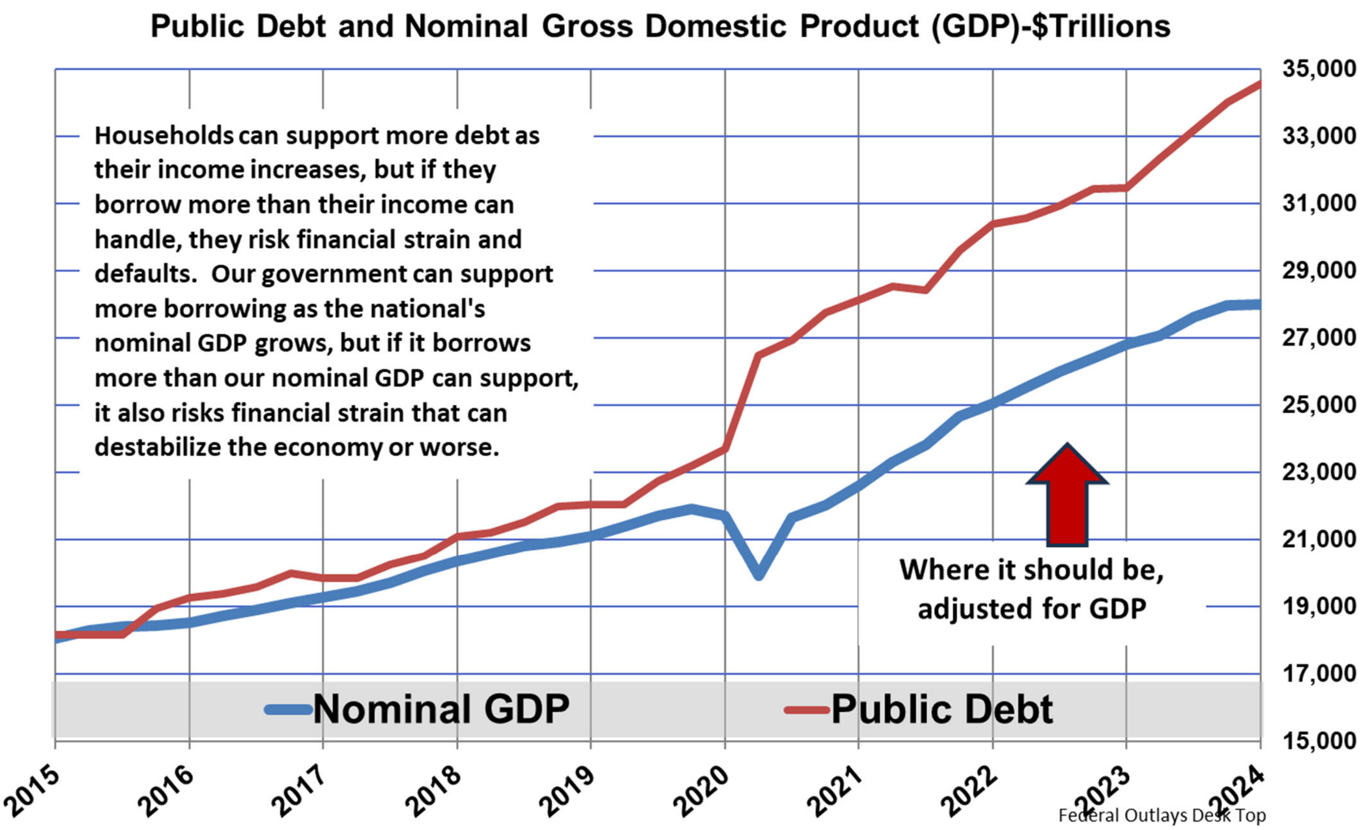
The Fed as Sisyphus

The gods punished Sisyphus by forcing him to roll an immense boulder uphill, for eternity. We wonder if the Fed feels like Sisyphus as it continues to battle inflation by raising interest rates and reducing the amount of money in circulation while our government's ever-expanding borrowing injects new money into the economy, which hampers the Fed's actions. This in turn prolongs the Fed's goal of reducing inflation, which may lead to a recession or financial crisis.

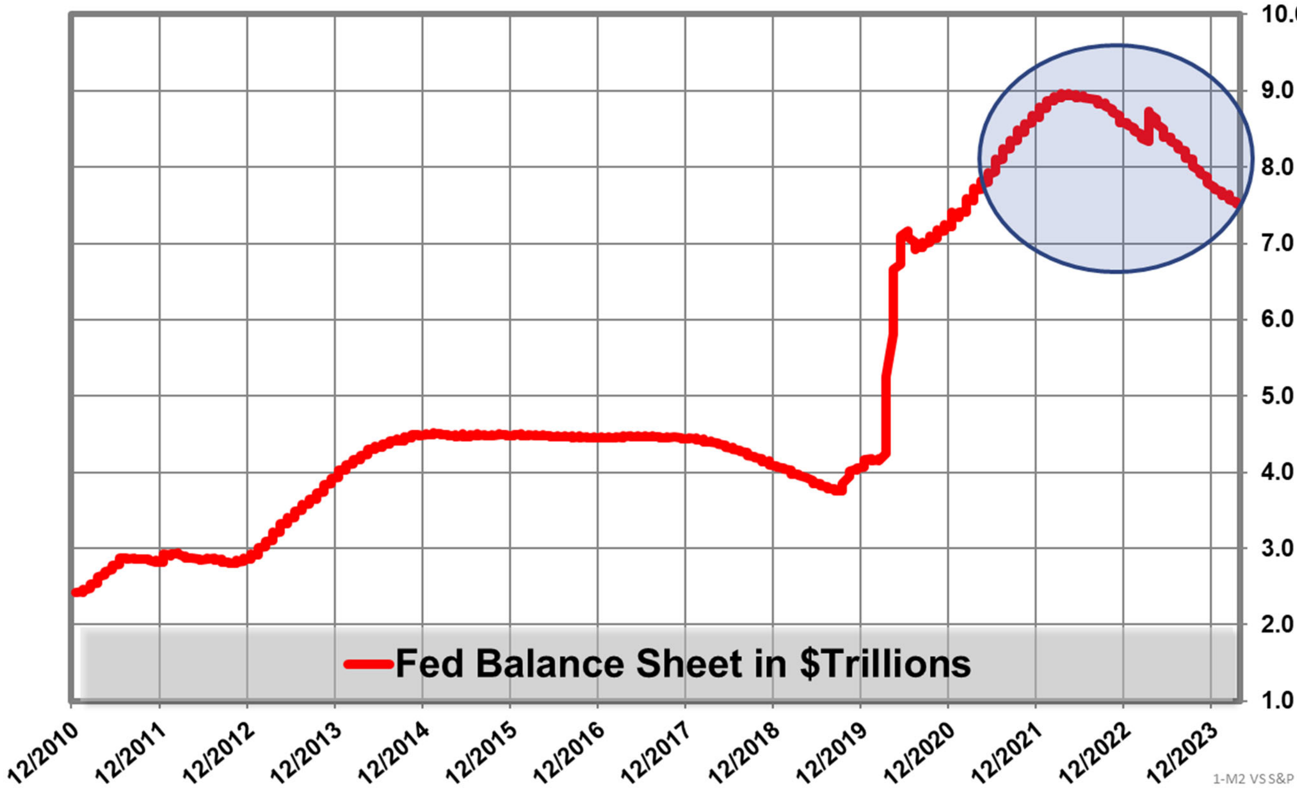
The interest cost of the debt explosion in 2020-2021 (see exhibit below) was about 0.5%. The interest cost to refinance that debt and new borrowings is now at least 4.5%. As the cost to carry debt increases, so must nominal GDP (inflation-adjusted, total economic output), or household incomes. The exhibit also shows that Nominal GDP growth has not caught up to the growth of our debt, and the gap is widening.



