Navigating by the Stars Under Cloudy Skies

The title of this month's missive comes curtesy of Federal Reserve Chairman Jerome Powell's recent Jackson Hole speech. The full quote was, *"As is often the case, we are navigating by the stars under cloudy skies. At upcoming meetings, we will assess our progress based on the totality of the data and the evolving outlook and risks. Based on this assessment, we will proceed carefully as we decide whether to tighten further or, instead, to hold the policy rate constant and await further data."*

This sounds less like navigating and more like, let's wait and see what happens. What captivated me about the phrase is that there were actually real explorers who did just this, navigating by the stars under cloudy skies.

The Vikings began using sails in the 7th century, and sometime around the 10th century they developed a way to navigate the treacherous waters of the north Atlantic. In 1966 archeologists discovered the remains of a Viking sun-dial, a splendid instrument composed of a wooden disk with a perpendicular gnomon in its center. In the disk, some hyperbolas were engraved, which corresponded with the curves described by the tip of the gnomon's shadow cast on the disk from sunrise to sunset during the sailing season from April to August on the 61 degrees north latitude.

This was all well and good as long as the sun was shining, but still left the question of what the Vikings did while socked in clouds and fog. The common theory is that the Vikings used a sunstone, a double refracting crystal, that would signal the direction of the sun by displaying polarized light traveling through the crystal. This crystal would allow the Vikings to determine where the sun was at dawn and dusk, and therefore know where North was.

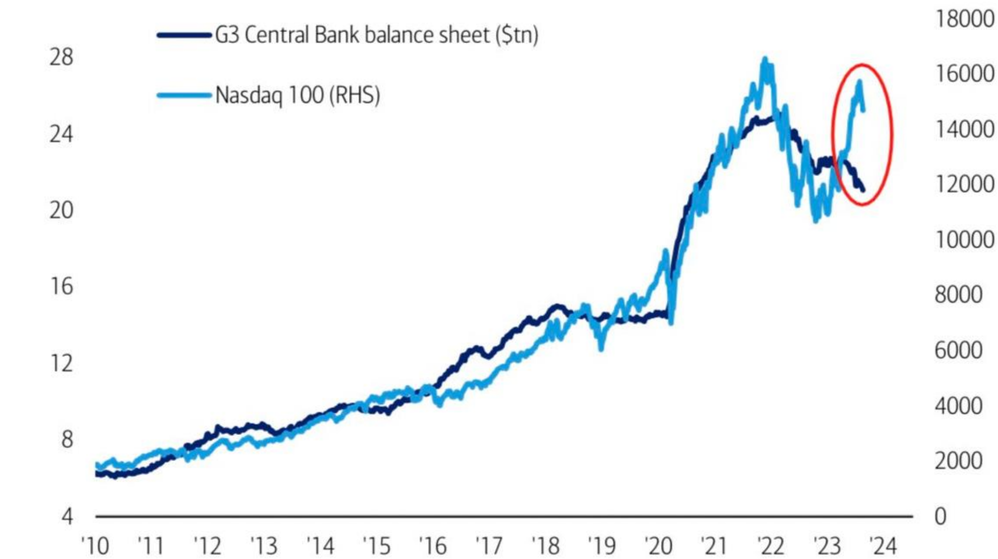
If you've ever been on the water, or even on the beach, totally cocooned in fog, you know how scary it can be. Now imagine being the Chairman of the Federal Reserve, publicly admitting that you are equally as blind when it comes to navigating the world's largest economy…scary!

I love poking fun at economists, Central Bankers, and politicians in general because very few of them operate in the real world. They make decisions and set policy from the comfort of their ivory towers, while we commoners are actually trying to live our lives based on these policies.

The chart below is a great depiction of what actually happens when the central bankers decide policy. As you can see, when the big three central banks decided in 2020 to flood the world with liquidity, that excess liquidity immediately flowed into risk assets, depicted here as the NASDAQ 100. What's interesting, and somewhat troubling, is the recent disconnect. Even with the Central Bankers removing liquidity (i.e., raising rates) the NASDAQ 100 has continued to rise.

