



Money for Nothing 2024 Annual Letter

January 26, 2024

Unusually uncertain times are back. Global tensions, U.S. politics, and higher interest rates have upended decades of the status quo. Our temptation was to channel our inner Frank Costanza and title this piece “**Serenity Now, Serenity Now!**”

Markets can climb a wall of worry, and 2023 is a fresh example of this truth. December's global stock market performance was nothing short of spectacular. Full-year 2023 was good but super terrific in the Magnificent 7 - Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla. If a U.S. stock portfolio did not have an unhealthy concentration in these 7 stocks, 2023 was a tough year relative to the S&P 500.

While our clients enjoyed modest gains in 2023, our caution and portfolio defensiveness were penalized compared to market averages.

Entering 2024, we believe the central questions are:

- What are the key forces shaping the investment landscape?
- Has the Federal Reserve (the Fed) successfully whipped inflation?
- Will the Fed soon pivot to an accommodative policy to prevent a recession?
- Could multi-front wars change risk appetites and impact markets?

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Money for Nothing

With lyrical revisions, the mid-80s Dire Straits song “Money for Nothing” applies to the last decade of ultra-low interest rates. The popular refrain improves by adding the U.S. stimulus programs: “Money for Nothin’ and **Checks** for Free.”

Since early loans in Mesopotamia, circa 1700 BC, **the price of time has been expressed in interest rates**. Businesses pursue time-sensitive opportunities that exceed their interest cost, labor, and materials. Savers earn interest funding opportunities to enjoy more capital in the future. Interest rates act as the gravitational force that



matches borrowers' and savers' different time, effort, and risk preferences. *For a 5000-year history of interest rates, see Exhibit A.*

"Time is precious. Time is money – Time is the stuff of which life is made."
Benjamin Franklin's Advice to a Young Tradesman (1748)

Fast forward to 1907 - after severe bank runs, Congress wrote the Federal Reserve Act to address reoccurring panics. At first, The Fed's charter was to stabilize the banking system, but Congress broadened it throughout the Great Depression. A significant leap in Fed power occurred in the 1940s when Fed policy forced interest rates lower to obtain cheaper financing for WWII and the Korean War. It didn't take politicians long to understand the power of manipulating the price of time.

Today, the Fed plays an outsized role by setting interest rate policies to manage the boom/greed and bust/fear cycles. When the economy struggles, the Fed hits the gas by lowering rates to stimulate opportunities. Conversely, the Fed taps the brakes by raising rates when demand exceeds supply, causing inflation. Because the process involves greed, fear, and **politicians**, this simple flywheel is anything but simple. That is because every administration, from Lyndon Johnson forward, seems to quietly pressure the Fed to stimulate growth with low interest rates.

We will lose our entire reading audience if we try to explain the financial plumbing of the Fed and the U.S. Treasury. Admittedly, every time we study it, we are relearning it.

Keeping it short – in the wake of the 2007/2008 Global Financial Crisis, Fed Chairman Ben Bernanke proposed an aggressive policy of stimulating economic growth. Bernanke's policy was to keep ultra-low interest rates and buy U.S. debt securities to improve market liquidity.



*"Please, do go on about modern financial theory
—but with someone else."*

CartoonStock.com

Japan adopted this strategy after the collapse of human history's greatest real estate bubble. The theory was that – after a bust, **Money for Nothing** brings back the animal spirits in the economy. For over 30 years, this policy has not worked well in Japan, but it has worked swimmingly in the U.S.

By 2015, with near-zero 10-year U.S. Treasury Bonds, the economy regained full employment and robust growth. It was terrible for quality fixed-income but great for equities, leveraged buyouts, real estate, and venture capital. Then, in 2018, President Trump appointed Jerome Powell. After eight months on the job, Powell rang the bell that rates needed to rise.

"The really extraordinarily accommodative low-interest rates that we needed when the economy was quite weak, we don't need those anymore – they're not appropriate anymore." The Atlantic Festival, Fed Chair Powell, 10/10/2018.

As the Fed hiked rates in 2018/19, the S&P 500 fell 20%. Then, President Trump, not so quietly, unleashed a barrage of Twitter and media criticisms of the Fed. Soon after, the Fed coincidentally started cutting rates and eventually sent rates back to zero in the Covid

crisis. With 0% Fed Funds back again and breathtaking support from Congress, post-Covid transient hyper-inflation hit the economy with a force not seen in 30 years.

