

## **Jelly Donut Policy Part II: Navigating by the Stars Under Cloudy Skies**

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Over a decade ago, I had the opportunity to discuss the Federal Reserve's monetary policy in a speech titled "Jelly Donut Policy." Today, I am grateful to Jim for extending the invitation for an update.

On the off chance that a few of you might not have been here in 2012, and those who were might not remember what I said, let me start with a summary.

In 2012, we were well through the bottom of the great financial crisis. Real GDP growth was running 2-3% and inflation was about 1.5-3%. The S&P 500 had more than doubled off the 2009 lows and was trading at 14x earnings. The 10-year Treasury yielded about 2%. Unemployment was about 8%. U.S. debt was \$16 trillion, which was around 98% of GDP, and the budget deficit was about \$1.1 trillion or under 7% of GDP.

Despite the bottom of the crisis being a full three years in the rear-view mirror, the Fed funds rate was between zero and a quarter of a percent and the Bernanke Fed promised rates would remain at that level for several more years. Further, the Fed had completed two cycles of quantitative easing and was contemplating QE3.

The general economic concern at the time was the relatively low level of economic growth, considering the slack in the economy evidenced by the 8% unemployment rate.

The Jelly Donut hypothesis I spoke of began as follows:

*A Jelly Donut is a yummy mid-afternoon energy boost.*

*Two Jelly Donuts are an indulgent breakfast.*

*Three Jelly Donuts may induce a tummy ache.*

*Six Jelly Donuts – that's an eating disorder.*

*Twelve Jelly Donuts is fraternity pledge hazing.*

*My point is that you can have too much of a good thing and overdoses are destructive. Chairman Bernanke is presently force-feeding us what seems like the 36<sup>th</sup> Jelly Donut of easy money and wondering why it isn't giving us energy or making us feel better. Instead of a robust recovery, the economy continues to be sluggish. Last year, when asked why his measures weren't working, he suggested it was "bad luck."*

*I don't think luck has anything to do with it. The blame lies in his misunderstanding of human nature. The textbooks presume that easier money will always result in a stronger economy, but that's a bad assumption.*

I posited at that time that the connection between monetary policy and economic performance isn't linear. Reducing interest rates from 12% to 8% has a different impact than lowering them from 4% to zero. At some point, easier monetary policy may hinder growth rather than support it.

As a preview of where I'm going with this: the converse is also true. When you start with rates at zero, raising rates by a few percent doesn't slow the economy, but rather, it stimulates it.

Before coming all the way to the present, I'd like to spend a few minutes reviewing what has happened since 2012. COVID was such a traumatic experience on all of us personally and on the economy broadly, it is hard to recall how things were before those dark times.

In the years following the original Jelly Donut Policy until COVID hit, there were positive developments. The unemployment rate steadily declined to below 4%. Real GDP growth was consistently between 1.5% and 3%. Inflation sat above zero, but below 3%. The federal budget deficit ranged from 2.4% to 4.6% of GDP. S&P 500 earnings compounded at 6% per year and the multiple expanded to 20x, generating a 15% annual return. The 10-year bond yielded between 1.35% and 3.25%.

The Fed continued feeding the economy Jelly Donuts by maintaining its zero interest rate policy through the end of 2015 and executing a third round of quantitative easing. Starting in 2016, the Fed gradually increased rates, reaching 2.5% in late 2018. In 2019, when there was a wobble in financial markets, Chairman Powell gave up on the effort to further tighten policy to preemptively fight inflation that had not yet materialized.

Instead, the Fed then cut rates three times by the fall of 2019. Essentially, inflation was running below the Fed's 2% target and it wanted to do something about that. How much below, you might ask? It was 1.7%.

When I first presented the Jelly Donut thesis, I wasn't predicting a calamity. It was just an observation that monetary policy was slowing the economic recovery. At the time, 8% unemployment was a legitimate concern. I would argue that the subsequent period of below-trend economic growth bore that out.

Of course, this period was followed by COVID. The economy was essentially shut down, and quite predictably, we had a new round of emergency Fed policy. Rates were immediately cut back to zero by March of 2020, while the Fed rapidly expanded its balance sheet and implemented a number of other emergency measures.

I don't have any issue with the Fed implementing emergency policy during an actual emergency. The obvious question, seems to me, is whether such policies should be maintained once the emergency has passed. In the case of COVID, it was reasonably clear that the true emergency had passed by the summer of 2020. This was evidenced by the S&P 500 recovering its full COVID loss by August 2020.

