Animal Spirits
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-Gray Howard, Senior Portfolio Manager

Great minds throughout history believed most of life's answers were found in nature. Leonardo Da Vinci said, "Nature is the source of all true knowledge. She has her own logic, her own laws, she has no effect without cause nor invention without necessity" [1] Of course, the western world would have us believe the world is linear with exponential growth and we can change the world if we just put our minds to it![2]

However, many of the great sages before us would say otherwise, and that nature is the perfect illustration of how everything is cyclical and perfectly, imperfect. Human nature and animal instincts have never changed and we continue to follow the same patterns over and over again.[3]

Since the summer of 2020, I've been writing about the parallels to the 1940s and how we've reached the end of the long term debt cycle. The 1940s were the only other time in the last 100 years that the US national debt had reached 125% of GPD (size of the overall economy). Historically, when a nation's debt is growing faster than its economy, it's very difficult to turn back the clock without some sort of debt default.[4] Given that the US is able to print their own currency, it's extremely unlikely that US would ever default on their debt obligations in nominal terms (before inflation). However, as we've seen over the past two years, the US dollar and other developed currencies will unlikely have the same purchasing power moving forward. Therefore, developed nations are slowly defaulting on their debts in real terms (net of inflation) at the expense its citizens and bondholders.[5]

And this is the beating heart of the matter. Whether it's inflation, higher interest rates, external threats like Russia and China, wealth inequality, political division, or the ongoing tug-of-war between big government and private enterprise, it's all inextricably linked to the natural progression of the long term debt cycle. [4]

Neil Howe and William Strauss write about these recurring periods in their book, *The Fourth Turning*, which I highly recommend. Every 80 to 100 years, society enters a crisis period that breaks the existing, worn out system and gives birth to a new. While many continue to cling to the existing social order, like nature, history moves forward and not in reverse. Unfortunately, during these periods many of our institutions, alliances, treaties, and media are mistrusted and are often infected beyond repair. While this may seem unsettling, it's always darkest before light and just like the winter solstice, fourth turnings mark the necessary transition from death to renaissance. [6]

I continue to believe our current inflation was intentionally created by the Federal Reserve and fiscal authorities and designed to inflate as much of the debt away as possible; or until they hit a wall with unacceptable inflation or the dollar loses too much of its value. Clearly the former began to occur at the end of 2019 which is why we turned fairly cautious heading into 2022, thinking the fed would be forced to fight the fire they helped create.[7] I titled our 2022 outlook 'Sailing into the Wind,' but in hindsight, it was more like a thunderstorm. While 2022 was a tougher year than I had anticipated, we were fairly prepared and held our own relative to the overall market and most of our peers.

I wrote in December of 2021: *I feel the greatest risk investors face is the nagging and persistent increase in inflation and interest rates. But most importantly, how that will impact various asset classes and sectors; particularly fixed* *income and expensive growth stocks. In my assessment a great deal of investors are NOT at all positioned for this scenario considering it's human nature to follow ways of the past, versus what will likely work in the future.*

I feel many investors are now making the exact same mistake but in the opposite direction as many of the headwinds we faced in 2022 are starting to subside.[13]

Headline Inflation has come down for six straight months, commodities prices such as oil and natural gas began to roll over in June, the 10 year Treasury rate is off 22% from its high in October, and most importantly, the US dollar index has dropped around 11% since September. [8] While the Fed is sticking with their hawkish narrative for now, the bond market is signaling that they are almost done and will likely cut rates later this year.[8] For context, investors should remember the Fed's very poor "inflation is transitory" call in 2021.[9] While many believe the Fed is completely incompetent, I'm convinced they are just following the playbook from the 1940s but can't exactly be transparent about our massive debt problem and their methods to rectify it.[4]

The real question is whether the Fed has done enough damage to send us into a recession or can we skate by with just a soft landing? Time will tell, but it's fascinating how many people feel a recession is already a forgone conclusion. Bloomberg noted in December that Wall Street strategists are the most pessimistic they've been in 22 years.[10] According to the latest Conference Board Survey, a recession ranks as the number one concern for CEOs in 2023.[11] As for investors, Bank of America's latest poll shows investors are the most underweight US stocks since 2005. Not to mention the amount of retail money that was scarred out of the market when the S&P 500 was down 25% last year.[12]

I have come to realize that studying history and human behavior is one of the better tools in trying to forecast the future. Most of us were not around the last time the world went through a government debt restructuring of this nature. Therefore many tend to make comparisons to 2008 or other periods in recent history but I believe that is a mistake. In 2008, it was the private sector that was massively over-leveraged and most of the debt was restructured and transferred over to government balance sheets. Today is just opposite as it's the governments that are overleveraged and this debt is being transferred back to the private sector in the form of inflation and currency devaluation; a much slower and sneakier process with far different investment implications.[4]

So what does this mean for 2023?

If past is prelude, we will be dealing with this debt restructuring for quite some time, however, nothing in this business moves in a straight line.[4] I think we will continue to see this push-pull approach from policy makers with periods of hot inflation and periods of disinflation, but without any severe recession or credit collapse. [14]

I continue to believe the stock market bottomed last year and is now sniffing out a Fed pivot and perhaps a new easing cycle later this year. I do anticipate the economy will continue to slow and unemployment will tick up, but I feel most of this was priced into the market last year. Unfortunately there is always a disconnect between the financial markets and the real economy and it's human nature to distrust the cycle, especially coming out of a bear market.[15]

Very similar to how a herd of animals may be hesitant to enter an open field, it only takes a few brave souls to initiate the animal spirits before they're all off to the races again. Precisely why Sir. John Templeton said, "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." [16]

Whether we maintain awareness of our connection to the natural order of things or not, our unrelenting animal instincts will always be present. But if we take the time to understand the big picture, I think we will actually find comfort in where markets and society are going from here.

All the best,

Gray

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