Market Commentary: Recessionary Winds

October 2023

Prior to diving into our normal market commentary, we thought it timely to comment on today's increasingly worrisome geopolitical environment. While we intend to deliver a more comprehensive review in upcoming commentaries beyond the following snippet, we felt it necessary to provide some context to today's environment. In the meantime, we wish safety and peace among all people and religions.

On October 7th, roughly 1,400 people, primarily civilians, were killed in a terrorist attack and at least 245 people were kidnapped in Southern Israel. This directly led to what is currently a regional war by the proxies of the Islamic Republic of Iran (IRI): Hamas (Gaza), Hezbollah (Lebanon, Syria), and Houthis (Yemen) versus Israel and America[1]. The charters of these organizations explicitly point to the destruction of a Jewish state by various methods and ill intent toward America[2]. There are secondary goals for IRI of a global caliphate[3]. So, while currently regional, this war can expand. A primary reason for the timing of the attack was an expected peace agreement between Saudi Arabia and Israel[4] which would have further cemented Saudi Arabia as a partner of the US and an important bulwark against China.

Given the already existing war between Russia and Ukraine, many are wondering if and/or how Russia might use this event to its advantage in Ukraine. More ominously, will Russia stir up more trouble in the Middle East, given they have re-manned previously vacant bases in Syria? Does this provide an opening for Xi to make a move on Taiwan? Is an Allies vs Axis WW III event lining up? At the least, the global world order is shifting as evident in China's exports to the US declining relative to Mexico and Canada. We plan to explore it all in upcoming commentaries.

We continue to closely monitor events in the Middle East and analyze how they may inform our market exposures.

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[1] It is important to distinguish between governments/organizations (e.g., Islamic Republic of Iran, Hamas) and people (Iranian citizens, Palestinians) as they may not have the same intents and many times have conflicting goals.

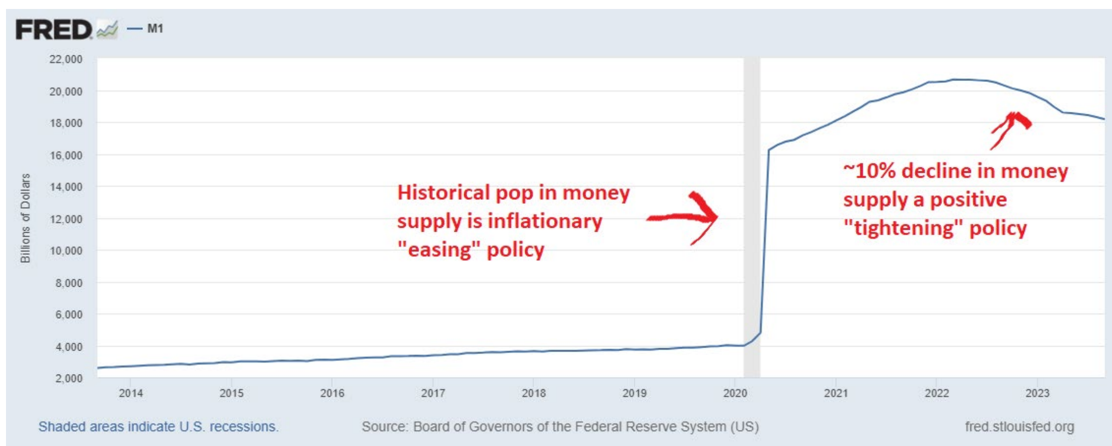
[2] There are variations depending on charter/constitution etc. Here are some references: Iranian Statements on Eradicating Israel | MEMRI, Hamas's Genocidal Intentions Were Never a Secret - The Atlantic, Hamas Official: We Are Victims, Everything We Do Is Justified | MEMRI – actual constitutions and charters are available online for those who care to review the primary sources.

[3] It is important to recognize that religious tenets vary in their practical consequences, as well as in the behavior of different groups who ostensibly share the same believes. The actions of religious people can be both negative and positive (. One should not generalize religions as "good" or "bad" based on the acts of certain groups, past or present (e.g., crusaders, Spanish Inquisition against Jews, Muslims and eventually Protestants). I would like to believe that religions are closer to pure with the humans being the problem.

[4] Our understanding is that this is still very much on the table, though timing will be sensitive.

The job of the Federal Reserve ("Fed") is to maintain a healthy and stable economy and financial system. Generally speaking, the Fed looks to "ease" or "tighten" conditions as necessary to achieve its initiative.

In the past, we have discussed the ripples emanating from the storm that was Covid. At the onset of Covid, the government, in partnership with the Fed[5] eased conditions by flooding the market with capital while dropping the Federal Funds Rate[6] to 0%. Consumer savings rates skyrocketed, while commercial entities were able to borrow at all-time low interest rates. The historical government bailout flushed the system with cash while services were essentially wiped out temporarily due to Covid-based restrictions. Demand for goods spiked at the same time supply chain disruptions caused significant stresses in getting those demanded goods to the market. Just as the supply chain started to sort itself out, a secondary shock was caused by the war in Ukraine. Inflation is a risk to financial systems and, if not dealt with aggressively, can become self-propagating.



