Markets Fix Problems Policymakers Create

Central banks inflation illusions, disorderly unconventional policy unwinds, inflationary recessions and earnings

[Barry C. Knapp]

Central Banks Illusion of Control

Just prior to the pandemic panic in February 2020, we attended at small group dinner lead by a former Fed research staffer who asserted the prior three decades of disinflation referred to by the Fed, their Keynesian disciples on the street and in academia as the Great Moderation, was attributable to Paul Volcker and the resultant inflation fighting credibility. We asked about Alfred Kahn (The Father of Airline Deregulation), supply side economics and Reagan's deregulatory policy, Chinese integration into global supply chains, the technology investment boom in consumer goods and services and shale energy supply shock. All of our disinflationary theories were summarily dismissed by the former Fed economist. While debating the Great Moderation ideolog was an exercise in futility, a simple chart of goods, services and energy price CPI leaves little doubt that the primary disinflationary impulse over the last three decades came from goods prices. In the years following China's entrance to the WTO that lowered tariffs and boosted their market share of global exports, goods price deflation accelerated. Energy prices plunged in the '80s and US production recovered sharply following Reagan's unwind of Nixon and Carter energy policies. Airfares and transportation costs plunged following their deregulation begun during the Carter Administration. Walmart, followed by Amazon, capitalized on transportation deregulation, globalization and technology innovation to deliver goods at 'everyday low prices.' The Fed went from being a cheerleader for technology investment during the Greenspan Fed in the '90s to fighting global goods disinflation by boosting domestically determined services inflation during the Bernanke Fed ostensibly due to concerns about policy efficacy near the zero lower bound but in reality, because they had no tools to offset the goods disinflation. Paul Volcker's contributions to decades of disinflation, while not inconsequential, were unsustainable without these exogenous factors. Consequently, Fed credibility is overrated by the FOMC, their staff, street economists, most of academia and market participants, but not us. Policymakers got us into this mess, markets and the spontaneous economic order will get us out of it.

