

Simplistic Thinking: Why so Many Have Been So Wrong!

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I consume a lot of financial news and commentary every day. For the most part, I feel like most “experts,” pundits, and “unbiased” TV personalities are hearing and seeing the same things I am, but in too many cases they are applying a filter of sorts that hinders their ability to analyze and communicate unbiased and useful opinions.

At the Federal Reserve’s September FOMC meeting the committee voted to lower the Federal Funds Rate by one half of one percent or as they call it, fifty basis points. Some experienced observers were espousing the merits and justification for a fifty-basis point cut ahead of time, but many public observers and commentators were vocal that the Federal Reserve should cut 25 basis points if they are going to cut at all. Many of these people do not think it is necessary to cut interest rates when the economy is growing over 2%, unemployment is under 5%, and the stock market is near record highs.

These same people (talking heads) are now in disbelief that the Federal Reserve cut rates by 50 basis points, and they point to the decision possibly being politically motivated or they contend that the Federal Reserve must see significant risk of recession ahead but are remaining silent. I am in disbelief that any unbiased and objective person who pays attention to the economy and monetary policy would not have made a 50 basis points at the September meeting their base case. But those panning the Federal Reserve’s action to cut 50 basis points are not at all unbiased and objective, they either have a financial interest or political interest in rates staying higher, the economy weakening, and the stock market selling off or they have a philosophical point of view that after many years of “cheap money” that we need to keep interest rates high to wring out the excesses created over the last 15 years. In other words, these espousing the view the excesses need wrong out of the system believe that most of the advanced economy world needs to suffer through severe economic consequences to cleanse the system. If you delve into the philosophy that we need to “pay the piper” to fix our cheap money and our high debt problem, you will find that most who espouse this idea have largely missed out on the equity and bond bull market that unfolded from 2009 to 2020, and they are invested outside of the stock and bond markets, and instead they espouse the virtues of either gold or if they are younger, cryptocurrencies.

I find that much of the misunderstanding of modern economics and financial markets has a lot to do with being unable or unwilling to unshackle oneself from viewing data through a prism of the past without adjusting or factoring in how today is different. As Mark Twain famously said, “history doesn’t repeat itself, but it often rhymes.” In economics and the markets, the same can be said. But it is important to remember that there are differing degrees of rhyming. Over the last 15 years our economy and markets have experienced several very significant unprecedented shocks and aftershocks that upended many conventions previously thought to be as close to iron clad as can be found in these realms. Off the top of my head, here are a few examples:

- Central Banks will never lower interest rates to zero or negative. This happened after the 2008-09 financial crisis here and in many other advanced economies.
- We would never see a time when a health crisis will be severe enough to warrant a state of emergency measures that restrict the freedom of movement and the closures of private sector businesses for an extended period. This happened beginning in March 2020 and persisting into early 2021.
- Global oil prices could never fall below \$0 per barrel. This happened early in the pandemic year of 2020.
- The Federal Reserve cannot significantly raise interest rates every meeting for over one year, leading to what is known as an inverted yield curve (when short-term interest rates are higher than long-term interest rates) and a drop in the consumer sentiment index level below 100 that persists for over 12 months without experiencing a recession. This happened! The University of Michigan Consumer Sentiment has been persistently below 100 since April of 2020 and the Federal Reserve hiked interest rates from 0.50% at the beginning of 2022 to 5.50% at the end of August 2024 and the U.S. economy, which narrowly escaped going into recession in 2022, has been growing above an annualized 2% Real GDP since the second quarter of 2023, with 2% being considered at or near the “potential growth” rate of the U.S. economy.
- The Federal Reserve does not cut interest rates until it sees imminent and material economic weakness. The Federal Reserve just cut interest rates by fifty basis points following four quarters of Real GDP growth which annualized 2.90%, 3.10%, 2.90%, and 3.10%, with the Atlanta Fed’s latest quarterly Real GDP NOW forecast for the third quarter of 2024 sitting just under 3%.

