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Healthy Correction

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-Gray Howard, Senior Portfolio Manager

Global markets have been under pressure, and it's now clear that we are in the midst of a market correction that tends to occur a couple of times a year.[1] Of course, healthy, normal pullbacks never feel healthy and normal at the time; only in hindsight.[2] The fact is, investor sentiment tends to swing from *the fear of missing out* to *the fear of losing everything* with very little time spent in the middle.

In just a few short weeks, the narrative went from the economy is doing fine, inflation is still above target, and the Fed may only cut interest rates one or two times this year - to now, we are heading for a nasty recession and the Fed must rapidly cut rates.[3] No doubt, we have seen some weaker economy data over the past week, including weaker manufacturing and housing data, along with a softer employment report. But we would need to see far greater deterioration in the data before one can say a recession is looming.[1]

The most likely scenario, in my view, is the economy is slowing, as the Fed had intended to get inflation down, but not slowing enough to cause a large contraction in credit or liquidity in the financial system.

As I mentioned in my June note, *Liquidity is what drives markets. It's the expansion and contraction of money or credit in the financial system via the Federal Reserve, bank lending or fiscal spending. In the old days, it was mainly the first two but now government spending has been the main driver of liquidity. Even with interest rates at these levels and the Fed doing quantitative tightening, liquidity in the system is more ample than before the Fed started raising rates. This is what the consensus missed last year as you have to go back to the 1940s to find a parallel with this much fiscal dominance in the financial system.*[4]

Nothing has changed on this front while the government is still running a budget deficit north of 5% and the Congressional Budget Office (CBO) is projecting that US budget deficits will steadily grow over the next ten years.[5]

As regular readers know, we've been discussing this global government debt problem since the summer of 2020 and the ramifications that follow, such as inflation, currency devaluation, wealth and income gaps, political chaos, and geopolitical threats.[6] But a large downturn in the economy is not part of the mix, in my judgement. For example, federal spending makes up about 24% of GDP or the overall economy and GDP growth is running around 2.8%.[5] If the US federal government were to magically balance their budget, GDP growth would turn decidedly negative, and the economy would be in a recession. But as long as the government continues to spend at these levels, it would be difficult for the economy to have a meaningful downturn, in my view.

It is a mistake in my opinion to use the last 40 years as an analogue for this economy's functions. We breached the Rubicon in 2008 with zero interest rates and quantitative easing, but the 6 trillion in fiscal spending during Covid19 sent us well over the edge of a sound monetary system.[7]

What does this mean for markets?

As mentioned, the narrative has swiftly shifted to how the Fed is now behind the curve and should have already begun cutting rates, which I don't disagree. But they are always behind the curve as they are "data dependent," and all their data is backward looking.[8] However, markets are forward looking and attempt to discount the future which is what we are seeing now. But markets aren't perfect either as the pendulum tends to overshoot in both directions.[9] As you may recall, the consensus on Wall Street was too negative for most of 2023 and as a result have had to play catch up most of this year.[10] And just as everyone was thinking the Fed had pulled off a soft landing, (bringing down inflation without slowing the economy), weaker data arrives, and markets adjust lower to wring out some of the recent excess optimism.

That said, my longer-term thesis has not changed, and I think we will look back and view this period as a healthy pullback and another good buying opportunity. In the near term, the market is pretty oversold so I would anticipate a snapback rally fairly soon and the quality and magnitude of this rally will give us clues as to whether the bottom of this correction is in, or we have more downside work to do.[1]

This morning's downside flush certainly illustrated signs of panic which is usually a good sign, but it wouldn't surprise me to see a couple of months of volatility before a yearend rally. But given the amount of liquidity in the system, rates cuts on the horizon, and corporate earnings continuing to remain firm, I'd caution investors in getting too negative here.[11] We will eventually have a downturn in the economy but that likely comes with a reduction in government spending. And while that would create short term pain for longer term gain, I don't see that anywhere on the horizon at this point.

Please feel free to reach out if you have any questions or concerns.

All the best,

Gray

Please note: *If you do not have assets under management with our group and would like more information on our process and performance, please let us know.*

Also, If you've been forwarded this email and would like to be included on future commentary, please feel free to reach out to hilary.miller@ubs.com.

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