pays a supplier late, it is not a default. Government officials know that interest and principal on Treasury debt will be paid first, above all else, but stating that does not help them increase their political leverage.

Sad Random Fact: In the fiscal year ended September 30, 2022, the deficit was $1.4 trillion dollars, or approximately $160 million per hour.

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