Excessive household debt strains budgets as more income is used for debt payments, leaving less money available for spending on essentials like food, housing, education, and healthcare. Excessive government debt also strains budgets as more income is used for debt payments, reducing the amount of money left for spending on essentials like infrastructure, defense, education, healthcare, and Social Security.

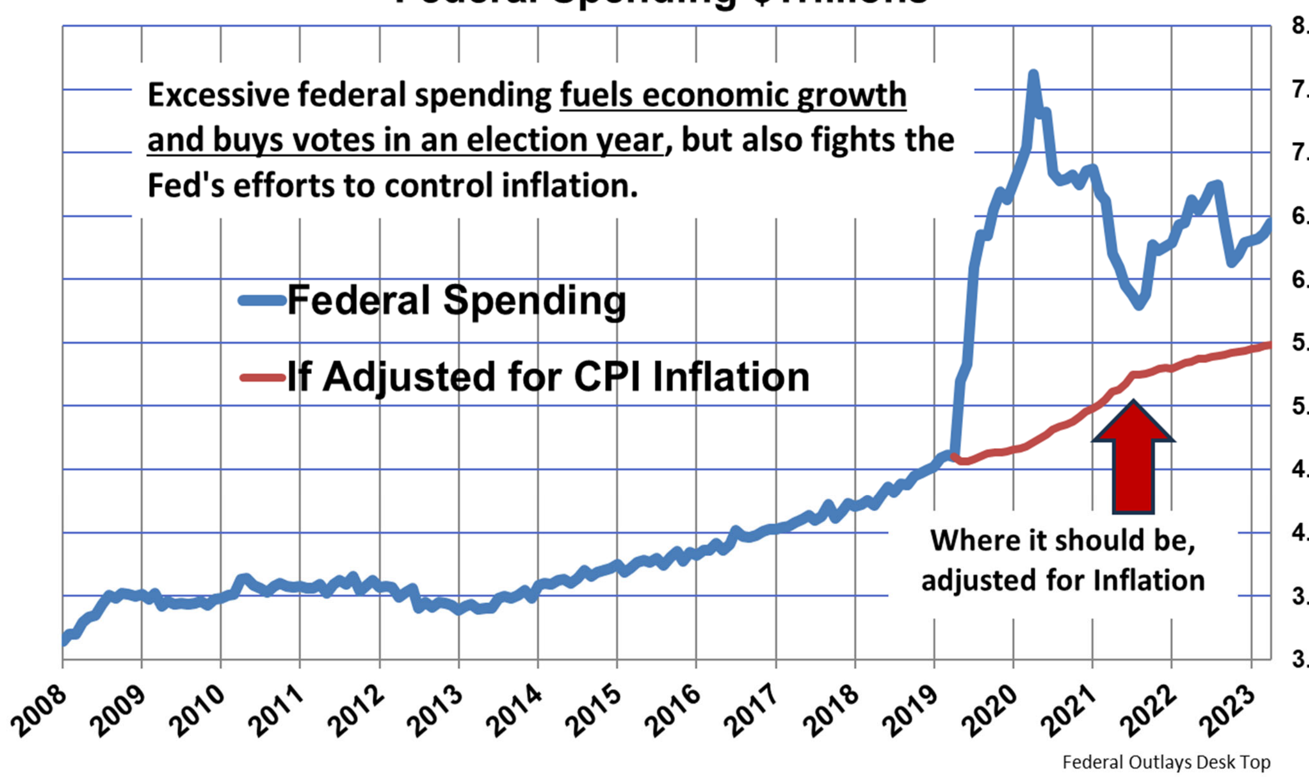
In addition, excess debt erodes confidence and trust in an individual, a corporation, or a nation. It also affects the broader markets by reducing asset prices. Households or governments that want to ensure long-term financial stability and confidence need to strike a prudent balance between productive borrowing (borrowing that leads to growth) and non-productive excessive debt (which results in interest payments without corresponding growth).

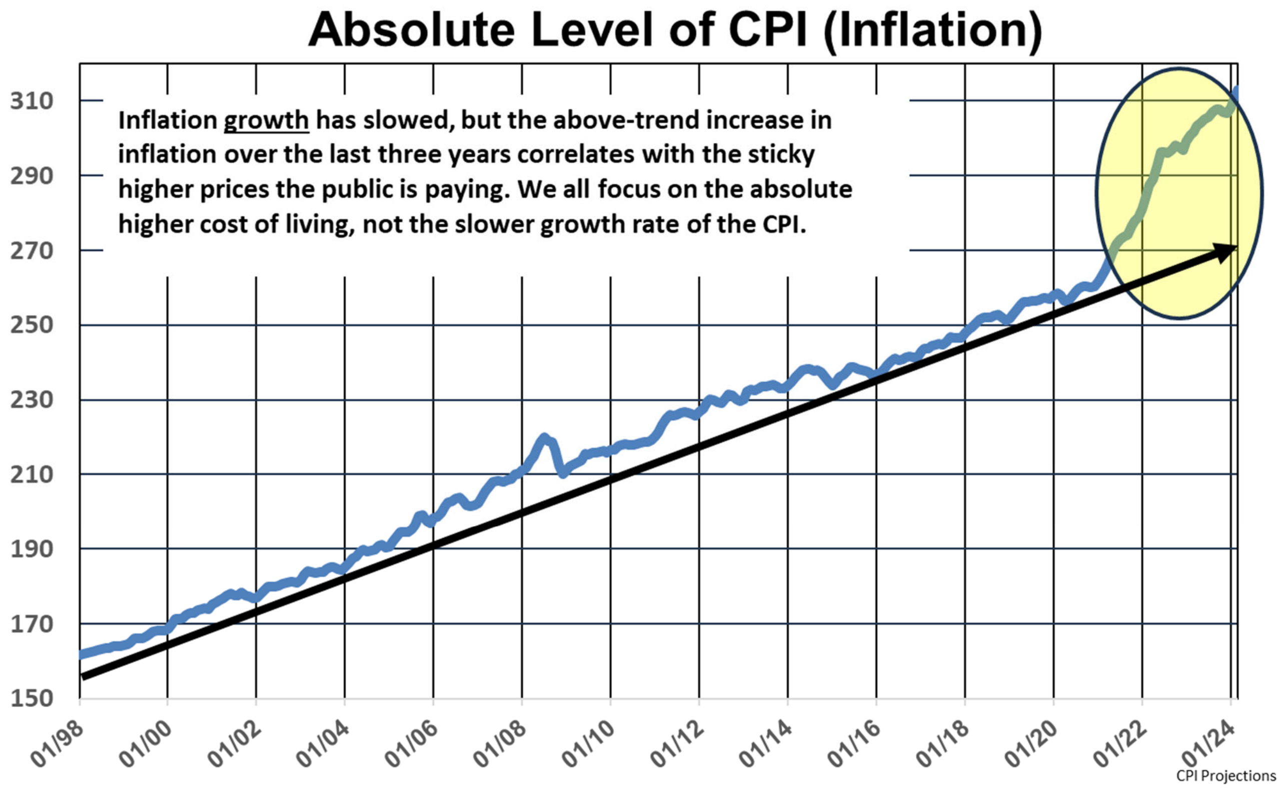
Fed Continues to Shrink its Balance Sheet



