BESPOKE BRIEFING

REICH FITZPATRICK PRIVATE WEALTH
GROUP OF WELLS FARGO ADVISORS

"A First Time for Everything"

"Everyone is entitled to his own opinion, but not his own facts."

-Senator Daniel Patrick Moynihan

At the conclusion of our February Edition of “Bespoke Briefing” I promised to “share more on why I find myself resisting the ‘No Landing” scenario.“ Wishing to follow as closely as possible Senator Moynihan’s admonishment to favor facts over opinions, whenever possible, I decided to defer this topic until April, after the First Quarter’s economic indicators had been released.

In an effort to be clear, I am also inclined to share with you what Henry Kaufman, renowned Wall Street economist, referred to as one’s “autobiographical screen.” Kaufman discusses the concept of "autobiographical screens" in the introduction to his book *Interest Rates, the Markets, and the New Financial World*. He explains how personal experiences and backgrounds can shape an individual's perspective and influence their professional outlook and decisions, particularly in the context of economic analysis and financial forecasting. In other words, individuals might interpret data through the lens of their own experiences, potentially biasing their conclusions and recommendations.

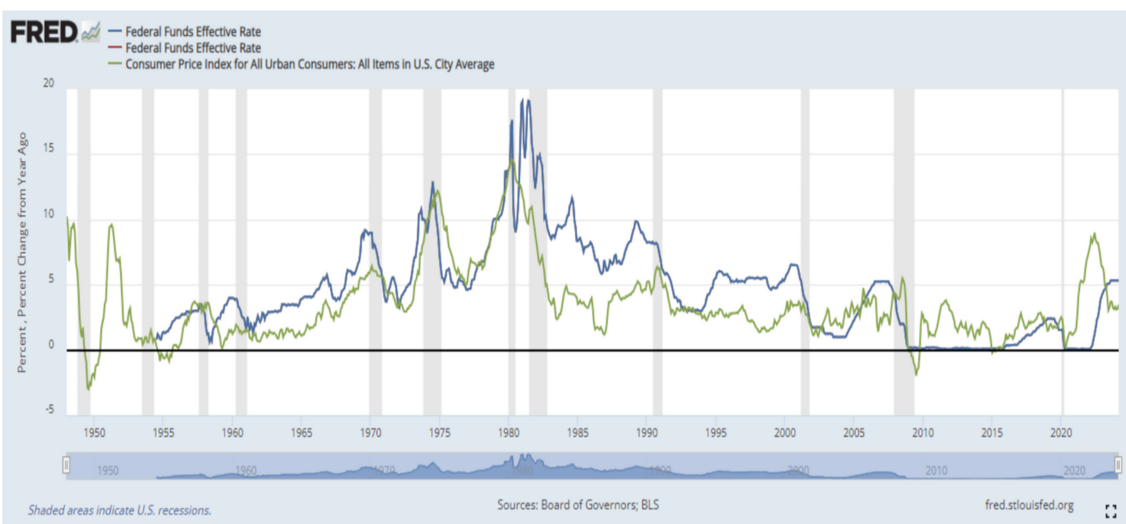
My “autobiographical screen” includes having come of age and entered the financial markets during the early 1980s, just at the tail end of a period known as the “Great Inflation.” During this period, very high inflation was combined with high unemployment, creating a miserable cocktail known as “stagflation.” When I began my first full time job in the industry, the US 10-Year Treasury Note hovered near 15.84%. So, it is fair to say, that like Kaufman, I am especially wary of inflation.

"Those who cannot remember the past are condemned to repeat it."

– George Santayana, in his work [The Life of Reason: Reason in Common Sense](), published in 1905.

No Federal Reserve Chairman wants to be the next Arthur F. Burns, who preceded Paul Volcker as Chairman of the Fed, serving from 1970 to 1978. Burns' policies and the Fed's actions during his chairmanship are frequently criticized for failing to effectively combat inflation, which led to the economic difficulties of the 1970's.

The chart below illustrates the historical levels that inflation reached during Burns' leadership at the Fed, and the impact this had on interest rates. The chart also reflects the extreme actions Volcker had to take to finally bring inflation back under control.



"History does not always repeat itself, but it often rhymes."

-Attributed to Mark Twain

In the current environment, what makes the chart so concerning is not the extremes of the moves in inflation and interest rates, but rather the path they followed. We are focused on these key observations:

1. Inflation persisted for an extended period of time, first breaking out above "trendline" in 1970 and remaining well above those levels until the early 1980s.

2. The economy slipped into recession in December of 1969, which persisted until November of 1970. The Fed declared victory far too soon and aggressively lowered rates.

Inflation re-ignited, exacerbated by the “Arab Oil Embargo of 1973”, and inflation increased dramatically above it’s previous levels.