Chart 3: CB liquidity highly correlated with tech stocks

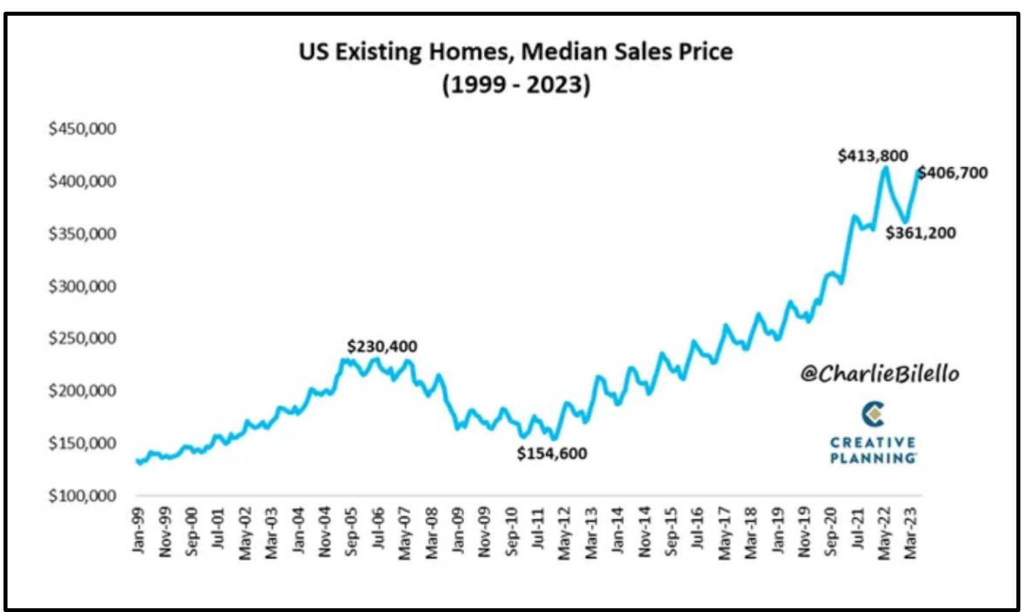
G3 Central Bank balance sheet vs Nasdaq 100



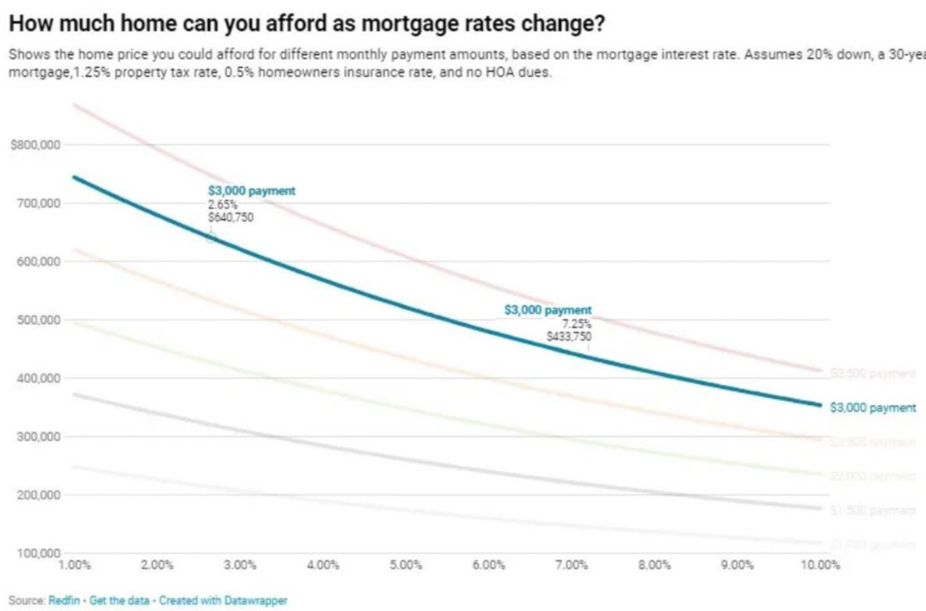
Source: BofA Global Investment Strategy, Bloomberg, G3 = Federal Reserve, European Central Bank, Bank of Japan

BofA GLOBAL RESEARCH

A similar story can be seen here in the median sales price of existing US homes. Again, see the sharp rise in home prices around 2020 after the Central Bankers flooded the world with money. Also, just like the NASDAQ 100, home prices haven't fallen much yet even though the bankers are tightening.