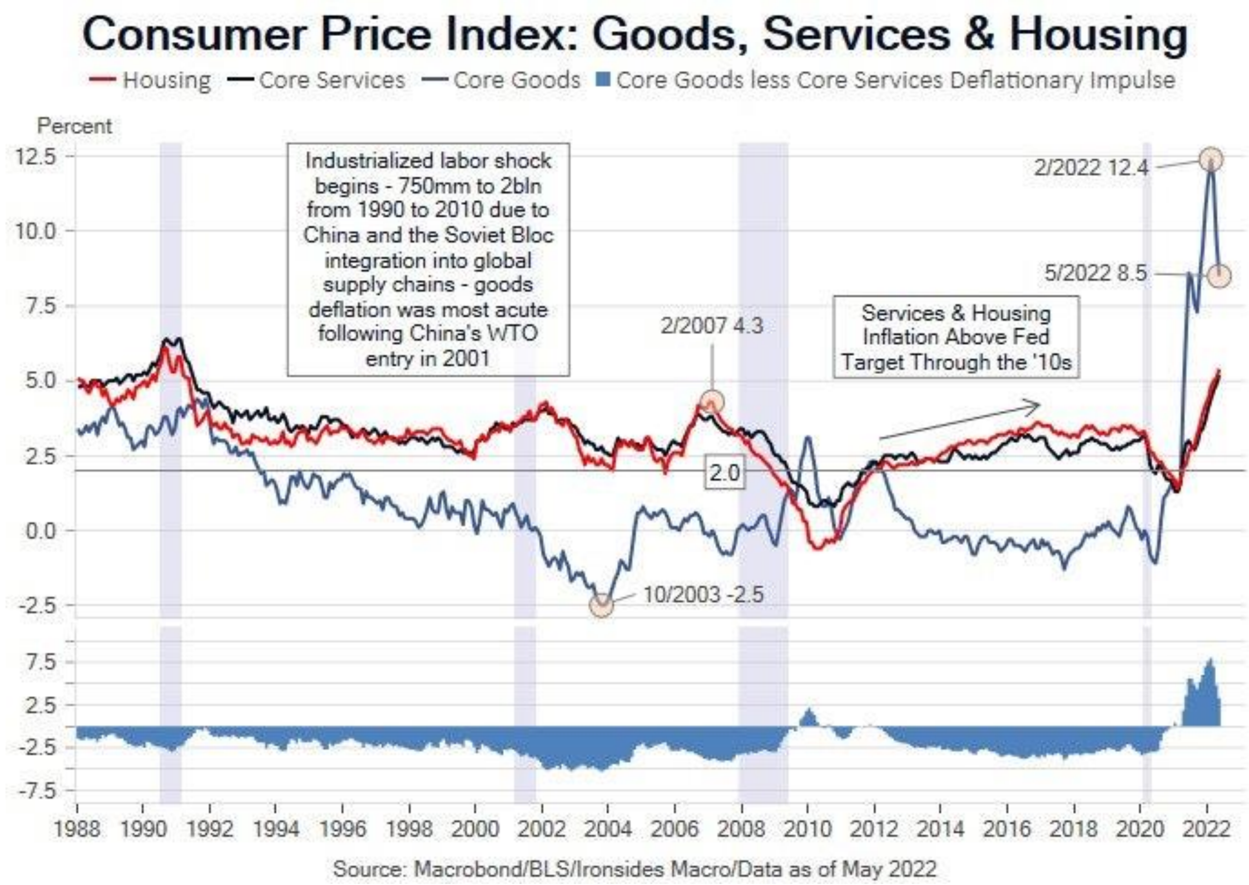

Figure 1: Despite the Fed's frustrations following the financial crisis, they were successful in raising the cost of housing. Unfortunately, because higher prices resulted from market interventions, supply did not respond. The pandemic policy response made the imbalance much worse.

The Fed's First Mandate

From the time when Andrew Jackson effectively closed the nation's central bank through the foundation of the Federal Reserve in 1913, markets were on their own to stabilize during inevitable cash crunches. The original Fed mandate was not to manage the economy, rather to act as lender of last resort and stabilize the monetary base. The Federal Reserve liquidity pledge during the Crash of '87, the emergency easing and managed unwind of Long Term Capital Management in '98, 9/11 liquidity injections, financial crisis asset purchases that facilitated bank recapitalizations, European sovereign debt runs, and the pandemic, were all successful lender of last resort stabilization measures. Following the financial crisis, stabilization policies evolved into increasingly complex programs to optimize inflation, employment, export growth and even climate change. In some cases, not the US, these policies attempted to overcome Mundell's 'Impossible Trinity', that postulates a nation cannot have an open capital account, independent monetary policy and fixed exchange rate. The Fed's mission creep culminated in average inflation targeting, an approach that served to rebalance the dual mandate to a greater weight on employment. This set the stage for the policy mistake to come. Regulatory policy intended to make the taxpayer supported system safer following the financial crisis through the use of leverage ratios forced market making functions in the US Treasury to agency mortgage-backed securities market from broker dealers to hedge funds. When governments lockdowns caused a cash crunch, Treasuries and agency MBS markets became disorderly leading to unlimited Federal Reserve purchases. While the interventions may have been unnecessary if not for misguided regulatory policy, the intervention was successful lender of last resort policy. During the subsequent months, Fed's purchases evolved from market functioning to providing broad support to economic activity. The Fed's pandemic stabilization purchases of mortgages led to the lowest rates and spreads ever. These purchases sparked the 2021 housing boom when the 20 cities in the Core Logic Index went to near perfect house price correlation, strong evidence that policy, not market forces caused the boom. By mid-2021, the FOMC found themselves cornered by both average inflation targeting and a policy normalization process they utilized last cycle, taper asset purchases, wait, raise the policy rate, wait, then passively let the balance sheet shrink as bonds mature all the while providing forward guidance to smooth the process.