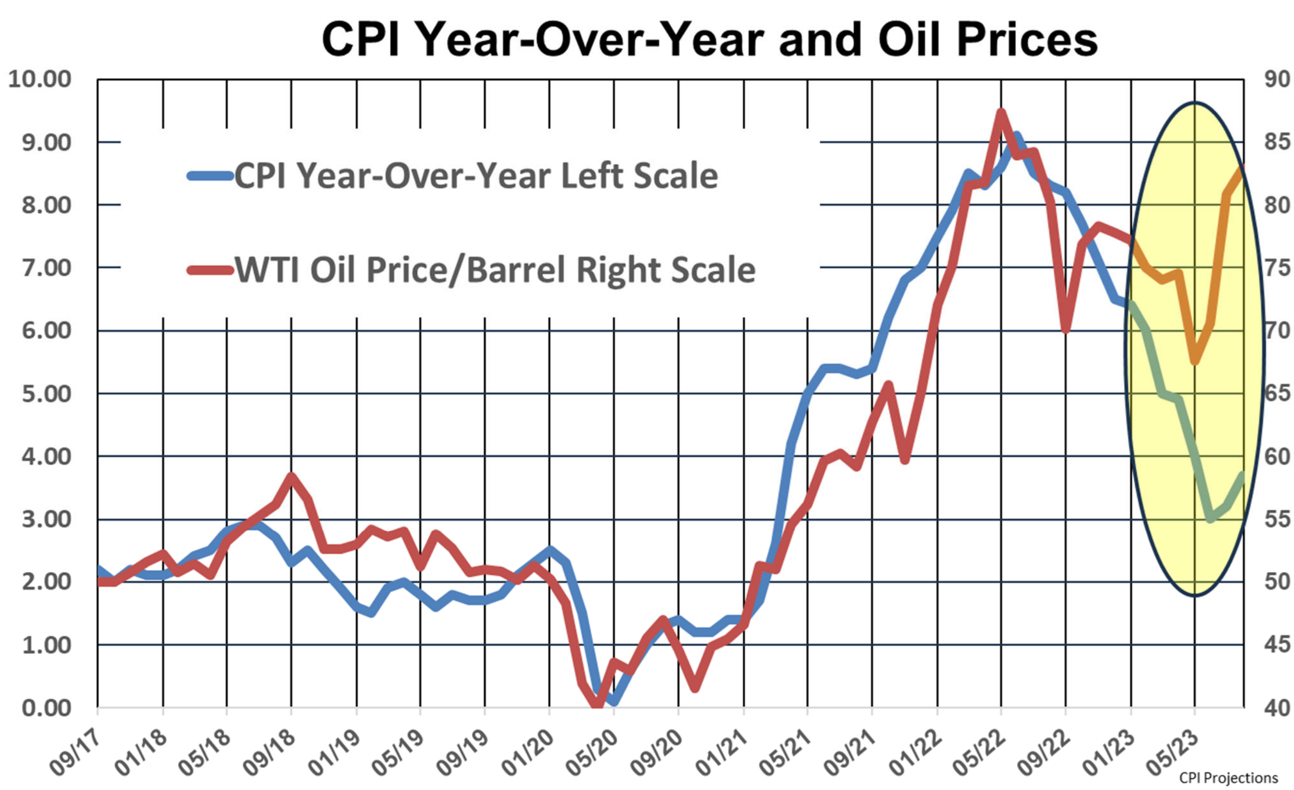
The Fed continues its fight to reduce inflation by keeping the Fed Funds rate at 5.5% and reducing the size of its balance sheet (see above). However, our government thwarts that effort by incurring unsustainably high and ever-increasing borrowing and spending (see below).