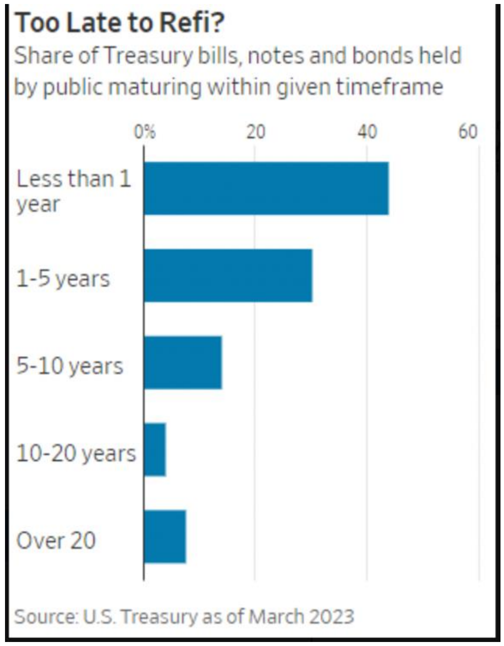
While asset prices have not declined by much yet, what has declined is actual purchasing power. Assuming a $3,000 monthly budget, a 2.65% mortgage rate in January 2021 could have bought you a home worth $641,000. That same $3,000 budget today with a 7.23% mortgage rate would only buy you a home worth $434,000. **A whopping 32% decline in purchasing power in just 2.5 years!**



Because of the sharp increase in mortgage rates, and subsequent decline in purchasing power many existing home owners are extremely reluctant to sell their homes and trade in their sub-3% mortgage for a 7+% mortgage. Unless forced to sell, or dealing with cash, homeowners are deciding to stay put.

For well over a decade, the Fed kept interest rates near zero and borrowers of all stripes got very comfortable sailing in clear blue skies with nary a concern over fog or clouds. Now, can you imagine being a heavily indebted borrower with 50% of your debt maturing in less than one year, and 75% maturing in less than five years. You're being forced to enter this hostile rate environment to refinance a lifestyle that was built under the guise of free money.

One such borrower just happens to be the worlds biggest debtor, our U.S. Treasury. That's right, after years of exorbitant spending that would make a drunken sailor/Viking blush, our U.S. Treasury is now faced with refinancing 75% of their debt at interest rates that haven't been seen in 20 years.



Maybe Jay Powell could be forgiven for being lost in the fog, if he hadn't been responsible for creating the fog in the first place.

Alright, enough Fed bashing, let's move on to the markets.

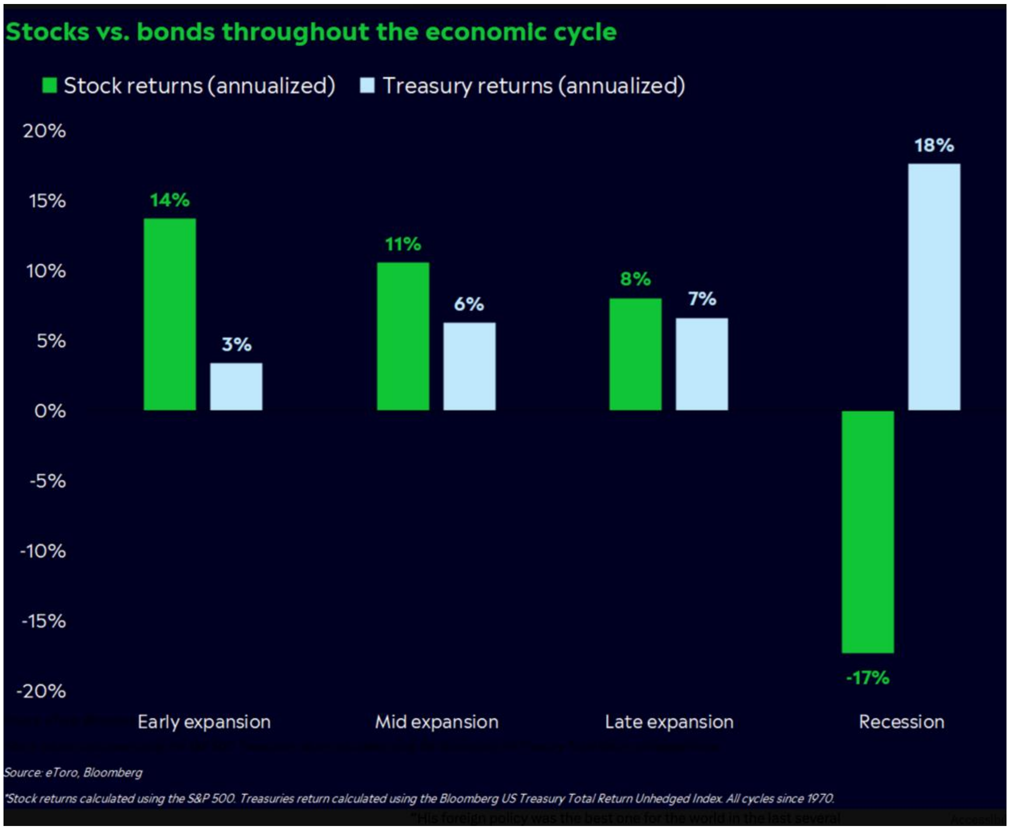
Remember that 2022 was a very difficult year, with the S&P 500 falling by 18%, and nearly everyone expecting a recession to start in 2023. Instead, this year has seen the market rally by 18.8%, as that expected recession has yet to materialize. We started this year with the Fed rapidly raising interest rates, an inverted yield curve, and one of the most well telegraphed recessions in history.

