# The Taylor Economy

## Quick Look

- The economy has been much stronger than expected, and the driver has been consumer spending, which makes up 2/3 of the U.S. economy.
- A strange divergence has developed between consumer sentiment and consumer spending. Consumer sentiment has reached all-time lows, but consumption remains robust.
- Excess consumer savings peaked at $2.1 trillion, a staggering $900 billion of which came in the form of pandemic-related stimulus checks. Excess savings are on pace to be depleted by the end of the year.
- As summer turns to fall, there are growing headwinds that will challenge the sustainability of the current pace of consumer spending.
- The Fed has raised the funds rate to 5.50%, its highest in 20 years, and may not be done. The reality is that Fed tightening cycles often end in recessions, and this current cycle is the fastest and steepest of the last 40 years.
- Not everyone is cursing the higher rate environment. Savers can finally enjoy a positive real rate, as money market funds are paying interest above the annual rate of inflation.
- Forward looking bond returns appear favorable. Starting yields for intermediate bonds are a strong indication of 10-year forward returns. At 4.5%, this asset class is poised to offer annualized returns of 3% above its past ten-year performance.

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# *Quarterly Investment Letter, Q3 2023*

Did Taylor Swift prevent a recession? The question is obviously preposterous, but for a Federal Reserve intent on slowing the economy, Taylor has become their, ahem, "Anti-Hero". Cincinnati was fortunate enough to be one of the chosen cities for her Eras Tour, and it certainly provided the weekend of summer weekends. According to Visit Cincy, the concerts brought nearly $50 million to Cincinnati. Hotel occupancy was 98% in the downtown business area and 92% for the whole of Hamilton County. Nearly 50,000 people even attended "The Taygate", many of which did not have tickets for the show, just for the opportunity to buy merchandise and maybe a Lavendar Haze cocktail.

The numbers for her Eras Tour this summer are dizzying. Swifties were estimated to have spent $1,500 on hotels, travel, and food for every $100 spent on tickets. Taylor's tour included 53 shows over five months that generated nearly $5 billion in consumer spending. Glendale, Arizona's concert generated more local revenue than February's Super Bowl. The Federal Reserve Bank of Philadelphia noted in July's Beige Book, "May was the strongest month for hotel revenue in Philadelphia since the onset of the pandemic, in large part due to an influx of guests for the Taylor Swift concerts in the city."

The economy has been much stronger than expected, with the driver being consumer spending, which makes up 2/3 of the U.S. economy. The first two quarters of the year posted 2% growth, and third quarter growth could reach 5%, thanks, in part, to the outlier effects of Swift's tour, coupled with Beyonce's tour and the Barbenheimer craze that drove everyone back into theatres. Morgan Stanley estimates that these one-time events could account for nearly 1% of consumption growth in the third quarter.

A strange divergence has developed between consumer sentiment and consumer spending. Consumer sentiment has reached all-time lows, but consumption remains robust. Historically, sentiment wags the tail of spending, but the relationship has broken down post-pandemic. Surveys are noting that consumers loathe higher prices, but their actions suggest that high prices and higher interest rates have not deterred spending. As seen in the chart in the following column, after the deep, but temporary, drop in spending during the height of the pandemic, personal consumption (adjusted for inflation) has not only rebounded, but is above pre-pandemic trend level. This pattern is broadly consistent with the notion that the economy has been terrible for everyone except themselves. To this point, all the doom and gloom and grousing over the economy has amounted to nothing more than "Champagne Problems" (Sorry, couldn't help ourselves).

**US Real Personal Consumption Expenditures ($)**


Source: The Daily Shot

Part of the consumer's resiliency can be attributed to the psychological impact from the lockdown. There is a prevailing feeling to enjoy life now because the future is too unpredictable. Consumers are making sure to get in vacations that had been delayed, or splurge on must-see experiences, regardless of cost. Historians have found comparisons to the economy of 100 years ago, in which those fortunate enough to make it through the other side of the first World War and their own global pandemic made sure to enjoy life to the fullest, ushering in the spending spree of the Roaring Twenties.