Japan is the most extreme example of mission creep. Over the last 20 years following a decade of futile exchange rate intervention, quantitative easing evolved from bank reserve injections intended to ease bank recapitalizations a decade after the twin bubbles (real estate and stocks) burst, to credit allocation extending beyond private sector credit to REITs, exchange traded equity funds, negative policy rates and yield curve control. The Japanese now find themselves struggling with a weaker yen due to outsourcing manufacturing production and the dollar evolving into a petrocurrency. The

ECB, other independent European, and global central banks, have widely adopted QE, negative rates, capital controls and exchange rate management. Although it is an unproveable counterfactual, we strongly suspect these extraordinary interventions impaired create destruction, thereby reducing economic dynamism and slower productivity growth. Like the shift towards government control over the means of production during and after World War II detailed in Daniel Yergin's "The Commanding Heights", greater market intervention ultimately led to the Great Inflation and a shift in the pendulum of economic thought towards classic liberalism and a greater reliance on markets to solve problems, not omnipotent technocrat policymakers.

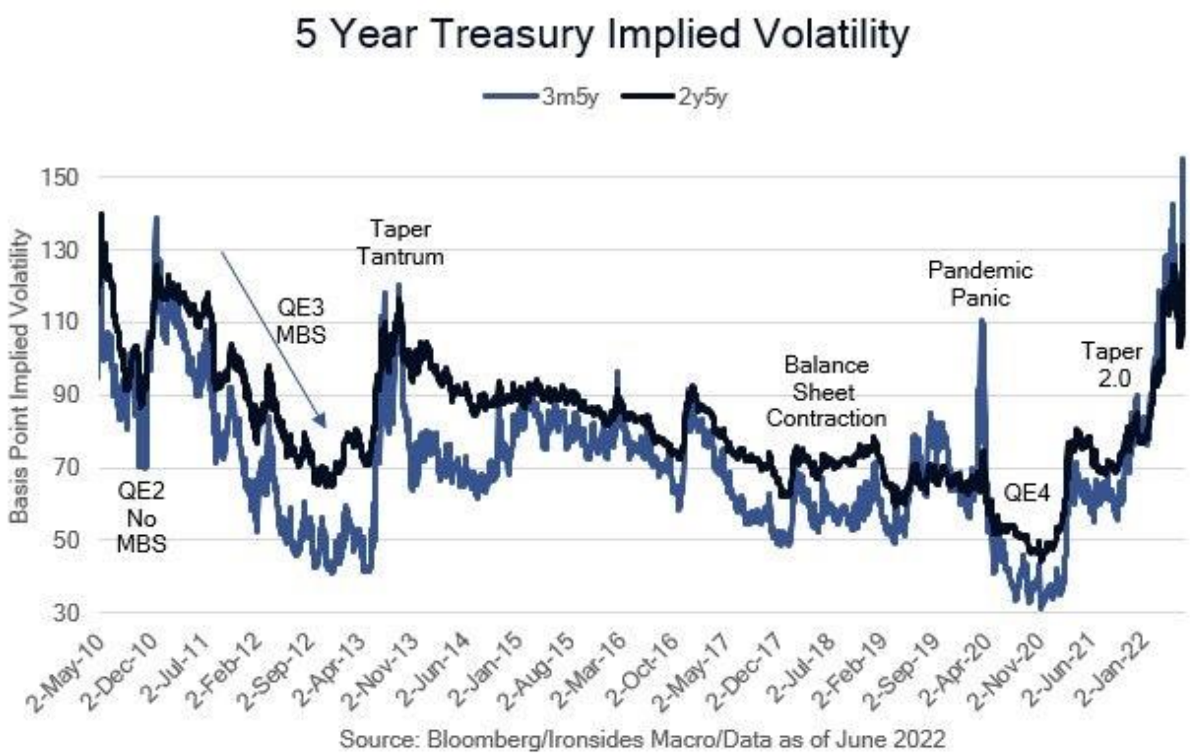

Figure 2: The most persistent effect of QE, particularly mortgage purchases, is to suppress volatility. Despite their passive ending, and contraction of purchases, the spread of mortgage to swap rates is at all-time highs and implied volatility is exceptionally high.

