STRATEGIC OUTLOOK

Strategic Frontier Management

Q4 2023

Regime Reset Anxiety

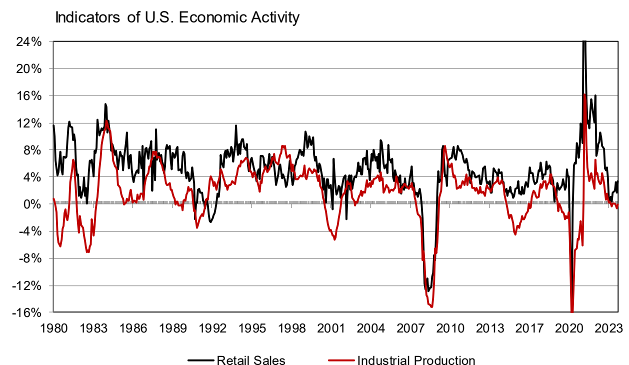
A long era of disinflation is winding down with maturation of the *Fourth Industrial Revolution*, and one of many regime resets unfolding. Hopes of targeting 2% U.S. inflation are unrealistic in the foreseeable future, absent a steep recession to drive inflation expectations much lower. The anticipated economic hangover is visible now with fiscal spending and monetary cliffs ahead, as excessive U.S. government spending and hiring, as well as monetary stimulus reverse.

Many remain fixated on the inflation rate, but price levels rose 17.4% since January 2021 based on CPI. Without deflation or increasing household income, discretionary spending will be limited and the savings rate will struggle to remain positive--reduced affordability cannot be easily undone. Higher inflation expectations and unleashed pricing power will be difficult to contain. There is still a housing shortage keeping inventory low and prices higher, so housing affordability remains challenging, particularly now as national average mortgage rates exceed 7-3/4% or highest rate since 2000—this is one of the widest spreads of mortgage rates vs U.S. Treasuries.

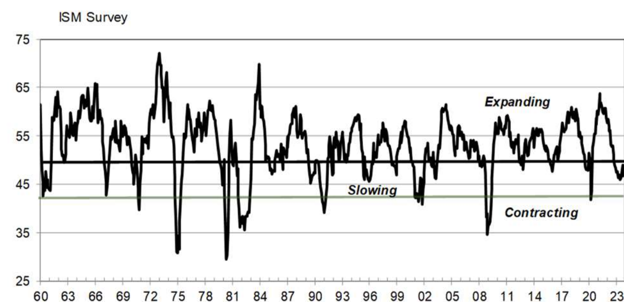
While others focus on whether the Federal Reserve will hike or cut interest rates next, a more critical issue is how fast their balance sheet normalizes by reducing bond holdings. *Quantitative Tightening* (reducing Treasury holdings) has only begun to reduce the Fed's $8.9 trillion balance sheet toward $2 trillion we estimate is the necessary holdings, but still more than double versus before 2008. The European Central Bank is similarly situated with €8.7 trillion in bond holdings, as are others.

We expected and now observe a US economic hangover of stagflation after a decade-long fling with excessive government spending and overly stimulative monetary policy from unconventional *Quantitative Easing* to *Forward Guidance and extended near 0% rates*. The Federal Reserve kept interest rates too low for too long. When global inflation soared last year, hiking interest rates with unprecedented speed (>5%) exposed consequences of *explicit moral hazard.*

The greatest economic surprise in 2023 is likely the resilience of U.S. Real GDP, although below reduced potential growth expectations. It is all the more surprising given the weakness in many higher frequency economic variables such as growth in retail sales, industrial production, construction, business sales, and profits. We'll discuss these in more detail below, but we conclude that without new or expanded government programs and hiring, real GDP growth would be near 0%, if not flirting with recession, as other economic growth measures suggest, including earnings growth.



Real retail and business sales (net inflation) experienced recessionary conditions for over a year. Since a Spring 2021 economic peak, real growth has steadily declined to a now negligible level. ISM has dipped to 46.7. How much less would growth have been without exceptional government spending and hiring? The private sector has been in recession, but real GDP (still just 0,5%) remains positive only by virtue of the government sector. If economic growth lags, then companies struggle to be profitable—S&P 500 profits are languishing too (-1%).