A more straightforward explanation of the consumer spending engine is the excess reserves still left in the tank. Excess savings peaked at $2.1 trillion, a staggering $900 billion of which came in the form of pandemic-related stimulus checks, with the other half deriving from reduced spending during the lockdown. Once inflation began to surge, savings rates fell and have stayed below pre-pandemic trend for the past two years. With only 10% of that $2.1 trillion remaining, the final pandemic-era savings will likely be depleted by Christmas. "'Tis the Damn Season", indeed (last one, we promise).

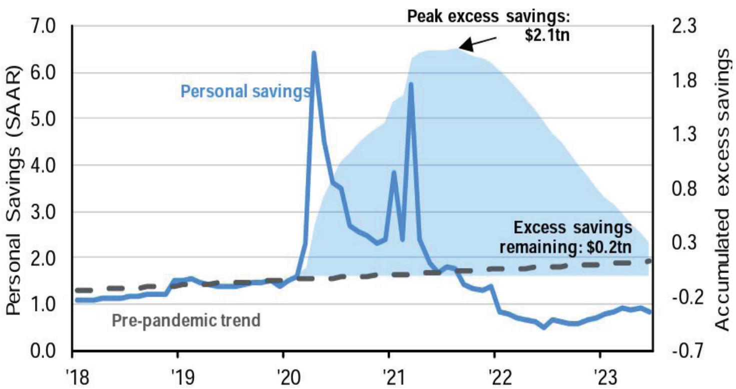
**U.S. EQUITY RETURNS (%)**

| As of 9/30/2023 | Q3 2023 | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|
| S&P 500 | -3.3 | 21.6 | 10.2 | 9.9 | 11.9 |
| Russell 1000 (Large Cap) Growth | -3.1 | 27.7 | 8.0 | 12.4 | 14.5 |
| Russell 1000 (Large Cap) Value | -3.2 | 14.4 | 11.1 | 6.2 | 8.5 |
| Russell 2000 | -5.1 | 8.9 | 7.2 | 2.4 | 6.7 |
| Russell 2000 (Small Cap) Growth | -7.3 | 9.6 | 1.1 | 1.6 | 6.7 |
| Russell 2000 (Small Cap) Value | -3.0 | 7.8 | 13.3 | 2.6 | 6.2 |

Source: Morningstar

# *Continued from page 2 . . .*

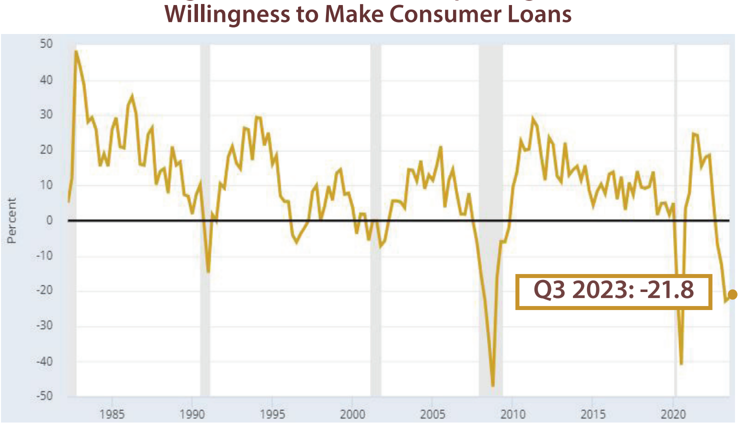
**Household Excess Savings (Trillions of USD)**




Source: JP Morgan

As summer turns to fall, there are growing headwinds that will challenge the sustainability of the current pace of consumer spending. The moratorium on student loan payments is no more; some 40 million borrowers will resume loan payments with an average payment of $350 per month. Energy costs are again rising; crude oil prices jumped more than $20 a barrel over the past quarter. Energy costs are excluded from core consumption, but those spending costs will likely come at the expense of discretionary spending items. Consumers needing to borrow are not only faced with higher interest rates, but also more stringent requirements for obtaining credit. As can be seen in the chart below, the willingness of banks to make consumer loans or issue credit cards has dropped precipitously. Credit is the lifeblood of our economy, and this chart suggests the credit window is closing.

