After going back and rereading last month's Double Eagle Partners investor letter, I now realize that it was filled with gloom and doom for the markets and our economy. Yet Double Eagle Partners' clients remained invested in the markets and some have asked, "Why?" Why not get totally out of the market and park it in Treasury bills when they're yielding 5.25% and there are dark clouds forming above? Because market timing doesn't work! The S&P 500 is up 14% this year, but just eight trading days in 2023 explained all those gains. Thanks to my friend Nick Colas at Data Trek for this great analysis (for complete story click here.) Had you not been in the market on those eight days this year, your return for 2023 would have been far worse and possibly negative. That doesn't mean you can't keep some powder dry when you're nervous and getting mixed signals from the markets, especially when three-month US Treasury bills are yielding 5.25%. We are in good company with our "dry powder" parked in T-bills, as legendary investor Warren Buffett is sitting on $157 billion in T-bills as well!

Another reason to stay invested is because we would have missed out on the beginnings of a seasonal rally called the "Santa Claus Rally." The Santa Claus effect has been observed in the US markets for almost 75 years and it was first coined as an investment term in 1972 as a seasonal effect for the last trading week of the fiscal year. While this may have looked like a statistical anomaly, we now realize that some of this buying momentum comes from year-end window dressing from portfolio managers who want to make sure they have the right amount of certain securities represented in their portfolios when holdings are published as of December 31st. Also, accounting rules have many investors using tax loss harvesting to offset portfolio gains with unrealized losses to minimize tax liabilities. These trades come in the last couple of weeks of the fiscal year, usually forcing the markets higher through momentum buying while many market participants are on holiday.

While our client portfolios are positioned nicely to take advantage of the Santa Claus rally, as well as benefiting from 5.25% T-bills, I remain cautious on the markets and will now return to being "The Grinch."

The Federal Reserve and the US Treasury, headed by Jerome Powell and Janet Yellen respectively, have totally misread the economy for more than two years now. Why? Because their government agencies are "data dependent," which is a backwards looking way of analyzing data, and relying on the hope that the "past is prologue" is a terrible way to anticipate future economic environments. This is the same dynamic duo that got it wrong a year and a half ago when they told everyone that "inflation was transitory." Jamie Dimon is the CEO of the largest bank in the United States, JP Morgan Chase, and he agrees with this analysis as he was just quoted as saying "Wall Street and the Feds got it 100% wrong." He is now building up rainy day cash reserves at JPM.

So why should we continue to follow Central Bankers like Powell and Yellen now or ever trust them again? We don't have to trust them, nor do we have to follow them, but we do need to ***listen*** to them. Why? Because of the realization that we are no longer operating under the auspices of free market capitalism in the United States. We are now struggling to adjust and learn how to suffer through operating under "political capitalism." Political capitalism is a term used to describe the relationship between the state (politicians and regulatory agencies) and the market economy in Western economies. It is characterized by the use of political power to secure economic gains for favored industries or constituents without concern for the negative economic ramifications that may occur. The worst part of political capitalism is that no one will be held accountable for any mistakes caused by their policies, whether that be rent-seeking, inefficient allocation of resources, reduced economic growth or regulatory capture [when regulatory agencies work hand-in-glove with the industries they are supposed to regulate like how “Big Tech” influenced the 2020 elections].

Despite what some pundits might say, political capitalism is not the same as free-market capitalism. In a free-market system, the government’s role is limited to ensuring a level playing field and protecting property rights for all. By contrast, political capitalism involves the use of political power to secure economic gains, which can lead to a distortion in the allocation of economic capital.

Some examples of political capitalism affecting the US economy are;

- Since the pandemic, COVID stimulus distribution (“helicopter money”) has pulled demand forward and increased inflationary price pressures.
- Political capitalism also is distorting the markets for electrical vehicles as well as solar and wind power through unnecessary tax rebates.
- The Biden administration has drained the Strategic Petroleum Reserve just so they can try and keep gasoline prices low at the pump during election season, regardless of any negative effects to our national security and no idea how much it will eventually cost to refill it!
- The expiration of forbearance on student loans will cause demand destruction in the economy as people resume paying these loans yet have no other money left in their household budget to spend on necessities. Not to mention the fact that *someone* in the economy will end up paying for these loans one way or another, loans do not just “disappear”!