Unconventional Policy Hotel California

During the last couple of weeks, markets struggled with a disorderly unwind of unconventional monetary policy. The ECB was forced into an emergency program to prevent 'fragmentation' following an announcement they intended to end negative rate policy and QE. Fragmentation is ECB code for Italian government bonds trading at higher rates than Germany to compensate investors for the risk of much higher debt. Federal Reserve forward guidance was shattered by the last minute decision to hike the policy rate 75bp after 6 weeks of assurances the next hike would be 50bp. The Swiss National Bank suddenly gave up on targeting their exchange rate and raised their negative policy rate from -0.75% to -0.25%. The pressure on the Bank of Japan's yield curve control led to record levels of 10-year government bond purchases and sharply higher rates in longer maturities. A potential successful attack on BOJ yield curve control risks global fallout due to the Japanese being the largest foreign holders of US Treasuries. Despite the Fed's passive approach to unwinding their pandemic bond purchases, mortgage spreads to swaps and rate volatility are at multidecade highs. Governor Waller gave a [speech](#) over the weekend that called their process and forward guidance into question; however, we don't think he went far enough. We remain convinced that group think, and institutional inertia has trapped them into reliance on their blunt policy rate tool rather than unwinding bond purchases that provided the majority of stimulus. In short, central banks helped get us into this mess, but markets, and what Hayek referred to as 'the spontaneous economic order', are far more likely to get us out.

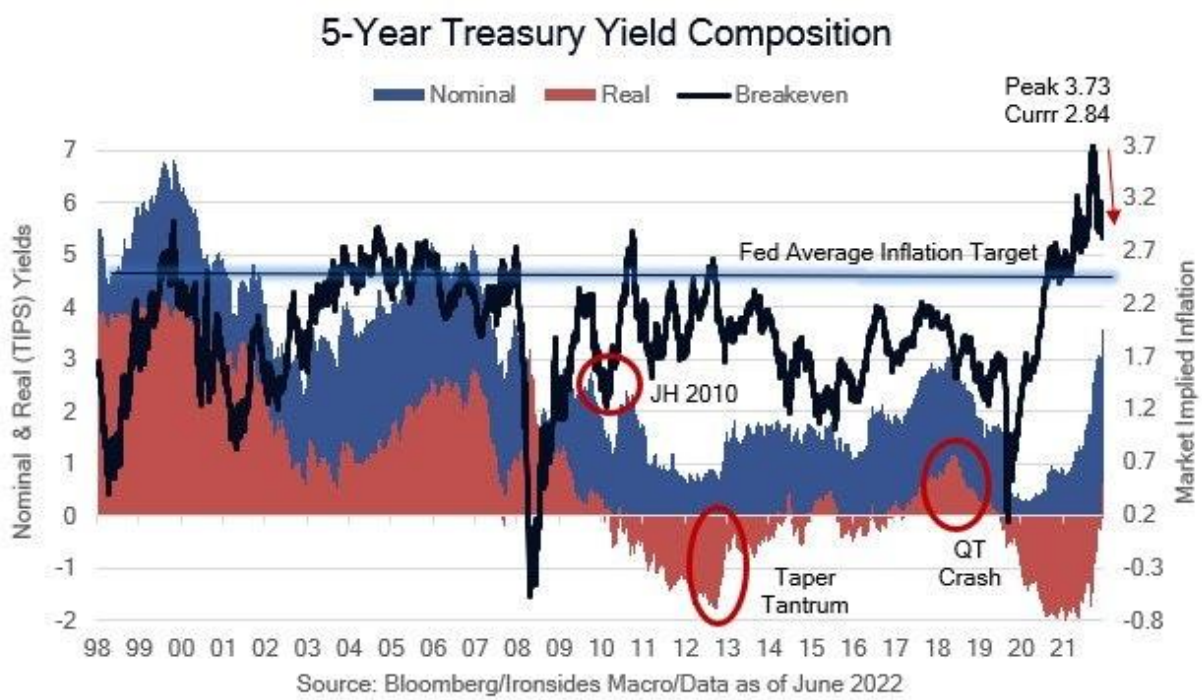

Figure 3: Inflation breakeven rates have been falling for three months. Markets are unstable not because of inflation, rather the Fed's reaction to the politics of inflation.

