

# Ivory's Economic Outlook

SPRING 2023 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

*"The propensity to swindle grows parallel with the propensity to speculate during a boom".*

Charles P Kindleberger, Economic Historian

My social status began to take shape in the 8<sup>th</sup> grade when my friend and I received an invitation to a New Year's Eve party. Our parents didn't think much of it because these were wealthy private school kids and not our roughneck friends from the neighborhood. In retrospect, they probably assumed that the parents would serve as chaperones and monitor this underaged group of well-behaved preteens trying to fit in.

This would turn out to be an ill-fated gross miscalculation. It seems the chaperones had been replaced by alcohol and stuff we hadn't been exposed to, the very things our parents figured the neighborhood kids would do, which they hadn't, yet. Instead of a sanitized gathering we found ourselves jumping out of the jelly and into a jam. We took our time to avoid looking like rookies, calculated what we could get away with and decided to ease into adulthood by drinking the wine.

We were having a great time until my dad picked us up in his Oldsmobile 98 and immediately smelled the wine on our breath. Without saying a word, he dug into his bag of tricks, turned up the heat and transformed his vehicle into a furnace. The trap had been set. Pops would teach us a lesson about drinking alcohol by making us sick to our stomachs.

We were middle class by now, no more NYC public school for us, but that also meant my father's Oldsmobile didn't just have plush velour seats but electric windows too. When I rolled my window down in a desperate attempt to get some fresh air, he'd wait a couple of minutes, allow us to get relief, and then he'd roll the window back up. Over and over again he tormented these two middle schoolers until the inevitable happened. He never mentioned the incident. Didn't even punish me. In his mind he made his point: excessive behavior has consequences.

**First Republic Joins List of Biggest-Ever Bank Failures**  
Collapse is second-largest, behind Washington Mutual

Bank	Assets	Deposits
Washington Mutual	\$307 billion	\$188 billion
<b>First Republic</b>	<b>\$229 billion</b>	<b>\$104 billion</b>
Silicon Valley Bank	\$167 billion	\$119 billion
Signature Bank	\$110 billion	\$89 billion
IndyMac	\$32 billion	\$19 billion
Colonial Bank	\$25 billion	\$20 billion

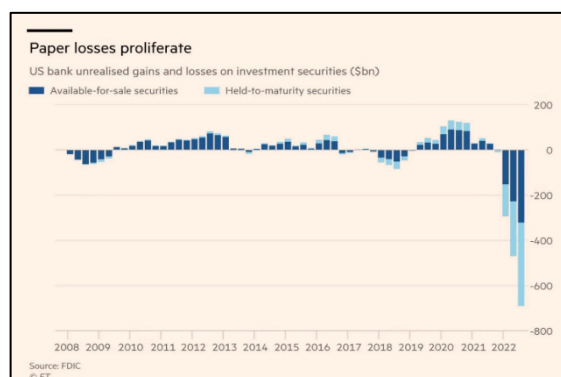
Sources: Company filings, FDIC statements  
Note: Data represent failures from October 2000 to the present

Bloomberg

Things tend to happen slowly and then all at once. A sip of wine here, an interest rate cut there, until somebody makes you pay the price. Silicon Valley Bank and First Republic Bank would have done well to hire my dad in the risk management department. When the Fed lowered rates, these banks had to invest deposits in longer-term bonds to get any type of interest at all. The problem is when rates increase the longer-term bonds go down the fastest because investors must wait longer to get their money back and benefit from the higher rates afforded by the market.

These institutions didn't do anything particularly egregious because the bonds they purchased were issued by the United States Treasury and government agencies. This was simply a liquidity issue once social media told depositors they could get higher rates across the street with the click of a button. The banks, having tied their money up in a quest to increase yield, had to sell those long-term bonds at a loss to give depositors their money back. Worse yet, the price of these bonds, and the scale of the losses, were not yet public because they had not previously been sold and no market price had been set.

The sale of these assets let the market know these banks had been drinking too much wine and the chaperones were nowhere to be found. Once the cat was out of the bag and there was a run on the bank, the Fed (the parent responsible for bringing wine to the party in the first place), created a facility with more fake money to buy the bonds from the balance sheet of the bank and make depositors whole. Looks like they still have their work cut out for them - rumor has it 50% of U.S. banks are insolvent<sup>i</sup> and depositors are still searching for higher yields<sup>ii</sup>.