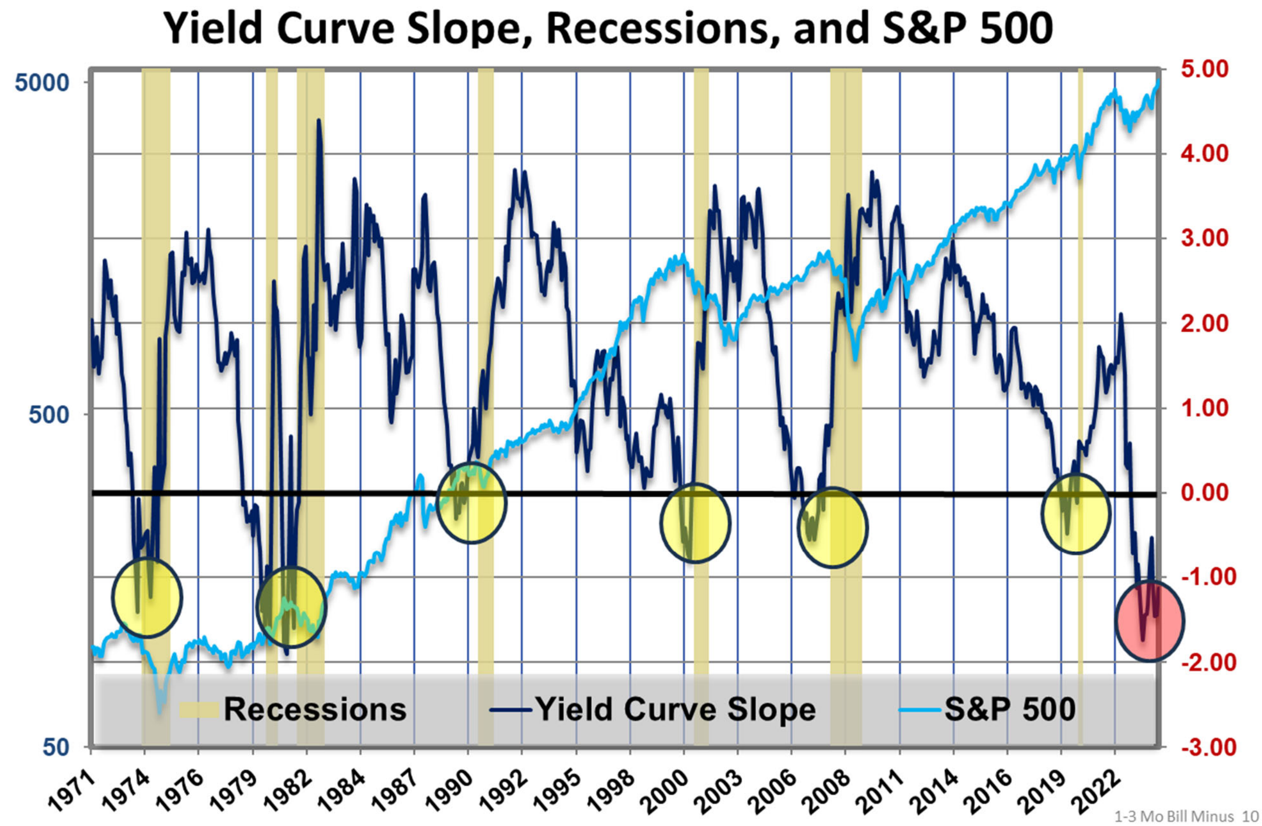
Federal Spending-$Trillions



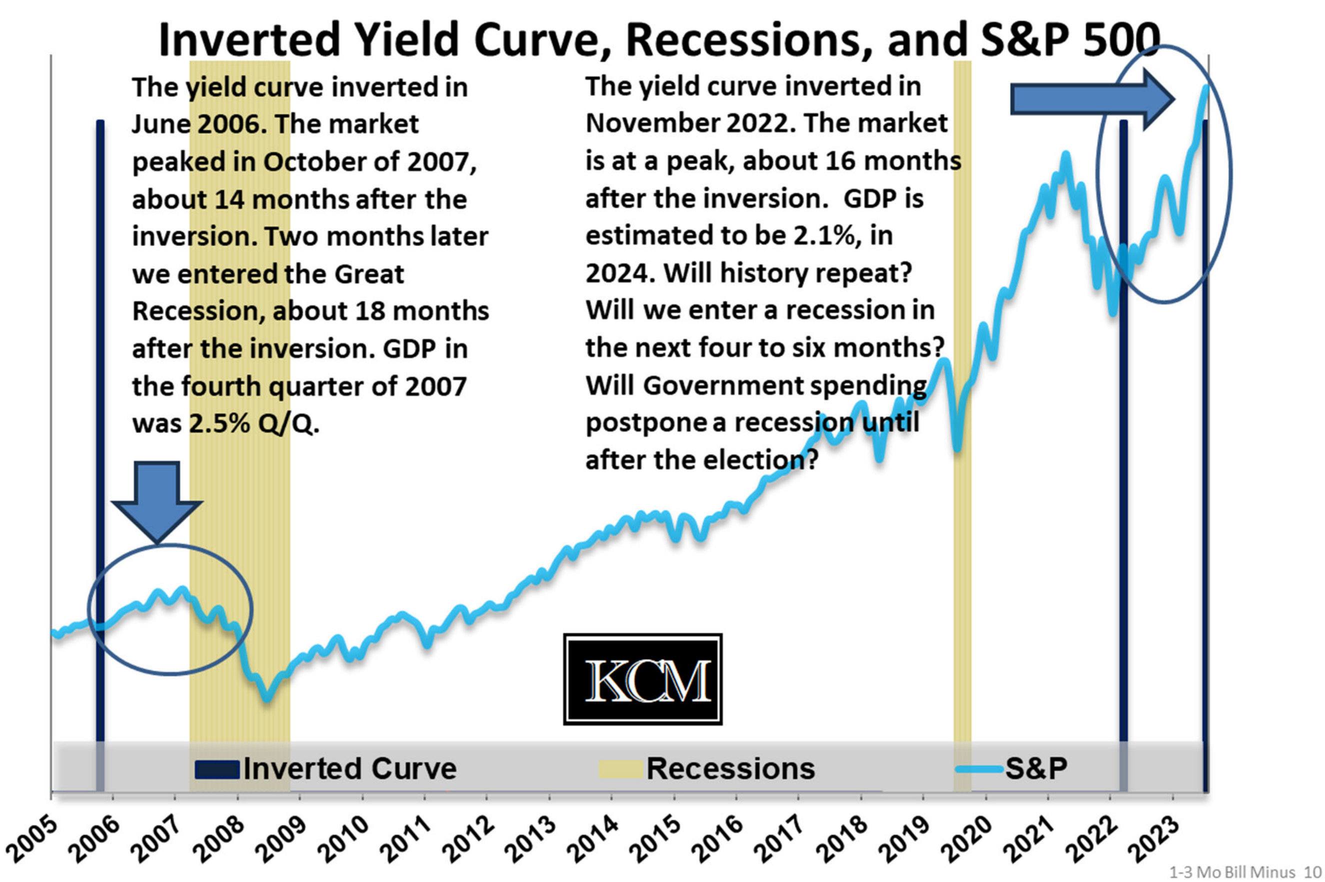


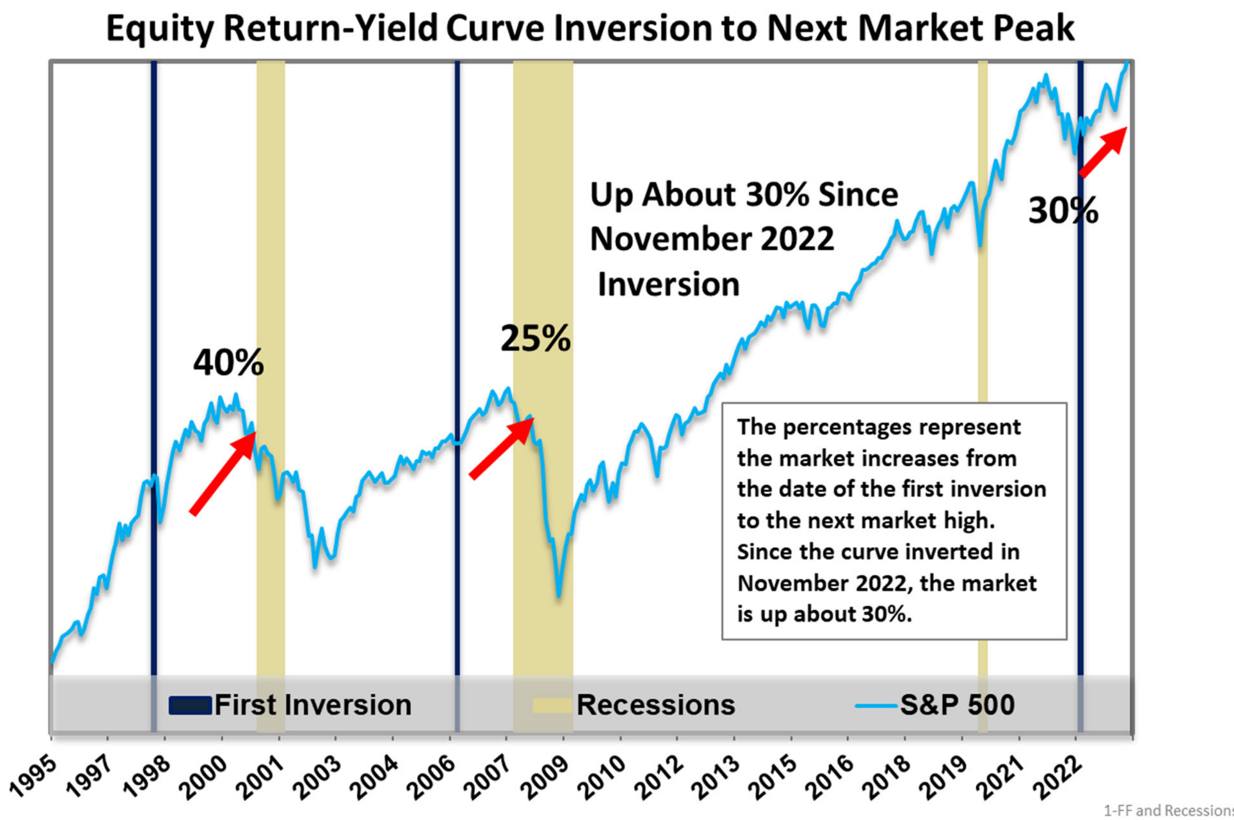
The inflation rate has fallen from 9.1% in June 2022 (see exhibit above). While this is good news, consumers are still feeling the impact of the absolute price increases over the last three years. Recent increases in the price of oil are concerning because oil prices have a high and quick correlation to inflation (see exhibit below).