**Percentage of Domestic Banks Reporting Increased Willingness to Make Consumer Loans**




Source: Federal Reserve

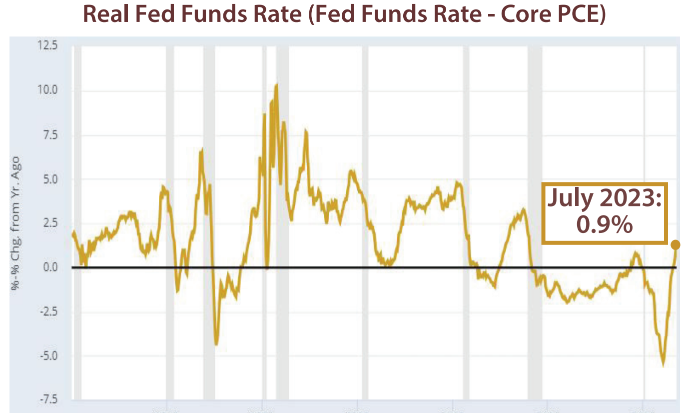
These headwinds, coupled with the removal of the before-mentioned tentpole events from the summer (Swift's tour heads overseas in November) will likely cause consumer spending to fade in the coming quarters. That said, the consumer is our economy's workhorse, and should not be discounted as long as jobs are still being added and wages are growing more than 4% annually.

In most environments, economic growth surprises are a good thing. One catch, however, is that stronger than expected consumer spending puts upward pressure on prices. Inflation is well off its 7% peak, but remains too high, and the Fed has found that slowing demand enough to achieve their 2% target is requiring far more restrictive policy than initially anticipated. The Fed has raised the funds rate to 5.50%, its highest in 20 years, and may not be done.

Fed Chair Jay Powell concluded his recent Jackson Hole speech by saying, "We are navigating by the stars under cloudy skies." Monetary policy works with a lag, but the Fed must be a bit perplexed at how well the economy has, thus far, digested their rate hikes. Investor sentiment has improved, which has helped U.S. stocks perform well this year, even if the gains are mostly concentrated within a few stocks. Bank of America's latest global fund manager survey found that 65% of fund managers now see a soft landing for the economy over the next 12 months. The consensus is that we are "Out of the Woods".

Interestingly, by his own admission, Powell refused to call a soft landing his baseline expectation at the Fed's September press conference. Powell knows the Fed's track record of soft landings; it has happened only once in modern history. The reality is that Fed tightening cycles often end in recessions, and this current cycle is the fastest and steepest of the last 40 years. As seen in the chart below, the Fed has reversed the Real Fed Funds rate (i.e. adjusted for inflation) from -6% to +1% in the span of 18 months. And aside from one instance in the mid-1990s, the gold line peaks at, or just in front of, the gray bars, which represent recessions.

**Real Fed Funds Rate (Fed Funds Rate - Core PCE)**

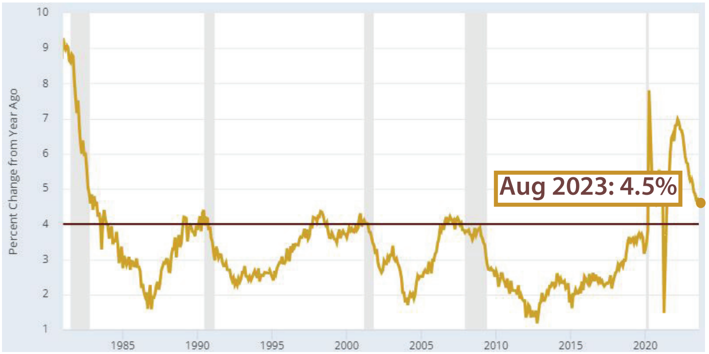



Source: Federal Reserve

Here is the Fed's Puzzle:

- An inflation target of 2% seems unachievable with wage growth at 4%.
- There is no precedent in which wage growth fell below 4% without a recession (see graph on next page).
- Wage pressures subside only in conjunction with job losses.
- Any period of sustained job losses has either been the cause, or effect, of a recession.