3. Each time since 1955, when the Fed materially raised Fed Funds Rates, the economy slipped into recession, depicted on this chart as the vertical gray bars.

These are the factors that make the “no landing” scenario so difficult for me to embrace. But I have always found it useful to be skeptical of my own opinions and where possible subject them to the evaluation of people more knowledgeable than me in such matters.

> ***“If I have seen further, it is by standing on the shoulders of Giants."***
>
> ***–Sir Isaac Newton***

Darrell L. Cronk, President, Wells Fargo Investment Institute (WDII) Chief Investment Officer, Wealth and Investment Management

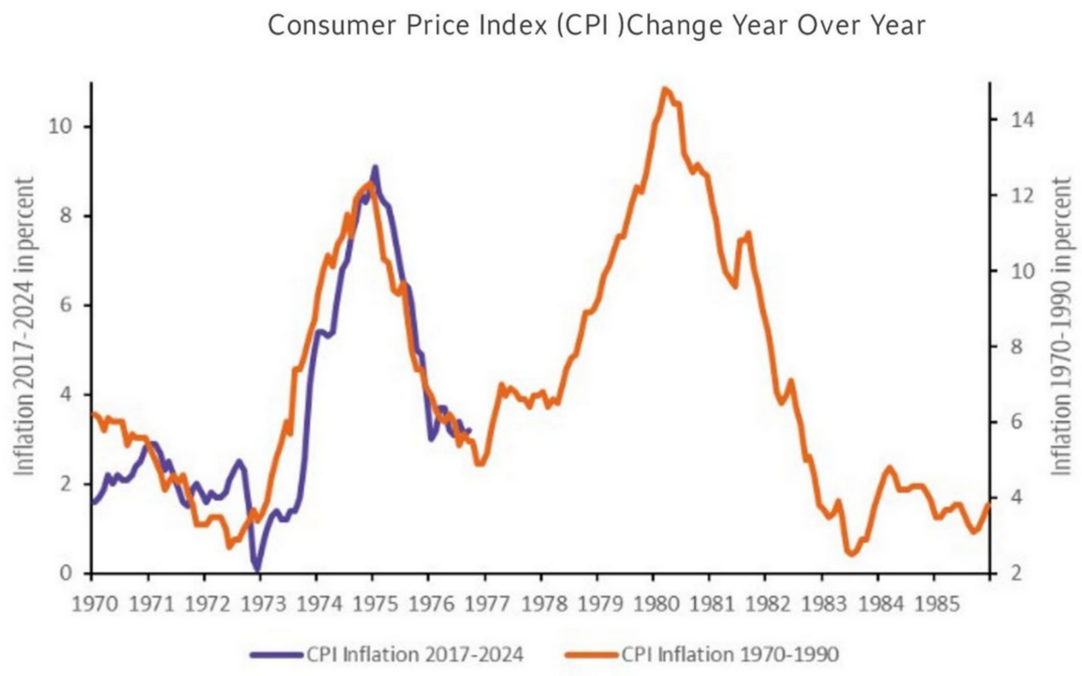
I had an opportunity to discuss my reservations regarding the “no landing” scenario, as well as concerns about the “stickiness of inflation,” with WFII President Darrell Cronk. who often shares his perspective across platforms like Bloomberg and CNBC.

I began our conversation outlining my concerns that the market is overly “bullish” with regard to how quickly inflation will be brought under control, and how aggressively this may allow the Fed to react by cutting interest rates.

I specifically asked Darrell if our view regarding inflation and interest rates remaining “higher for longer” differed materially from his own or WFII’s.

He replied, “It doesn’t sound like it specifically. Inflation is sticky and if history is any guide, extremely difficult to extinguish once ignited.” Attached below is a chart he uses to show two points about inflation and this latest regime versus the 1970’s/80’s.

Durable Inflation History: What if the inflation can kicks back?
Inflation has the potential to rebound until the Federal Reserves' (Fed's) job is finally done.



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data as of 02/29/2024. CPI = Consumer Price Index. See Index definitions at the end of this report. 2

Darrell continued, “First, inflation historically has come in waves. We believe we are at/close to the end to the first wave, but there is risk that inflation may rise again over time and not just calmly come back to the Fed’s preferred 2.0-2.5% stated goal and stay there. Simply put, inflation has a historical tendency to rise quickly, fall quickly, consolidate for a period of time and then re-rise. The second point is how closely it is tracking to the late 1970’s/early 1980’s path at least through similar time regimes. We do expect inflation to rise back anywhere close to the July 2022 prior levels of 9.1%, but it may experience renewed upward pressure from a number of key points.

- Latest Average Hourly Earnings (AHE) in jobs report show 4.1% YOY increase, a proxy for wage growth that is still too hot.
- Services inflation, different from goods inflation today, remains over 5.0% and is coming down very slowly.
- Commodity prices continue to rise putting upward pressure on inflation heading into the summer namely with $85/$90 oil on the latest geopolitical issues.”