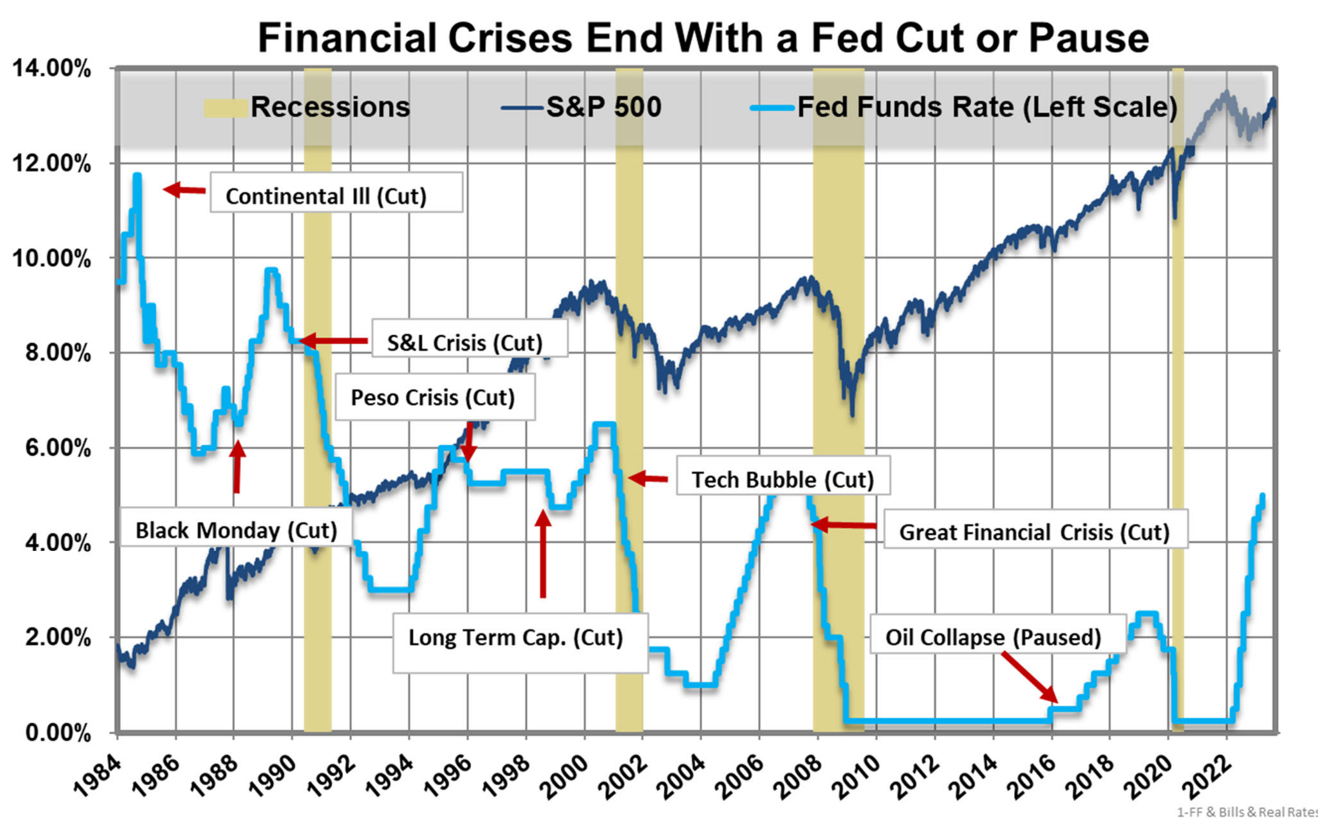


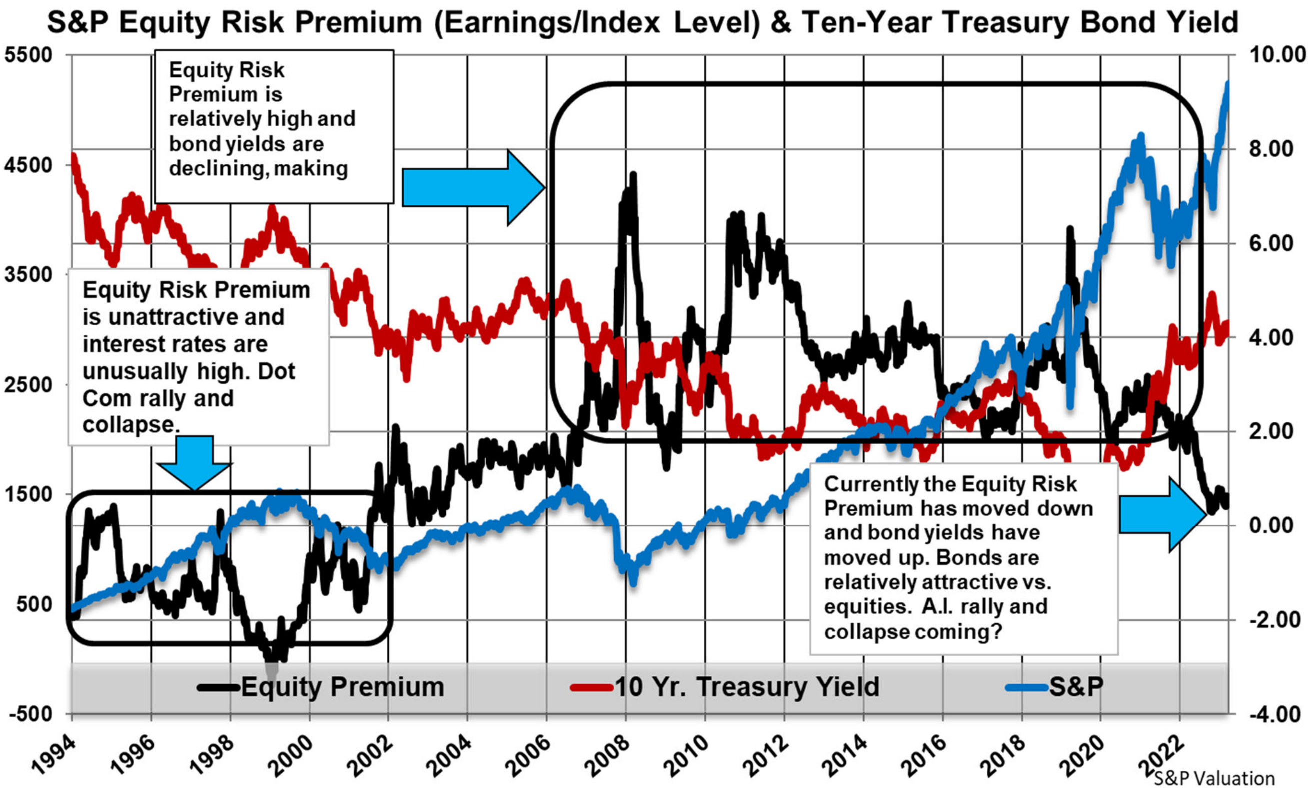
While inflationary federal outlays in this election year may postpone a recession for a while, history strongly suggests, based on data going back to 1970, that a recession is on the horizon, potentially later this year (see exhibits above and below).





The stock market has been a powerhouse since the November 2022 yield curve inversion. The economy remains robust (2.14% estimated GDP this quarter, latest unemployment claims were only 210,000) and our analysis suggests there is potential for further growth. It is important to note, however, that the current 30% price increase (see exhibit above) is comparable to previous rises just before a pause. While a financial crisis is not our base case scenario, historically, many Fed tightening cycles have ended with one (see exhibit below).