### Average Hourly Earnings of Nonsupervisory Employees



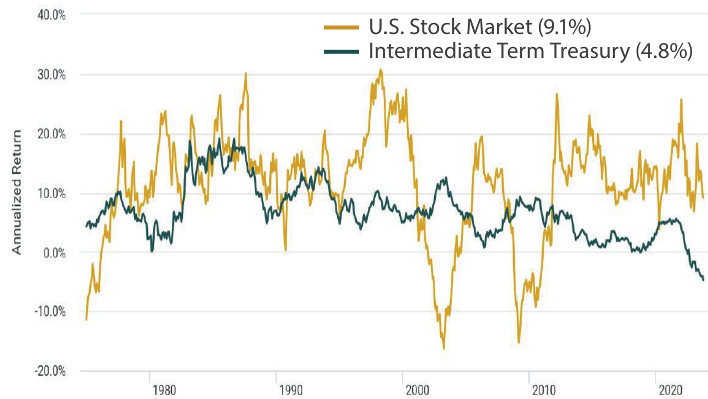

Source: Federal Reserve

Counting on this time to be different is rarely an effective strategy, but the pandemic and the corresponding bazooka of a policy response resulted in ripple effects to economic data that have been without precedent. Maybe it really is different. For now, so long as the economy is at full employment, the Fed has no incentive to change its policy course. It is very difficult to envision Fed rate cuts before the end of next year without the plane crashing first.

In the meantime, not everyone is cursing high rates. Savers can finally enjoy a positive real rate, as money market funds are paying interest above the annual rate of inflation. The Fed's current strategy is to incentivize savings, and the real interest rate is the reward for postponing spending into the future. Real rates should continue to climb, either via additional rate hikes or by disinflation, until inflation falls back to the Fed's 2% target. Consumers without borrowing needs, or those locked into low mortgage rates, are largely unaffected, or even benefitting, from the current environment. Going forward, required returns can be obtained with less reliance on capital appreciation of risky assets. For the first time in nearly 20 years, cash and bonds can meaningfully contribute to portfolio returns.

The elevator ride higher for interest rates since 2020 has been a painful repricing for existing bonds. Rolling three-year returns for Intermediate U.S. Treasurys are -5%; our chart to the right goes back 50 years, but this is, in fact, the worst three-year stretch for the asset class since 1928. 10-year Treasury rates have climbed to 4.5% for the first time since 2007. Yes, rates could move higher; a 1% rise in yields would equate to a 4% loss, but thanks to positive convexity of bond prices, a corresponding 1% fall in rates would equate to a 12% gain. Additionally, starting yields for intermediate bonds are a strong indication of 10-year forward returns. At 4.5%, this asset class is poised to offer annualized returns of 3.5% above its past ten-year performance. And while not guaranteed, bonds have a strong track record of performing well during the times that stocks do poorly.

### 3-Year Annualized Rolling Returns (Stocks and Bonds)




Source: Portfolio Visualizer

Stocks remain in a 21-month drawdown from all-time highs, but you would not know it from their three-year rolling return, which is just under its median historical average of 11%. The equity risk premium, which is a measure of the stock market's earnings yield less the 10-year Treasury yield, has fallen to its lowest level since 2007. While stocks can still perform well at these levels on an absolute basis, odds are favorable that its sheer dominance over bonds for the past decade will not be replicated over the next ten years.

In summary, here is how we see the current landscape *(Taylor's Version)*:

"Bad Blood" = Borrowers

"Happiness" = Savers

"Invisible String" = The Fed

"I Forgot That You Existed" = Positive Real Rates

"Soon You'll Get Better" = Bonds

"Question…?" = Stocks

Thanks for indulging us, and for your partnership. Please contact us if you have any questions or needs we can help with.

### INTERNATIONAL RETURNS (%)

| As of 9/30/2023 | Q3 2023 | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|
| Int'l Developed ex US | -4.1 | 25.7 | 5.8 | 3.2 | 3.8 |
| Emerging Markets | -2.9 | 11.7 | -1.7 | 0.6 | 2.1 |

Source: Morningstar

### FIXED INCOME RETURNS (%)

| As of 9/30/2023 | Q3 2023 | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|
| Aggregate Bond | -3.2 | 0.6 | -5.2 | 0.1 | 1.1 |
| Muni | -2.9 | 2.6 | -1.9 | 0.8 | 1.7 |
| Int'l Bonds | -3.0 | 4.1 | -5.4 | -1.6 | -0.7 |
| High-Yield | 0.6 | 9.5 | 1.8 | 2.5 | 3.4 |
| Short-Term | 0.6 | 3.6 | -0.6 | 1.3 | 1.3 |
| 90-Day T-Bill | 1.4 | 5.1 | 2.1 | 1.9 | 1.2 |

Source: Morningstar