Source: ISM

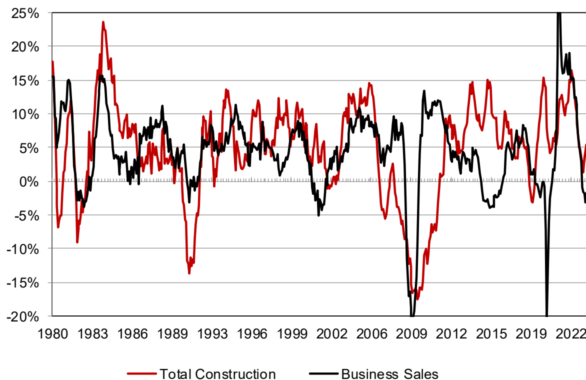
Financial imbalances helped trigger a U.S. banking crisis (ex: reserves imprudently invested in long bonds at

Silicon Valley Bank and other credit issues) in February 2023, and a pension liquidity crisis rooted in leveraged and extended long maturity bond holdings in the United Kingdom last Fall 2022. There is rapidly increasing government bond supply from still high fiscal deficits, rising interest burdens on Debt/GDP > 100%, and the need to unwind $7 trillion of Federal Reserve holdings, even as global bond yields rose significantly since 2021.

Economic Forecasts	**2020**	**2021**	**2022**	**2023e**	**2024e**	**2025e**	**2026e**
GDP Growth (Y/Y Real)	-1.5	6.1	1.0	0.5	1.8	2.0	2.0
S&P500 Op Earnings Gr	-13.8	49.0	5.2	-1.0	5.9	7.3	6.0
CPI Inflation (Y/Y)	1.5	7.1	6.4	4.5	3.5	3.0	3.0
Unemployment	6.7	3.9	3.5	4.2	4.5	4.8	5.0
Fiscal Deficit (vs.GDP%)	-15.5	-11.2	-5.5	-5.0	-5.0	-4.5	-4.0
Fed Funds Target[1]	0.25	0.25	4.50	5.50	5.00	4.00	3.50
10y Treasury Notes	0.91	1.50	3.83	4.80	5.20	5.00	4.75
S&P 500 Target	3756	4766	3840	4200	4400	4600	4800

1. Target denotes top of published ¼% policy target range
Source: Strategic Frontier Management (Year-end or Y/Y change)

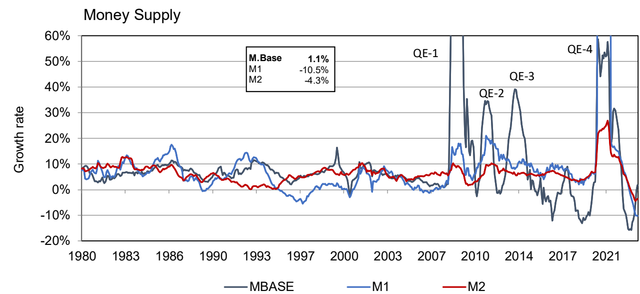
The *Wealth of Our Nation* was crippled in just under three years by policies believing in too many *Impossible Things,* which undermined American productivity, global competitiveness, and prosperity (given rising inflation). A misguided pivot in U.S. energy, labor, economic, commerce, trade, and regulatory policies enacted by Presidential Executive Orders, and agency rules or regulations (bypassing Congress) crushed real potential growth and profit margins. Who imagined such a radical change in Government policies in just three years could cause such a rapid deterioration in incentives driving American entrepreneurial spirit? The anticipated economic hangover is visible now, as excessive U.S. fiscal spending and monetary stimulus reverse.



Source: LSEG Refinitiv & Strategic Frontier Management

Low interest rates pulled forward consumption by lowering financing costs and reduced interest expenses for mortgages, businesses, and even government, but sacrifices future economic growth potential. Now we must reckon with extreme volatility in money supply after years of QE must be unwound. Money supply growth has fallen below 0%, knowing less than 5-6% growth limits U.S. potential growth. We expect similar issues globally.

A sustained contraction in money growth—necessary to reverse QE—can trigger bond liquidity issues or even a financial crisis, if not limiting potential growth for years. Accelerating draw-down of central bank holdings should indeed have a far greater impact on achieving the Fed's goal of stable prices—this is where Chairman Powell's lawyer instincts are of little help with complex economic and financial challenges in the uncharted realm of unwinding *unconventional monetary policies*.



