POXONO CAPITAL

INVESTMENT STRATEGY NOTE

Federal Reserve Whack-a-Mole

SEPTEMBER 2024

From time to time, we like to highlight some of the thoughts of the firm outside of our traditional updates on a quarterly basis. Please see below. We try to write in a conversational way because we want and expect emails in response with questions if you have any. We're an open book—don't hesitate to reach out for a meeting if you have any questions.

TLDR: The Fed cut rates and potentially created a flare up in inflation that we will feel in Q4 and Q1. In our opinion, this will lead to bull market in commodities and rising interest rates in the next 3 to 6 months.

Below is an excerpt from a Morgan Stanley strategist:

"Hornbach's quick take:

Half (9) the committee dissented in their 2024 dots. That's crazy...

Do you really think the two people who think NO MORE cuts are appropriate this year really wanted to go 50 today? They dissented, silently, in their dots

7 people think the Fed should only deliver one more 25bp cut this year... Do you think they really wanted to go 50? No.

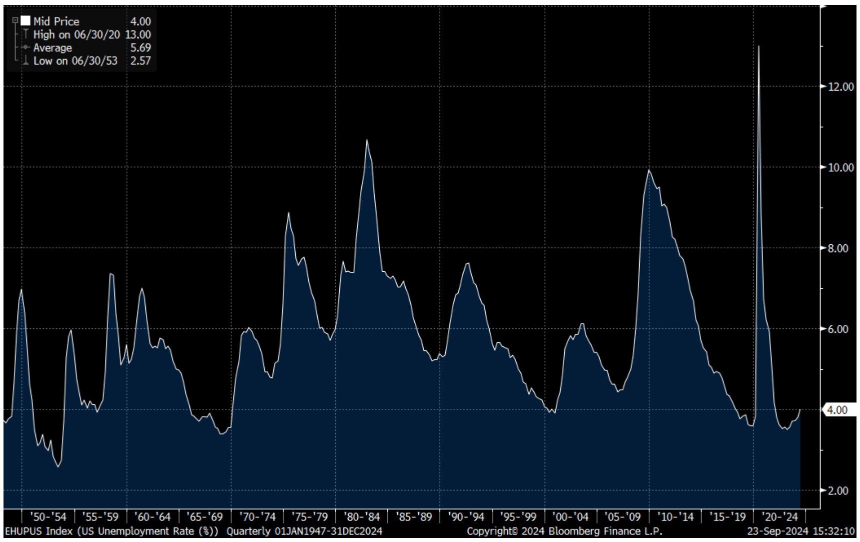
This is a very very divided committee. He (Powell) wanted to go in July, he got trumped, So, he demanded a catch-up cut - That's what this was."

What does this mean in our opinion? The Federal Reserve is not in agreement on the best path forward, and it knows it has a difficult situation to manage because a move in any direction (hike or cut) will create a new problem to deal with. There is a concept we want to touch on that is affecting the Fed, and we think it psychologically affects a lot of people. It's the reason why the Fed can't really control inflation and shouldn't be blamed for it. Society—specifically Americans as the leaders of the western world—are too rule based and often don't understand the spirit of the rules and why they were put in place. The Fed needs to avoid thinking independently about employment and prices. The Fed cut due to its mandate for full employment but its not considering that full employment and the current fiscal deficits have never really occurred before—more to come below.

Quick Overview: The Fed has 2 mandates: Stable prices and full employment. The Fed was given that mandate when the US debt structure was materially different and fiscal policy was much more stable (the federal budget was closer to balance with less deficit and less debt as a percent of GDP).

The Fed can only control monetary policy and interest rates are the main tool. Two main options: cut or hike rates.

On 9/18/2024, the Fed cut 2x or 50 basis points or half of a percent. The Fed cutting is because Jerome Powell and the rest of the Fed board are focused on one of the rules—full employment. Employment data has deteriorated but the BLS does not define full employment. We'll leave you with this chart from Bloomberg (below). This is the US unemployment rate—currently 4% unemployment. As the jobs data has deteriorated, inflation has also stabilized. A weak jobs market helped inflation subside because a weak job market weighs on the demand for goods. This cut was for unemployment—not for inflation, which is still over the Fed's 2% target.

