SMEAD capital management

Missive

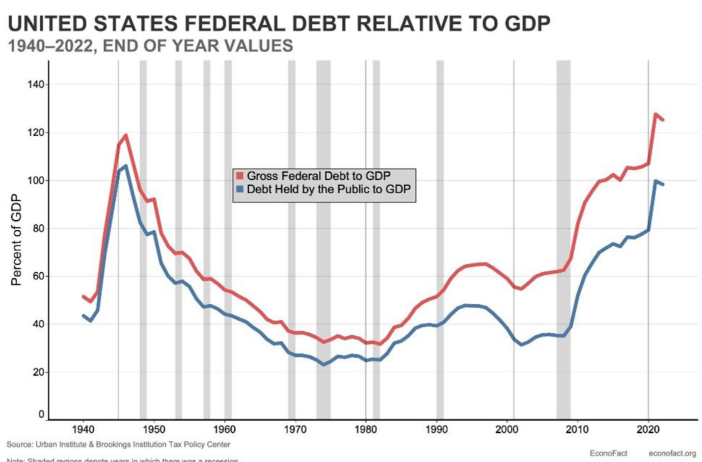
FEBRUARY 21, 2024

The Great Conflagration

We consider Ben Bernanke to be the father of 21st-century central bank policy. His work in dealing with the credit crisis in 2008-2009 was just the right policy at that time. The problem for economists is that they tend to fight the last war. The Great Financial Crisis was an economic problem where demand was dropping off from credit evaporating. The government tried to spend money to replace this destruction, but couldn't politically equal the loss of economic output. The central banks could only pray that the most accommodative monetary policy would ease the fiscal belt that wasn't loosening at that time. This was the last war for economists and has dominated economic research. Like anchoring or recency bias would tell us, this may have little to do with the problems in our future.

As we mentioned in a recent missive, Chairman Bernanke gave a speech in 2004 called *The Great Moderation*. This message has been the north star of central bank policy since then. The principle established from this speech is called the clean, rather than lean doctrine. The idea is that the central bank wasn't made to lean into potential bubbles in the economy or asset market. Instead, they are there to clean up what transpires from their unwinding. If you want to get a quick read on this, go look at the banks' runs in 2023. The Fed cleaned up by giving unlimited FDIC insurance, but even that wasn't enough to save each bank.

This unwillingness to lean into euphoria would show a willingness to let the natural order of things play out and accept whatever consequences that may mean in the end. It also allows market rates to be set by something other than prudence, but rather by the market operators. This wouldn't be problematic if the United States had a German-style means of government spending where the principle of being a spendthrift is the cross you die on. Instead, we have a government that just pushed up aggregate demand stronger than at any point in US history to fight the war on COVID. Below is a chart looking at federal debt to GDP over the last 100 years.



As shown to the right, we took on a large amount of debt to fight World War II. We even branded it well by selling low-interest rate products to investors back then, called war bonds. Your patriotism guaranteed that you earned low returns. Analogously, people bought the same ultra-low interest risk-free securities as the 10-year US treasury hovered below 1%. Wall Street is getting so much better at marketing products that they didn't need to add a dash of patriotism at those rates. The investors were willing buyers at the time while the government was a willing spender.

Here's the inherent issue we are dealing with today. To quote Harold James in his new book, *Seven Crashes*, "The government's spending capacity is infinite; all that is limited are the productive resources in the economy." We all saw this transpire coming out of COVID. Lumber, used cars, airline prices and many other products that take time to produce couldn't be supplied fast enough. The rhyme that most people are missing, and would be blessed to understand by James's book, is that COVID was a war. It was a war against an invisible enemy, but it was a war nonetheless. Was it as consequential as winning World War II? Our investors can decide that for themselves, but you can mark me personally in the no camp.

This government largesse wasn't present in the 2000s when Bernanke gave *The Great Moderation* speech or when we dealt with the economic devastation of 2008 to 2009. Shortly after the GFC, congress agreed to the Simpson-Bowles sequestration to cut spending. That's how tight fiscal policy was then. The government spending isn't ebbing with the coming political cycle of 2024. To quote the current soothsayer Larry Summers on the spending that we've seen since the start of the pandemic:

> *The checks were a "pretty serious mistake." They were the product of a merging of thought of Trump and left-wing Democrats, and in particular the Democratic Socialist Bernie Sanders: "When you see the two extremes agreeing, you can almost be certain that something crazy is in the air...When I see a coalition of Josh Hawley, Bernie Sander and Donald Trump getting behind an idea, I think that's time to run for cover."*