Source: Federal Reserve & Strategic Frontier Management

With more than 60% of government spending indexed to CPI inflation, the US Budget is more susceptible than ever to stagflation of slower economic growth and higher inflation. High interest burden of debt with rising bond yields will strain fiscal deficits for years. Failing economic policies of *Bidenomics* remain unpopular given just 37% approve of the President's *Handling of the Economy*.

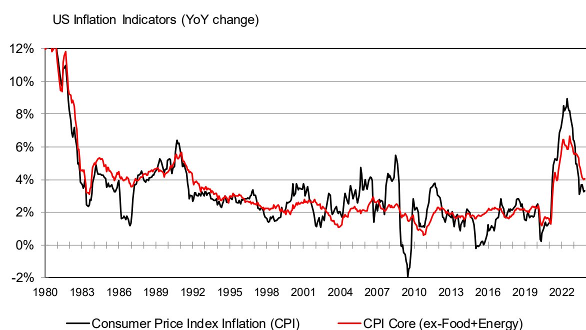
Higher Inflation Expectations

We expect higher for longer US inflation. Energy and commodity prices began rising in early 2021, which was quickly compounded by supply chain and labor inefficiencies, which triggered pricing power for goods and services, as well as higher wage and benefit demands. When bottlenecks in shipping and ports arose with increased regulatory, labor, and energy costs, the result is predictably higher inflation and shortages in traded goods with cascading logistic dependencies further along supply chains. The shock from supply chain disruption simply compounded the effect of rising commodity, energy, and basic material costs. We remain vulnerable to strategic dependency on China and supply chain disruption.

It is not surprising that what triggered higher energy, commodity, and basic material prices, spread to food and staples, then housing and labor costs. From there inflation expectations triggered manufacturer pricing power, which spread globally. Energy prices impact nearly every household and business activity. Tighter leasing and permitting of oil and gas exploration, production, and pipeline construction limited energy supply, thereby increasing production, manufacturing and transportation costs. Basic resources and commodities were similarly constrained, reducing our global competitiveness. The shock from supply chain disruption simply compounded the effect of rising commodity, energy, and basic material costs. Throughout this inflation cycle, we have seen inflation begin with the U.S. and then drive inflation globally.

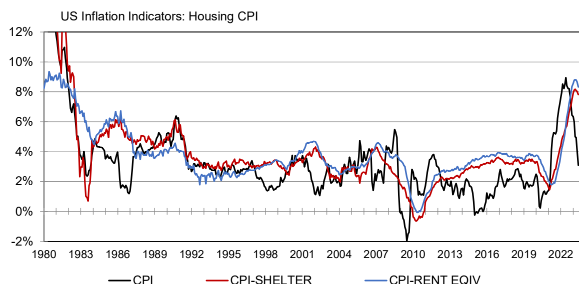
Inflation surged in mid-2022 to historic levels not seen in over four decades. Higher inflation expectations become permanent when the inflation rate remains high for an extended period. CPI inflation soared toward 9% in mid-2022. Now labor and housing costs will be difficult to bring down without severe deflation or recession. The resulting regime shift in inflation expectations can't be easily extinguished, even by belatedly raising interest rates, particularly if the yield curve slope is inverted. Policy rates rose a remarkable 5%, yet inflation is still grinding away purchasing power and retirement savings.

Inflation moderated recently, but a lower inflation rate doesn't undo the harm done to living standards and affordability from the 16% cost-of-living increase. Only catastrophic deflation can get us back to near pre-2021 living standards. The longer high inflation persists, the more it reinforces inflation expectations. Indexing of cost-of-living increases and contract price adjustments are still flowing through, so we expect higher wage increase demands to continue. Core inflation, ex-food and energy, hasn't experienced the volatility of CPI Inflation, but it also didn't peak as high, nor declined as much either.



Source: LSEG Refinitiv & Strategic Frontier Management

Housing supply has been limited for some time as household formation accelerated. Higher mortgage rates with the national average 30-year approaching 7-3/4% affect affordability and defer second home purchases. Given housing's contribution to CPI inflation (33% or 43% of core inflation), if follows that rising housing costs have driven inflation higher since 2012. We don't expect much housing weakness—existing home inventories and new construction are still low. Higher building and financing costs should drive prices even higher with rising replacement value given limited supply.



