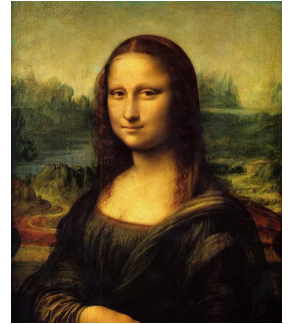




## The Mona Lisa Effect: Connecting the Dots of the U.S. Economy



### Key Takeaways

- Connecting the dots underneath and between economics and finance can help you understand what’s going on in the big picture.
- The Inverted Yield Curve: odds of a hard landing have increased.
- Financial quantities and economic quantities will be brought back into alignment. *It happens every time.*



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Leonardo da Vinci was a master of “sfumato,” a painting technique he applied to the Mona Lisa where he softened the transition between colors, blurring the lines around Mona Lisa’s face. At first glance, the subject of the world’s most famous painting seems to be smiling. Look again and her smile fades. When it next reappears, it is a different type of smile. No matter how many times you look, you’re really not sure what is happening.

Are you confused about the 2023 economic outlook for the U.S., the world’s largest economy? You are far from being the only one. In terms of the economy’s expected “*landing*,” over the past six months, the consensus narrative among economists and Wall Street analysts has gone from soft—to hard—to a banking turmoil-induced crash—and now back to the likelihood of a soft landing.

In terms of the government debt ceiling, we thought we would—with high conviction—avoid default, but it would (to use an apt, albeit graphic analogy) be like passing a kidney stone—*we know it will pass, it is just a question of how painful it will be*. We assert that **May was the painful period, creating volatility throughout the financial markets, with the kidney stone (debt ceiling) finally passing.** Biden and McCarthy agreed to extend the debt ceiling to 2025, freeze discretionary spending, and make a few other small changes. This illustrates the *futility* of budget negotiations. Any change significant enough to matter draws vigorous opposition from those who depend on the status quo. Every spending program has a well-organized constituency. Politicians of both parties pay attention, so we get a lot of noise and little real action. **Avoiding default was great but the longer we kick this can down the road, the harder it’s going to be to finally deal with this massive debt and deficit that we run every year, which will continue and now accelerate.**

Most of us remember time in our childhood, crayon in hand, connecting numbered dots that gradually revealed a picture that we couldn't foresee simply by looking at the separate dots. With experience, we got better at looking at those isolated dots and mentally connecting them into a coherent picture.

As investors, unfortunately, we see the Federal Reserve (Fed) pursuing an *unstable* monetary policy on the one hand, and an emerging bank crisis on the other. A potential recession on the horizon, massive Federal debts and deficits, record corporate profits paving the street of gold behind us, rising labor costs underfoot, yet we may look at each of these as separate dots, not realizing that they're all connected parts of a single coherent picture.

Without an understanding of how each dot is connected, we may fall prey to fairy tales that are data-free assertions and misconstructions of reality that the Fed tells Congress, professors tell their Econ 101 students, and Wall Street talking heads repeat on financial television that transform the actual picture into a distorted and incoherent mess, where fuzzy logic and superstition connects the dots of economics and finance, rather than having thought and evidence and clear lines of cause-and-effect arguments. **They are dangerous because they encourage strikingly misguided monetary policy that ultimately hurts real people.**

## The Relationship Between Monetary Policy and Economic Outcomes

The objective of this quarter's insights is to connect the dots. We'll look at some data, examine the dots underneath, and the connection between them. If I've done my job, you'll have a much deeper appreciation for what's going on in the big picture.

When one compares the claims that are made about economics and finance with actual historical data, the only conclusion is that the unverified assertions and unexamined clichés dispensed by most talking heads on television, market observers, and even Federal Reserve officials is that people are more interested in *saying something*, than whether or not *what they say* is based on truth.

### Exhibit 1: Federal Reserve Act

## Section 2A. Monetary policy objectives

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

[12 USC 225a. As added by act of November 16, 1977 (91 Stat. 1387) and amended by acts of October 27, 1978 (92 Stat. 1897); Aug. 23, 1988 (102 Stat. 1375); and Dec. 27, 2000 (114 Stat. 3028).]

A small example: Most investors imagine that the Federal Reserve is an independent branch of government, and Fed officials encourage this belief with regular talk of Fed "independence." The fact is that the Federal Reserve is a government agency, regulated by Congress, subject to the provisions of the Federal Reserve Act.