To combat inflation, the Fed raised rates in 2022 and 2023 from 0% to 5.5% (Exhibit B), **showing**

unexpected resolve. As mentioned in prior letters, we watched at least a dozen times a May 2022 recorded testimony of Powell on C-Span. Powell praised his predecessor, Paul Volker, for fighting inflation and taking interest rates to 20%. Powell testified that Volker was among the greatest public servants in the Fed/Treasury history. Our impression – “Look out - Powell is very serious about inflation.”

But the prior period [2009 to 2018] discouraged normal saving and investing and accelerated returns and, importantly, risk-taking. Owing to ultra-low rates for that decade, animal spirits flourished.

“I likened the effect of low-interest rates to the moving walkway at the airport. If you walk while on it, you move ahead faster than you would on solid ground. But you mustn’t attribute this rapid pace to your physical fitness and overlook the contribution from the walkway.”

Howard Marks, Oakmark Capital Management “Easy Money” memo of January 9, 2024

With the walkway now in reverse, debt-heavy and/or unprofitable companies refinance at roughly double the interest rates they once enjoyed. Can these borrowers' financial “fitness” sustain them with the walkway in reverse? Further, consider the U.S. Treasury refinancing U.S. debt today at roughly 4x higher interest rates. It won’t be long until U.S. debt service exceeds defense spending.

Early indications in New York City, Los Angeles, and San Francisco show that real price pain is gaining momentum in office buildings. This negative office trend started in 2020 with the Covid work-from-home movement. With that movement firmly in place, office borrowing costs doubled – the perfect storm. Browsing the [Commercial Observer](#) website, it is easy to find large class-A and B offices selling for half of prior sales in these cities.

According to The New York Times, 96 million square feet of NYC office space is empty. According to our estimate, that vacancy equals 35 Empire State Buildings of empty office space. Except for the Southeast, this distress is severe and still unfolding with seasoned 5, 7, or 10-year loans maturing. If interest rates are a “gravitational force” in the economy, this trend will likely impact the broader economy.

The silver lining is that we have **thoroughly enjoyed** buying quality bonds at much higher interest rates. Finally!!, after nearly 15 years of saver repression from ultra-low interest rates, fixed-income assets actually pay a fixed income.

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Switching gears - as is our custom for annual letters, we offer answers to questions that we have heard from clients recently. Forecasting gives us hives, and the precarious nature of markets only adds to our discomfort. We are humble forecasters, so please view these answers as directional with a wide range of possible outcomes.



Q: What are the key forces shaping the investment landscape?

“Money for Nothing” has ended. All investments should be examined through the lens of higher interest rates. Consider that home mortgages moved from 3% to 7.5%, commercial building loans from 5% to 9%, credit cards from 15% to 25%, etc. As we said in 2022, the Fed is stuck between the choices of fighting inflation and avoiding a recession. Unless the Fed abandons its restrictive policy and drops rates soon, this structural shift will slow growth and shrink profits in many sectors of the economy.

The other structural shifts changing the landscape are power and alliance changes in geopolitics. This new constant will affect supply chains, trade, and commodity prices. A common theme we’ve heard lately – geopolitical shifts and uncertainty are like nothing I’ve seen in my career.

Both shifts are structural, not cyclical. A defensive and diversified portfolio still seems appropriate. In terms of positioning, this translates to a higher-than-normal cash position, a small allocation to crisis hedges in gold & managed futures, quality bonds, and reasonably priced dividend growth/value stocks. And, importantly, an open mind to a wider range of possible outcomes.

Q: What is the Magnificent 7, and why are they getting so much attention?

The Magnificent 7 refers to a group of stocks that have recently far outpaced the performance of the other 493 companies in the S&P 500. They include Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla. This is a concentration of performance like never before, fueled by each company's revenue potential from Artificial Intelligence (AI).

A stock market this concentrated is risky. Looking back on U.S. history, we can’t find a more concentrated situation. The dot.com bubble was concentrated - but not this tight. The Nifty 50 stocks of the 70s were similar but, in both cases, spread to around 50 stocks.

Q: Has the Fed whipped inflation?

No. The Fed has made substantial progress, but inflation is hard to whip. The current consensus is that inflation is under control. We disagree because the Atlanta Fed’s Sticky Prices (medical, auto, rent) inflation gauge is still at 4.6% vs. 3.6% for headline CPI. We are further skeptical of consensus because history tells us that inflation is hard to control without a recession and higher unemployment.