Source: LSEG Refinitiv & Strategic Frontier Management

As inflation generally fell for 40 years, cognitive bias can be etched into underestimating bond risk, so investors will be likely caught off guard with regime change of higher average inflation (CPI: 3.0%) and interest rates (3.5%). Investor surprise is the Fed's greatest tool to affect behavior. Too much *transparency* increases difficulty in managing the Fed's dual mandate of stable prices and full employment.

Restoring Natural Order

The Federal Reserve's dual mandate is to maximize the economy's long-run potential real growth—*fostering economic conditions that achieve both price stability and maximum sustainable employment.* Inflation will be more difficult to restrain as disinflationary forces diminish and inflation expectations revert to historical averages. Long-run Federal Reserve forecasts for equilibrium inflation and interest rates have drifted lower for 20 years, in mythical departure from its average for generations.

Future lower potential growth of 1.8% can't support already stretched valuations, and consensus earnings expectations should recede further through 2023-2024 without significant reversal in government agency policies, rules, and regulations. We believe the quarterly *Summary of Economic Projections* below limits the Federal Reserve's effectiveness fighting inflation with implicit forward guidance in the table.

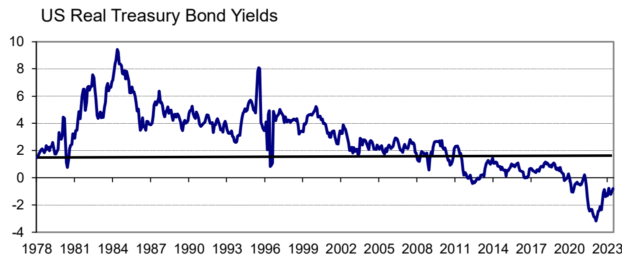
Median Forecast										LongRun Forecast	
U.S. Fed %	2018	2019	2020	2021	2022	2023e	2024e	2025e	2026e	Fed	SFM
GDP	3.05	2.15	-2.40	5.90	0.50	2.10	1.50	1.80	1.80	1.80	1.80
U.Rate	3.70	3.55	6.70	4.80	3.70	4.10	3.80	4.10	4.00	4.00	4.50
PCE	1.85	1.45	3.40	4.20	5.60	3.30	2.50	2.20	2.00	2.00	2.50
Core PCE	1.85	1.50	3.00	3.70	4.80	3.90	2.60	2.20	2.00	2.00	2.50
Implied CPI	2.35	2.00	1.50	3.50	6.10	3.80	3.00	2.70	2.50	2.50	3.00
Federal Funds Avg.	2.38	1.55	0.09	0.13	4.38	5.28	5.05	3.97	3.22	2.66	3.50

Interest Rates	2018	2019	2020	2021	2022	2023e	2024e	2025e	2026e	Longer Run
FOMC Avg.	2.38%	1.63%	0.13%	0.13%	4.38%	5.28%	5.05%	3.97%	3.22%	2.66%
Forecast[1]	2.50%	1.75%	0.25%	0.25%	4.50%	5.50%	5.00%	4.00%	3.50%	3.50%
Rate Change	1.00%	-0.75%	-1.50%	0.00%	4.25%	1.00%	-0.50%	-1.00%	-0.50%	

1. Top-end of indicated Fed Funds range

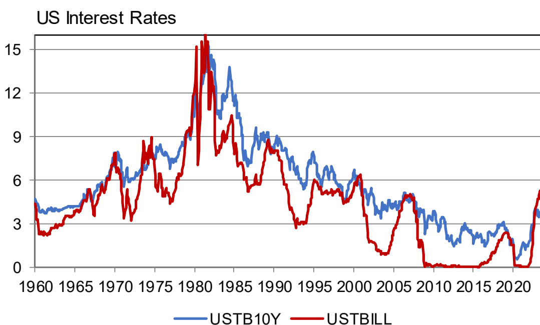
Source: U.S. Federal Reserve & Strategic Frontier Management

A long era of disinflation is winding down with maturation of the *Fourth Industrial Revolution*. Hopes of implicitly targeting 2% U.S. inflation are unrealistic, but there is no explicit inflation target. PCE inflation averages -0.5% lower than CPI inflation by design when the Fed believed CPI was overstating inflation. Yet, we still rely on relative interest rate relationships versus the CPI index. The CPI index methodology is used globally, and is still the benchmark for cost-of-living and contract inflation adjustments. A normal interest rate gap versus CPI inflation of 1% historically compares to the Fed's forecast of just 0.7% vs. PCE inflation, instead of a more logical interest rate gap of 1.5%. However, use of the PCE index remains limited to the Federal Reserve.



