StraightTalk
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Stuck In The Middle With You

One of my favorite songs from the 1970s is "Baker Street" by the Scottish musician, Gerry Rafferty. If the tune with the unmistakable eight bar saxophone riff does not immediately pop into your head, listen to it on iTunes, Spotify or Pandora - or dial up the Yacht Rock channel on satellite radio where the song is sure to come on. It's a true classic!

However, the title above is from one of his earlier hits – before he was a solo artist – when he was a founding member of the band, Stealers Wheel. Their 1970 hit, "Stuck in the Middle with You" has this line as the chorus, *Clowns to the left of me, Jokers to the right, Here I am…Stuck in the middle with you.*

I believe that line is fitting for where we find ourselves in this market. On one hand, experts are warning that the market has risen too far, too fast, and the economy will fall into a recession, based on the massive governmental stimulus during and after the pandemic. On the other hand, different experts point out that consumers are still spending because real wages are up, profits are rising, and many of the great companies in the index are becoming less expensive based on earnings, therefore there is continued upside. Stuck in the middle, indeed.

It seems each week brings a different batch of data, with some big banks missing earnings estimates due to smaller net interest gains than expected, while other banks beat estimates due to growing deposits as customers seek higher yields on savings. Manufacturing data is now in expansion territory which signals future growth, while inventories are building, which often signals a slowdown. Hmmm, also stuck in the middle.

Taken to a more granular level, anything in this market thematically attached to Artificial Intelligence or cryptocurrency just keeps rising, and classic, dependable dividend-paying investments seem moribund and trapped in a trading range, so we find ourselves stuck in the middle there too. Of those two "hot" investments, A.I. and digital tokens, I firmly believe one will be transformative to business productivity, the overall economy, and almost every area of our lives – and the other is a speculative mania…I will let you guess which is which.

So, defined broadly, or narrowly…*stuck in the middle with you.* A point of clarification is needed, however, because I do not consider myself "stuck" with any of you - I love what I do, where I do it, and with whom I do it (all of you) - so if anyone is stuck, it is you that are stuck with me. But the investing *middle* part is 100% correct and is actually by design.

The timeless beauty of a classically diversified portfolio is that you miss out on the few highly speculative moonshots that skyrocket in value, while avoiding the far more numerous concentrated bets that can wipe out an investor. Remember what we own…the great companies of America and the world, which are durable, cash generating businesses, with both a competitive edge and a long runway for current and future profits. In other words, the exact opposite of hot fads, meme stocks, momentum plays, or speculative mania…we just don't do that here.

That investing middle ground is a fertile universe of great companies, some of which will be doing well in any given environment, and some of which will not. When the investment and/or business cycles turn, those companies that were doing well in price appreciation take a pause, and the companies that appeared dormant in your portfolio will have their turn leading.

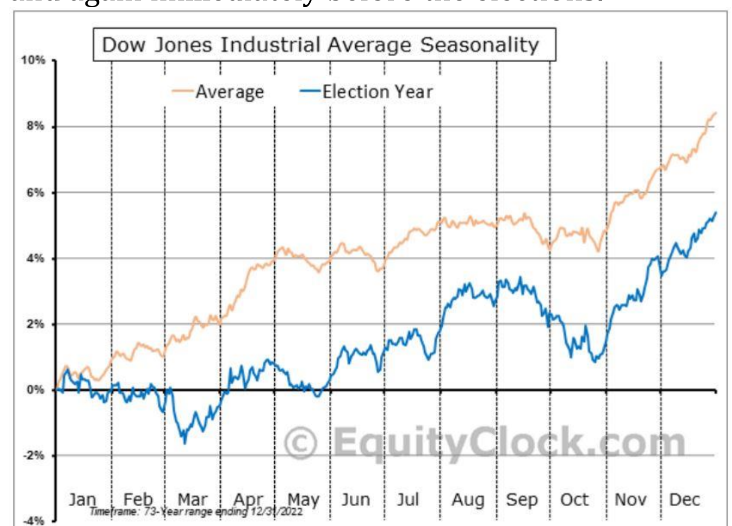
It has been this way for more than two centuries, and this immutable trend does not change due to elections, or Fed hikes and cuts, or celebrities launching blank check SPAC companies, or investors speculating on a joke cryptocurrency with a dog's head on it. (Look it up.)

Speaking of Fed hikes and cuts – it appears we are stuck in the middle there too. Much as the Ben Bernanke-led Federal Reserve were students of policy mistakes made leading to the Great Depression (most notably making money harder to access, rather than easier) – this current Fed board are all students of the 1970s mistakes on inflation. Determined to not end up like then Fed Chair Arthur Burns, Jay Powell does not want to ease up on interest rates until it is a certainty that inflation is tamed. So…. markets trade each week on the casino-style betting of which meeting will announce the first interest rate cut of this cycle. While the Fed appears "stuck in the middle'" this is actually purposeful policy, with the goal of reducing inflation with intentionally high interest rates, without completely choking off the economy in the process.

Aside from the publicly visible interest rate policy, the Fed is combating inflation using other tools. For example, without almost anyone noticing, they have allowed the overnight repurchase facility to be drawn down significantly. This is important because while that facility is technically used for interbank lending, it is also a major source of liquidity for the bond market. The Fed reports that balance today at roughly $440 billion, down from over $2.3 trillion last year – so, supply has been reduced by over 80%. Less easy-to-access money available to banks slows down the circulation of money. The Fed has also been reducing the supply of bonds on their balance sheet, allowing them to mature rather than be refinanced. This is termed a "runoff" and gradually shrinks the supply of short and intermediate term bonds in the marketplace.

Even without an advanced economics degree, most of us know that if the supply of something is reduced sharply, then the price rises concurrently. So, by reducing the supply of bonds in the marketplace, the Fed is helping the inflation fight, because when bond prices rise, their yield falls. Over the next several quarters, shorter and intermediate term interest rates should begin to decline, which helps us in two ways. One, a lower cost of shorter-term financing is a lubricant in the gears of our economy, and two, as the yields on short term cash equivalents like CDs and money markets fall, some of the $6 trillion parked there will move into the investment markets. Sometimes being stuck in the middle has its advantages!

Obviously, money shifting from cash equivalents into the stock market is a good thing for prices, but there again, we may be in the middle. Unless you wear noise-cancelling headphones all day, or don't have access to television or the internet – you are aware that this is an election year. And election years tend to have a distinctive pattern to them. Using history as a guide can be quite effective if the data set is large enough. The blue line in the chart below shows trading patterns going back to 1950, with larger than average market pullbacks in the spring and again immediately before the elections.



However, the pattern also clearly shows a recovery in price shortly after the election. Of course, this is not a guarantee, but seven decades is a very large data set. The bigger picture is that A.I. will become ubiquitous in almost every sector of our economy, and I believe will drive efficiencies and productivity gains for most industries. And in the shorter run, S&P Research reports that earnings look poised to improve dramatically in 2025, so this period of being stuck in the middle may be short lived. Maybe not as short or as enjoyable as a classic 70s song, but not too long either…

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