October 3, 2024

Dear Clients and Friends:

To paraphrase Tolstoy, every unhappy generation is unhappy in its own way, and apparently the millennial generation is rather unhappy. This is according to the Gallup Annual World Happiness Report issued in March of 2024. "What seems to be the issue?" you might ask. Is it the usual complaints from what could be referred to as the "whiniest generation," or is it something specific and do they have grounds to be dismayed? Reading the report, it seems that the complaints center on the high cost of housing and the unfair advantage the older generation has received. Apparently, the greedy geezers refuse to sell their homes and transfer them to the next generation. Do the millennials have a legitimate complaint and a reason to be upset? Are the geezers being greedy, or has the market been distorted and, if so, by whom? When looking for market distortions and their causes, we always begin with those master manipulators, those monetary Magoos, the Federal Reserve.

The zero-interest rate policy (ZIRP) the Fed implemented for over a decade had many deleterious and distorting effects on markets. The most recent brush with double-digit inflation got the most print, but it was far from the most pernicious. For that, I think we have to turn to the housing market. By the time the Fed began raising rates in 2022, approximately 70% of the mortgage market had a fixed rate less than 3.5%. Normally when interest rates rise, one of the first areas to feel the effect is housing, and as interest rates rise, demand slows and prices fall. Now the Federal Reserve employs over 400 PhDs, and while they are not real doctors subject to the Hippocratic Oath, you'd think that would still be a primary principle to follow! And being really smart, you'd think they would have been able to see with all those fancy models the outcome of not only current policy but also how it would interact with the policy of the past decade.

So what happened? According to data from the St. Louis Fed, the number of available homes for sale in July of 2019 was 1.235 million units. This fell to 647 thousand by July of 2023, essentially cutting the number in half. At the same time, the median sales price went from $276,000 to $397,000, an increase of 43%. So here we have it. The price of a new home rises by 43% and interest rates double, making it even more unaffordable for those unhappy millennials. At the same time, the paper wealth of the geezer class rose by the same amount. Perhaps this younger generation has a cause to be unhappy, but rather than focus their ire on the older generation, it should be placed where it belongs, on those masters of monetary mayhem, the Federal Reserve.

The bad news is that this is an issue that will not resolve quickly, and it is significant, apart from the happiness of the millennial generation. Housing is wildly unaffordable, and the generational transfer of wealth to the geezer class was both unfair and possibly destabilizing. While a matter of great importance, it was certainly not addressed at the recent post Federal Open Market Committee meeting press conference. It was a time for celebration, self-congratulatory high fives, and back slapping all around, as the inflation genie had been put back in its proverbial bottle. The reality is that their policies likely had little to do with the decline in inflation, and their obsession with cutting rates and returning to an impossible-to-define neutral rate is alarming. So where does all of this leave us?

The market has convinced itself that rates will decline to around 3% by the end of 2025. Prices for all things related to the present value of future cash flows have been repriced accordingly. This includes, of course, bonds of all types as well as equities and all forms of risk. There is nothing to be gained by leaning this way, as the market has already priced in that scenario. So naturally we look to benefit to a degree, should the Fed prove to be incorrect in their view of inflation or the strength of the economy. One, because the probability of an alternative scenario is significantly greater than the zero the market is implying, and two, because the cost of taking this position is exceedingly low. We have seen this movie countless times, and we believe this is the best way to position for it. Just ask yourself, "If the Fed is calling the shots, what could possibly go wrong?"

Sincerely,

Mark M. Egan, CFA
Managing Director