Yet when inflation began to appear, the Fed chose to continue pursuing emergency monetary policy. Chairman Powell first argued that the inflation was “transitory,” but by the fall of 2021, with inflation running at over 6%, he had to acknowledge this was not the case. Despite recognizing that inflation was not transitory, the Fed continued quantitative easing for several more months, holding rates at zero until March 2022.

Of course, by then, inflation was running at a very high 8.5%.

I would argue that from 2008 until March 2022, the Fed was consistently running Jelly Donut monetary policy like it was in a jam. Rates ranged from low to “emergency.” Quantitative easing was often employed, sometimes in response to emergencies and sometimes when there was no actual emergency in progress.

The long, steady diet of dozens of donuts has led the economy to develop “Fed diabetes.” Financialization has taken over everything. Many parts of the economy are leveraged and fundamentally dependent on low interest rates. In addition to aggressive monetary policy, there have been numerous bailouts of creditors. It started with the bailouts after Lehman failed and continued into the COVID response. It was extended again this spring to bank depositors in response to the failures of a couple of systemically unimportant, but grossly mismanaged, regional banks.

Low rates, combined with periodic bailouts of creditors, have a way of softening the waists of credit analysts. We have learned that if there is a major problem, credit risk will inevitably be socialized onto the biggest balance sheet of them all – the U.S. Federal Government.

Does anyone seriously doubt that if the markets ever test the mettle of over-leveraged state governments, that Uncle Sam won’t save the bondholders? Texas might be more likely to secede than the creditors of, say, Illinois, will experience bond losses that would otherwise seem to be baked in at this point. As a guy who grew up in Milwaukee, now might be a good moment to interject that the Bears and Cubs still suck. Oh, and Aaron Rodgers to the Jets...

But, I digress.

The point is that we have received a decade and a half of conditioning that the Fed will always bias policy to the easy or emergency side. We must understand the resulting long-term implications. It is no wonder that, for the last year and a half, the market has consistently underestimated how high the Fed would raise rates and over-anticipated the timing and pace of future rate cuts.

Today, everyone from homeowners taking on new mortgages, to creditors restructuring loans on half-empty office towers, to bank regulators ignoring mark-to-market of hold-to-maturity portfolios, has a tinted vision of much lower rates in their base case analyses to support future refinancing.

It's hard to quit Jelly Donuts cold turkey and the addiction withdrawal symptoms are indeed painful to financial markets – even as they are strengthening the real economy.

Though the 10-year Treasury still yields less than it did at any time from 1966 to 2002, diabetic Jelly Donut brains think rates are now well above normal and can't be sustained.

However, inflation is tricky. And in the response to COVID, it's even trickier. I'd like to spend some time on why that is.

Understanding inflation during the pandemic is challenging because various prices changed for different reasons. Yet the sum total of all price changes is aggregated into a single inflation statistic. If you want to quibble, you might say that we can look at the calculation ex-this or ex-that and pick and choose what we think core inflation is, or what core inflation ex-rents is, or what core goods inflation or core services inflation is, or what core inflation is ex-how much Kellogg's reduces the number of corn flakes in a box.

This type of analysis seems flawed to me. All these varying ways to quantify inflation go to the question of how much prices are going up, but they fail to address why they are going up. Failing to understand the impetus of inflation led to the Fed first incorrectly concluding that all the inflation was transitory, before coming to the equally wrong conclusion that all the inflation was not transitory after all.

I think the truth is that some of the inflation was transitory and some was not. It's worthwhile to think about what is what.

COVID and our response created an enormous distortion between supply and demand. When the economy was shuttered and most workers were told to stay home, supply was dramatically reduced. Whatever those workers were doing, many weren't able to do it from home. We learned that some jobs could be done remotely, but many that create economic supply cannot.

At the same time, the various emergency programs replaced the lost income for workers who weren't working. If you get paid not to work, your demand doesn't fall. The result was stable demand in the face of collapsing supply.

Sometime during the first week of freshman Economics, you learn that if demand outpaces supply, it is inflationary. Somehow, this surprised the Fed.

When idiosyncratic prices shoot up astronomically because of an acute imbalance between supply and demand, the price increase is likely to be transitory.

The easiest example is short-term profiteering. When everyone wants to fill their cars with gas ahead of a storm and the gas station doubles the price, that's obviously transitory. It will take just a few days after the storm passes for the gas station to receive a fresh gas supply to match normal demand and prices rapidly return to the prior levels.