Source: LSEG Refinitiv & Strategic Frontier Management

Given the 40-year decline in interest rates and decade-long manipulation of bond yields, investors likely have become too complacent about risk of bond market loss. Yet, investors are surely growing weary of persistent losses on bond portfolios, and we expect bond yields will increase further in 2023-2024. If long-term CPI inflation averages 3%, then 10-year Treasuries should exceed 5% in 2023 on the way toward 5.5-6.0%, as global yield curves should steepen. A normal term rate risk premium can infer a Treasury 10yr - 3mo. slope of 1.5%. Given 5.25-5.5% Fed Funds rate, 10-year Treasury yields could range as high as 6.5-7.0% if the Fed maintains a higher-for-longer policy.

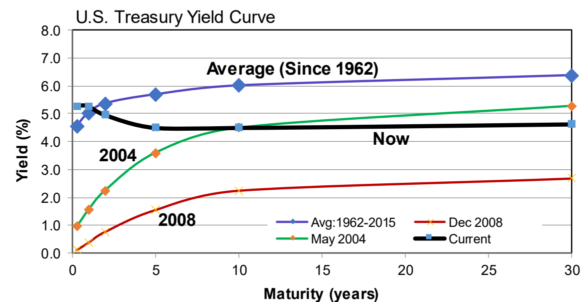


Source: LSEG Refinitiv

When high inflation persists for an extended period, changes to economic expectations are difficult to reset. Reduced profit margins and stagflation naturally result in lower potential earnings growth. Lower earnings growth can reduce tax revenue from business profits and investor capital gains as equity returns disappoint. This can further increase fiscal deficits.

US pricing power was generally absent over the last two decades given manageable labor cost increases combined with persistent disinflationary forces of the *Fourth Industrial Revolution* and globalization. Instead, inflation jumped to over 9% by June 2022. Non-transitory inflationary forces boosted secular inflation expectations, and we expected to observe later cycle conditions such as higher inflation, slowing real growth, and stalling productivity for years to come as a result of increased policy-driven economic inefficiencies and unleashed inflation expectations.

While investors are fixated on rising interest rates, normalizing the Fed's balance sheet may have a greater effect on steepening the yield curve, and risk causing a global financial (liquidity) crisis due to overreliance on unconventional monetary policy. If interest rates exceed 5%, then 10y Treasury yields should exceed 6.0-6.5%. If interest rates average 3.5% vs. CPI inflation averaging 3.0%, why is the yield curve inverted now given economic conditions? Consider how much the yield curve differs from May 2004 (start of rate hikes: 10y-3m = 3.5% or Dec. 2008 (10y-3m=2.2%) during the Global Financial Crisis. Global yield curves should be upward sloping, but most remain peculiarly inverted.



Source: LSEG Refinitiv

Global yield curves should be positively sloped given current economic conditions, yet we still observe perverse risk premiums (i.e., value-growth and small-cap equity, illiquidity, volatility, term, inflation, etc.). Whereas trend-following has likely exaggerated such dislocation, we expect the reversal or reversion to normal to emerge in the new year. Years of unconventional monetary policy has affected behavioral biases and induced financial imbalances after two decades of central bank manipulation. Rising global bond yields will further increase fiscal deficits as refunded government bonds also must be refinanced at higher rates, further increasing interest burdens. U.S. Treasury should be issuing longer maturity debt to take advantage of an inverted yield curve, but opted for shorter maturity issuance. Thus, we expect Treasury bond returns will be negative for awhile, and rising bond yields may overshoot the longer it takes to normalize.

We are now deeply indebted without a fiscal safety net to support us in a crisis. We have sacrificed energy independence and border security as crime rates soared in cities managed by inept progressive bureaucrats. The speed which this happened was breathtaking, but only possible with administrative statism emboldened by new controls imposed post-global pandemic, combined with Executive Orders and Executive Branch control over agencies that manage regulations and rules.

We expect inverted global yield curve to steepen as bond supply increases with greater issuance, given real interest rate valuation and high fiscal deficits, just as the Fed begins unloading $7 trillion of Treasuries. Negative bond sentiment will reduce bond demand too. Bond

market returns should continue to struggle for the foreseeable future. Risk of a *global debt liquidity crisis* increases with supply-demand, if not higher currency and bond volatility. There is increased risk of systemic financial chaos exiting extended monetary policies. A global bond correction, after a decade of manipulation, could trigger the next financial crisis. We expect greater economic, currency, and bond volatility with flatter yield curves that need to steepen significantly.