Want to know the Fed's actual legal "mandate"? Take a close look at the "shall" of Section 2A in **Exhibit 1** below. The Fed doesn't have a "dual mandate." It has a single mandate, to maintain long run growth of the monetary and credit aggregates (by loosening or tightening financial conditions) commensurate with the economy's long run potential to increase production (GDP), which it is expected to pursue in a way that effectively promotes several policy objectives: **maximum employment, stable prices, moderate long-term interest rates, and financial stability.**

Entering 2021, the Fed made a serious mistake of keeping rates near zero, even as we were returning to a period of GDP growth, low unemployment, and record-high stock prices.

From there, it was the post-pandemic supply disruptions, excess demand (fueled by the pandemic subsidies of unemployment insurance, stimulus payments, and deficit spending,) and money that earned zero, that combined to provoke the most extreme episode of asset speculation in U.S. market history, which we observed as *inflation*. **So much for the policy objectives of stable prices and moderate long-term interest rates.**

To compensate for its earlier mistake of being late to respond to inflationary pressures, the Fed has been aggressively raising short rates since early 2022. The Fed's failure to *pause* rate hikes in early 2023, amid signs of moderating inflation, is now placing the Fed in danger of overshooting—**increasing rates well beyond when it should have stopped**. Over the last 10 months, CPI has been running at an annualized rate of 3.3%, not the Fed's 2.0% target, but close. Although the Fed *skipped* a rate hike in June, the damage has been done, and any

further hikes mean more damage. **The likelihood of a hard-landing recession has now been heightened.**

## The Inverted Yield Curve

The yield curve is a term used in finance and is closely watched by economists and investors because historically it has been a reliable indicator of future economic activity, uncertainty, or even recession.

To understand it in simple terms, let's imagine you have two options to lend your money to the government: a short-term loan (e.g., 3-month Treasury bill) and a long-term loan (e.g., 10-year Treasury bond.) In a healthy and growing economy, you would expect the long-term loan to have a higher interest rate because you are committing your money for a longer period. This makes sense because the longer you have to wait to get your money back, the more compensation you would want in return. This would be referred to as a *positive (or upward)* sloping yield curve (short-term rates lower than long-term rates.) An upward sloping yield curve is also good for the health of banks as well because banks generally **pay interest** on short-term rates (for savings deposits) and **receive interest** on longer-term rates on their loans and investments in longer-term government bonds.

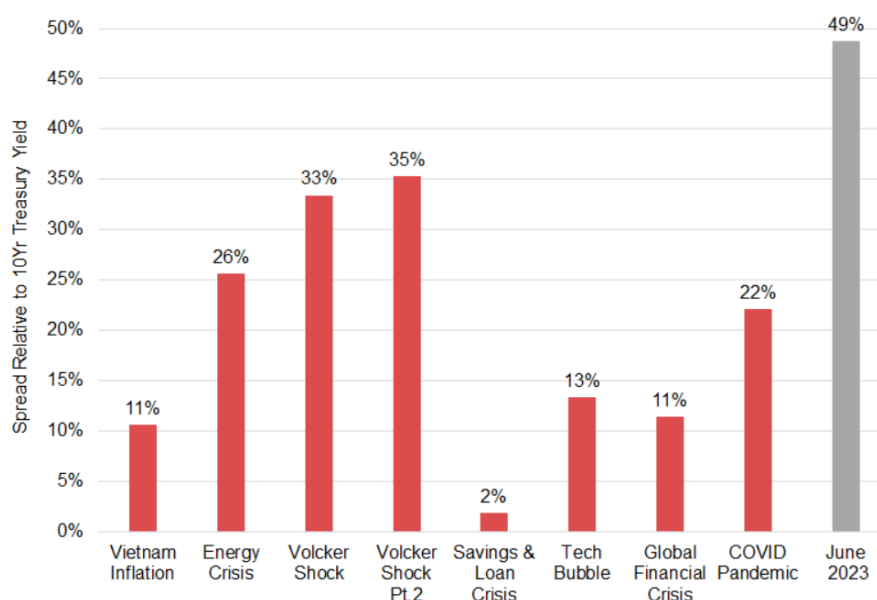
However, in an *inverted (or downward)* sloping yield curve scenario—largely the Fed's handiwork—the short-term loan has a higher interest rate than the long-term loan. It's like the government is saying, "If you lend us money for a short period, we will give you more return than if you lend us money for a long period."

