This Is What a Soft Landing Looks Like, People

As mythical creatures go, you've got Leprechauns, Mermaids, Unicorns, the Loch Ness Monster and Big Foot among others. Disney caused a bit of stir recently by putting a mermaid in a movie, but that was nothing like the stupefaction being foisted on global investors right now at the prospect we might just be facing that most mythical creature of all: a Federal Reserve-engineered soft landing.

First, we think we might fairly have to ask the question what exactly is a soft landing? Most investors would probably categorize it under the "know it when we see it" column and just move on. We have certainly seen plenty of hard landings in the global economy, so let's start there. Most recently there was a hard landing in the US in 2007 as the Federal Reserve tightened monetary policy to try to cool the residential housing market which at the time was experiencing a pricing bubble. This contributed to the Great Recession, which begat the Global Financial Crisis. This process has been repeated though: in 1970, 1974, 1980, 1990, and as mentioned above 2007-08, inflation was running higher than 5%, and in each of those years, Fed policy hikes led to a recession.

It might be meaningful to go into some greater detail. Obviously, the basic premise is that the monetary authorities, in this case, the US Federal Reserve would intervene in the capital markets in order to curb inflation. Well, with 10 rate hikes in the past year, we think the point that the Fed has intervened is established. But has inflation been cured and what is the state of the global economy in the aftermath of those rate hikes?

First, on inflation, we have a trusted friend, who knows his stuff when it comes to these markets and insists US inflation is significantly higher than market participants currently believe. Our friend is of the opinion that there has been so much manipulation in the way the Fed measures inflation that we have waded waist-deep into a GIGO (garbage-in, garbage-out) scenario. Our friend is not alone, but we want to focus on numbers, not just suspicion and sentiment. In this century, up until about a year into COVID (March of 2021), US CPI had averaged 2.1% with a high of 6%. That 2.1% average inflation figure, by the way, is almost exactly in line with the Fed's goal. Since that time, from March of 2021 until today, inflation has raged as high as 9% last June while averaging 6%! However, the case that inflation has recently been tamed is not weak. During the twenty-five years from 1975-2000 inflation averaged ~5% with a high ~15%! The trend, it is said, is your friend and over the last year the CPI is down from 9% to 3%. That trend shows inflation has fallen by two thirds in a year. The history of inflation in this century is not anywhere near as fierce as it was in the final quarter of the last century. We come down firmly in the camp which believes inflation news will get better going forward.

If inflation is likely under control, how is the economy faring? To take a measure of that we ought to look at employment and wages. Let's start with wage growth. Currently, average hourly earnings for workers in the US is 4.4%. The long-term value for workers in the US 3.0%. That means workers are enjoying a hefty premium on their long-term average pay. Wages are solid, what about unemployment? Over the last 50 years US unemployment has averaged 6.2%. During this century it has averaged 5.8%. In the last two years it has averaged ~4% and the current level of unemployment is 3.6%.

So, if there is a case to be made that we are actually living through a proverbial soft-landing what are the implications for global stocks? Well, it almost certainly doesn't mean a recession is coming. Yes, we speak of that same recession we were all "promised" would happen this year. Since the global economy does not seem anywhere near a recession today those doomsayers have postponed the predictions of recession into 2024. Investors were told this time last year that an inverted yield curve implied recession was imminent, but the yield curve (defined here as 2's-10's) has been inverted for more than fifteen months. The global economy has been more resilient than investors had expected…and so have stocks.

Now, the real problem here is that investors may well have become too sanguine. The VIX Index or so-called "fear gauge" is hovering 35% below its average of this century. There is still a war being fought in Europe, the Federal Reserve is almost certain to raise rates this month and the two biggest economies on Earth are bordering on a Cold War, and yet the MSCI ACWI ex-US index is up almost 21% in US dollar terms YTD. That just does not seem to compute. It appears that going forward investors will face a slower growth but still higher interest rate environment. In such an environment many are coming to the conclusion that owning Quality stocks might be a smart move at this time.

What does it make sense for investors to do? At Haven we have always been of that mind that buying, owning and holding High-Quality stocks which have been purchased at a discount to their underlying value has dependably beaten benchmarks over time. We remain confident that this will continue to be the case. We welcome the company of other investors who have come to agree with us, at least for the time being that Quality stocks are a good thing to own. Many other investors may pass through the Quality space and all are welcome, but they would be well warned to make certain that they don't overpay for that Quality they crave because out among those mythical creatures we mentioned at the outset there are also Vampires & Bogeymen to be found. With the VIX index telling us that investors' expectations of volatility are particularly low, while we see multiple risks on the horizon and we have already seen stocks go up 20% thus far this year, investors should be prepared to witness a reversion back to the mean on the VIX. Higher volatility is likely to bring with it higher interest rates which will continue to draw risk-averse investors away from the world's stock markets. Hold on tightly to those quality stocks as there might be some difficult days to endure!