Q: Will the U.S. experience a recession in 2024? Will the Fed pivot and lower rates? Maybe, and yes.

Frankly, we’ve been surprised at the resiliency of the U.S. economy. With the help of credit cards and buy-now-pay-later, consumer spending is ok. However, the manufacturing sector is showing clear signs of contraction. One of the best predictors of a recession is the Institute for Supply Management (ISM) Manufacturing Index. When the ISM is above 50, the economy is expanding – below 50 contracting. For the 14th consecutive month, the ISM Index has registered below 50. The ISM Services Index is better but also in a downtrend, just a smidge above 50. See Exhibit C

The much-anticipated Fed “Pivot” arrived in mid-December. The sudden posture change came in the form of dot plots – See Exhibit D. Each committee member shares their view



Wikipedia: Whip Inflation Now (WIN) was a 1974 attempt to spur a movement to combat inflation in the US, by encouraging personal savings and disciplined spending habits in combination with public measures, urged by U.S. President Gerald Ford. The campaign was later described as "one of the biggest government public relations blunders ever."

of the Fed Fund's interest rate. The median expectation of members now stands at 4.625 by the end of 2024.

With manufacturing contracting and inflation still a problem, we sense that the Fed will start reducing Fed Funds in the summer. Of course, the 2024 Presidential Election will play a role in each committee member's private deliberations.

Q: Could multi-front wars impact markets? Absolutely.

We should start with the fact that we are not geopolitical experts. It is a specialized field we haven't had to worry about for most of our careers. We have gained valuable insights from several leaders in the field: John Mearsheimer¹ – University of Chicago; Jeffrey Sachs² – Columbia University; and Felix Zuluf³ – Zuluf Consulting, Baar, Switzerland.

Since last Fall, the war in Ukraine has shifted in favor of the Russians. And support for Ukraine in Washington is waning. Without a deal ceasing planned NATO expansion into Ukraine, it is just a matter of time before Ukraine becomes a failed state partially occupied by Russia.^{1,2,3} Ukraine becoming a failed state will likely impact the food and fertilizer supply, adding to inflationary pressure.

The Israel-Hamas war is quickly becoming a complex multi-front war. In addition to Hamas in Gaza, Israel is fighting Hezbollah on the Israel-Lebanon border. In protest of Israel's ongoing destruction of Gaza, Iran-backed Yemen Houthis' are attacking container ships in the Red Sea. If Israel expands fighting Hezbollah in Lebanon, Syria will respond, and Syria has a military agreement with Russia.^{1,2,3} Because Iran and Russia are old pals, Iran could respond by closing the Strait of Hormuz. This 21-mile channel separating Iran from the Arabian Peninsula transports a fifth of the world's petroleum liquids. Closing the Strait of Hormuz will damage the oil market – a lot – and inflict damage to the global economy. If this seems complicated – See Exhibit E.

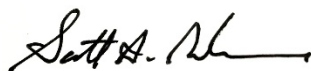
For a long time, the U.S. has tried to broker a two-state solution in Israel. So far, Netanyahu will not budge. While we wait for an elusive solution, the U.S. is shooting down cruise missiles and drones in the Red Sea with ongoing retaliatory attacks in Yemen and Iraq. This fighting is a very serious situation, and it is getting worse.

"When goods don't cross borders, Soldiers will."

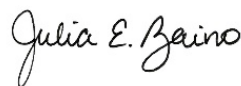
Attributed to Frederic Bastiat 1801-1850

In closing, 2024 is off to a bumpy start. We look forward to spending time with you soon and appreciate having you as a client and a friend. Thank you for your trust in our team.