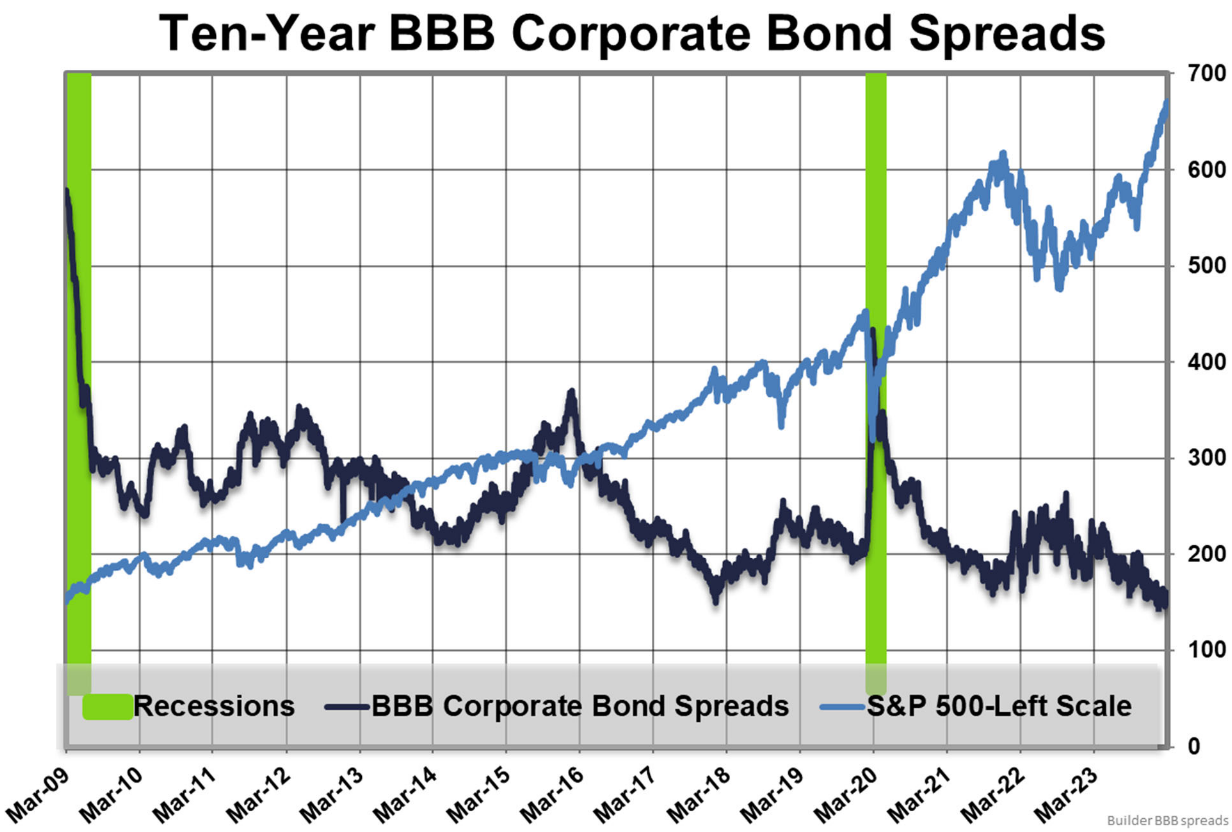


Equities are a riskier asset class than Treasury bonds and highly-rated corporate or municipal debt. One way to calculate whether the extra return and associated risk of owning stocks is worth it, compared to the guaranteed return high-quality bonds offer, is to calculate the equity risk premium. We can do this by using our projected 2024 earnings estimate for the S&P 500, $250, divided by the current index level of about 5,225, resulting in an equity risk premium of approximately 0.5%. Historically, equities have performed relatively well when that risk premium is 2.0% or higher. Currently, the risk-reward analysis for owning stocks or bonds is moving towards favoring bonds (see exhibit above).

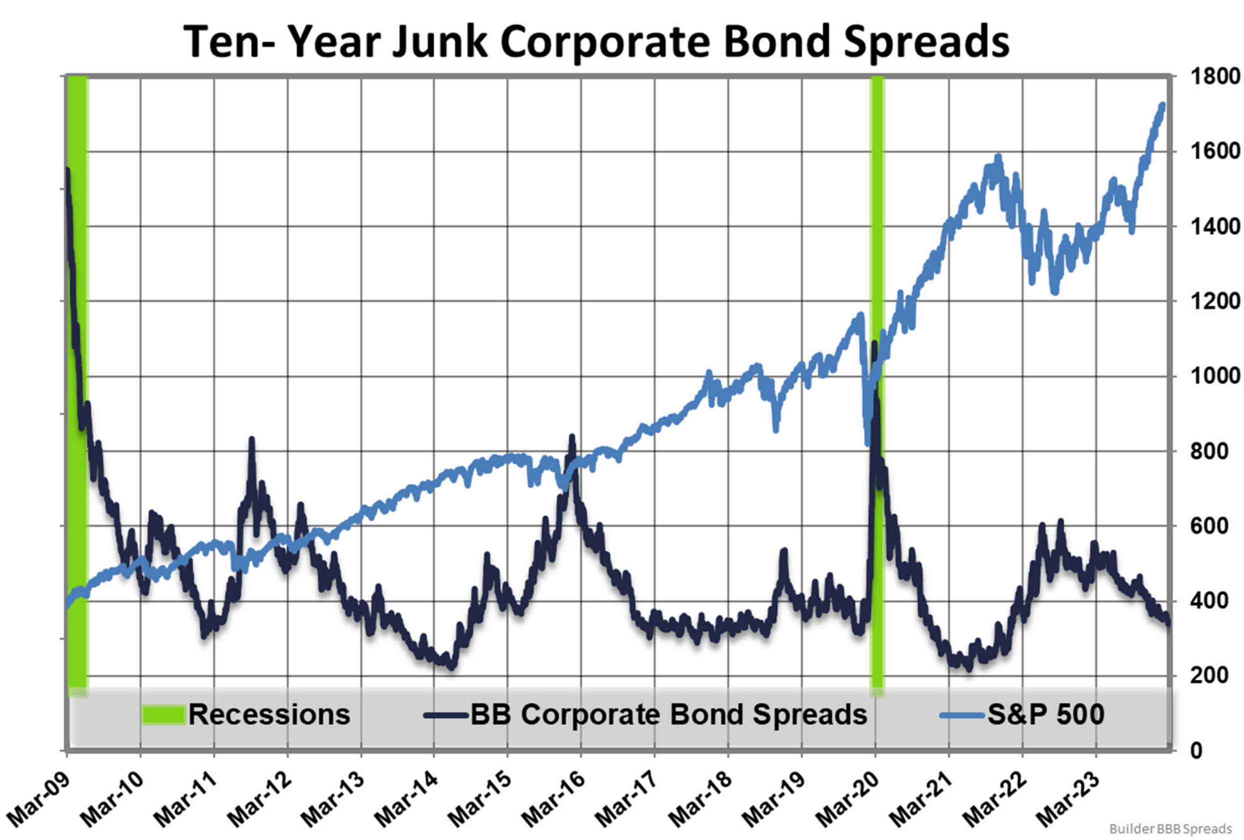
Another way to assess the attractiveness of stocks is to compare the projected price-to-earnings ratio (P/E ratio) of the stock market versus historical peaks (see exhibit below). We note that the forward P/E ratio is approaching historical peaks but has not reached them yet. The market is not necessarily in bubble territory compared to those past market peaks. The economy is strong (unemployment rate of just 3.9%!) and it is an election year, and the government continues to implement expansionary fiscal policies, which may well support further increases in stock prices and other risk assets.