As central bank's disorderly unwind wreaks havoc on markets, there is an abundance of data that inflation has peaked due in large part to supply chains clearing as private sector creativity overcomes counterproductive pandemic policies aided by exchange rate adjustments. While the public is increasingly concerned as evidenced by consumer sentiment and inflation surveys, no doubt in part due to Fed credibility on a downward spiral towards the dire presidential polls and direction of the country surveys, market measures of inflation have been in a 3 month downtrend. 5-year breakeven inflation is heavily influenced by energy prices, current inflation readings and the Fed's large holdings of TIPS which all put upward pressure on this part of the curve. Nevertheless, since the March peak, 5-year breakeven inflation (the spread between nominal 5s and TIPS) has fallen 90bp. Similarly, lumber futures have dropped 50% since the March peak despite a still tight market exacerbated by Canadian tariffs. It is often said, the cure for high prices is high prices. This is a simple way of explaining the spontaneous economic order and how markets fix problems. In short, we think inflation is far more likely to fix itself due to economic dynamism and the private sector substituting capital for labor as opposed to the Federal Reserve engineering a gradual reduction in demand for the supply constrained housing, autos and labor markets. We are not as concerned as Larry Summers because we trust markets to solve the inflation problem and do not believe Fed policy is the only solution.

SUMMERS: US NEEDS 5 YRS OF JOBLESS RATE ABOVE 5% TO CURB CPI

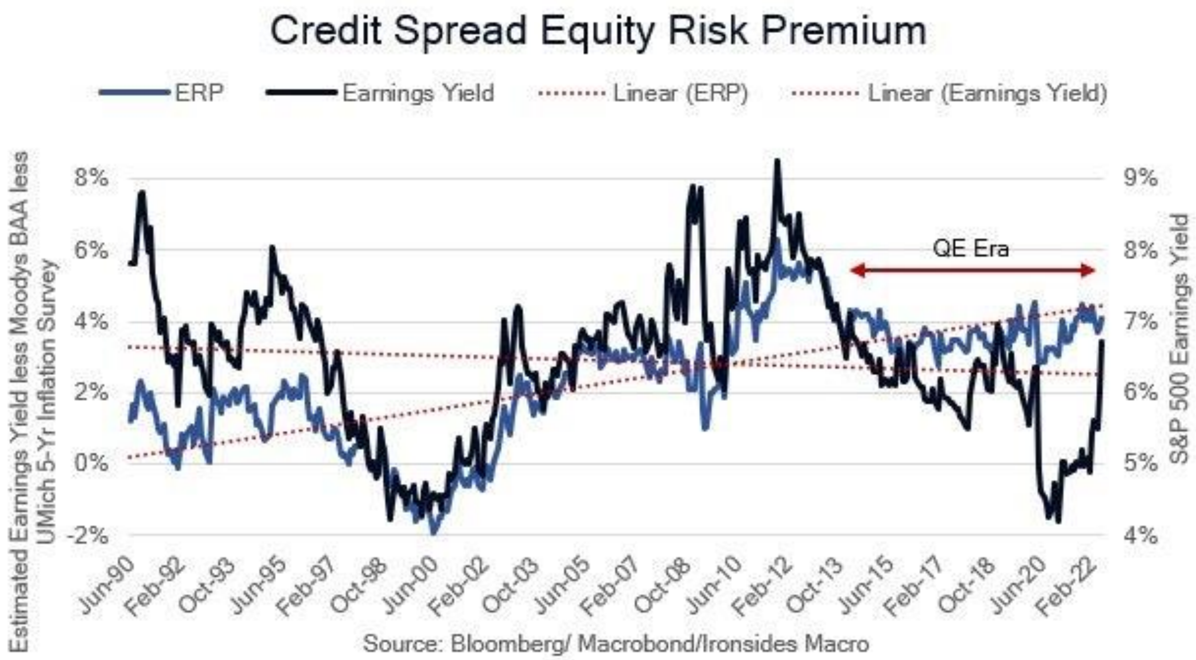

Figure 4: This equity risk premium model uses investment grade credit rates and the University of Michigan longer-run inflation survey. Consequently, the risk while lower than our model that utilizes TIPS, at 4.1% it is well above the median of 2.5%. In other words, the equity portion of the capital structure is cheap relative to debt.

