THE EQUUS REPORT

—BY BARNABY LEVIN

BEHIND THE CURVE

August 16th, 2024

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At the last FOMC meeting (on July 31st), the Fed chose ***not*** to lower rates (even by a quarter percent!) when inflation is already at or under 3 percent. Because of this – with Fed Funds stuck at 5 ½% – most market participants consider this "restrictive," especially for interest-rate sensitive industries like housing. And sure enough – just two days after that fateful decision – Unemployment ticked up to 4.3%, triggering the "**Sahm rule**" and causing a sell-off in Markets as it dawned on people our Fed was **Behind the Curve**.

So, what ***is*** the Sahm Rule, and what does it ***mean*** for the Fed? According to JPMorgan Private Bank,' the **Sahm Rule** is a rule of thumb (created in 2019 by Claudia Sahm, who found it "coincided with every recession since 1970") to serve as an "early diagnosis."[1] A recession (as defined by our friends at the National Bureau of Economic Research) is a significant decline in broad, economic activity that lasts more than a few months. In essence, when the three-month, average Unemployment Rate rises by half a percent or more from its 12-month low, it has (in the US) meant a recession is underway and, on August 2nd, the rule was triggered when the rate rose to 4.3%, indicating the **threshold** at which policymakers *should* have started (to respond to a downturn) had been crossed.

But is it possible there's something about today's environment that somehow makes it an exception to the rule? The July jobs report did indeed show a "slowdown" (because "unemployment" picked up) – but was it because of ***Layoffs***? Or was it because of the growth of the **labor force itself** (as a result, for example, of the *millions* of people who've been crossing, illegally, into our country, over the past several years)?

According to the St. Louis Fed, the U.S. civilian labor force stood at 166.2 million as of July 31st – an increase of 1.2 million over the prior year. But for the *month*, it increased a whopping 420,000 (more than a third of the 12-month total). In other words – while (according to the Bureau of Labor Statistics) the economy only added

[1] Privatebank.jpmorgan.com as of 8/14/24

(an anemic) 114,000 jobs (and the number of unemployed people increased from 5.9 million a year ago to 7.2 million)[2] – it seems evident the growth of the ***labor force*** was a ***big*** factor in causing the rate to rise.

But if the rule ***wasn't*** triggered by increased layoffs, doesn't that mean the Sahm Rule is overstating economic "weakness" (which, we've said, has been going through a series of "Rolling Recessions," striking one industry after another instead of the more "classic" Recession, which hits the broad economy all at once)? There's no denying (that a higher "Unemployment Rate" suggests a ***slowing*** economy), but ***we*** think the labor market data is pointing to an economy closer to full employment than a recession characterized by a collapse in aggregate demand. That is, that the rise in the Unemployment Rate is due to increased labor ***Supply*** – not weakening ***Demand***.

So again, what does this mean for the Fed? Remember, the Fed has a dual mandate: to promote stable prices **and** maximum employment. Chair Powell hasn't wanted to cut rates until he was "sure" it wouldn't cause inflation to increase again, as it did in the 1981-82 recession (which, at the time, was the worst economic downturn since the Great Depression). With unemployment reaching nearly 11% late in 1982 – while Unemployment was widespread, it was residential construction and automotive manufacturers that were particularly hard hit. While goods producers accounted for only **30** percent of total employment, they suffered ***90*** percent of the job losses and, to some degree I think, that may be true again today (that whatever is being affected by the slowdown is highly selective and limited at this point).

One big difference (back then) was that the economy was already in bad shape, coming into the downturn. Both the 1980 and 1981-82 recessions had been triggered by tight monetary policy (to fight inflation) because economists were operating under the auspices of the **Phillips Curve.** The Phillips Curve is an economic concept that suggests there's an inverse relationship between inflation and unemployment, based on the premise that, when more people are employed, wages tend to rise due to

[2] Bureau of Labor Statistics, August 2, 2024

increased demand for labor (which, in turn they believe, leads to higher inflation). Therefore, economists like Ben Bernanke have long believed that, in order to fight inflation, ***un***employment needs to rise.[3] Because of this, during the 70s, the Fed pursued what turned out to be a "stop-and-go," monetary policy. During the "go" periods, the Fed would lower rates to loosen the money supply and target lower unemployment while, in the "stop" periods (when inflation was rising), the Fed would raise rates to reduce inflationary pressure. But the Phillips Curve has proven unreliable over the long-run, as inflation and unemployment sometimes increase at the same time (leading, in the extreme, to what's known as "Stagflation") and the principle has fallen into question.

But that's why Paul Volcker was appointed chairman of the Fed in August 1979 – in large part because of his anti-inflation views. He felt mounting inflation should be the Fed's primary concern – and it was he who shifted Fed policy to target the **money supply** rather than interest rates. First of all, while the **nominal** rates the Fed targeted could be high, he believed the ***real*** rate (which is the rate after adjusting for inflation) could still be low due to ***expectations*** of inflation. Second, the new policy was meant to signal to the **public** that the Fed was ***serious*** about low inflation – because inflation is driven (in part) by *expectations* where inflation will go, going forward.

Unfortunately, Volcker's first attempt (to lower inflation) proved insufficient, as the credit-control program initiated in March 1980 precipitated a sharp recession and, as unemployment mounted, the Fed eased. So (in late 1980/early 1981), the Fed tightened the money supply *again* and, ***this*** time, allowed the federal funds rate to reach 20 percent before they achieved their objective. *This* time, Volcker was adamant the Fed wouldn't back down – like Mario Draghi's infamous pledge (years later, in 2012), when ***he*** said he'd "do whatever it takes" to maintain the unity of the Eurozone.

