

## Apothenia

Apothenia, a term coined by psychiatrist Klaus Conrad in 1958, describes the human brain's tendency to perceive patterns and make predictions, even when logic suggests those patterns do not exist. We know the odds of the ball landing on either red or black during a game of roulette are always equal, but we always tend to have a pattern in mind when we play i.e., "three blacks in a row, it's time for red", or "red is on a hot streak, bet on red".

Amidst the rapidly changing economic environment of the past year, one thing that has surprised us is how investor behavior has remained broadly consistent with clinging onto the same old pattern that worked in the past. The pattern is one of secular economic stagnation and central banks willing to provide a backstop on risky assets every time there is turbulence, which in turn encourages a buy-the-dip mentality among investors. This is at odds with our own view that we are at an important inflection point and entering a new market regime that will dictate economic policy and asset prices in the years ahead. In this letter, we share some first thoughts on that topic, starting with the fundamental drivers behind the original market pattern, the triggers that are setting the stage for a new regime, and the corresponding investing implications.

Globalization and technological progress have been the defining forces of change over the past 25 years. Following the collapse of the Soviet Union, globalization entered a new era that saw the integration of the vast workforces of developing nations into the global economy, and the formation of new trade and financial channels. Technological advances facilitated this integration through faster information transfer speeds, automation, and the enabling of global supply chains. The result was a disinflationary trend in consumer goods and wages across the developed world. In the absence of inflation, US monetary policy was able to prioritize maximum employment, the second part of the Fed's dual mandate, and ensuring the "stability of the financial system", a concept so broadly defined that essentially allows them to intervene in financial markets during any type of crisis. The central bank is supposed to be above political influence, but political pressure is always there, and its members would rather do too much than too little when a crisis unfolds. It is telling that in every interest rate cycle since 1980, the Fed cut rates faster and deeper than the one before. Volatility was suppressed, and corporate profits flourished, aided by low wage growth, declining interest expense (i.e., interest expense to total debt for nonfinancial firms declined by 3% in ten years), and a global race to the bottom on corporate tax (average corporate tax rate for G20 countries fell by more than 10% in the past 25 years).

The narrative changed in the past couple of years when we suddenly faced an inflation problem. Since 1990, on a two-year rolling basis, inflation has averaged 2.25% and stayed within a tight range, with a low reading of 0.75% and a high of 3.35%. In the past two years, it has averaged 7.05%. The pandemic created some distortions, but the gargantuan scale of the stimulus response has probably been more impactful and less widely understood. The Federal Reserve increased its balance sheet by \$4.2 trillion, of which \$3 trillion was added almost instantly, between March and June 2020. To put this in context, during the 2008 financial crisis, the balance sheet expanded by \$3.6 trillion over the entire six-year period between 2008 and 2014, in what was then seen as a monetary experiment with no precedent. On the fiscal side, over \$5 trillion of federal money was dispersed (for details on where it went, check the link: [How Covid Stimulus Was Spent](#).) This is more than three times the amount spent during the 2008 crisis and seven times the amount spent in the

1930s, adjusted to today's dollars. The stimulus entered an economy that was booming right before the pandemic, but which was being severely disrupted by an external, and ultimately temporary, shock.

The rapid economic recovery and inflationary pressures that followed are less surprising once the scale and nature of the stimulus are considered. The recovery was uneven because different parts of the economy benefited at different times, with tech companies (stay-at-home beneficiaries), single-family homes (migration out of city centers), and equity prices (flows from retail investors with money in their pocket and time to spare) benefiting during the first wave, and consumer services such as travel and leisure benefiting during a second wave that is still ongoing. The Fed eventually reversed course, raising rates at the fastest pace in four decades, and since then the economy has been caught in an intense tug of war between the lagged impact of those rate hikes and the lingering effects of the stimulus (on the latter point, consider that consumers entered this year still with \$1.2 trillion of excess cash in their checking accounts, and fiscal spending has remained highly expansionary, including spending on green initiatives, infrastructure, a splurge for the semiconductor industry via the Chips Act, and potential student debt forgiveness). Normally, there can only be one winner in this tug of war, because the positive force is wearing off—consumers are eating into their savings buffer at a rate of \$100 billion per month—while the rate hikes and resulting “accidents” (see Silicon Valley Bank) are only just beginning to bite, but there lies the one key unknown: the Fed's reaction function. Based on the old pattern, any sign of economic weakening would reignite the disinflationary trend, and the Fed would quickly capitulate, lowering rates and pumping liquidity into the system. To give you an indication of how the market is programmed to think that way, in the span of just two weeks in March, as the regional banking crisis unfolded, the rates futures market immediately went from pricing a hike of another 70 basis points in the Fed funds rate, to a cut of 100 basis points. Proof of a highly efficient market, or a classic case of apophenia?

Economic forecasts should always be probabilistic rather than deterministic, so we do not know exactly how things will play out. Nevertheless, we suspect that applying the old template to today's economic situation would be a mistake. This is not to say that the Fed will no longer bow to political pressure or remain eager to protect financial markets, although we expect some hesitancy, considering that their aggressive expansion during the pandemic is now widely recognized as an error of judgment. Rather, we struggle to see how we return to that long-term secular trend of disinflation. The labor arbitrage trade is mostly over and, given developments in China, could go into reverse. Nearshoring, or the process whereby corporations bring production closer to home to reduce supply chain complexity, is accelerating and will result in higher production costs that companies will try to pass on through higher prices. Decarbonization is sparking multiyear investment programs by both the government and corporate sectors that increase demand for labor and materials and put upward pressure on prices. Government spending on national security is also rising structurally, particularly among nations that had underinvested and misjudged the geopolitical threat (e.g., Europe). Those are all sources of structural inflation.

The short-term business cycle will still dictate the level of inflation and interest rates to a degree, but we believe the new average levels will likely rest at a higher plateau, closer to the 100-year average rather than the outlier that was the period from the mid-90s to today. Interest rates are extraordinarily important. The present value of a \$100 bill received ten years from now is \$95 at 0.5% interest rates but only \$61 at 5%. All else equal, higher average rates should result in a lower valuation range for equities, greater divergence

between the strong and the weak, structurally higher volatility and more frequent credit episodes, less ability to juice returns through leverage or fund projects with cash flows well into the future, and a premium for established businesses with stable and rising cash flows that keep up inflation.

## Important Disclosures

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