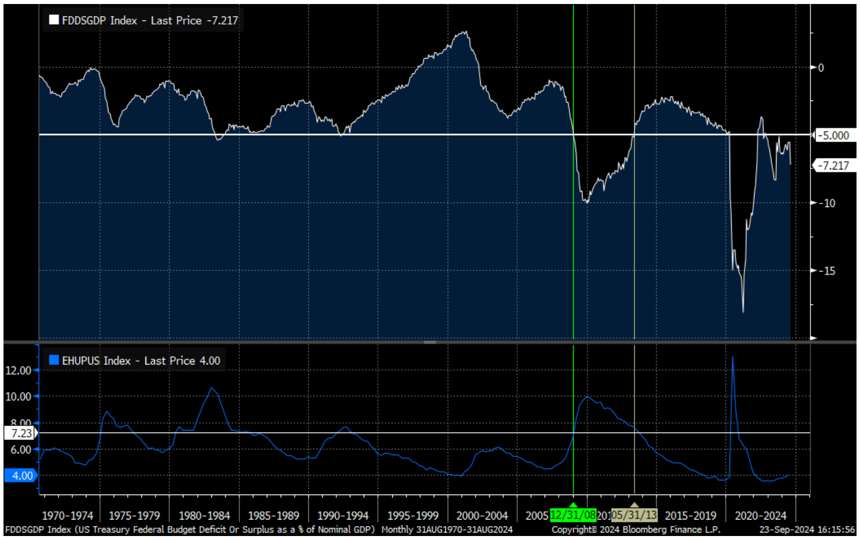


Interest rate hikes or cuts have delayed reactions in the economy, but there are market reactions we can look at now that often ahead of economic data. For example, as the Fed began to telegraph its 50 basis point hike in early September through Fed governor speeches, commodities began to rebound from a drawdown caused by demand concerns caused by weakening economic data such as the jobs data that pushed the Fed to cut. Below is the BCOM Index produced by Bloomberg.

The rise in commodities on the back of the Fed's 50 basis point cut will stoke the still-burning flame that is greater than 2% inflation. The Fed is going to begin playing "Whack-A-Mole" (coined by hedge fund manager Martin Taylor of Crake Asset Management). When it helps prop up employment with cuts, it will stoke inflation and be pushed back towards hiking rates to curb inflation. We're a lot more afraid of inflation because it is much more difficult to control than unemployment. The Fed will struggle to control rising inflation because if the Fed raises rates (action) to create a stable price environment, the federal debt coupon price going forward will make the fiscal deficit worse (1st derivative), which will in turn weaken the US dollar's purchasing power (second derivative), which will then make goods more expensive (third derivative) and then require the Fed to raise rates again—which brings us back to the original start of the cycle.

That is a nasty feedback loop. How do you stop the game of "Whack-A-Mole"? Get fiscal policy under control. If we can balance the budget, demand created from fiscal deficits will subside and the Fed can cut rates to keep full employment without the fear of inflation flare-ups because the demand created from cuts will be offset by the demand being taken away by balancing the fiscal budget. Is Trump going to do that? No. Is Harris going to do that? No. (For more on the politics of this—ask us for our piece from June 2024 on the election.) Therefore, if inflation goes higher from Fed cuts, we restart the hiking cycle.

Below is the US deficit as a % of GDP (top white line) from Bloomberg. A couple of dates are highlighted with vertical lines. Before we begin on this topic, there is not doubt that fiscal deficits are an important part of stabilizing an economy and unemployment (bottom blue line). Longer-term deficits of greater than 5% of GDP have occurred when unemployment is between 7% and 10% in the last 50 years but not when unemployment is barely touching 4%. In our opinion, the Fed is cutting too much and too soon and will cause inflation—but again not the Fed's fault. Inflation is going down (but above the target) and unemployment is rising. If the Fed wanted to thread the needle perfectly with its two mandates, it would need Congress to help by cutting fiscal spending to curb goods and labor demand while the Fed cut rates which in this case is intended to create private sector jobs.