Today, the economy remains in good shape and, as we've pointed out, policy rates are restrictive. The economy may be cooling, but it's not unraveling – and cutting rates

[3] I specifically asked him this at a SIEPR Award Ceremony (honoring *him*) in 2022. He said an increase in Unemployment was necessary to make the Fed cut rates. The Fed, it seems, is *always* worried about the potential impact of a "Wage-Price Spiral"which (they fear) could lead to Stagflation, against which they have no weapon. Until people start losing their jobs and unemployment rises, they believe their job isn't done!

would provide welcome relief to support those industries most affected by high rates. Again, there's a big difference between the Fed controlling **Inflation** and controlling ***rates***. ***Inflation*** (as we've pointed out) is controlled – not by the Fed (though ***they*** may think otherwise) – but by **the M2 Money supply**, which reached an all-time high of $21.7 ***Trillion*** in April 2022 and (according to the Mises Wire) has been falling for more than two years. Granted – given it had grown more than 145% since 2009 – a 10% drop may not seem like much, but it helps.

Also, as often happens in the face of increased fear and volatility (illustrated by the VIX doubling, intraday, to more than 65 on August 5th)[4] it has led to calls for the Fed to deliver cuts far larger and faster than any they might otherwise have intended. Other than *that*, the narrative hasn't changed much.

Perhaps (as I've suggested before) we're asking too much of our Fed – and the Central Bank should go *back* to focusing on price stability alone, leaving "Full Employment" to Congress, whose ***job*** it is to create conditions that help ***businesses***, which are what create **jobs** in the first place. On the other hand, money flows into and out of banks every day – and sometimes, things get "unbalanced." This is where the Fed (as the "Lender of Last Resort") can and should step in – to fill in the gaps through overnight lending, for which banks pay them interest at the "Fed Funds" rate. That way – by standing ready to loan commercial banks enough cash to repay their On-Demand Depositors –they can maintain stability in the System, with the tools they have and that have a direct and immediate impact on the thing they're trying to control. It would certainly take some of the pressure off, so they're not forced to deal with vague, sometimes contradictory things like "Full Employment" and the infamous threat of "Wage-Price Spirals," especially when raising rates act (at best) with a "long and variable" lag before they can work their way through the economy (and, along the way, have all kinds of Unintended Consequences, like they're having now on Lending and the world of Commercial Mortgage Backed Securities).

So all in all, it's little wonder people no longer feel "safe" – or that they only want to keep their money in those big, "money center" banks considered "Too Big To Fail" (but

[4] "Wall Street's Fear Guage Spike Isn't that Surprising," Lu Wang, Bloomberg, August 12, 2024

which everyone was so worried about in 2008). US government bonds are *supposed* to be the "safest" assets around – but when rates rise as much and as fast as they did in one year (from 2022 to '23), they can be every bit as volatile (or "risky") as stock, at least until they ultimately mature and pay back Principal (in ***devalued*** dollars), because of their inverse-relationship to rates (because they go *down* in Value when interest rates rise, as Silicon Valley Bank was "reminded" with "their" Bond Portfolio).

So why do we mention all this? For one thing, Lending and Credit have (in many areas of the economy) slowed or come to a standstill – and real estate (which so many say "never goes down") ***has*** – especially when it comes to Office space in urban centers. With vacancies (according to Jon Gray at Blackstone)[5] still running higher than 25%, that will mean a lot of "heavy lifting" and a "long grind" before equilibrium is restored. But we've *already* reached the point where (in my opinion) the Fed should have started to cut, *long* ago – and let M2 Money Supply and the market force of "Demand Destruction" take it from there, when it comes to driving inflation lower from here.

Our mission in our Reports and Podcasts is to ***educate*** – to help Clients make informed decisions *whatever* stage of life they're in, and to help them grow their wealth while maintaining a sense of financial security, every step of the way. In our opinion, the best place to start is by redefining and understanding what "**Risk**" ***truly*** means – and not just from one day to the next, but over the long-term. As Jon Gray (again) said, "Markets are like Speed Boats, zigging and zagging; but the ***Economy*** is more like a Super Tanker." A slowing economy gives the Fed room to cut, which they should do at their earliest convenience.

But the ***problem*** (as I've said) is that, what most people consider "low-risk," no longer ***is*** – especially when we're basing our decisions on false assumptions. It's critical we define Risk "monetarily" *and* "emotionally" – and (again) with a long-term perspective.

When it comes to "**Inflation Risk**," for example, we need to determine what a good or service we purchase today will cost years from now (which is important when trying to figure out what it will take to retire). But in this regard, other Risks (like misguided or

[5] "Squawk on the Street," CNBC, August 13, 2024

ill-timed Fed actions) play a part as well – especially when they raise rates faster than they have in 40 years and (then) remain on Pause, longer than they need. If inflation *were* to continue to rise anywhere near the rate it has, any attempt to make credible projections for what it will cost to live twenty or thirty years from *now* would be an exercise in futility. You could forget about those fancy "Monte Carlo" simulations so many Financial Planners use – where (*knowingly* or not) they're using randomly-selected returns for the past ten, twenty and thirty years, when interest rates were *declining* and (then) for years, remained near zero – to calculate an "expected rate of return." The odds your calculations will be off will increase, by which point it will be too late (because, by then, you'll ***be*** retired).

This is why we feel so strongly that young people today need ***more*** (not less) emphasis on basic math and financial skills – to help them make good choices and decisions, whether (for example) it's better to rent or buy a home; to buy or lease a car; or if going to college will be worthwhile, after taking Student Debt (assuming it ***won't*** be "forgiven") into account.

Well, thanks for reading, everyone. I hope you enjoyed it. This is Barnaby Levin for "**The EQUUS Report**," signing off.

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