Very truly yours,



Scott A. Roads
Founding Principal

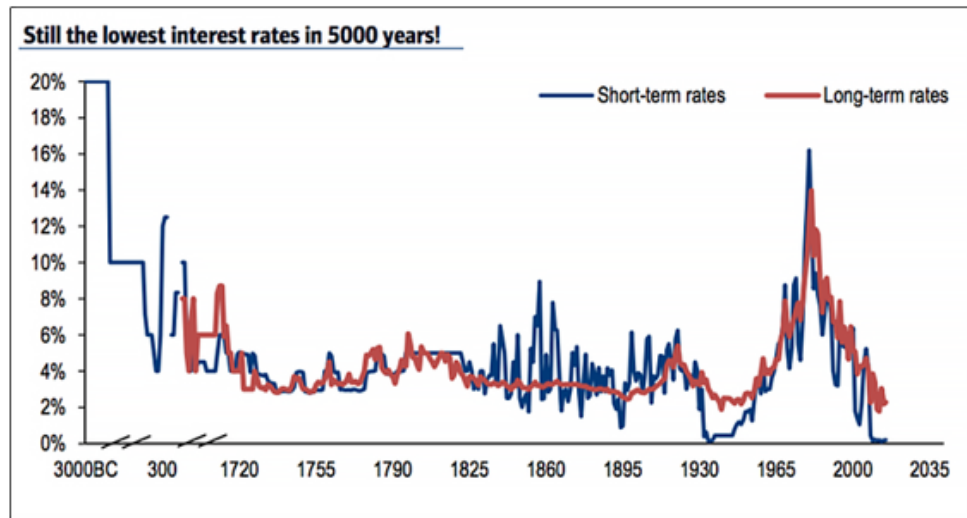


Julia E. Zaino
Principal

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Exhibits

A. History of interest rates



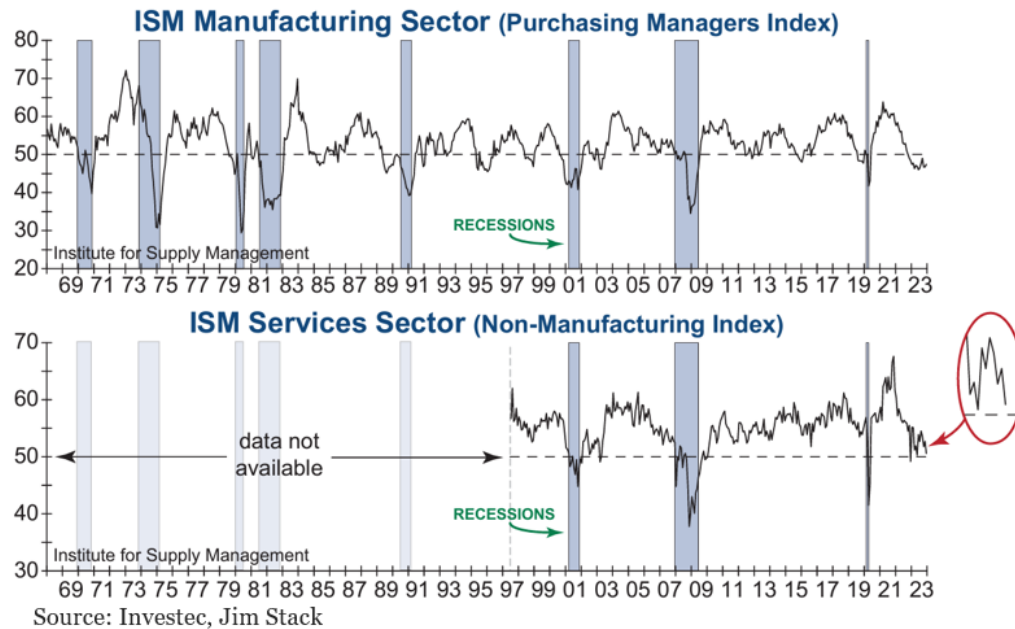
Source: Bank of England; Global Financial Data; Homer & Sylla "A History of Interest Rates." Note: The intervals on the x-axis change through time up to 1700. From 1700 onwards they are annual intervals.