By aggressively raising short rates, the Fed has upended the normal model and created risk. Because the Fed kept rates near zero, **the consequence is that banks and other institutions now hold portfolios of longer-duration bonds and loans that earn low rates of interest.** According to the FDIC, the average interest rate paid on savings accounts is about 0.50%— and far lower at the "too-big-to-fail" (TBTF) banks—while the average government money market fund rate is over 4.50%. Why are the big banks not paying depositors higher rates? Simply, because 0.50% is all they can afford given their asset/liability mismatch. Depositors are already moving to government-backed money market funds. The risk of more bank stress seems obvious. As you can see in **Exhibit 2** below, the magnitude of the current yield-curve inversion, which far surpasses previous inversions, is increasing the risk in the U.S. banking and financial systems.

The successful track record of the inverted yield-curve signal (10-year Treasury bond yield *minus* three-month Treasury bill yield) has an eight-for-eight success rate in forecasting recessions since 1968 and no false signals. The current inversion is warning consumers and businesses alike to be cautious ahead of a likely recession. Saving more and postponing business investment naturally leads to slower growth. If the Fed had stopped hiking rates earlier this year, we probably would have had a soft landing or possibly no recession at all. **There goes the monetary policy objective of Financial stability.**

One is not paying attention if one has not connected

### Exhibit 2: Magnitude of Historical Inversions Preceding Recessions: 10-Year US Treasury Bond/3-Month US Treasury Bill



Note peak historical inversions correspond to the following dates: Vietnam Inflation (8/69), Energy Crisis (6/89), Volcker Shock (3/80), Volcker Shock Pt. 2 (12/80), Savings & Loans Crisis (6/89), Tech Bubble (12/00), Global Financial Crisis (3/07), COVID Pandemic (8/19). Source: ResearchAffiliates, LLC, using data from FRED.

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the dots from the Fed's sustained suppression of interest rates after the 2000-2002 tech bubble crash; to the lowering of lending standards (NINJA Loans—No Income, No Job, no Asset verification;) that fueled a speculative housing bubble and a massive subsequent collapse in 2007-2009 at the cost of millions of jobs.

One is not paying attention if one has not connected the dots from a decade of “quantitative easing”— the Treasury’s printing and the Fed’s purchasing of trillions of dollars of Treasury securities—creating forced zero-rate bank deposits held by investors who could not, in aggregate, get rid of the stuff; to speculation in every sort of asset that might offer a “pickup” in return (“covenant lite” corporate debt, leveraged loans, equities, crypto currencies, and even digital Pokémon); to record equity valuations beyond 1929 and 2000 extremes; to emerging crises in pension funds; to bank failures as losses on even “safe” securities like Treasury bonds created bank insolvencies, while \$8 trillion of deposits in excess of FDIC insurance limits trigger bank runs; to the likelihood of a collapse in the S&P 500 on the order of 30-60% as this Fed-induced yield-seeking spectacle is likely to unwind in tears.

Even members of the Federal Reserve itself don’t seem to realize that we’ve got an emerging banking crisis coupled with preposterous stock market valuations and downside risk—**not because there is too little Fed intervention, but because there is too much!**

## Investment Implications

While extreme valuations hold enormous influence over stock returns and the extent of market losses *over the complete market cycle*, investor psychology—speculation vs. risk-aversion—holds enormous influence over outcomes during *shorter segments* of the market cycle. The increasingly ragged behavior of market internals is most clearly evident today in the performance gap between the broad market and the small number of very large capitalization “glamour” stocks. Dubbed by many as “The Magnificent 7”: Apple; Microsoft; Google; Meta (formerly Facebook); Amazon; Tesla and; Nvidia, now comprise around 8.8% of the S&P 500’s year-to-date gain of around 10%. **The Big Tech dominance highlights a concern as to the market’s overall resilience: a lack of breadth.**

It’s tempting to watch the S&P 500s advance this year and imagine that neither valuations nor market internals matter. But, remember the 2000-2002 and 2007-2009 collapses. Both included several *extended bear market rallies* (which is how we would characterize the advance this year). When extreme valuations are joined by ragged market internals, the collapses come seemingly out of nowhere—the market gets caught in a “bear trap”. The strongest return profiles for the stock market typically emerge when *reasonable* valuations are joined by favorable market internals, particularly amid Fed easing. We’re nowhere close to that point now, but I expect we will be over the completion of this cycle. **Until then, portfolio safety nets are highly recommended.**

The only way to obtain a clear picture of the economy and the financial markets is to connect the dots that link them together. The greater the misalignment between financial quantities and economic quantities, the more distorted and grotesque the whole picture becomes, particularly if nobody carefully connects the dots. One way or another, the two are brought back into alignment. Why? Because the economic quantities can’t properly fund the bloated and misaligned financial quantities. **It happens every time. It’s happened throughout financial history. Unfortunately, many investors and policy makers, too, repeatedly insist on learning that the hard way.**

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