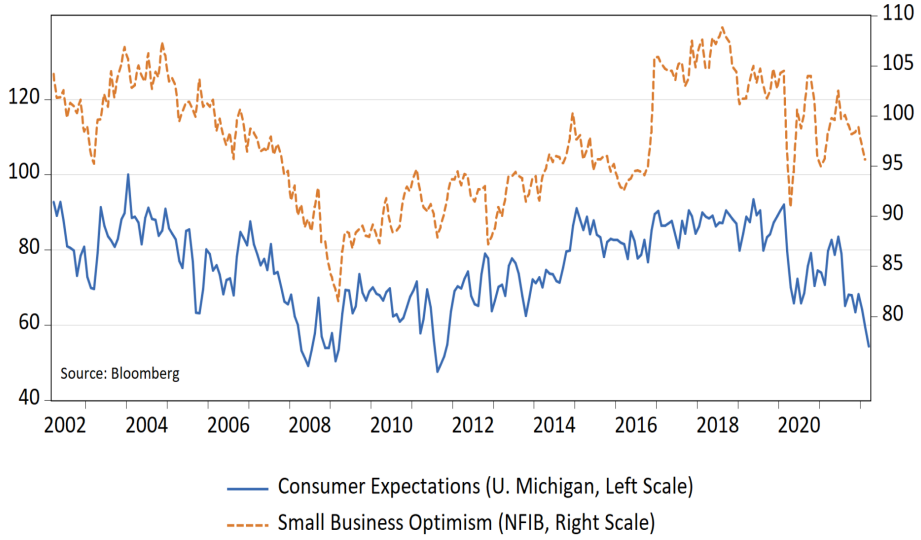
MARKET COMMENTARY

EXPECTATIONS AND CYCLES

Surveys of consumers and businesses reveal a sense of unease about the future. Despite relatively full values for stocks, bonds, and real estate, there seems to be a good deal of uncertainty and worry about what comes next. The University of Michigan's consumer expectations survey is near lows not seen since 2008, and small business confidence is declining toward levels last seen at the start of the pandemic (chart on page 2).

Chart A

CONSUMER AND SMALL BUSINESS CONFIDENCE



THE "CYCLE"

There are many cycles in markets. The business cycle, inventory cycle, accounting cycle, and capital investment cycle are a few, but the list goes on and on. Many sought to describe various cycles before, each with a slightly different take on the story. The basic idea is that crises are periodic. They come and go again with some regularity as economic conditions move from boom to bust and back again.

Economists have long sought to describe and explain the stages and causes of the cycle. Irving Fisher, for example, advanced in the 1930s a Debt-Deflation Theory to try and describe the happenings of the 1920s and 1930s. John Maynard Keynes laid out his theory of the business cycle, drawing on his understanding of the macroeconomy throughout his life. Ludwig von Mises laid out his Theory of Money and Credit in the 1950s. Many others saw similar patterns in economic life, each adding something to the conversation to better understand economic life.

We are not economists, yet we are familiar with cycles and have our own understanding based on what we have seen in our lifetimes.

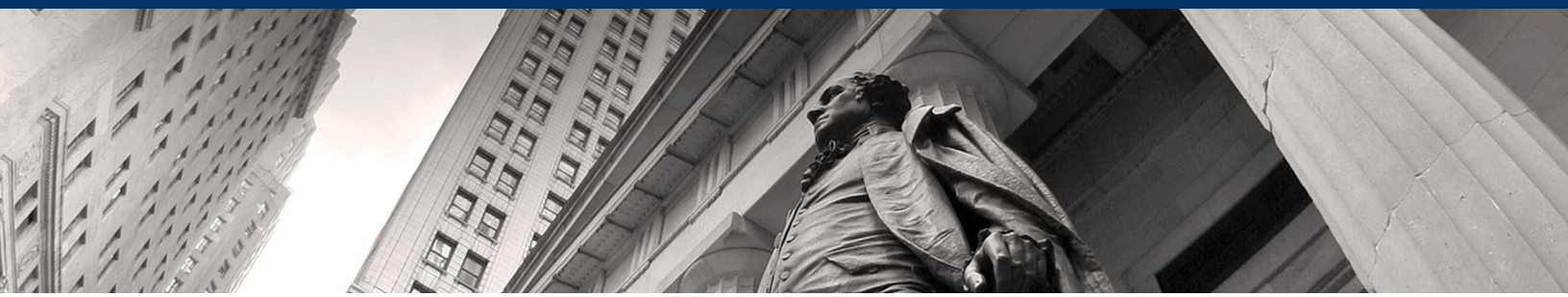
As we emerge from the pandemic-driven environment of 2020-2021, we see that conditions are changing. Importantly, we note that inflation is running hotter than expected (up 8% from a year ago), and the central bank is beginning to tighten monetary policy.