B. Fed Funds Rate 1975 to January 26, 2024

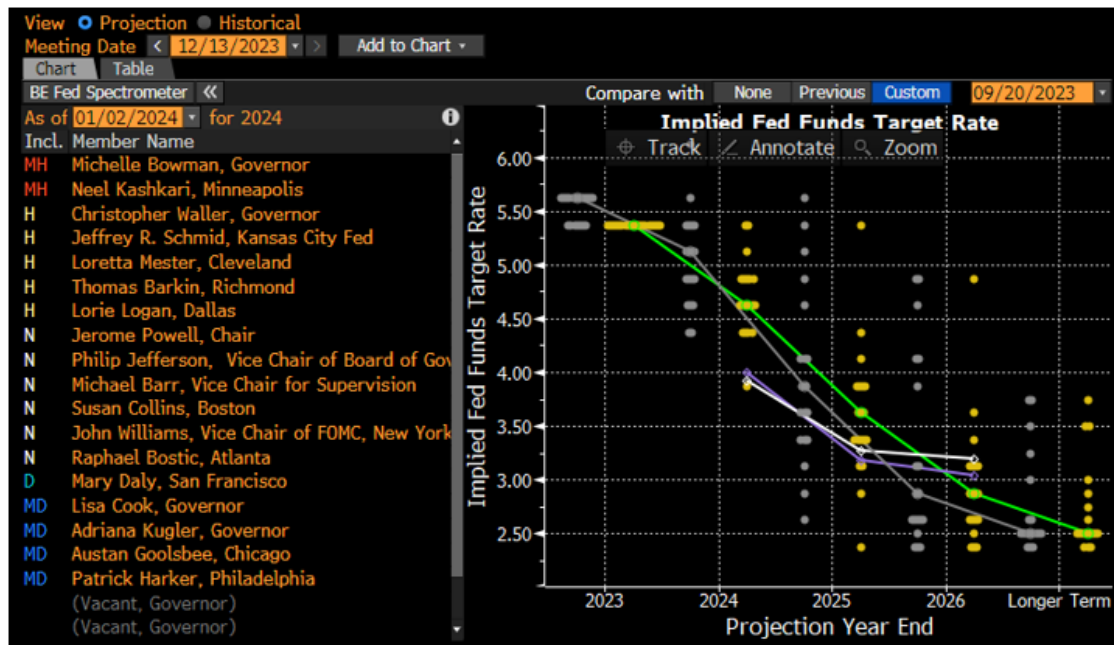


Source: Bloomberg

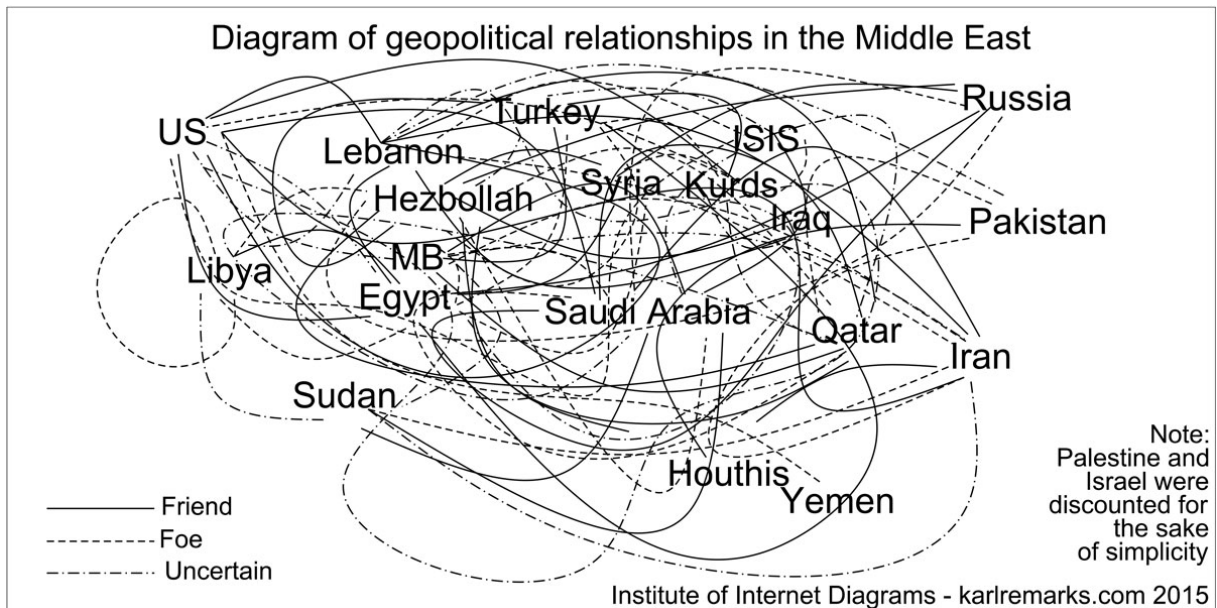
C. Institute for Supply Management – Manufacturing and Services



D. The Fed's dot plot is a quarterly chart that records each Fed official's view of future Fed Funds interest rate. Our view is that it's more interesting than reliable.



E. Diagram of geopolitical relationships in the Middle East. Complex? Little Bit!



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