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Volatility - Quantitative Tightening - Liquidity

> "Strong economy, big storm clouds. I'm calling them storm clouds because they're storm clouds. If it was a hurricane, I would tell you that."
>
> "Brace for an economic hurricane. Everyone thinks the Fed can handle this. That hurricane is right out there coming our way."

The first statement comes from Jamie Dimon's presentation at the JPMorgan Investor Day conference on May 23, 2022, with the second following one week later at a Bernstein conference predominantly attended by investment analysts and CEO's. It's important to note the drastic change in tone and message from the CEO of the largest U.S. Bank. Volatility will likely be an increasingly prevalent theme across the broad spectrum of financial markets, media outlets, government bodies, and behavioral patterns moving forward. Dimon's "storm on the horizon" analogy alludes to the uncertain impact of imminent unprecedented structural changes to financial systems and the economy.

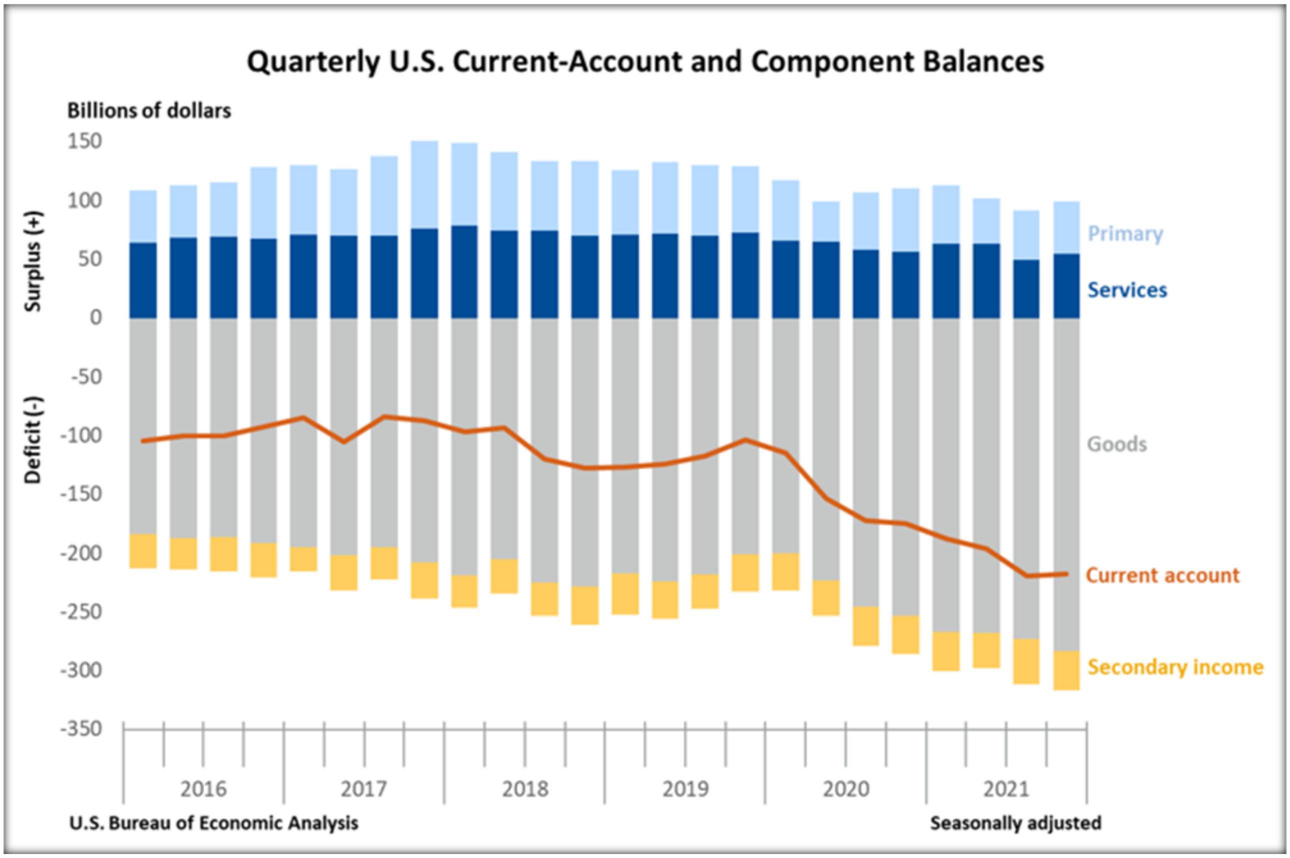
The Federal Reserve's Quantitative Tightening (QT) begins mid-June as they passively tighten their balance sheet by rolling over fewer Treasuries and Mortgage-backed securities (MBS) with the caps shown below.