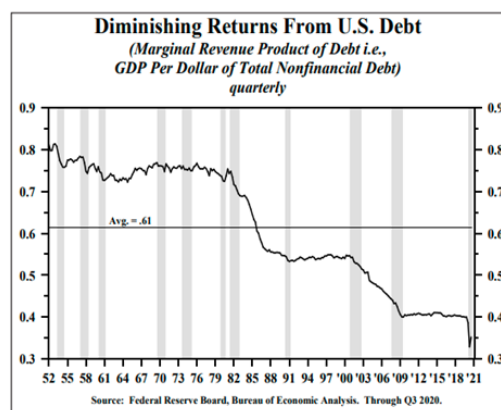
The Zero Interest Rate Policy (ZIRP) has likely created several problems we don't even know exist yet, namely in the form of misallocating capital. Investors hell bent on earning more yield, of getting more bang for their buck, often purchased illiquid investments that might end up giving them the bang without returning their bucks when they need them. One example is the private equity firm Blackstone's real estate investment trust named BREIT that recently limited redemptions despite having \$880 billion under management<sup>iii</sup>.

The markets might believe the worst is behind us and I sure hope they're right, even if the data has its doubts. Earnings growth on a year over year basis was 54.38% in Q1 of 2022, 21.1% in Q2 of 2022, 6.6% in Q3 of 2022 and -12.7% in Q4 of 2023<sup>iv</sup>. Moreover, GDP growth went from increasing on a year over year basis by 12.5% in Q2 of 2021, to 1.8% in Q2 of 2022<sup>v</sup> and the Blue Chip Consensus expects it to be near zero in Q2 2023<sup>vi</sup>. This is what one would expect when you have a high cost of capital, high cost of living and a staggering decrease in liquidity needed to pay the most debt ever recorded in human history.

That's not to say a calamity is a foregone conclusion. Congress might get its act together, pay the piper and ask the American public to accept sacrifices and embrace third rail politics grasping at a tattered white flag. After all, the positive impact deficit spending has on GDP growth wanes over time, the Marginal Productivity of Debt has been raising its eyebrows since the 1950's<sup>vii</sup>, and the Law of Diminishing Returns can't seem to stop grinning.

Nevertheless, Jerome Powell could let the lack of liquidity run its course. Danielle DiMartino Booth of Quill Intelligence makes the case that we could reduce the footprint of the unregulated shadow banking system that provides nearly 60 percent of total consumer and business credit<sup>viii</sup> and moderate the securitization market which she believes is an inefficient way to price credit and return it to the banking system that must withstand the light of day.

Bloomberg suggests that 20% of publicly traded U.S. companies are zombies who lack a sound business model and only exist because they had access to cheap credit<sup>ix</sup>. Allowing them to fail would create more capacity for the remaining 80% who can compete for better priced credit. Worst case scenario the Fed announces that 2% is the new zero, but that the days of the Zero Interest Rate Policy are behind us because it feeds the non-banking sector that adds little value to economic growth. These would be painful concessions, and even if alternative strategies are adopted, they are unlikely to offer immediate relief that's pleasing to the eye, or the pocketbook.



A more likely bullish catalyst would be economic conditions that go from awful to only bad, which is good. Some believe the odds are just about even that we'll have a fair fight on what the second half of the year looks like. Should GDP go from flat to barely positive, investors would want to be more aggressive. Wages should also be more manageable now that layoffs have been announced and consumers will have overcome the shock of inflation and resumed their normal spending habits.

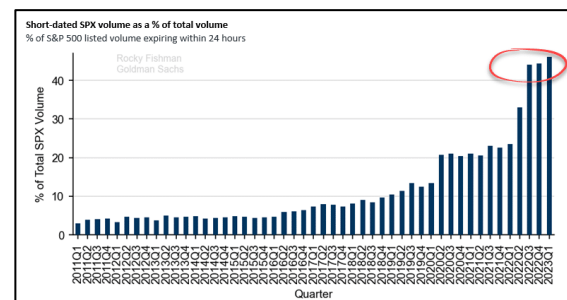
Drevan Anderson-Kaapa is a three-time conference champion in college that represented his country in the World University Games. He also served in the military and recalled a survival training exercise when he was dropped off in the woods with limited supplies and extreme sleep deprivation. When asked to explain how some guys kept their cool and others did not, he replied that "when there's a difference between what you project and what you are capable of it crumbles under stressful situations". He believes "it's easy to be tough when you know that you can handle the situation. The true test comes when you can't".

