ISO MTS

October 2024

On Thursday September 12th I had a zoom call with an Op-Ed editor from the *Financial Times ("FT")*. This Zoom came about following an unexpected call I received from a long-time acquaintance of mine, a reporter at the *FT*. My reporter acquaintance asked my view on markets and upon hearing how disconnected I believed common market narrative and reality were, he suggested I write an Op-Ed for the *FT*. This led to my call with the Op-Ed editor, where I pitched my ideas. He liked them and asked for a draft by the following Sunday night, with plans to publish it right after the upcoming Federal Reserve Open Market Committee meeting that Wednesday.

I spent a few hours that weekend crafting what I thought was a compelling explanation of this market disconnect. I had just listened to Bill Simmons' podcast *"The Rewatchables"* in which they reviewed a Bruce Willis movie from the 1990's called *"The Sixth Sense"*. During the podcast, Bill and team discussed movies from that era known for their mind-bending plot twists. I thought that was a fitting analogy for the current market set-up.

I share all this because, ultimately, the editor decided not to run the opinion piece. As you will read, it would have proven prescient given what has followed. In any case, I am sharing it here in the ISO Q3 letter to best describe why we believe performance was poor this summer. Investing in banks includes a healthy measure of macro-economic calculus. By focusing on their performance and behavior we should have a strong lens into the business cycle and be able to anticipate shifts in market sentiment and opportunity across the capital stack. Now, as we sit here in early Q4, the plot twist has finally revealed itself, and we believe ISO should be well-positioned moving forward.

See below for the unpublished version of "ISO's Sixth Sense":

> The Fed easing is finally upon us. The time for some intellectual honesty regarding the US economy is as well. Listen to the news, read a column from former Fed members, or listen to Wall Street economists and, in most cases, you hear and see a desperate call for interest rate cuts. Many even argue that it may be too late for the Fed to save us from recession. On the contrary, I see a robust economy and labor market hidden (by this noise) in plain sight. Some of the most popular movies of the late 90s – *The Usual Suspects, Fight Club, and Primal Fear* are a fun way to contextualize the current market narrative's disconnection from reality. These movies all had mind-bending twists at the end – with the viewer left shocked. Perhaps my favorite was *The Sixth Sense* in which Bruce Willis' character spends the movie working as a child psychologist helping Haley Joel Osment's character who sees dead people. In the end Willis's character realizes he too has been dead the entire movie, just one of the ghosts his patient can see. Upon rewatching the movie, the clues to this twist are in plain sight all along.
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> The analogy fits current popular analysis of recent economic data – except for the dead part. There are three core tenets to the thesis that the economy is in need of urgent interest rate cuts. The first argument suggests labor market weakness is now appearing and may accelerate quickly. The second is that the long and variable lags of monetary policy are still coming, and third, the Fed's policy is generating "passive policy tightening" – inflation is falling relative to an unchanged Fed Funds Rate. These arguments suffer from dogmatism and human inertia. Let me explain.
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> The labor market is handling a generational influx of immigrants into the US workforce with incredible efficiency. The unemployment rate has risen due to this new supply of labor. Does this count as weakness or is it simply taking a bit more time for these new entrants to locate a job? We will know only after the fact, but further analysis can provide a head start. Numbers beneath the surface in the latest payroll report suggest these new entrants will ultimately find work. The payroll proxy which measures available aggregate consumer income growth and the diffusion index, a simple measure of the number of industries adding jobs vs losing jobs, are showing significant resilience. The latest payroll proxy suggests that aggregate available labor market income growth is near 5%. The significance of a number this high is enormous; it means that strong consumer spending, which has propelled the economy over several quarters, will almost certainly continue. If the US consumer is strong, the labor market will be too. Then consider that the August Diffusion Index mid 50s reading means a solid majority of industries are

adding jobs. Said another way, there is good breadth in the demand for workers across the various segments of the economy. To argue the labor market is deteriorating feels like a stretch.

The second argument supporting urgent need for significant Fed accommodation is that of Milton Friedman's long and variable lags. In a word – "no". Monetary policy's long and variable lags tend to come via tight financial conditions. For example, banks limit their lending and corporate bond and equity markets close to risky companies. Over time, these conditions impair the economy. That certainly isn't the case today with banks actually loosening lending standards and capital markets activity thriving[1]. To put a fine point on this: in 2023 the Fed introduced a new model[2] to measure how their policy and prevailing market conditions were impacting the economy. I suspect they were unsure what historically fast and large rate hikes were doing to economic activity. This new index indicates that for the past nine months, financial conditions are stimulating economic growth. High yield companies have extended their debt maturities, banks aren't seeing further deterioration in existing loans, and the stock market is trading near an all-time high.

The final and most dogmatic thesis is that the Fed is engaging in "passive tightening" which occurs if inflation falls faster than the Fed Funds Rate. I believe this dynamic is actually supporting GDP growth and consumer spending. You read that right. If inflation is falling faster than wages, consumers are actually receiving a real wage increase. At the same time, consumers are pouring money into money-market funds which are still earning 5%. This 5% adjusted for inflation's fall means that consumers are benefitting from the so-called passive tightening. The entire argument is rooted in academia and, as I've just described, misses the true dynamic nature of this unique situation.

The US economy grew at 3% in the second quarter and, with a few weeks left in the third quarter, the Atlanta Fed is predicting it will grow around 2.5% in Q3. Lower inflation and high rates are working well together to create an incredible twist to upend popular expectations. We are about to arrive at the big reveal in the movie. The economy has adjusted well to higher interest rates and is thriving. Hopefully people see the big plot reveal in time. I have been a market participant for nearly 30 years and have never seen a market consensus more dislocated from reality. Unfortunately, this groupthink is creating enormous financial risk. Here comes the twist.

We would be pleased to discuss our views on the market and our portfolio with you in greater detail. Thank you again for your support.

Sincerely,

Justin D'Ercole
CIO

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1 https://www.federalreserve.gov/data/sloos.htm

2 https://www.federalreserve.gov/econres/notes/feds-notes/a-new-index-to-measure-us-financial-conditions-20230630.html

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