July 6, 2022

Dear Clients and Friends:

Humans are required to make a multitude of decisions under conditions of uncertainty by sifting through a dizzying amount of information across a wide array of subjects. No matter how much time, effort, or raw brainpower is brought to bear, no single person can understand everything in a sophisticated and nuanced way. In fact, we should not expect even the best and brightest among us to master more than a handful of sufficiently complex subjects. In order to thrive, we must often defer to others and trust in their judgment when we are simply out of our depth. Blind belief in authority is not the goal, of course. We need to develop a keen sense of whom to trust on what subjects, and when a healthy dose of skepticism may be warranted. But make no mistake, we have evolved over the course of human history to rely increasingly on "the cognoscenti," aka people who know things, not just our own limited individual knowledge and gut instincts.

Much has been written in recent years about the so-called "epistemological crisis" and the widespread loss of faith in institutions and experts. Regarding this somewhat radioactive topic, I would only posit that trust in experts, judiciously applied, is a practical necessity in the modern world. It is certainly not inherently bad, a statement that seemingly runs counter to the zeitgeist. These days, being a legitimate subject-matter expert almost discredits your opinions on said subject, rather than the other way around. The internet is a great and powerful thing, but access to a bottomless pit of information does not translate automatically to knowledge per se. This brings to mind a cognitive bias known as the "Dunning-Kruger" effect, which suggests that people of low competence in a given domain (as measured objectively) tend to greatly overestimate their competence in that domain. In other words, they don't even know enough about the subject in question to realize that they don't know jack squat about it.

Which brings us yet again to our dear friends, the Board of Governors of the Federal Reserve System. This is not about the Fed suffering from the Dunning-Kruger effect, however. That would be too facile, as well as false. The Fed members are undoubtedly all highly intelligent, highly capable people, and some are probably even well intentioned. The Fed knows a lot about how the economy works, enough to understand that they have little ability to predict how things will actually unfold over the coming months and quarters. Yet they continue to make authoritative forward-looking statements that invariably wind up being wrong, and sometimes laughably so.

I could list the Fed's greatest hits over the years, but looking at just the dot plot from a year ago proves the point perfectly well. Back in June 2021, the median expectation was that the Fed funds rate would be unchanged until at least 2023. The most hawkish projection was a mere two 25 bps hikes by the end of 2022. Compare these figures to the most recent median estimate of another 175 bps hikes this year, bringing the Fed funds target range up to 3.25% to 3.50%. It all looks rather ludicrous in the cold light of day. My point is not that the Fed should have known back in the summer of 2021 that they would need to adopt a much more hawkish stance in short order – OK maybe that is my point, just a little bit – but mostly their mistake is in making definitive-sounding statements about the future in the first place.

I suppose they have to continue this kabuki theater, since the alternative – a Fed that throws its hands in the air and says: "We don't have a clue" – would be too scary. But do we really need to place so much importance, so much credibility, on their every utterance? All manner of experts are being challenged or ignored altogether right now. The Fed has somehow largely escaped this fate despite having a demonstrable record of being consistently wrong. When it comes to the Fed, collectively we have proven quite susceptible to the "genetic fallacy" within the field of logic, which is the acceptance of claims based solely on their source rather than their actual merits.

If we are going to call out the Fed for being bad at predicting things, we have to hold ourselves accountable as well. Fair is fair. We recently wrapped up a closest-to-the-pin contest where each investment team member predicted, back in Q4 2021, what the 10-Year Treasury rate would be on June 30, 2022. The winner was ~70 bps below the actual 10-Year rate, meaning our predictions were woefully inaccurate. Which is the whole point. We aren't very good at predicting Treasury rates. The Fed isn't very good at it. No one is very good at making long-range predictions like this with any consistency.

Thankfully, our investment process does not depend on looking into the crystal ball and making bold predictions about the future. This is especially true in the current environment, which remains highly uncertain. We don't know if the economy can achieve a soft landing, or if growth will decelerate sharply while inflation remains stubbornly high. Most likely, it will be something in between. Only time will tell.

What we do know, with a high degree of certainty, is that our clients will likely benefit from owning investment grade and high yield credit at current spread levels, that real yields are reasonably attractive at current levels, and that the yield curve will be positively-sloped again at some point in the not-to-distant future. We have added a fair amount of risk exposure year-to-date in alignment with these views, but we still maintain ample capacity to add to our existing positions or take advantage of new opportunities, should valuations become even more compelling during the balance of 2022.

Sincerely,

Mark M. Egan, CFA
Managing Director

SR22-0173 I Exp. 11/15/2022