History, Valuation and the Outlook

Through the long weekend we were asked on a number of occasions whether we thought we were near the equity market bottom. The short answer we gave was that the history of market corrections resulting from Fed policy tightening, valuation and our economic outlook implies the market should spend the second half of 2022 recovering from the declines in the first half. Our outlook and expected valuation are the most controversial aspects of our view. A frequently asked question was what if we are already in recession and earnings fall from here? Let's consider the two deepest inflation recessions, the first was the OPEC embargo 16-month contraction (the median is 10 months) from November 1973 to March 1975. The monetary policy rate was increased to 11%, the peak to trough contraction in real GDP was 2%, however nominal GDP increased 9.5% leading to a shallow 15% decline in S&P 500 earnings relative to credit cycle recessions. During the second Volcker recession following a 20% policy rate that also lasted 16 months, real GDP contracted 2.6%, nominal GDP increased 6.3% and earnings declined 13.7%. In contrast, the TMT boom/bust earnings decline was 32% and housing collapse decline was 57%. We suspect these credit cycle recessions play an outsized role in shaping investor expectations due to recency bias. Without much risk of a credit cycle contraction and far easier policy than '73 or '81, if demand does fall sharply enough for the NBER to declare a recession, it seems unlikely it would last for 16 months. Consequently, any earnings decline is likely to be similar to the first Volcker and Carter credit controls 6-month recession from January to July 1980 when real GDP dropped 2%, nominal GDP increased 4.75%, S&P earnings contracted 4.3% and the index dropped 17%. Given the 24% contraction in the multiple and 21% drop in the index, an inflationary recession where real GDP drops, nominal GDP increases, and earnings have a shallow decline, is more than adequately discounted.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Strategic Recommendation	ERP	ERP Z-Score
SPX	18.37	16.08	2.27	3.65	2.60	12.41	0.45	Market	5.59%	-0.31
SPW (equal weight)	17.50	14.27	1.55	2.76	2.02	11.48	0.18	Overweight	6.38%	-0.93
Discretionary	28.93	22.18	1.86	8.00	2.13	14.48	1.25	Market	3.88%	0.01
Financials	11.08	11.90	2.12	1.37	2.14	6.06	-0.67	Overweight	7.77%	-0.69
Technology	23.01	19.94	5.19	7.76	5.31	15.83	0.95	Market +	4.38%	0.04
Comm Services	15.37	14.47	2.51	2.86	3.18	10.04	0.47	Market	6.28%	-0.37
Industrials	21.92	16.88	1.82	4.48	2.18	13.24	0.78	Overweight	5.29%	-0.23
Materials	13.85	12.24	1.83	2.73	2.20	9.48	0.24	Overweight	7.54%	-1.30
Energy	12.96	8.10	1.24	2.29	1.48	8.03	0.24	Overweight	11.72%	-2.25
Healthcare	17.21	14.55	1.69	4.49	1.89	13.46	-0.22	Overweight	6.24%	-0.34
Staples	19.97	19.84	1.49	6.15	1.75	14.51	0.85	Underweight	4.41%	0.11
Utilities	19.48	18.81	2.47	2.11	4.34	13.76	1.85	Underweight	4.68%	0.59
Real Estate	37.02	33.99	6.71	6.71	9.59	21.18	-0.68	Underweight	2.31%	2.23
Russell 2000	43.14	17.53	1.02	2.09	42.53	1.81	-0.16	Overweight	4.65%	-0.63

Source: Bloomberg/Ironsides Macro/Data as of June 2022

Figure 5: Economically sensitive cyclicals are discounting a recession that we believe is unlikely.

Key Investable Themes & Asset Allocation:

- ***Deglobalization & Capital Spending Boom: Industrials, Semis***
- ***Recession Resistance: Materials, Financials, Energy, Small Caps***
- ***Technology Innovation Diffusion: Healthcare, Industrials and Financials***
- ***Fed Balance Sheet Contraction: Short Duration, Curve Steepeners, Long-term Fixed Income Volatility (PFIX)***
- ***Global Equity Allocation: Overweight US equities, underweight export dependent economies (China, Germany, Japan)***
- ***US Asset Allocation: Overweight equities, underweight fixed income spread products, use cash as your risk reducer. Reduce cash, add equities.***
- ***Portfolio Hedging: Credit protection***

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