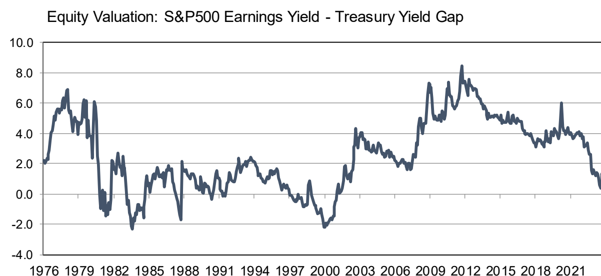
Earnings

Earnings growth and profit margins have been core principles driving our asset allocation research for over three decades. *Economic growth* translates *revenue* into *earnings* growth through *profit margins*. It is this translation that investors often fail to fully appreciate in their investment process—today equity investors seem fixated on high economic growth, but overlook differences in margins, currency effects, and even translation of revenue to earnings.

Operating Earnings	2025e	2024e	2023e	2022	2021	2020
IBES Consensus	6.0%	11.2%	1.0%	4.8%	49.0%	-13.8%
S&P500 E[Growth]	6.5%	6.5%	-1.0%	4.8%		
S&P500 Target	4600	4300	4000	3840	4766	3756
Index Return (no Div)	7.0%	7.5%	4.2%	-19.4%	26.9%	16.3%
Dividend Yield	1.74	1.76	1.70	1.75	1.29	1.48
S&P 500 @18x SFM TE	4410	4140	3888	3926	3746	2515
S&P 500 P/F12	14.9	14.9	13.9	17.8	21.9	18.0

Source: I/B/E/S vs. Strategic Frontier Management Estimates

More realistic future earnings of 5-8% won't be enough to correct current extended valuations. Unfortunately, we are entering a period of falling margins as economic growth slows, and we've already observed negative sequential quarterly earnings growth. We now expect a decline in 2023, albeit just -1%, but it could get much worse. Other than 2021, which benefited from a post-pandemic rebound (energy and basic material producers reported 2020 losses), earnings growth remains anemic and S&P 500 valuation is stretched nearly to 2001 levels. We can see why equities are so sensitive to bond yields with little earnings growth observed.

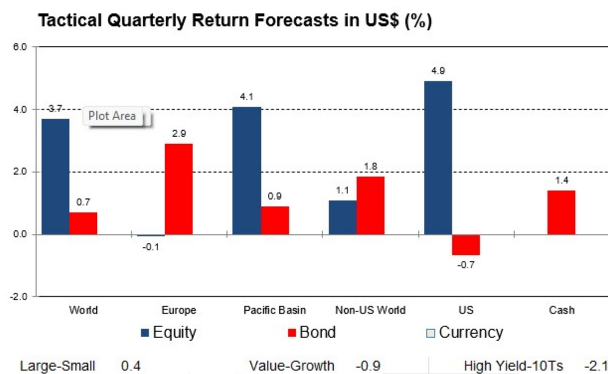


Source: Strategic Frontier Management

We expect further decline in earnings estimates will increase downside risk. Persistent higher inflation combined with significantly higher interest rates could further undermine equity and bond investments. A normal earnings multiple should also adjust lower with higher inflation, higher interest rates, economic uncertainty, and greater equity volatility. If the US economy slows and margins decline, US earnings growth should be limited. With rising interest rate burdens, zombie enterprises and over-indebted nations deserve additional scrutiny with higher cost of capital.

Global Tactical Asset Allocation Strategy

Asset allocation remains a critical determinate of long-term wealth. Our outlook reflects mean reversion of global bond and equity valuations, both which are still stretched. Negligible to negative growth in earnings in 2023 with the S&P 500 index increasing combined with higher interest rates suggest the fundamental downside for US large-cap equities only increased. Investors should expect higher equity, bond, currency, and commodity volatility as interest rates and monetary policies normalize globally. Increased volatility within and between asset classes is also expected, whereas relative fundamentals should become more critical driving relative returns.