We saw this during COVID on a mass scale. There were all kinds of temporary shortages, initially starting with toilet paper and household disinfectants. A few months later, with the sawmills still closed and the demand for houses soared, lumber prices tripled.

People wanted whatever Amazon could deliver, including goods made halfway around the world, at a time when commercial air travel collapsed. So, air freight prices soared.

People also wanted cars to avoid public transportation; while manufacturing slowed in the face of component shortages, new cars sold at a substantial premium to sticker price.

There were dozens of other examples of problems in the supply chain causing shortages, rationed by price and in some cases profiteering. All of this was transitory.

However, some of the price increases were not transitory.

When something triples in price, that's a bottleneck or shortage. However, when something that used to have a stable price goes up 10%, that's the non-transitory part of inflation. It now costs about 10% more to go to the movies, and 15% more to go to the dentist or join a gym than it did prior to COVID. Many in this room might have noticed that the cost of a room in a luxury hotel at a resort destination is over 30% higher. Car rental prices are up about 40%, but riding in an Uber costs about 80% more. Everyone in the room has probably noticed that the cost of a ticket to this conference is up only 10%. Jim could probably re-examine his pricing power in this new era.

These types of price increases are not transitory. In recent years, they were supported by enormous fiscal deficits financed by newly created money from the Fed.

And as those costs of living rise, incomes follow. Sometimes it happens automatically with a lag. Nine percent inflation in 2022 meant that social security benefits rose nearly 9% in 2023. Twenty-three states increased the minimum wage this year. As workers see costs rise, they ask for and often receive higher wages. The national statistics say private employment costs are up 4.5% year-over-year. President Biden raised pay for all federal workers by over 5% in August. Some pay is negotiated on a multi-year basis. American Airlines pilots got a 46% increase over the next 4 years. UPS workers got large raises. The UAW auto-workers are on strike, but the debate is whether wages should rise something close to the 21% offered or the 36% demanded. According to an anonymous tip, even the base salaries at Greenlight improved across the board last year.

Obviously, businesses – Greenlight excluded – will try to pass the higher costs on to customers.

This is called a wage-price spiral and once it gets going, it's hard to stop.

Jim said I need to propose some CUSIPs. Here is one: One-year inflation swaps are priced at 2.56%. You get the difference between current expectations and whatever realized CPI turns out to be. I recommend going long that. While you are at it, I think picking up 10-year

inflation swaps at 2.61% also makes sense. For those that can't do swaps, buying TIPS gets you the same exposure without the leverage.

Turning back to monetary policy, there seems to be a lot of surprise that despite the Fed raising rates by more than 5%, the economy hasn't come to a collapse. In fact, GDP growth appears to be accelerating.

If Chairman Greenspan might be best remembered for the phrase "*irrational exuberance*;"

and if Chairman Bernanke might be best remembered for "*we believe the effect of the troubles in the subprime sector on the broader housing market will be limited and we do not expect significant spillovers*" (the Nobel Committee may have forgotten that gem);

and if Chairwoman Yellen might be best remembered for saying she didn't expect another financial crisis in her lifetime;

then I suggest that Chairman Powell might be best remembered for "*we are navigating by the stars under cloudy skies.*"

To which I ask, in this day and age with modern GPS systems, why would anyone try to navigate by the stars? I wouldn't even walk across town or drive home to Westchester without help from an app.

While Fed backers might try to explain the strong economy as an effect of long and variable lags, or blame other factors, or just point to monetary policy being more an art than a science, I think the answer is simpler – and has nothing to do with navigating using stars on a cloudy night.

It is the Jelly Donut Policy in reverse. Or in today's language, it is *Ozempic season*.

A decade ago I contended that changes in interest rates have significant effects on household balance sheets. Interest costs are mostly mortgages and are typically fixed, while cash and money market balances are more variable. Higher rates, therefore, drive increased household income.

I argued that low rates hurt savers, requiring the amount needed to save to finance a reasonable retirement to increase, causing the need for savings to rise, which stifles consumption. From 2009 to 2019, the savings rate rose steadily from about 5% to 8%.

I argued that if low rates spur corporate capital spending, beyond some point, further rate reductions don't spur much more additional investment. This is because risks other than the cost of capital take over the decision-making process. From the cyclical peak in 2007 to 2019, corporate capital spending grew a measly 2.6% per year.