- $47.5 billion per month ($30 billion Treasuries - $17.5 billion MBS) – Starting June 2022
- $95 billion per month ($60 billion Treasuries - $35 billion MBS) – Starting September 2022

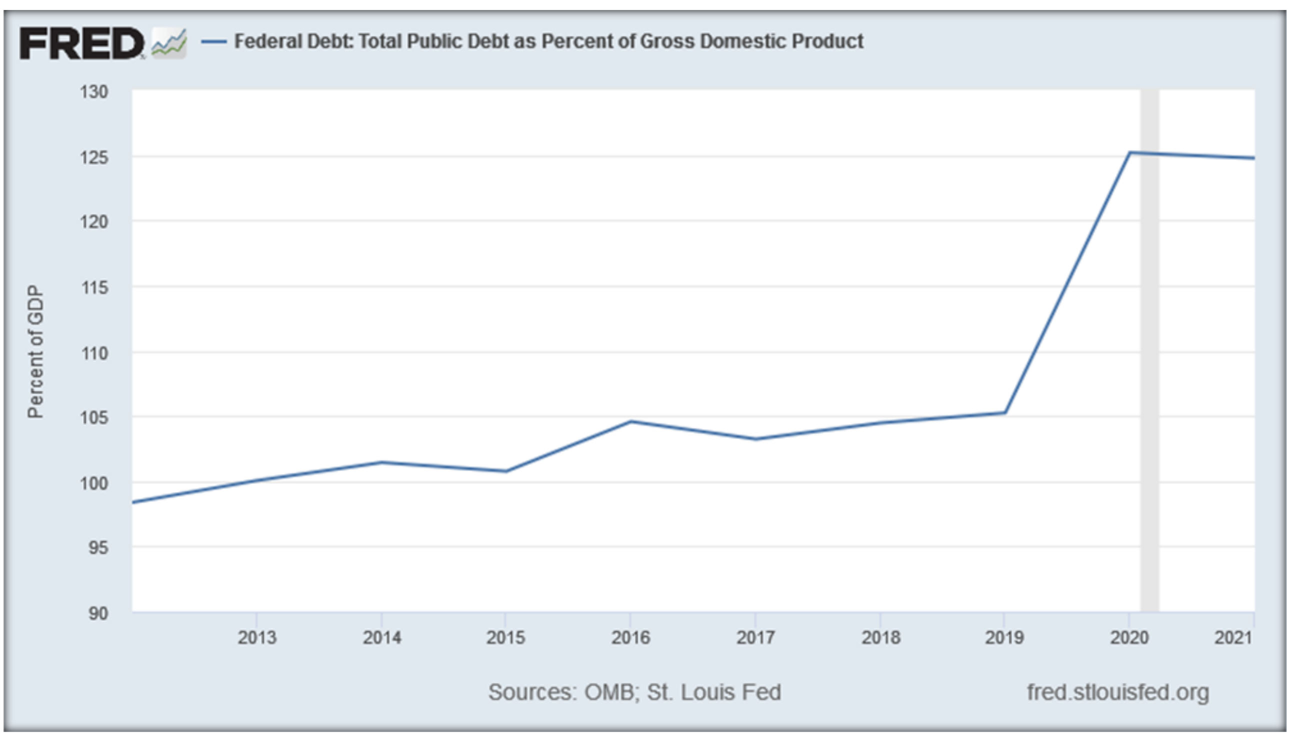
This equates to roughly $1.1 trillion runoff per year or two times the pace of the prior QT from 2017-2019. The last attempt at QT reduced the Fed's balance sheet by $650 billion over the course of two years, before liquidity issues in overnight lending markets pushed the Fed to stop tightening and revert to balance sheet expansion for stabilization. The QT process mechanically reduces bank reserve assets (cash held by banks) and alters the composition of debt ownership. Private sector investors will have to absorb this paper - in addition to any increase in net Treasury issuance relating to Government spending.

Persistent inflation remains the primary concern for the U.S. economy today, and a focal point for the Fed. The Fed's inflation playbook appears to be continual rate hikes, balance sheet runoff, and demand destruction. Successful implementation while avoiding a deep recession or other unforeseen consequences will be an extraordinarily challenging task. The following U.S. economic figures emphasize the level of difficulty in the current environment.

In 2021 the U.S. budget deficit totaled $2.775 trillion while the current-account deficit widened to $822 billion. [(LINK)]



Financial flexibility and available actions are further limited by U.S. public debt at 125% of GDP.



Entitlement spending for Social Security, Medicare, and Medicaid is forecasted to grow 10.6 percent rising to $2.784 trillion in 2022. The U.S. economy has produced an average annual real GDP growth rate of 2.01 percent over the last 10 years. This rate of growth was produced in an accommodative environment of low inflation and the federal funds rate averaging 0.71 percent.

