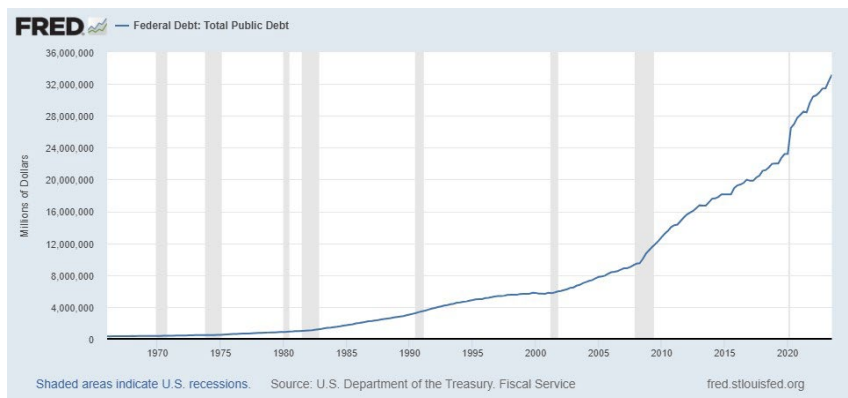


Every year has unforeseen events that shape the narrative for financial markets, politics, and social commentary. At year-end, the media recounts the events with elaborate stories on their impact and transcendence. In financial markets, 2023 might be most notable for the degree to which economists and strategists got it wrong. In a December 24, 2023, article titled “Don’t Expect Predictions to Find Their Target,” author Jeff Sommer laments the inaccuracy of Wall Street predictions which he notes have “a track record that is extraordinary in its ineptitude.”¹ Indeed, many got the economy, the stock market, the level of interest rates, and many other forecasts wrong in large part because events during the year defied previously reliable patterns.

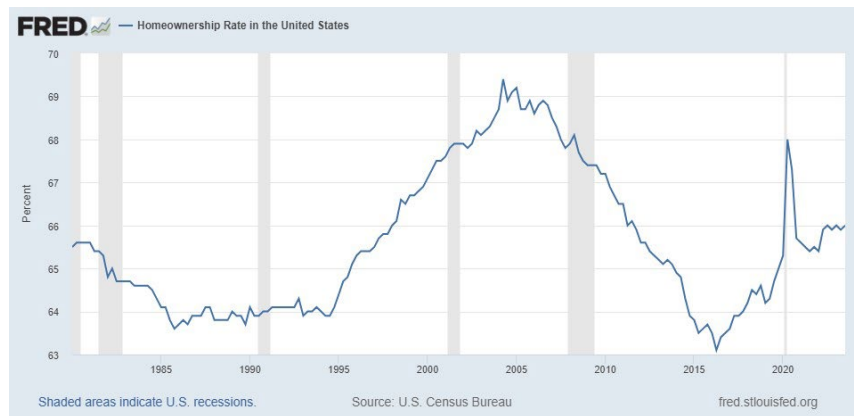
Thankfully, most of the wrong predictions in 2023 were pessimistic ones. We did not experience a recession as many forecast, nor did stock prices crater. Instead, strong capital markets overcame unprecedented rate hikes and major geopolitical disruptions across the globe. Commencing in March 2022, the Fed raised rates eleven times by a total of 525 basis points with the last occurring in July 2023. That was the fastest pace of hikes in history. Economists might be forgiven for forecasting economic deterioration as an outcome. Not only did the U.S. economy dismiss the Fed, it ignored a regional U.S. bank crisis, the highest mortgage rates in over 20 years, the collapse of China’s housing bubble, the ongoing conflict in Ukraine, and the Israel-Hamas war. Why were so many smart people so wrong?

At the risk of oversimplifying, the pandemic engendered a few monumental changes that likely altered people’s behavior and the economy. The first major change was a gargantuan transfer of wealth from the public sector to the private sector. Specifically, from March 2020 when the pandemic started through late 2022 – a period of about 30 months – the Federal government enacted over \$7 trillion in government programs. That astronomical sum exceeds 25% of GDP. While not all the appropriations were to be disbursed in a single year, over the period from March 2020 through December 2023, the federal government’s debt exploded by over \$10 trillion. Debt grew by 43% in nominal terms and from 107% of GDP to 123% of GDP in relative terms.