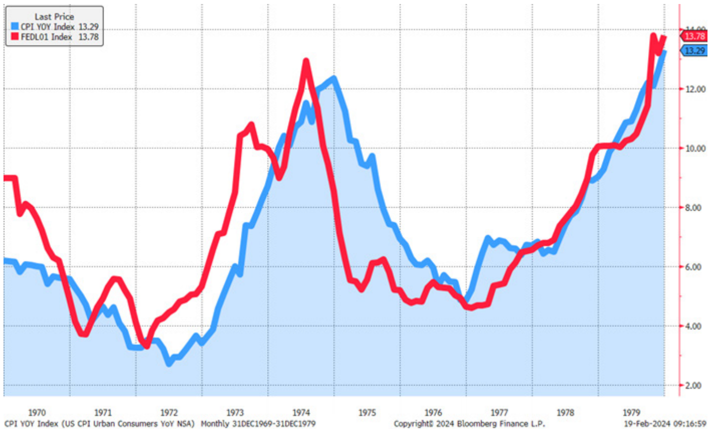
Mr. Summers is not just harping on the fiscal problem. In a fire, you need two elements: fuel and oxygen. The fuel from fiscal policy is there. While market operators are running their premature victory laps on inflation, they should be scared. They believe that the policy tools of the Powell regime have licked inflation. As Bernanke admitted as a possibility in 2004, it may just be "good luck."

The Great Conflagration

What Larry is trying to warn against is feeding The Great Conflagration with more oxygen. The oxygen in inflationary eras where aggregate demand (government spending) is too high while the cost of money is too low. Just this week on Bloomberg's Wall Street Week, Mr. Summers said:

> *I think the Fed is going to have to be very careful. They were never right to be focused on March for a cut. I had been saying that seemed premature and they are the markets have come around on that. I think that may is odds off at this point and probably should be odds off. And gosh, I think we've got to recognize what no one's talking about. There's a meaningful chance maybe it's 15%, that the next move is going to be upwards in rates, not downwards in rates.*

Mr. Summers then went on to explain that lowering rates would be akin to a patient not finishing their antibiotics. The patient stops taking them because they feel better, but the disease tends to come back and hit harder the second time. As seen below, during the 1970s, lower rates would be like oxygen for this conflagration. The lowering of the risk-free rate matched with large government spending then (Guns and Butter) caused inflationary pressures to spiral twice during the decade of the 1970s.



Market operators and the Fed are very excited to get rates lower because the golden goose of central bank policy is referred to as NICE (Non-Inflationary Continuing Expansion). We have the continuing expansion as the economy chugs along because there is so much federal spending floating around on both sides of the aisle. If we can just bring rates down to match the NICE narrative, you can retire as a central banker and ride off into the sunset. Politicians need to get reelected and spending buys votes. Watching Republicans debate Ukraine denies all math and accounting. Ukraine's spending doesn't matter in the overall federal budget. As Wilbur Ross said at a recent event we attended, it's not even significant in the overall deficit, let alone the actual budget. The real spending problem is the continued climb in Social Security and Medicare/Medicaid.

Admittedly, no one can get elected in America by saying they will cut these categories, so we know the fuel will be present. The Fed and the market operators' belief that inflation is licked, followed by lowering rates, will add oxygen to this fire. The faith in *The Great Moderation* is likely to transmit the inflationary problems to The Great Conflagration. The likes of which the Fed, market operators and Americans will never forget.

Fear stock market failure,

Cole Smead, CFA
CEO & Portfolio Manager

The information contained in this missive represents Smead Capital Management's opinions and should not be construed as personalized or individualized investment advice and are subject to change. Past performance is no guarantee of future results. Cole Smead, CFA, CEO and Portfolio Manager, wrote this article. It should not be assumed that investing in any securities mentioned above will or will not be profitable. Portfolio composition is subject to change at any time and references to specific securities, industries and sectors in this letter are not recommendations to purchase or sell any particular security. Current and future portfolio holdings are subject to risk. In preparing this document, SCM has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources. A list of all recommendations made by Smead Capital Management within the past twelve-month period is available upon request.

This missive and others are available at www.smeadcap.com.

SMEAD capital management
smeadcap.com
2502 East Camelback Road
Suite 210
Phoenix, AZ 85016
Sales Desk US 877.701.2883
Sales Desk UK +44 (0)20.8819.6490
info@smeadcap.com