As the Fed has raised rates, all of those things have worked in reverse to support a strengthening economy.

U.S. households have over \$13 trillion of short-term, interest-bearing assets, but only \$5 trillion of non-mortgage consumer debt. A 5% increase in rates implies \$400 billion of incremental interest income.

As households earn more on savings and can invest safely while earning positive returns, the demand for savings has naturally fallen. Higher rates mean seniors need fewer interest-bearing assets to create annual income to support retirement.

Currently, the savings rate sits at 3.9%, which is under half of the 65-year average of 8.5%. While there may be some truth that some of the low savings is deferred spending on the other side of COVID's forced savings, it is also possible that the better outlook for savers due to higher rates has reduced the need for savings.

Meanwhile, corporate capital spending has accelerated, compounding at 7.3% per year off the pre-COVID peak and has continued to rise at a slower pace since the Fed began hiking.

It has been surprising to market observers in that many corporations termed out their debt, while holding cash on the balance sheets. Albert Edwards at SocGen pointed out that corporate net interest expense has actually *fallen* in response to higher rates. How is that? Corporations have large cash balances that have benefitted from higher rates, while they have a lot of fixed-rate debt that was financed when rates were very low.

So just like households, as Edwards put it,

*Companies have effectively played the yield curve in reverse and become net beneficiaries of higher rates, adding 5% to profits over the last year instead of deducting 10%+ from profits as usual.*

The other side of this, of course, is the Federal Government. Higher interest rates drive up the cost of issuing and refinancing government debt. The average rate on government debt is currently 2.92%, up from 1.56% before the tightening began. On about \$33 trillion of debt, that is about \$450 billion of extra interest expense. With \$7.6 trillion of debt set to mature in the next year, in addition to the need to borrow to support the current deficit, the federal interest tab is likely to grow another couple hundred billion in the next year.

What is another phrase for additional government spending that isn't financed by taxes?

How about fiscal stimulus?

So, if both households and corporations benefit from higher rates, where higher rates support income, profits and capital spending, which is funded by increased fiscal stimulus while also reducing the need for savings, why would anyone expect raising rates from zero to 5% to topple the economy?

The Fed doesn't seem to appreciate this dynamic at all. Instead, it has focused on the one area where higher rates and quantitative tightening has a slowing impact – financial assets.

The most obvious is the stock market. Last year the Fed appeared to hope that if it could drag down the S&P 500, it could put a dent in consumer spending. Merry Christmas!

It didn't really work out. The S&P 500 fell 18% last year. Yet, retail sales were up about 7% during the Christmas quarter.

Higher rates clearly hurt the financial sector. Banks borrow short and lend long. Higher rates and an inverted yield curve are a drag on profits derived from maturity transformation.

Highly levered assets are at risk of being repriced. Everyone understands that commercial real estate will have defaults. Yet, it's hard to see how defaults on commercial real estate cause job losses. If an over-leveraged owner turns the keys over to the lenders, who then sell to a new owner, it is clear the old owner has a loss and the lender may have a loss. But, it isn't clear why anyone has to lose their job. And, without job losses, it's hard to see how this filters into the real economy.

So, what is the point of all this?

When Chairman Powell expresses uncertainty about the impact of monetary policy by saying things like, "We are navigating by the stars under cloudy skies," he is acknowledging that monetary policy has limited impact and that economic forecasting is difficult.

I think we should credit this point as being true.

But, if that's the case, why are we all so focused on what the Fed says and does?

I think it is because we, all of us in this room, are in financial markets and what the Fed says and does has a large impact on the prices we see flashing on our screens.

But, the Fed's mandate isn't about financial assets. It's about inflation and employment. On that front, the Fed may have only limited impact, especially when it comes to interest rate setting. It appears to consistently misapprehend the non-linear relationship between rates and its policy goals. In fact, if I'm right, the Fed actually has the sign backward when rates are very low.

It is very convenient for Washington to message that the Fed is responsible for the economy. It enables Congress and the President to avoid responsibility for their contributions. It feels like a game of distraction.

The Inflation Reduction Act, for example, did nothing that I can see to reduce inflation. Instead, it provided various incentives that will increase the cost of many things – most particularly energy, while adding hundreds of billions to the deficit.

Perhaps, instead of having press conferences every few weeks on monetary policy, we would be better served to have routine press conferences on fiscal policy – if we could only figure out who is responsible and would take the podium.