In short, there was historical easing followed by historical tightening. Over the last 20 months, the Fed increased the federal fund benchmark rate by 5.25% and decreased its balance sheet by $1 trillion (over 10%). The M1 money supply[7] has declined ~10% as well.

Our prior two Investment Wars podcasts discussed the potential for recession. Jack Janasiewicz of Natixis was optimistic about the economy given the strong balance sheets of both the consumer and business entering this tightening cycle. Victoria Vogel of Trust Company of the West ("TCW") was more bearish, calling for a deeper recession based on the view that these balance sheets are eroding quickly and will be further stressed by the current high-rate environment. These views, in conjunction with our own research, assist in managing a well-constructed portfolio for the long term.

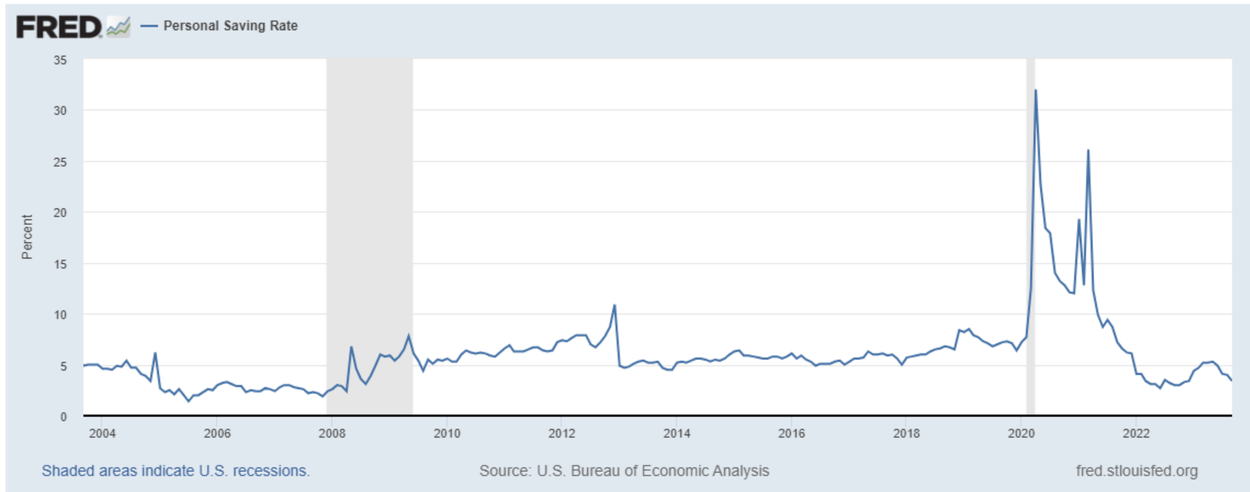
Ultimately, there is no denying that higher rates will eat into the pocketbooks of the consumer, corporations, and the US government. Given the majority of debt in the US is based on a fixed, rather than variable, rate (e.g., mortgages, most public corporate debt, government debt), stressed balance sheets will not happen overnight. But we can already see the effects of higher rates playing out in the market.

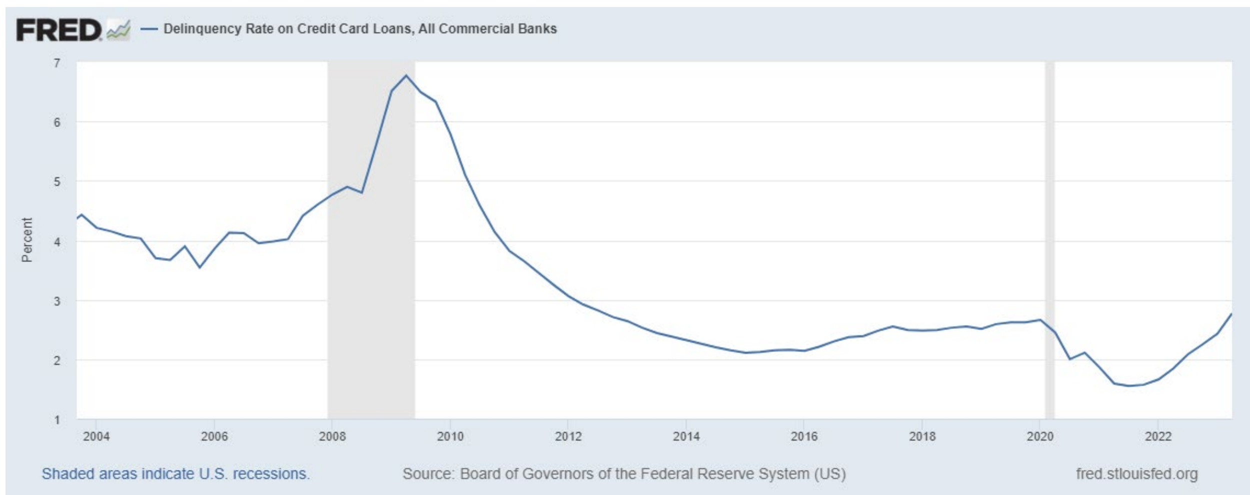
[5] Who Owns the Federal Reserve Banks | In Plain English | St. Louis Fed (stlouisfed.org)