The book "Do Hard Things" believes toughness doesn't happen from weeding out the weak or finding out who can suck it up, but rather an ability to handle uncertainty enough to guide your response in the right direction. Toughness is about embracing the reality of where we are and what we must do. In fact, research consistently shows that tougher individuals can perceive stressful situations as challenges and not threats. According to the book, the ones who shrug off uncertainty and say things like "I got this; it's a piece of cake" are the first ones to fall apart.

Suffice it to say these are uncertain times and investors are uncharacteristically bearish. They'll have to be patient though; macroeconomic realities often take their sweet time to materialize. The NASDAQ jumped by double digits 11 times between March 2000 and September 2002 en route to what became a 79% drawdown. The data that suggested we were on the precipice of a recession during the dot com bust were obvious if you had the patience and a process. There are also Zero Days to Expiration Options that currently manufacture demand for stocks.

Here's how it works: a July XYZ call option with an exercise price of \$40 means you can buy XYZ stock at \$40 before the end of July. If XYZ goes to \$45, you pay \$40 for something that's worth \$45. The catch is you pay a premium (a bet if you will) for this right. If XYZ doesn't go above \$40 before July the position becomes worthless and you lose your premium.

Zero Days to Expiration Options are options that expire within 24 hours. Why would somebody place a bet on something that's about to expire and become worthless? Well, the person who receives the premium, the one who would have to buy XYZ at \$45 and give it to you at \$40, will immediately go out and hedge their position to some extent based on assumptions of how likely it is they'll have to make good on fulfilling the terms of the option.



Right now, nearly 50% of S&P 500 options are 0DTEs that are correspondingly being hedged and that generates a huge demand for the underlying asset. According to JP Morgan, \$1 trillion in notional value currently trades every day from 0DTE options alone<sup>x</sup>. That's a lot of volume and it creates artificial demand for stocks. This practice is no more illegal than the impact stock buybacks have on price action, but we simply don't know how sustainable it is, and if it isn't, what would take its place to establish a floor.

We are wrestling with something we can't seem to put our arms around, that the past is trying to keep the future at bay. It is a quarter of office-building loans that need to be refinanced in the next year at higher rates<sup>xi</sup> looking over their shoulder at the lower quality properties hiding in the shadows of illiquid alternative investments. This is a debt ceiling showdown between two political parties ill-equipped to stop spending too much money and a \$1.4 trillion private debt industry<sup>xii</sup> that securitized adjustable-rate loans made to small and midsized companies who are headed into a recession.

All of these uncertainties and nuances should be accounted for with a measured approach: own fewer growth stocks, have little more cash and keep a position in gold. Whether conditions improve or take a turn for the worst, the goal is to not get run over and live for another day. If the concept of a hard landing is difficult to fathom it's because the circumstance of gold and cash being everything is too unimaginable to consider. For safe havens to become nothing, however, would likely be a victory for the ages and we should all pray like the biggest sinners in Babylon for them to hit rock bottom.

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*The S&P 500 is an unmanaged index which cannot be invested into directly. This index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*

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<sup>i</sup> Half of America's banks are potentially insolvent – this is how a credit crunch begins; *The Telegraph*; 5/2/2023

<sup>ii</sup> Deposit Outflows Shine Light on Fed Program That Pays Money-Market Funds; *Wall Street Journal*; 4/5/2023

<sup>iii</sup> Blackstone Limits Breit Withdrawals for Fourth Straight Month, *Barron's*; 3/1/2023

<sup>iv</sup> NASDAQ Data Link

<sup>v</sup> U.S. Bureau of Economic Analysis

<sup>vi</sup> Federal Reserve Bank of Atlanta

<sup>vii</sup> Federal Reserve Board; Bureau of Economic Analysis

<sup>viii</sup> Financial risks grow in shadowy corner of markets, worrying Washington; *Washington Post*; 12/19/2022

<sup>ix</sup> Zombie Firms Face Slow Death in US as Era of Easy Credit Ends; *Bloomberg*; 5/31/2022

<sup>x</sup> What Is Volmageddon? Why Record Options Trading Could Risk Another 20% Stock Crash; *Forbes*; 3/8/2023

<sup>xi</sup> The coming commercial real estate crash that may never happen, *CNBC*; 4/9/2023

<sup>xii</sup> Analysis: Private debt markets face reality check as companies grapple with rising rates, recession; *Reuters*; 12/20/2022