FCI ADVISORS

PERSPECTIVES

Third Quarter 2023

Consider Other Viewpoints

By Bill Koehler, CFA, President and CEO

"It is the mark of an educated mind to be able to entertain a thought without accepting it."

This is a quote attributed to the Ancient Greek philosopher Aristotle. He advocated having a mind open enough (gained through education and training) to consider an idea first, before making a judgment on it. With such a viewpoint, it's not hard to imagine Aristotle being an accomplished investment management professional were he in today's world.

Too often, human beings make the mistake of prejudging an idea as true or false before even considering it. We tend to anchor our thinking to past decisions or prior thought patterns and summarily dismiss competing points of view that may actually improve our decision making, if thoughtfully considered.

We, at FCI, believe in Aristotle's philosophy. Not only do we believe in it, we have endeavored to make it a bedrock principle of our firm. We feel our ability to think in this way has been a hallmark of FCI's success for our clients over the past nearly 57 years.

In that spirit, we attempt to consider many viewpoints when formulating investment policies. One example of outside thinking we evaluate is the July 1 issue of *Kort Sessions,* which is a blog (https://kortsessions.com/) authored by Bill Kort. Bill, whom I first met in 1984, is a thoughtful, respected investment professional who has been active in the capital markets for over 50 years.

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In this issue, he brings up an idea few are considering – that the level of interest rates may well be **less** important than most market participants believe in terms of impacting this year's stock market returns. Bill makes the case, with the help of economist Scott Grannis, that while the Fed has indeed raised rates, they have maintained healthy liquidity in the system by keeping their ownership of treasury securities near an all-time high. This liquidity has been one of the drivers of this year's surprisingly strong stock market. As Bill says, the Fed has **not** taken the punchbowl away and that liquidity could continue to be important fuel which buoys equity markets.

Jerome: Tough Talk on Inflation without Persuasive Evidence
Bill Kort | July 1, 2023

— Powell talks tough on the inflation fight two weeks in a row without persuasive evidence that the Fed needs to do more.

— Threatening rate increases or actually implementing them does not mean the Fed is removing the liquidity punchbowl.

— The market seems to be chomping at the bit to begin the next stage of the secular bull market that began in April 2013.

Since May of last year the annualized, adjusted Consumer Price Index (CPI) growth for the United States was 4%. This compares to over 9% for the 12 month period ending June 2022. When the numbers are reported for June 2023, the trailing-12-month CPI is likely to drop well below 4% because the June number for 2022 (+1.2%) will be removed from the calculation and June 2023 will be added. The *biggest increase in CPI we've seen in the past 11 months is .5%. If that were to be the number, we would be looking at a trailing-12-month number of only 3.3%. This would represent significant progress over the past year and a policy success, considering the sharp rate increases implemented by the Fed over the past 16 months and the still very healthy economy.*

June 2023 CPI numbers (to be released July 12) versus June 2022 (an easy comparison is coming) plus the Fed's "full-employment" mandate should make it difficult for Chairman Powell to defend his hawkish position.

Threatened or Actual Rate Increases do not Mean the Liquidity Punchbowl has been Withdrawn

We don't hear much about Quantitative Easing (QE – expanding the Fed's balance sheet) or Quantitative Tightening (QT — Shrinking the Fed's balance sheet) these days. QT plus rate increases were supposed to be the double-edged sword that the Fed would use to tank the economy to get inflation under control. The reason you don't hear much about QT is that they haven't really done much of it since the Fed balance sheet peaked in May 2022 at near $9 trillion. As of June 14, 2023 it stood at $8.4 trillion vs. $4 trillion just before the pandemic. When the Fed bought all those government and mortgage-backed securities they injected a huge amount of liquidity into the economy. Despite the hawkish rhetoric, very little of that liquidity has been pulled back in … $600 million versus a nearly $5 trillion infusion during the pandemic.

According to economist Scott Grannis, M2 money supply "is still about $2.6 trillion above where it might have been in the absence of the Covid crisis." He argues that "this 'extra' amount of M2 (Cash in hand, checking accounts and savings accounts – not including CD's and money market funds) serves as a cushion against recession, because it means that the economy is still flush with cash and liquidity."

It would appear that the more important issue governing our economy and Fed policy is liquidity and not what the money cost. Thus while the average pundit and talking head bemoans the certain catastrophe that lies ahead arising from the recent rapid rise in rates, they have missed the fact that the Fed never took the liquidity punchbowl away.

The Market's Chomping at the Bit for New Highs

This may be disturbing Powell … a reason behind all the tough talk and bluster. He may be worried that an explosive equity market could re-exert upward pressure on prices in general. On the other hand Fed/monetary policy is not a game of perfect. There may be additional lagged effects of rate increases put in months ago. Who knows? We might even have a recession. Most importantly we may have already priced a recession into the market last October … a recession that has yet to materialize.

Sir John Templeton once said, "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." I've been monitoring this secular bull market since the spring of 2013. I would be hard pressed to show you any period in the last 10 years that could be confused with the "optimism" stage. As the market chomps at the bit, some naysayers are positing that they may have been early on their negative call. I say, no, they were right last October … they just forgot to turn positive. Someone once told me "you can never be too bullish in a bull market"!

What do you think about the possibility that we will have our cake and eat it too this time around?

By focusing on an issue most Wall Street research houses are not covering, Bill is drawing a different conclusion. He is concluding the vast majority of market participants may well be overlooking the Fed has actually not been that restrictive. He is positing inflation can continue to decline, as it likely will again on July 12, and short-term interest rates can stay elevated in the near term. This is what Bill calls "the cake." He also posits a recession can be avoided and stock prices can continue to advance. He calls this "eating the cake."

Will he be right? Nobody knows with certainty. However, we fervently believe by having a decision making process incorporating diverse views, we will have fewer errors in reasoning. In the investment management profession, reducing unforced errors is the pathway to investor success. By giving thoughtful consideration to alternative viewpoints such as Bill's, I believe we undoubtedly increase the odds of success for our clients – and I suspect Aristotle would approve of our efforts.

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