[6] Federal Funds Rate: What It Is, How It's Determined, and Why It's Important (investopedia.com)

[7] M1 Money Supply: How It Works and How to Calculate It (investopedia.com)

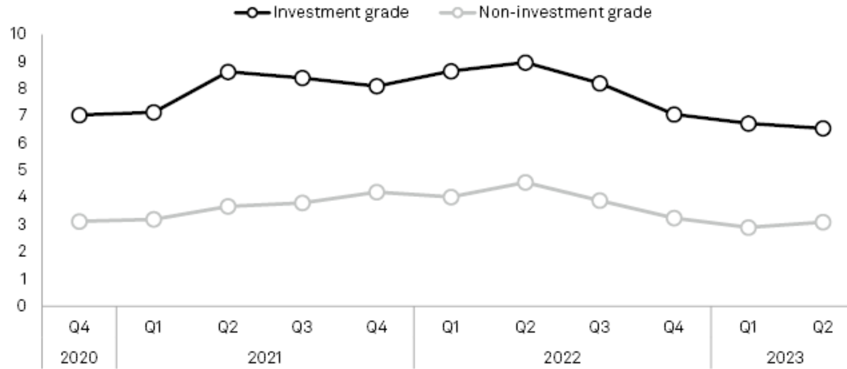
For example, on the consumer side, savings rates are lower than they have been since pre-2008, while delinquencies are increasing.



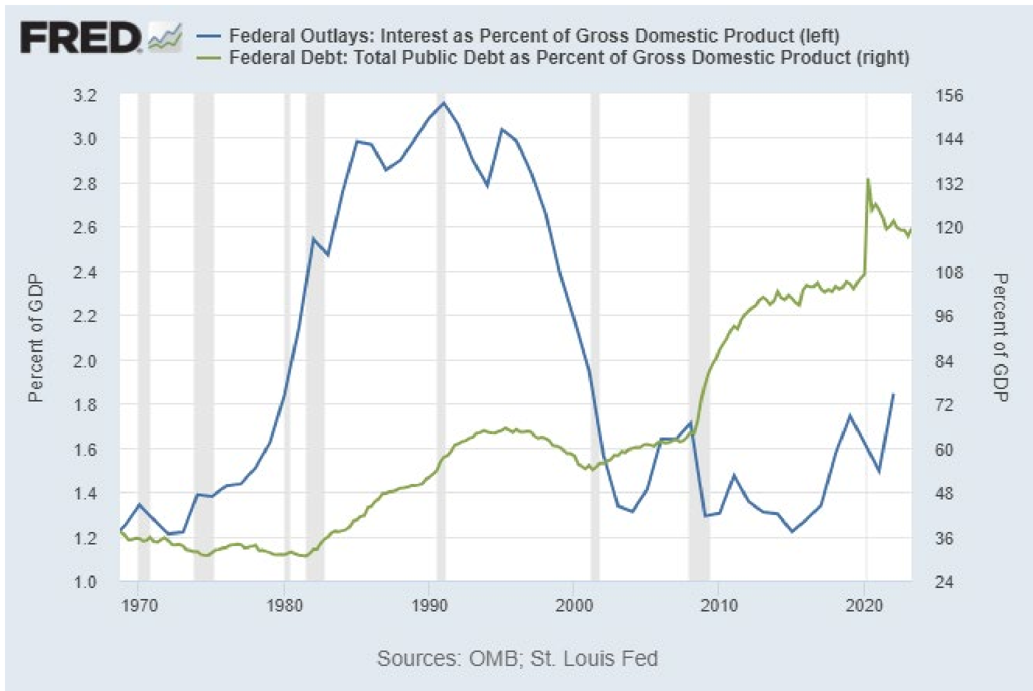


On the corporate side, interest coverage ratios are dropping materially. Interest coverage is a measure of a company's ability to pay its interest expense[8].

[8] Interest Coverage Ratio (ICR): What's Considered a Good Number? (investopedia.com)



The government itself, with its hefty debt load, is not immune. The blue line on the following chart is the more important one, reflecting the government's interest obligations as compared to GDP (left axis). That line, unfortunately, will continue to spike up rather quickly if rates remain where they are. That line can easily match the position we were in during the 1980s and 1990s given the government's inability to balance a budget.



It is important to note that financial markets are valued based on future expectations, not current economic conditions. It is one of the reasons the market declined significantly last year. The market has already priced in some level of recession which is perhaps most evident in the inverted yield curve (see our June 2023 commentary).

In conclusion, though one can see a turn for the worse in a lot of the data that has come out recently, it is worth pointing out a couple of positives: (1) While sticky, inflation has come down and is expected to decline further, which will allow the Fed room to navigate and support the economy if indeed more cracks appear. (2) The artificially low-rate environment we had for over a decade was not healthy either, resulting in negative real rates for bond holders. Current interest rates provide positive real rates which is great for fixed income investors and healthier for markets generally. Furthermore, hopefully the Fed will be able to navigate to a reasonable rate environment going forward and achieve its goals of moderate US growth with full employment, and without a major recession.

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