Instead of a recession, we continue to have near record low unemployment, relatively strong GDP growth, and an AI (artificial-intelligence) mania that has lifted many tech stocks to new highs. Now everyone is expecting a soft-landing, or no-landing whatsoever. The market is laughing in the face of the most well-telegraphed recession ever.

But let's not get too giddy, some of us old-timers remember a quote in the January 2008 Wall Street Journal, *"It is hard to imagine any time in history when such rampant pessimism about the economy has existed with so little evidence of serious trouble."*

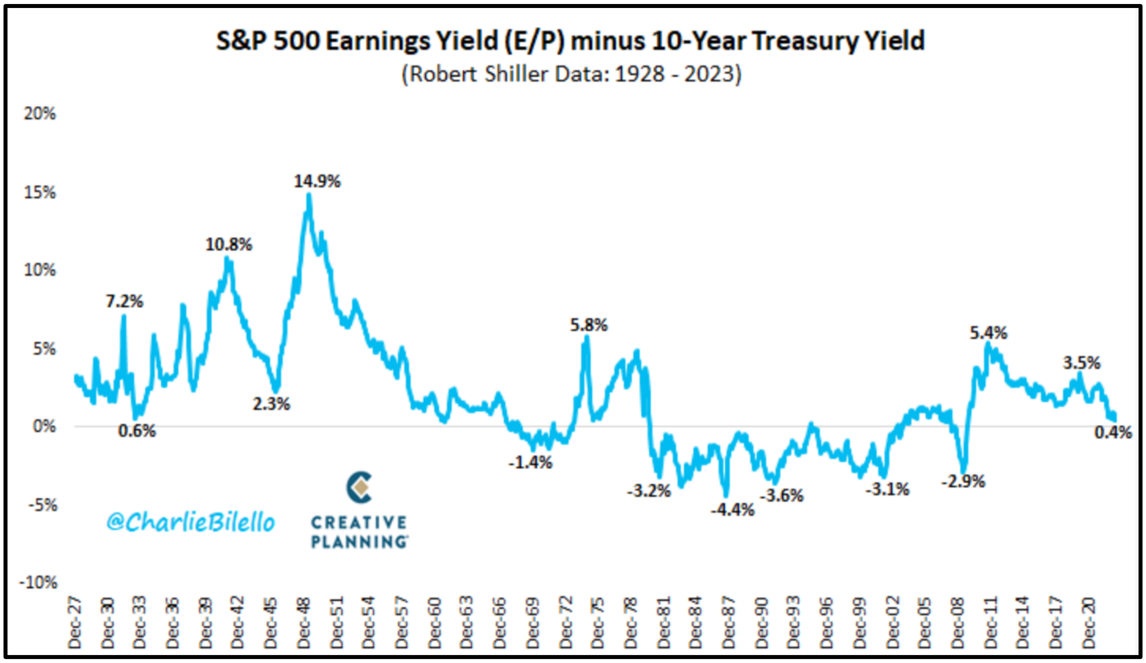
Complacency can be very dangerous, and while the Fed is signaling "higher-for-longer" rate strategy, Mr. Market is saying that the Fed will be forced to cut rates in the first half of next year. What will cause them to cut? Maybe it will be a rapidly slowing economy, or maybe it will be pressure from the Treasury who can't afford to refinance at such high rates, or maybe a bit of both. Remember, Chair Powell made it very clear he's sailing blind.

I'm not trying to play economist here, but let's just look at how stocks and bonds have historically performed during differing economic cycles.



Now I'll let you play economist. Do you think we are in an early, mid, or late economic expansion? Or do you think we are in a recession?

With yields on many fixed-income instruments now in the 5-7% range and stocks trading at relatively high valuations, bonds are the most attractive that they've been relative to stocks since 2009.



It's no fun navigating by the stars under cloudy skies, but if that's the predicament we're faced with I know that I want to proceed cautiously. Here at Medallion Wealth Management, we're focused on quality stocks, dividends, and a more favorable view of fixed-income.

As always, be careful out there.

Chris Wiles, CFA

Where Trust is Earned