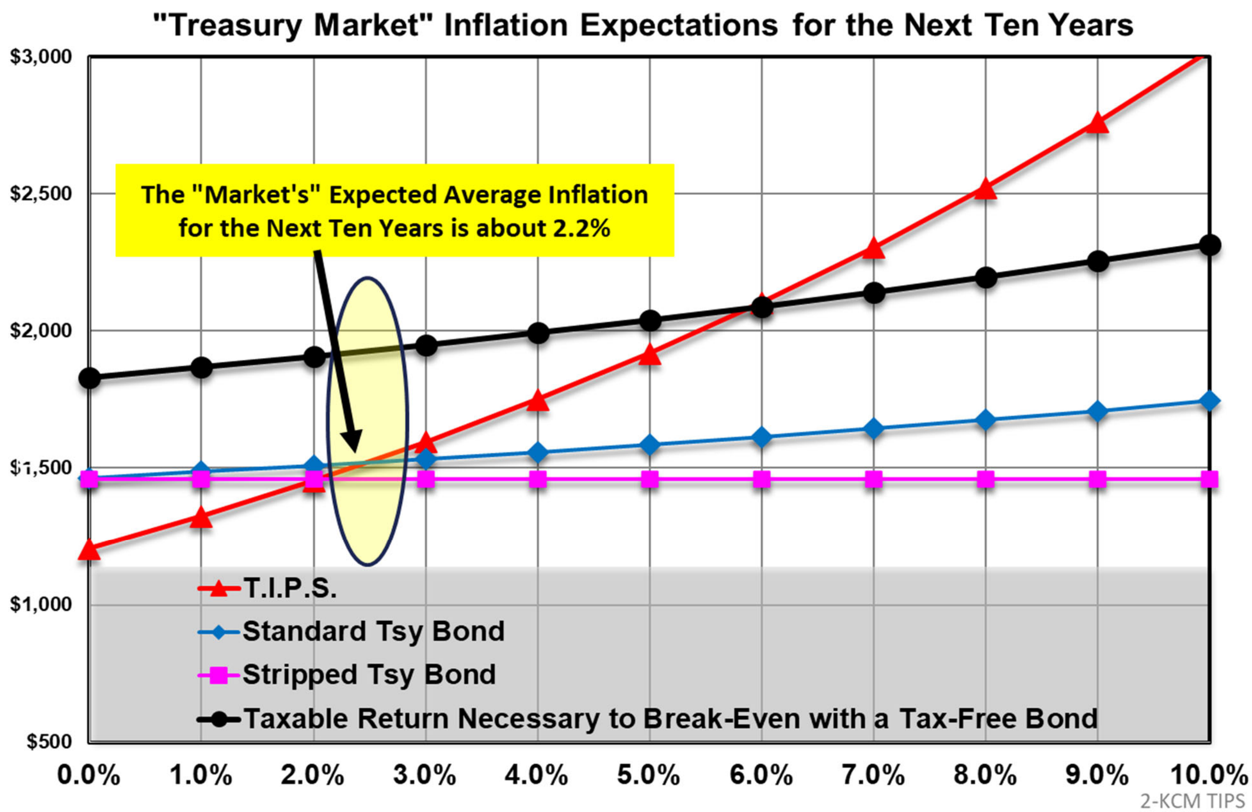
	Peak 3/31/2000	**Bottom 3/31/2003**	**Peak 9/28/2007**	**Bottom 3/31/2009**	**Peak 12/31/2021**	**EST. 2024 3/31/2024**
S&P 500 Forward PE Ratio	28.80	15.16	16.54	11.72	25.78	**20.81**
Dividend Yield	1.10	1.88	1.82	3.59	1.27	**1.53**
Fed Funds	**6.00**	**1.25**	**4.75**	**0.25**	**0.25**	**5.50**
3 Month T-Bill Yield	5.87	1.11	3.80	0.20	0.03	**5.27**
Ten Year Treasury Bond Yield	6.00	3.80	4.59	2.66	1.51	**4.23**
Consumer Price Index YC	**3.80**	**3.00**	**2.80**	**-0.40**	**7.00**	**3.20**

Stocks ultimately trade on earnings. With a P/E ratio of 21X on the 2024 earnings estimate of $250, the market is not necessarily in bubble territory compared to past market peaks of 29x in 2000 and 26x in 2021.

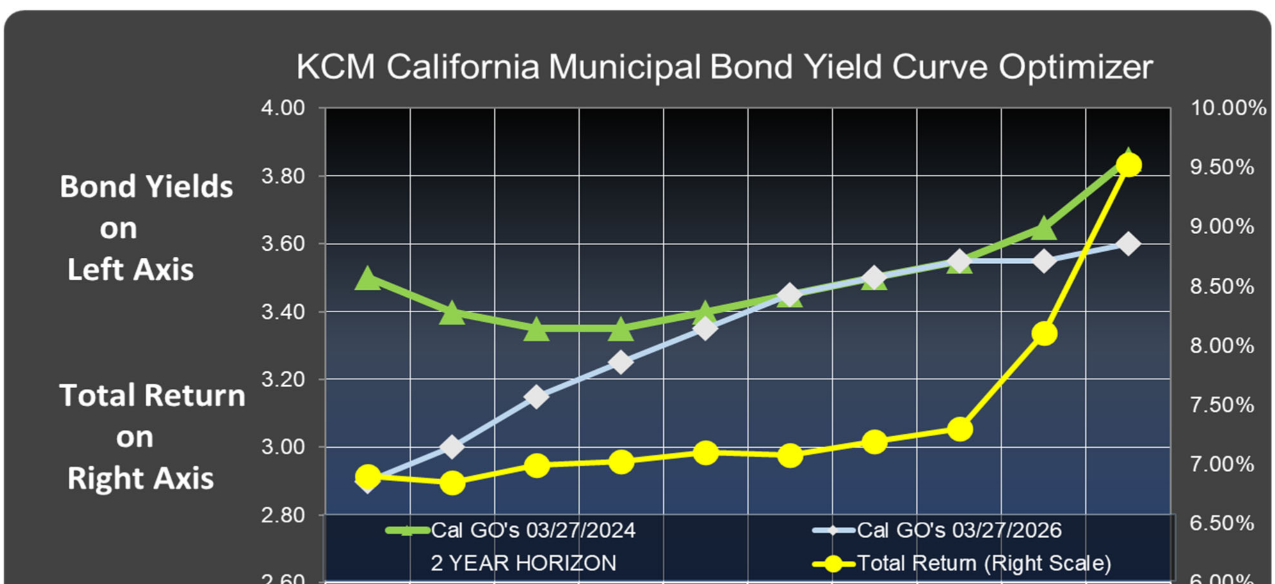


With the investment risk/reward tilting towards bonds, the question becomes which ones are attractive? Right now investment-grade corporate bond spreads and junk bond spreads are near historical tight spreads compared to Treasuries (see exhibits above and below). These spreads will likely widen significantly during any economic slowdown. Therefore, this is not the time to take on credit risk. Our advice is to stick to Treasury bonds and highly-rated corporate and municipal debt.