Source: Strategic Frontier Management

Conclusion

An economic hangover should be expected after hiking rates, withdrawing monetary stimulus, and slowing spending on excessive new government programs. Regime Reset Anxiety highlights various paradigm shifts underway and imbalances that should eventually be corrected.

Hiking interest rates and *Quantitative Tightening* will slow potential growth. Low-to-negative money growth is required for as long as it takes to unload $7 trillion of U.S. Treasuries, as similarly required for the ECB, BoE, BoJ, and other central banks. Misguided economic, trade, energy, and fiscal policies over just the last 30 months reduced global competitiveness, potential growth, and profit margins, as well as ushered in higher inflation expectations that are now difficult to contain. Such anti-capitalist policies undermine our global competitiveness, profit margins, and U.S. potential growth until they can be reversed.

Negative equity and bond returns have devastated retirement savings, pension funds, and particularly other

asset owners' portfolios depending on returns in excess of inflation. However, despite a correction in both stock and bond markets in 2022, valuations were still stretched. We believe even higher bond yields will further undercut speculative global equity valuations.

We expect higher economic and capital market volatility with tighter monetary policy, and liquidity issues during this period of U.S. stagflation or shallow intermittent recessions. We expect higher interest rates will persist through 2024, as other countries hike rates and unload their excess central bank bond holdings. Global bonds remain overvalued, but if yield curves steepen, global bond market losses could be significant. We prefer short maturity or floating rate debt, and cash equivalents (money market funds, T-Bills, and CDs), which are more resilient to interest rate changes.

A divergence from *Natural Order* was caused by excessive fiscal stimulus, and global central banks, which has manipulated global fixed income markets since the Global Financial Crisis. The effect has to been to extend financial imbalances and flatten yield curves through QE (buying Treasuries) and forward guidance, then drive the whole yield curve lower by holding policy rates (Federal Funds rate) near 0% for too long. The Federal Reserve may be done hiking rates, but the Fed must now focus on reducing balance sheet holdings significantly---selling or refunding bonds will increase supply of Treasuries. It will be increasingly difficult for the yield curve to remain inverted. We believe that global bonds will struggle to earn positive real return despite back-to-back awful years for bond investors.

It took too long for the Federal Reserve to realize delaying monetary tightening was reckless as CPI inflation rose from 1.5% in 2020 to 8.9% by mid-2022 believing inflation was *transitory*. Policymaker reluctance to tighten monetary policy triggered even higher inflation expectations. Interest rates rose a remarkable 5%, yet inflation is still grinding away purchasing power and retirement savings. We expect CPI Inflation will average 3.0% (PCE inflation: 2.5%), and Real Potential GDP will average 1.8%, down from 2.5% we estimated in 2019. Low interest rates encourage leverage, but time and again failures of risk management can take hold quickly under such conditions.

Inflation is persistently higher than expected after raising interest rates over 5%, and the yield curve is inverted. We believe the Treasury 10-1yr curve needs to steepen as much as 2.5% (US 10Yr Treasuries: 4.5%). The Fed must also reduce bond holdings, but there still has been little adverse impact on employment.

The U.S. profits recession in 2023 will limit tax revenue, and increase government debt as interest burdens increase. Spending must be restrained to limit unsustainable fiscal deficits. U.S. debt now well exceeds 100% of GDP with no indication of abating. With declining productivity and material non-transitory inflation that boosted inflation expectations, we expect there is still greater downside risk to US equity markets in particular over the near-term.

Risk of a global bond liquidity or financial crisis was enhanced by manipulating free capital markets (bond yields) for an extended period, while significantly increasing Federal debt and ongoing fiscal deficits. Central banks globally are under increasing scrutiny to deal with rising inflation—those who explicitly target inflation have little choice, but to raise interest rates until inflation is contained closer to their respective inflation targets. Emergency monetary stimulus ceased to be needed some time ago (2021), as economic conditions normalized following the Global Pandemic.

Free Market Capitalism as an economic organizing system has enabled incredible economic and social progress, while lifting global living standards in the developed world. The answer to society's current ills is incentivizing competition, free markets, and greater economic freedom. Capitalism, as an economic organizing force, delivered on reducing poverty, inequality, exploitation, class conflict, undue suffering, and unproductive behavior. Belief that the free-market capitalist system no longer works as it has for well over a Century is nonsense--it instead begs the question of what did Socialism, Communism, or Marxism alternatives deliver as political and social organizing systems over many generations.

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