Let's briefly touch on the dollar and its purchasing power because this is where our thesis gets its teeth. A few basics first—when the Fed hikes, the dollar should get stronger because the interest rates are higher and therefore holding the dollar is more valuable. When the Fed cuts, the dollar should weaken because holding dollars is less valuable (you are paid less interest for holding dollars). This held true for most of the hiking cycle until something broke…

Below is the US Dollar Spot (DXY Curncy – candle chart) from BBG and the lower bound of the Fed funds rate (blue line) provided by Bloomberg. As you can see, about two-thirds of the way through the hiking cycle, the dollar started breaking down even though the Fed was hiking.

Below we added 2 more panels to the chart from Bloomberg—the deficit as a percent of GDP (orange) and the amount of interest the US Government (purple) is paying. The dollar started weakening as deficits increased again, and this time the deficits are driven by interest payments. The US interest rate expenditures roughly doubled in the last 4 years.

In conclusion, the dollar is losing its purchasing power, the Fed is playing "Whack-A-Mole," and we want to own things that trade in value, not in dollars. Poxono likes to own commodities for portfolios where applicable and has added different commodities in portfolios after the Fed where appropriate. The commodities or currencies we like versus the dollar are gold, copper, and oil (short term) until the Fed pivots back to hiking. Simply put, this is debasement trade. The dollar is the base of the price of oil (barrels of oil/dollar or tons of copper/dollar). We also like the long-term catalyst calendar for commodities—global conflicts and China stimulus are the big catalysts.

One last point… Let's discuss crypto for a bit. Most of it is worthless, but we want to focus on Bitcoin. Bitcoin is the only one that matters to us at this time and that likely won't change. We want to use it as a way to express our debasement trade with more volatility than copper, gold, oil, etc.

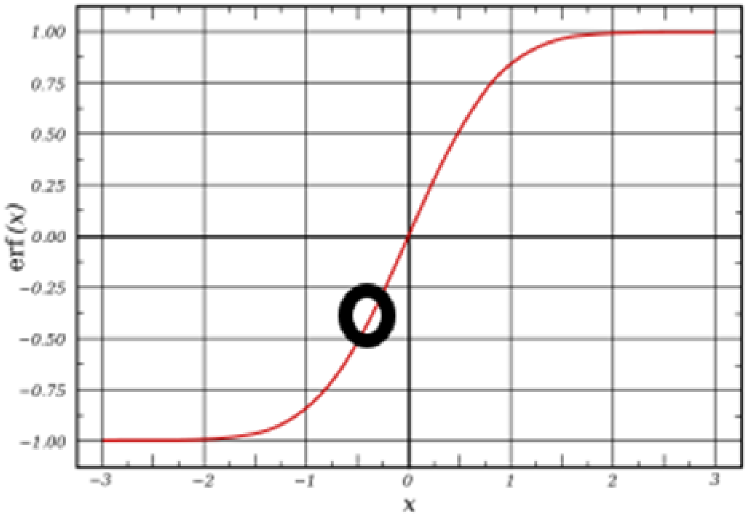
Crypto adoption can be summarized simply:

- Why is Bitcoin primarily used? To move money without government involvement.
- Why do most people do that? To avoid taxes and move money illegally.
- Do you think people will want to avoid taxes less or more in the future?
- Do you think people will illegally move money less or more in the future?

If you answered, people will want to avoid taxes and the market for illegal money movement will grow in the future, crypto adoption will increase (and the regulation surrounding it). We like Bitcoin as a higher-risk/higher-reward alternative to owning gold, copper, etc., because it is a higher volatility asset, and we think the trend of Bitcoin replacing gold as an international store of value is going to continue for the reasons stated.

Below is the Bitcoin priced in ounces of gold provided by Bloomberg. Since 2013, Bitcoin has been exponentially growing vs gold. We think this trend will continue for some time as adoption continues. This will likely slow as adoption reaches capacity.

This trend may continue until adoption slows, and we think adoption will continue on a sigmoid-like curve (sigmoid function via Wikipedia). We highly recommend *The Survival of the Wisest* by Jonas Salk, which describes sigmoid functions at length. Salk was wrong about a lot in the book but offers a great read of an ecosystem's capacity. Bitcoin adoption is roughly here (the black circle below) in our opinion. There is still more to go but definitely not day one in the adoption cycle. In conclusion, we will add crypto for higher-risk portfolios where applicable.



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