I contend that there is no meaningful historical analog for this time in history from an economic and market standpoint. Many will try to make a case that a particular circumstance or event happening today is akin to a period from a particular decade 40 or 50 years ago and they will mostly like end up looking foolish. Not only have economic/market conventions and correlations been broken or turned upside down, but the real-world economy does not look anything like it did 40 or 50 years ago and this is nothing new. For many people over the age of 50, the 1970’s and 1980’s do not seem that distant, but in reality the 1970’s and 80’s saw people flying between continents faster than the speed of sound on the Concorde, while most people who lived a similar 40 or 50 years earlier in the 1920’s and 1930’s had never set foot in an airplane and were just being introduced to indoor plumbing and the telephone.

So, the next time you see someone on TV or read something comparing the market or economy to the 1970’s or 80’s, remember how much time has actually passed since then and how the world we live in today barely resembles that time in many ways.

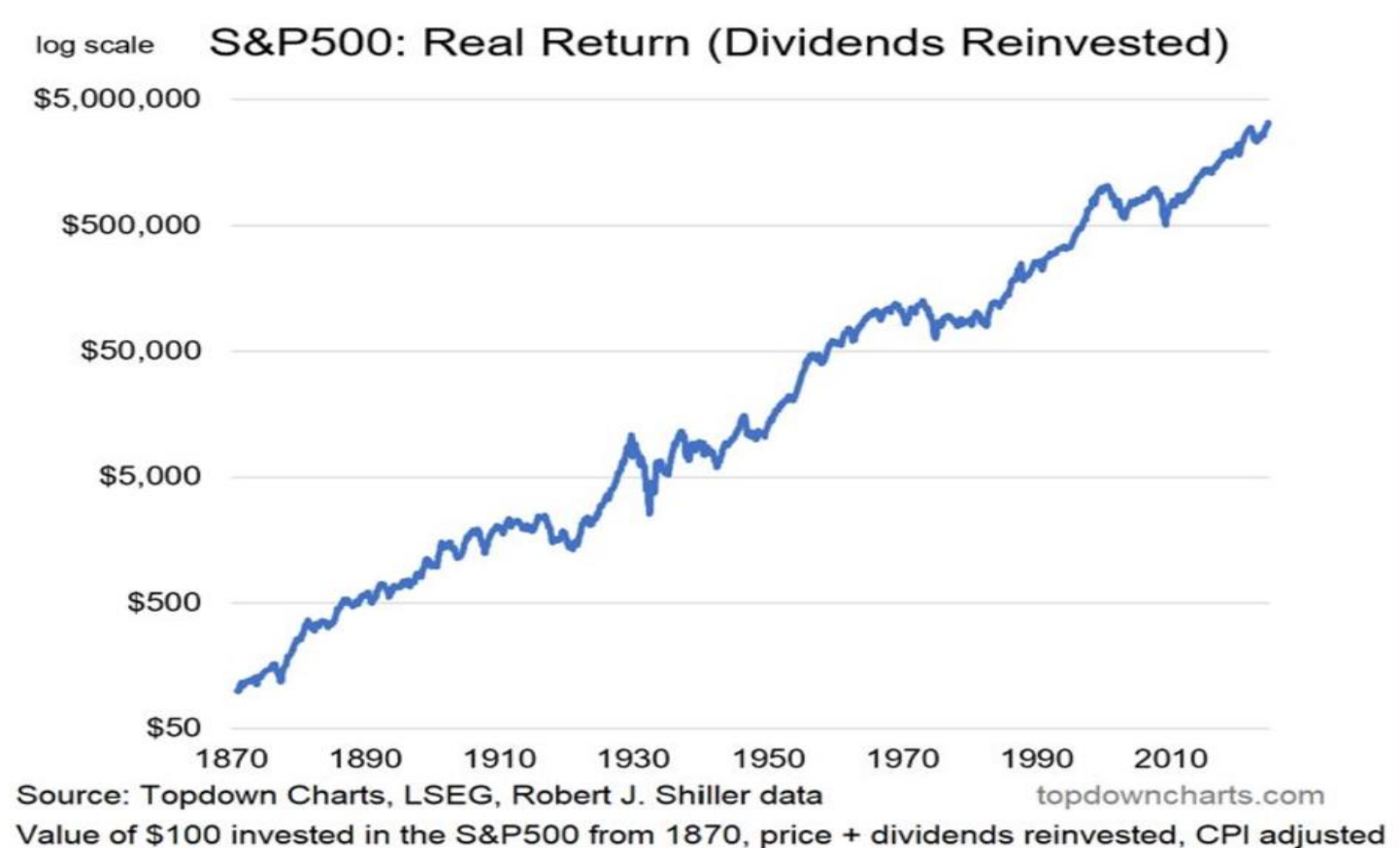
Because we consume so much economic/market data and opinion every day, we have gotten very adept at filtering out much of what only serves to confuse or mislead. We try hard to be objective and unbiased in how we interpret and analyze new information. Lastly, we are trained to look forward and not backwards when forming assumptions and forecasts. And on that note about looking forward and not backwards, I must commend Federal Reserve Chairman Powell for moving the Federal Reserve away from entirely real-time data dependency when it comes to setting policy and toward being more attune to trends and economic forecasting. Being real-time data dependent is what has caused prior Federal Reserve regimes to almost, with exception end up behind the curve of an economic downturn and therefore actually causing the economy to go into a recession. Waiting too long to loosen interest rates after pushing them up has been the legacy of the Federal Reserve over the last 30 years.