	Social Security	Medicare	Medicaid	Total	Total % Growth YoY
2011	$ 724.92	$ 559.64	$ 274.96	$ 1,559.53	
2012	$ 767.71	$ 551.15	$ 250.53	$ 1,569.40	0.63%
2013	$ 807.84	$ 585.22	$ 265.39	$ 1,658.46	5.67%
2014	$ 844.88	$ 599.81	$ 301.47	$ 1,746.16	5.29%
2015	$ 881.89	$ 634.11	$ 349.76	$ 1,865.76	6.85%
2016	$ 910.28	$ 692.49	$ 368.28	$ 1,971.05	5.64%
2017	$ 939.20	$ 702.28	$ 374.68	$ 2,016.17	2.29%
2018	$ 982.02	$ 704.52	$ 389.16	$ 2,075.69	2.95%
2019	$ 1,038.49	$ 775.41	$ 409.42	$ 2,223.32	7.11%
2020	$ 1,089.89	$ 912.12	$ 458.47	$ 2,460.47	10.67%
2021	$ 1,128.83	$ 867.68	$ 520.59	$ 2,517.09	2.30%
2022 (E)	$ 1,212.00	$ 983.00	$ 589.00	$ 2,784.00	10.60%
				Average Annual % Growth	4.94%

	Social Security % Growth YoY	Medicare % Growth YoY	Medicaid % Growth YoY
2011			
2012	5.90%	-1.52%	-8.88%
2013	5.23%	6.18%	5.93%
2014	4.58%	2.49%	13.59%
2015	4.38%	5.72%	16.02%
2016	3.22%	9.21%	5.29%
2017	3.18%	1.41%	1.74%
2018	4.56%	0.32%	3.86%
2019	5.75%	10.06%	5.21%
2020	4.95%	17.63%	11.98%
2021	3.57%	-4.87%	13.55%
2022 (E)	7.37%	13.29%	13.14%
	4.53%	4.66%	6.83%

The current federal funds rate stands at 1.00 percent as of 06/03/2022. A 0.50 percent increase is expected at each of the next two Fed meetings in June and July 2022. This will result in a 2.00 percent fed funds rate or a doubling of the "benchmark rate" over the next 40 days. Rising interest rates lead to an increasing interest carry cost burden on newly issued debt to support expanding mandatory entitlement programs. Budget cuts have been a rare occurrence since the discovery of Fed balance sheet expansion as a viable implement after the 2008 financial crisis. Slowing economic growth, increasing carry costs, and broad liquidity reductions may lead to questions about the U.S. government's ability to service its debt for the first time in nearly 100 years.

Observation Date	Real GDP growth (GDPC1)
Jan-11	1.55
Jan-12	2.28
Jan-13	1.84
Jan-14	2.29
Jan-15	2.71
Jan-16	1.67
Jan-17	2.26
Jan-18	2.92
Jan-19	2.29
Jan-20	-3.40
Jan-21	5.67
Average	**2.01**

Real GDP growth – Source

Observation Date	Federal Funds Rate
Jan-11	0.25
Jan-12	0.25
Jan-13	0.25
Jan-14	0.25
Jan-15	0.26
Jan-16	0.51
Jan-17	1.10
Jan-18	1.91
Jan-19	2.28
Jan-20	0.54
Jan-21	0.25
Average	**0.71**

Federal Funds Rate - Source

The risk asset bubble in equity markets continues to gradually deflate with the passage of time. For additional detail I would point you to my previous letter from January 2022 - covering the market mirage, inflation, and BRKB / ARKK comparison. Aggressive rate hikes and the start of QT could exacerbate the overall severity and frequency of short-term asset price swings.

Rising fear or uncertainty alone are insufficient to elicit change. A catalyst is required to trigger actions or alter behavior. In the human nervous system, this is a product of it operating on a contrast scale instead of an absolute scale. New incoming information is compared to that which immediately preceded it. This results in individuals failing to notice small changes unless the percentage change is above a certain threshold. Numerous potential catalysts are visible on the horizon, with an even greater number likely obfuscated from view.

As uncertainty and volatility rise, so too must rationality and discipline within thought processes. Filtering out excessive noise while consuming and evaluating relevant data and patterns grows in significance as it increases in difficulty. We will do our best to provide pertinent information and knowledge to supplement your due diligence and decision-making process in this environment. Our steadfast goal remains to add enduring value for you over time. In the words of Warren Buffett, "We don't have to be smarter than the rest. We have to be more disciplined than the rest."

Please feel free to contact us at any time with questions that may arise.

Reed C. Brenner
June 3, 2022