“I think it is realistic that inflation may settle stubbornly in the 2.5-3.5% level, above FOMC targets with short-term bouts where it could push temporarily back closer to 4%.”

Next, I asked Darrell how he and WFII “handicap” the possibility of the “no landing” scenario?

“I think the base case is that we fall somewhere between a soft-landing and a no- landing. Unless something breaks, which admittedly we are vulnerable to have happen at this juncture of the cycle, I give a side nod to the no-landing scenario if forced to choose. Simply put, a no-landing means above-trend growth with above-trend inflation (at least to FOMC targets) and that appears to be closer to where we are currently.

- For example, Q4 23’ US GDP growth finished at 3.4%, certainly above-trend expectations as consumer spending remains strong, labor markets are tight, and corporate earnings appear to be inflecting. It looks like Q1 24’ US GDP should finish in the 2.2-2.3% growth range with some data yet to be reported to finish out these numbers, which would be closer to “trend-growth” and a slight lean toward a soft-landing scenario. Very possible this year to us looks like 2-3% US GDP growth with 2.5-3.5% inflation which would be ok barring any exogenous shocks.
- I think the real key here is watching where interest rates settle. Last Fall when everyone on the street was putting out their annual outlooks, they all had a three in front of the YE 24’ 10-year US Treasury target. We found ourselves as a lone outlier with our YE 24’ target at 4.5% as we could not make the math work on term premiums, growth premiums and inflation premiums to get to a three something.

We wondered what we may be missing at the time, but at least through mid-April the market has come to us rather than us having to go toward the consensus. There is still a lot of 2024 yet to be played out, so ultimately, we will see what the right answer is, but if you believe inflation will remain sticky, then you must believe interest rates may be higher for longer.
- Watch real rates here. If they tick up to the 2.5-3.0%, that has historically been a level that puts extreme pressure on the economy. It could end up that a no-landing near-term only equates to an eventual hard landing longer term as excesses remain/build."

I closed my conversation with Darrell by asking a compelling question that the credit team Oaktree continues to talk about. Everyone wants to engage in the parlor game of guessing "when will the Fed move and by how much?" But Oaktree feels the important question is "why will the Fed move?" They are not in the business of supporting markets, but of maintaining inflation at their target and managing a stable labor market. Oaktree's position is we remain 50%+ over the Fed's own inflationary target and employment is stable, to say the least, so why cut?

Darrell said "I actually agree with Howard [Howard Marks, Chairman of Oaktree] if this is where he is at, although admittedly, I have not followed his comments recently. Two salient points here.

- First, what is underappreciated by markets is Fiscal may matter more today than Monetary policy. I agree everyone wants to play the Fed parlor game, and most are horrifically bad at it, including the bond market. Recall in first quarter of 2023, the Fed Funds Futures were pricing in 3 rates cuts for the back half of 2023. That did not happen. Then at the turn of this year Fed Fund Futures were pricing in 6-7 cuts for 2024. That isn't going to happen. You get the point. Fiscal spending, and its oscillation of periods of liquidity infusion and removal, has been much more closely tied to risk asset performance, or not, than anything to do with monetary policy full stop.
- Second, the comment I have been saying for some time regarding rates cuts, which sounds similar to Howard's point, is that if 5.25-5.50% slows nothing (economic growth, earnings growth, labor market, consumer spending etc.) then why cut? If the premise of monetary policy tightening to pull liquidity out of the economic engine and ultimately slow growth to bring inflation or excesses down to reasonable/target levels, it does not appear that the current neutral rate(R*) is 5.25-5.50%, but rather could be higher. If that is the case, it is a difficult case to make today based upon data and current conditions to cut interest rates when they haven't slowed growth nor brought inflation down to target. The only semi-legitimate case to make is the time lag effect and attempting to get in front of what will be an eventual slowdown, but that is both risky and like shooting into the dark. It is, as you aptly point out, the mistake the FOMC made in 1975, and should not be made again in my humble opinion."

In this edition of "Bespoke Briefings," we have navigated through a landscape dense with statistical data and technical analysis, understanding that a thorough assessment of our economic assumptions is imperative at this juncture. Guided by insights like Darrell's, we continue to hold that interest rates and inflation will remain elevated for an extended period, potentially leading to a "no landing" scenario. Consequently, our investment strategies are meticulously crafted around these projections.

Looking ahead, in future editions we will transition from theoretical discourse to addressing the practical implications of our forecasts—exploring the "so what of it all." We will explore how we as investors can adapt to benefit amidst high inflation, and protect our spending power?

Join us in upcoming issues for these pivotal discussions, where we bridge theory with actionable insights. Stay tuned!

Thanks, Rob

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