While we cannot know with certainty what lies ahead, we are interested in thinking about what might come next. What plausible outcomes should we consider at this point? In our experience, the business cycle does seem to recur and often generates results different than what might be regarded as the "consensus view." What follows is our own highly stylized image of a typical cycle with pieces borrowed liberally from economists like those highlighted above.

A "STYLIZED" CYCLE

STAGE	DESCRIPTION
Seeds of Inflation	The government, working through the central bank, engages in policies designed to encourage expansion of the economy, jobs, and credit. Everything seems to be working just fine.
Feeling Alright	Asset prices rise, and the stock market goes through a bull market. This is when the investing public "feels alright," but those not invested may feel they have "missed the boat."
Aches and Pains	Eventually, consumer prices will catch up, and debts mount. This can cause some "aches and pains," which tend to foreshadow higher interest rates and lower government deficits.
Exhaustion	The bull market tires and loses momentum at the end of the inflationary cycle. Inflation hedges like hard assets, gold, or other commodities may become more attractive.
Applying the Brakes	The central bank applies the brakes, typically failing to engineer the fabled "soft-landing." Immediately, interest and capital costs rise, liquidity recedes, and a credit crunch may ensue.
What Was That?	As markets become more volatile, many become surprised by events and the future seems very uncertain. Typically we see the liquidity drying up, stocks under pressure, commodity prices dropping, and recession worries increasing. Creditors and business owners pull in their horns and stop making loans and new investments.
Off a Cliff	Often, in this stage, credit growth slows or declines outright, unemployment rises, and the economy contracts further. It may even feel the economy has gone "off a cliff," leaving some to doubt whether to hang on or get out of formerly profitable investments.
Silver Lining	We are ready to start a new cycle with market prices much lower. The correction in asset values has left prices depressed, creating a reason for at least a few brave investors to step in and begin to buy. This is the downturn's "silver lining."
To the Rescue	Under intense political pressure, policymakers unite and scramble to enact new tax cuts and spending initiatives. The central bank is also easing monetary policies to "jump-start" the economy and ease the public's burden. By this point, exhaustion sets in, and public outcry for assistance is everywhere.
Full Circle	As the government and central bank intervene, sentiment improves, liquidity returns, the downturn ends, and an economic recovery begins anew. The cycle has come full circle, and a process of rebirth, renewal, and growth begins again.

CONCLUSION



The cycle described above is a simple, highly stylized version of what we might reasonably expect from an economy as it moves from stage to stage. This is an imprecise and unscientific endeavor, and past performance does not indicate future results. Yet, we think we are well served by using our experience and imagination to think about what could happen next. With inflation high, the Federal Reserve removing at least some of the "punch" in the "punch bowl," and asset valuations above average, we should start to think about the potential for some additional volatility.

At a deep level, it seems to us that cycles tend to emerge from disconnects between what is commonly expected and what can reasonably be delivered. If expectations are higher than what the economy can reasonably deliver, disappointment and corrections follow. A similar process unfolds in the opposite direction at cycle bottoms. At the turning points, overconfidence and a "herd" mentality often amplify the process. So, if history again repeats, we may find that the future looks different from what might otherwise be imagined today.

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