Another evolving change involves consumer behavior and spending habits. It is hard to tag behavior to one event like the pandemic because many factors influence people’s choices. However, the severity of the restrictions, their duration, and the rarity of the Covid health scare had a discernible impact on important sectors of the economy. For example, housing which had been moribund for a few years experienced a vigorous recovery. The homeownership rate, which started declining in 2005 and fell at an accelerated pace after the 2008 recession, leaped from 65% in Q4 2019 to 68% in Q3 2020

¹ The New York Times, December 24, 2023. “Don’t Expect Predictions to Find Their Mark,” Jeff Sommer



Source: U.S. Census Bureau, Homeownership Rate in the United States [RSAHURUSQ156S], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/RSAHURUSQ156S>, January 24, 2024.

and stabilized around 66% by 2023. Similarly, homeowner vacancies collapsed during the pandemic and, in 2023 stood at the lowest level in nearly 70 years. It became common to hear gripes about appliance backlogs, a dearth of new vehicles, and challenges finding leisure equipment.

In a coincidence worth noting, the U.S. population was traversing important demographic shifts as the pandemic hit. Specifically, according to the 2010 Census, the largest five-year demographic cohort corresponded to

individuals born between 1960 and 1965. When the pandemic started, that cohort, part of the “Baby Boomers,” was turning 60 and approaching retirement. At the same time, the next largest cohorts, Boomer children, were in their early to mid-thirties. The social dislocation that lasted nearly three years likely influenced decisions made by many, especially those facing life-changing choices like retirement and starting a family. Assuming, as is likely, that many behavioral changes followed the pandemic, their implementation probably occurred during late 2022 and 2023. In economic terms, these actions implied excess demand for goods and services at a time when supply was still constrained by the effects of the pandemic. Neither the excess demand nor the limited supply is permanent, but their coming together in 2023 likely prodded GDP in unanticipated ways that forecasters might not recognize.

After three years of “extreme” events that included lockdowns, record employment losses, record employment gains, unprecedented government largess, and untested monetary policy, discerning the economy’s future might be challenging. Thankfully, after 2023’s growth surprise, both monetary and fiscal authorities recognized economic intervention is no longer necessary nor warranted. As a benefit going forward, predictions may not have to adjust for distortions caused by government subsidies. However, because so much government intervention became a norm, the world now faces the immense challenge of its withdrawal.

In the U.S., we believe both fiscal and monetary authorities have daunting tasks ahead. To support the economy, the Fed grew its balance sheet from \$4.2 trillion as the pandemic started to \$7.2 trillion within three months and took it to a peak of nearly \$9.0 trillion during the first half of 2022. Quantitative tightening, also known as balance sheet “normalization,” began in June 2022 and reduced the balance sheet to \$7.7 trillion by year-end 2023. At that size, the balance sheet remained \$3.5 trillion higher than before Covid. By continuing to sell at the current pace, it will take another three years to fully reverse the pandemic-related stimulus and over six years to restore the pre-2008 normal.



The federal government's mountain of debt may be the most challenging and damaging problem we face, especially given the context of the world's geopolitical threats. Debt grew at an accelerating rate commencing in 2008 to address the recession and later for the pandemic. Like the Fed, the government failed to recognize when assistance was no longer needed, and, instead, consented to unsustainable expenditures in 2022 and 2023. We begin 2024 confronting a slowing economy, two wars, intransigent foreign adversaries, elections, and stubbornly fragmented governments. With increasing demands for our help, the loss of fiscal flexibility may increasingly endanger our national security and the independence of many democracies.



Source: U.S. Office of Management and Budget, Federal Surplus or Deficit [-] [FYFSD], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/FYFSD>, January 23, 2024.

While 2023 was surprising on the “up-side,” and we can celebrate the likelihood of a soft landing in 2024, we may no longer have the resources to address unexpected adverse conditions. In the past, we frequently advocated for the reversal of interest rate subsidies and excess spending. Now that it appears to be happening, we worry the task is insurmountable and the timing risky. There is little solace in the knowledge the U.S. is not alone in the excess debt predicament because when problems surface, we must spearhead the solutions. While we do not want to predict a crisis, the upside surprises for the economy and financial markets may be in the past.

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