The market expects about 2.20% annual inflation for the next 10 years (see exhibit above). Ten-year Treasury bonds yield about 4.2%, or about 2.52% after-tax, if you are in the highest tax bracket. Municipal bonds with a 10-year call currently yield 3.85% (see exhibit below), offering investors an attractive after-tax return of about 1.65% above expected inflation.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 03/27/2024	3.50	3.40	3.35	3.35	3.40	3.45	3.50	3.55	3.65	3.85
Cal GO's 03/27/2026	2.90	3.00	3.15	3.25	3.35	3.45	3.50	3.55	3.55	3.60
2 YEAR HORIZON										
Total Return (Right Scale)	6.9%	6.8%	7.0%	7.0%	7.1%	7.1%	7.2%	7.3%	8.1%	9.5%

5 - California Muni

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Equity valuations are historically stretched, bond yields have moved up and are relatively attractive compared to stocks. We advise investors to add correctly-priced, carefully-selected Bonds to their portfolios.

Bonds offer a certain return. Bonds are typically less volatile than stocks and can provide a guaranteed return as well as a steady stream of income. But it is vital to choose bonds that match your investment goals and risk tolerance.

- **Treasury bonds**, issued by the U.S. Government, are the highest-quality and most liquid bonds. You do not pay state tax on Treasury bonds, so their after-tax return often exceeds illiquid bank Certificates of Deposit.
- **Corporate bonds,** issued by companies, can offer a higher yield than Treasury bonds, but they carry more risk. They are also subject to federal and state income tax. Still, they may be a good option for investors in tax-free accounts, such as IRAs and 401(k)s.
- **Municipal bonds,** issued by state and local governments, are exempt from federal and state income tax. For investors in high tax brackets, especially those living in high-tax states, municipal bonds can offer the best after-tax return.

Wrapping up:

The Fed continues to confront inflation by raising interest rates and reducing the amount of money in circulation. Our government's ever-expanding borrowing injects new money into the economy, which places the Fed in a position that reminds us of Sisyphus, endlessly pushing the rock up the hill: the Fed's efforts to reduce inflation are hampered, prolonging its goal of cutting interest rates. This may lead to a recession or even a financial crisis. The interest cost of the debt explosion in 2020-2021 was about 0.5%. The interest cost to refinance that debt and new borrowings is now about 4.5%. As the cost of debt rises, so must Nominal GDP (inflation-adjusted, total economic output), or household income. Nominal GDP growth has not caught up to the growth of our debt, and the gap is widening.

Excessive household debt strains budgets as more income is used for debt payments, leaving less money available for spending on essentials like food, housing, education, and healthcare. Excessive government debt also strains budgets as more income is used for debt payments, reducing the amount of money left for spending on essentials like infrastructure, defense, education, healthcare, and Social Security.

Excessive debt has other effects as well. It erodes confidence and trust in an individual, a corporation, or a nation. Excessive debt also affects the broader markets by reducing asset prices.

Households or governments that want to ensure long-term financial stability and confidence need to strike a prudent balance between productive borrowing (borrowing that leads to growth) and non-productive excessive debt (which results in interest payments without corresponding growth).

The Fed continues to wrangle with inflation by raising interest rates and reducing the amount of money in circulation. Our government's ever-expanding borrowing injects new money into the economy which fights the Fed's inflation-reducing efforts. In turn, this prolongs the Fed's goal of cutting interest rates, which may lead to slower economic growth, a recession or even a financial crisis like we have seen during past Fed tightening cycles..

The Growth Rate of Inflation Continues to Slow

The growth rate of inflation has slowed from 9.1% in June 2022 to about 3.2%. While this is good news, consumers continue to focus on the impact of the sticky price increases over the last three years. Recent increases in the price of oil are worrisome because oil prices have a high and quick correlation to inflation.

History, Going Back to 1970, Strongly Suggests that a Recession Looms
Massive federal outlays may postpone a recession, stimulating the economy by boosting demand for goods and services. These outlays can enhance economic growth, trim unemployment, and lift wages and stock prices. But they can also lead to higher inflation and interest rates, as government spending fights the Federal Reserve's efforts to reduce inflation by hiking interest rates and taking money out of the system. This could force the Fed to raise interest rates and pare the size of its balance sheet more than it might like.

Ultimately, whether federal outlays can postpone a likely recession is a matter of debate. There is no guarantee that they will be successful, although they may be able to delay a recession for some time, perhaps until after the 2024 election. Also, do not forget that over-the-top federal outlays incur risk.

Is The Current Bull Market Due for a Pause?

The stock market has performed strongly since the November 2022 yield curve inversion. The economy remains robust (2.14% estimated GDP this quarter: latest unemployment claims were only 210,000), and our analysis suggests there could be potential for further growth. It is important to note, however, that the current 30% price increase is comparable to previous gains of 40% and 20% just before a pause. While a financial crisis is not our base case scenario, historically, many Fed tightening cycles have ended with one.

Are Stocks Still Attractively Priced?

Equities are a riskier asset class than Treasury bonds and highly-rated corporate or municipal debt. One way to calculate whether the extra return and associated risk of owning stocks is worth it, versus the guaranteed return high-quality bonds offer, is to calculate the equity risk premium. We can do this by using our projected 2024 earnings estimate for the S&P 500, $250, divided by the current index level of about 5,250, resulting in an Equity Risk Premium of approximately 0.5%. Historically, equities have performed relatively well when that risk premium is 2.0% or higher. Currently, the risk-reward analysis for owning stocks or bonds is moving towards favoring bonds.

Another way to assess the attractiveness of stocks is to compare the projected price-to-earnings (P/E) ratio of the stock market versus historical peaks. We note that the forward estimated P/E ratio is about 21X for 2024, approaching historical peaks of 26X and 29X but not there yet. The market is not necessarily in bubble territory compared to those past market peaks. The economy is vigorous (the unemployment rate is just 3.9%!) and it is an election year. Moreover, the government continues to implement expansionary fiscal policies, which may well support further increases in stock prices and other risk assets.

The Stocks to Bonds Risk/Reward is Tilting Towards Bonds

With the investment risk/reward tilting towards bonds, the question becomes: which ones are attractive? Investment-grade corporate bond spreads and junk bond spreads are currently near historical tight spreads compared to Treasuries. These spreads will likely widen significantly during an economic slowdown. Therefore, this is not the time to take on credit risk. Our advice is to stick to Treasury bonds and highly-rated corporate and municipal debt.

The market expects about 2.20% annual inflation for the next 10 years. Ten-year Treasury bonds yield about 4.2%, or about 2.52% after-tax, if you are in the highest tax bracket. Municipal bonds with a 10-year call currently yield 3.85%, offering investors an attractive after-tax return of about 1.65% above expected inflation.

2024 Is a Transition Year

The Fed is transitioning from two years of aggressively raising interest rates and reducing the size of its balance sheet to potentially cutting interest rates and stabilizing the size of its balance sheet without causing a financial crisis or recession. **Rate cuts and a stable balance sheet should be positive for stock prices.**

With 2024 being a Presidential election year, another layer of uncertainty is added. Political rhetoric and policy proposals can influence investor sentiment and market movements. The unpredictable nature of these conflicts adds to the uncertainty.

…And Being Flexible Is Key

As a possibly volatile 2024 unfolds, we need to observe, evaluate, adapt, and adjust to changing conditions in order to prosper. The economic outlook is not black and white. While the current situation presents both challenges and opportunities, staying informed and adapting our strategies can help us navigate the uncertainties and potentially thrive in the always-evolving and uncertain economic landscape.

As always, we are glad to meet with you to address your questions or concerns, and we thank you for investing with KCM. It is our constant goal to exceed your expectations.

Jay Kellett - Founder and CEO

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- All graphs were produced by KCM using data from Bloomberg. Bloomberg is also the source of the stated economic data.