INVESTMENT PERSPECTIVE Q3 2023

PROFESSOR FISHER AND THE ROMAN EMPIRE

When I am not thinking about the Roman Empire, my mind often drifts to Irving Fisher.[1] James Tobin and Milton Friedman credited him as the "greatest economist the United States [had] ever produced." As Professor of Economics at Yale, he made important contributions to the general equilibrium model that would become the mainstay of macroeconomics. His study of the trade-offs between future and present consumption would lead him to the first rigorous study of interest rates. As the U.S. benchmark 10-year Treasury bond yield levitated from 3.5% to 5% in the span of the last five months, I have frequently wondered what Fisher would make of it.

Fortunately, Fisher belonged to that class of economist who could derive intricate mathematical proofs and yet still manage to convey the underlying dynamics in succinct narratives. His narrative for the rate of interest is that it represented the price of impatience. People who are impatient want to consume goods now and hence are more willing to borrow, i.e. shift consumption from the future. The more impatient the marginal consumer, the higher interest rates. But what are the root causes of impatience? Fisher reasoned that the principal driver was peoples' optimism about the future. If consumers believed that they would be wealthier in the future (through innovations and productivity), they would be more willing to consume some of that excess wealth in the present.

Conversely, if economic growth weakened and individuals imagined their future selves as poorer, they would defer spending to augment their future consumption. As they reduced their borrowing, interest rates would fall. Moreover, he made a fascinating observation about how wealth distribution in a society could change interest rates. He asserted that the wealthy were naturally patient. In fact, that's how they got wealthy – by deferring spending, saving and accumulating capital. If more of a society's wealth migrated to the wealthy, their propensity to save would drive down interest rates.

In that microcosm, you can see the outlines for the great decline in interest rates from 2010 until the pandemic. Productivity and growth slowed. And wealth inequality increased. This narrative is not a perfect fit. Interest rates were also falling during the 1990s when growth was more robust. But Larry Summers' theory of secular stagnation and the savings glut seems to aptly describe the period from the Great Financial Crisis until recently. What changed in the aftermath of Covid? First, the enormous Federal outlays of 2020 and 2021 injected $5 trillion into households and businesses. But why would it take two years, until the third quarter of 2023, to see the effects? Perhaps there was a single large purchaser of all that debt who has started ramping down their Treasury holdings? And the spending surge is still ongoing from both households and businesses. Finally, there is the singular innovation of AI which sprung into the public consciousness in 2023. Could that prospect have altered optimism in the future? Tentatively, yes. Taken together, a bolus of income and excitement about AI, coupled with a little quantitative tightening, might have gotten us to these rates. But what about the way forward?

I think several trends will manifest themselves in descending order of conviction. First, I think the Federal Reserve will hold the line on inflation far beyond what is commonly believed. As interest rates start to bite, the U.S. will decelerate. Europe and China already have. Second, I think Congress will start to talk about controlling the deficit. Notice I did not say they will do anything. But even broaching the third rail of fiscal austerity will catch Wall Street's attention. Finally, while I think AI will fulfill its wildest promises, the AI revolution will struggle to produce the breakthroughs with the immediacy the market has priced in. Remember that AT&T launched the Picturephone in 1970. The upshot of these trends suggests a state of the world normalizing back to 2010–2020 rather than the brave new world we experienced since the pandemic. I see the pendulum swinging back to patience over impatience.

For our portfolios, that suggests that real interest rates on U.S. 10-year Treasuries at 2.40% look like a fair deal—verging on a bargain. In the past quarter we have adjusted our fixed income portfolios to a full duration positioning. If rates go higher from here, we will likely begin to overweight duration. The case is simple. If anything goes severely wrong in the world—either geopolitical or macroeconomic—the 10-year is likely to be a comfortable counterweight to all other risk assets.

A final reason to study Irving Fisher. In addition to his academic prowess, he became the country's leading stock market prognosticator. It is hard to find a parallel today—maybe a combination of Stanley Druckenmiller, Bill Ackman and Jeffrey Gundlach. In any case, investors hung on his every pronouncement. The Dow Jones Industrial Average peaked in August of 1929 and suffered a mild retracement of about 10% off its highs by mid-October. The revered Professor Fisher was a guest speaker at the annual dinner of the Purchasing Agents Association on October 15th. He told the group that stocks had reached "what looks like a permanently high plateau." Later that night in response to a question, Fisher went a step further, declaring that he "expected to see the stock market a good deal higher than it is today within a few months." Within one month of that evening, the market would drop 40%. Fisher's reputation would never recover.

But the text of the speech he delivered in October 1929 is a gem swept under the carpet of history. Fisher's argument for stocks is persuasive. By his reckoning, the market's price earnings was a reasonable 14x. Corporate earnings had grown 30% in the prior 12 months. Further earnings growth would come from the efficiencies of technological innovations, "scientific" management, merger synergies and improvements in labor relations. He also observed that the newly introduced Investment Trusts would ease stock ownership for the public. Fisher's buy case for stocks is such a compelling, well-rounded argument that it is painful to read. How could someone armed with superior data, contacts and a penetrating insight in economics fail so miserably? Rather than a laughable anecdote, it should inspire dread in the hearts of people who toil over market fundamentals for insight.

For me, the plight of Irving Fisher is a constant object lesson in humility. Not even the most insightful among us can see around corners. That's why we constantly stress balance in portfolio construction—always building in provisions for the unforeseen. Or, as Jon Hirtle reminds us, "Take your best idea and believe it a little."

[1] *https://www.nytimes.com/2023/09/15/style/roman-empire-men-tiktok-instagram.html?searchResultPosition=2*