Chairman Powell, a non-academic, has gone a long way to modernizing the Federal Reserve and making it more intuitive and real-world conscious. We believe that the best expert to follow if you really want to get a feel for what

the economy is doing and how the Federal Reserve will likely respond is Claudia Sahm, former Federal Reserve Economist and former member of the White House Counsel of Economic Advisors. In a September 19th podcast, Claudia Sahm was interviewed by Charles Schwab Chief Investment Strategist, Liz Ann Sonders about the Fed's first rate cut of this cycle and its size. Claudia had previously stated in her own comments predicted that the Federal Reserve would cut rates by 50 bps, which was at the time a non-consensus opinion. In the Schwab interview, Claudia clearly stated that the Federal Reserve "does not need a Recession to cut rates." She said this, in my opinion, because investors and the public at large have been conditioned over the last 25 years that the Federal Reserve does not end a rate hiking cycle and begin cutting rates unless the economy is at risk of falling into a recession.

We have been writing in this commentary over the last two years that we were not seeing a risk of recession being heightened and that inflation would clearly be on its way to the Fed's general 2% inflation target by the second half of 2024. We actually have been writing over the last 12 months that the Federal Reserve should have gained enough confidence that inflation was under control and declining toward the 2% target by May or June of this year, but the Federal Reserve was more cautious than we anticipated, waiting until September to cut rates. We do see the choice to cut the Federal Funds Rate by 50 basis points instead of the customary 25 basis points as an admission that they should have initiated the cuts in June or July.

Hopefully, moving forward into 2025 we will not have to be overly focused on the Federal Reserve and instead spend more time discussing investment strategy and valuation topics. We are always working to keep our client focused on the long-term power of staying invested as equity investors. Almost everything that investors consumer each day in terms of market reporting and solicitations from many financial services companies is centered on the short-term action of markets and various transactional activities to "play" that short-term action. We believe and history validates that short-termism as an investor is a "fool's game," but long-term, patient, disciplined investing is both a powerful wealth creator and as a long-term investor the greatest risk lies in the investor's inability to stick with a plan. Equity markets are essentially a reflection of human ingenuity and the power of American capitalism. See the chart below which illustrates the power of being a long-term investor who avoids market timing and stays invested through good and bad market periods



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- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately \$4.3 billion, median capitalization of \$1.2 billion and market capitalization of the largest company of \$18.7 billion.