The U.S. currently has a very easy fiscal policy. This year the deficit is projected to be \$1.5 trillion, or about 5.8% of GDP. We have never seen a deficit like this at a time of full employment.

I won't unduly belabor our unsustainable fiscal position. I think everyone agrees that it's unsustainable. But not everybody agrees *when* it becomes a problem.

In early September, Scott Galloway, who I deeply respect and usually agree with, wrote a piece called "Least Bad," where he took on the doom and gloomers. It's a good piece that I recommend.

However, toward the end he takes on the deficit, where he writes:

*Another catastrophist go-to: the debt-to-GDP ratio. Currently, our national debt amounts to 120% of our GDP. In other words, we're borrowing more money than we're making. Sounds bad. Until you look at other nations and realize it's, wait for it, less bad. Singapore is at 130%, Italy, at 150%, and Japan, at 260%.*

*For years, economists have been drawing red lines around "no-go" debt-to-GDP numbers, but time has shown these red lines are also meaningless. The Maastricht Treaty said don't go higher than 60%. The World Bank, 77%. One landmark Harvard study, "Growth in a Time of Debt," claimed 90% was the tipping point. That study caused panic until three years later researchers found the data was faulty and the conclusion wrong. The reality is there is no magic number. Japan is at 260% and Botswana, 20%. Would you rather hold Japanese yen or Botswanan pula?*

After looking into it, I'd suggest neither. Though I agree with him that there is no magic number. But, that doesn't mean that there isn't a problem.

In response, I'd like to quote a speech from someone else I usually agree with: *Me*.

Soon after the great financial crisis I said:

*It was once unthinkable that "risk-free" institutions could fail – so unthinkable that the chief executives of the companies that recently did fail probably didn't realize when they crossed the line from highly creditworthy to eventually insolvent. Surely, had they seen the line, they would, to a man, have stopped on the solvent side.*

Back then I was talking about financial institutions. But I think the same concept applies to the Federal Government, which in addition to its own direct obligations, has also implicitly backstopped large pieces of the rest of the credit markets.

In fact, the magic number is not a constant. Any highly levered entity that depends on others to remain solvent, is solvent right up to the point where mass opinion decides it isn't. The concept is called reflexivity. It's super important.

So, where does that leave us now?

One might think that with Jelly Donut Policy running in reverse, we would have clear skies ahead – absent the fiscal situation.

But, there is one more side to consider – the impact of inflation.

Inflation eats at purchasing power. Households might earn more interest income and demand higher wages, but inflation eats at that. So, the debate today is, if inflation was under control and we can glide down to 2% or so over a couple years like the Fed predicts, things will be ok.

I just don't think that's likely. I think the wage-price spiral is in place. I think commodity prices, most particularly oil and other energy prices, are again on the rise. Rents and home prices have stabilized and appear to be inflecting higher, again. The easy disinflation from prices that went parabolic, but now reverted lower, is behind us.

Higher inflation slows the economy. And my guess is that it has already begun to re-accelerate. If that causes enough of a shakeout in financial assets that financial stability becomes a risk, the Fed will be forced to defend the system.

More Jelly Donut Policy in the face of high inflation is a ticket to a large payout on inflation swaps, or if you prefer, TIPS.

Like all forecasts, especially those under cloudy skies, this one could be wrong. We shall see.

Finally, many people have asked me if we are adopting AI into our business. While I've struggled with that question, I thought of one use: I asked ChatGPT to summarize this speech into a limerick. Here is what came back:

*In a speech so profound and wide,  
"Jelly Donut Policy" he'd ride.  
From 2012 to now,  
Through financial woes, we'd plow,  
But monetary choices, he'd deride.*

*Rates were near zero for years on end,  
QE measures, the Fed did extend.  
But the impact was askew,  
Economic growth it didn't renew,  
Too many "Jelly Donuts" to comprehend.*

*Then came COVID's daunting might,  
Emergency policies took flight.  
Rates at zero, money supply did grow,  
Inflation started to show,  
A decade and a half of Jelly Donut plight.*

*Now, with rates on the rise, a new tune,  
Households, corps, and the government's boon.  
A reversal of the Donut's effect, Economic strength, we'd expect,  
But inflation's specter may loom all too soon.*

I understand Jim is serving Jelly Donuts at the break – let's enjoy *just one* together.

Thank you for having me. And congratulations to Jim on the anniversary. Forty years is something to be quite proud of.

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