Another terrible example of the negative effects of political capitalism is the machinations within the US Treasury bond market. The US Government, through the US Treasury and the Fed, was trying to keep interest rates artificially low during the COVID pandemic so as to stimulate the economy, yet they were also encouraging U.S. banks to buy more and more U.S. Treasuries to hold on their balance sheet as tier one capital. Two negative externalities came about because of this bad regulation. First of all, when inflation reared its ugly head and the FOMC began its historical rapid rise of interest rates, this created a negative price scenario for existing bonds which were held by U.S. banks. You may recall my discussion about this and its effects on Silicon Valley Bank during one of my earlier podcasts in 2023. The other negative externality that came about because of this prolonged environment of low interest rates and quantitative easing that the Fed had been undertaking was the fact that our U.S. Treasury debt servicing appeared to have lower interest expense than it actually would. The Treasury predicts what our interest costs to fund the government are going to be based on yields and the shape of the yield curve, which they were holding artificially low. And while they were holding interest rates artificially low, they front loaded the term structure of our government's borrowing rather than extending them out. They could have issued lots of 10 year and 30-year maturity debt to lock-in the lower rates, not unlike what you or I would do to re-fi the mortgage on our houses when interest rates were low. But instead, they chose to issue more Treasury bills and two-year notes because the near-term budgetary impact was lessened, but these loans will now need to be refinanced at dramatically higher rates.

Why does this Grinch think that the economy is slowing down and the inevitable recession is upon us? We discussed the topic months ago on these pages with the discussion of the inverted yield curve and how it portends a recession. [footnote - While every recession has been preceded by an inverted yield curve, not every inverted yield curve correctly predicts a recession]

Some signs that there may be a recession is coming;

- There is already a trucking recession going on. In the last three months, two major long haul trucking companies have filed for bankruptcy. Who will move our Amazon packages?
- Speaking of Amazon packages, we have to pay attention to the "cardboard box indicator." It is a non-traditional measure of activity in the economy. Obviously when goods need to be shipped, they need to go in corrugated fiberboard boxes. Demand for cardboard boxes has been falling steadily because of decreased demand in 2023.
- Banks are quietly closing hundreds of branches across the U.S. with thousands of layoffs.
- Chapter 11 bankruptcy filings are up 61% year over year through the first nine months of 2023. That is more than 4500 corporate bankruptcy filings.
- Private residential real estate foreclosures are also up 34% year over year as well.

Lastly, everyone is talking about the stagnant housing market and how the current 8% mortgage rates are making it impossible for people to buy homes. People with existing mortgages at 3% don't want to give up that mortgage just to be able to move to a new house. As discussed in my most recent podcast, the ramification of this is that fewer and fewer real estate transactions are taking place in 2023. As housing is such a dynamic and important sector of the US economy contributing hundreds of thousands of jobs through household creation, without this powerful economic engine, the economy will naturally slow in 2024.

The stock markets have priced in perfection for 2024, that being lower rates, lower inflation, no recession, and an end to the wars in the Middle East and Ukraine. But as a subtle reminder, the markets have been wrong many times before, especially when taking their lead from a Federal Reserve that practices political capitalism. While the Fed tells us inflation may be coming down from its peak of a year ago, prices are still obviously higher than they were a month ago. The ***rate*** of inflation has been coming down but that means prices are still going up, just at a slower rate. That is disinflation, not deflation (lower prices) which is what the economy desperately needs. If household incomes cannot keep up with inflation, then personal spending obviously needs to decline, thereby slowing the economy and leading us towards a recession.

While it is fun to believe in the magic of the season and leave out milk and cookies for Santa and carrots for his reindeer, we must be careful and not believe too much in the Santa Claus rally.