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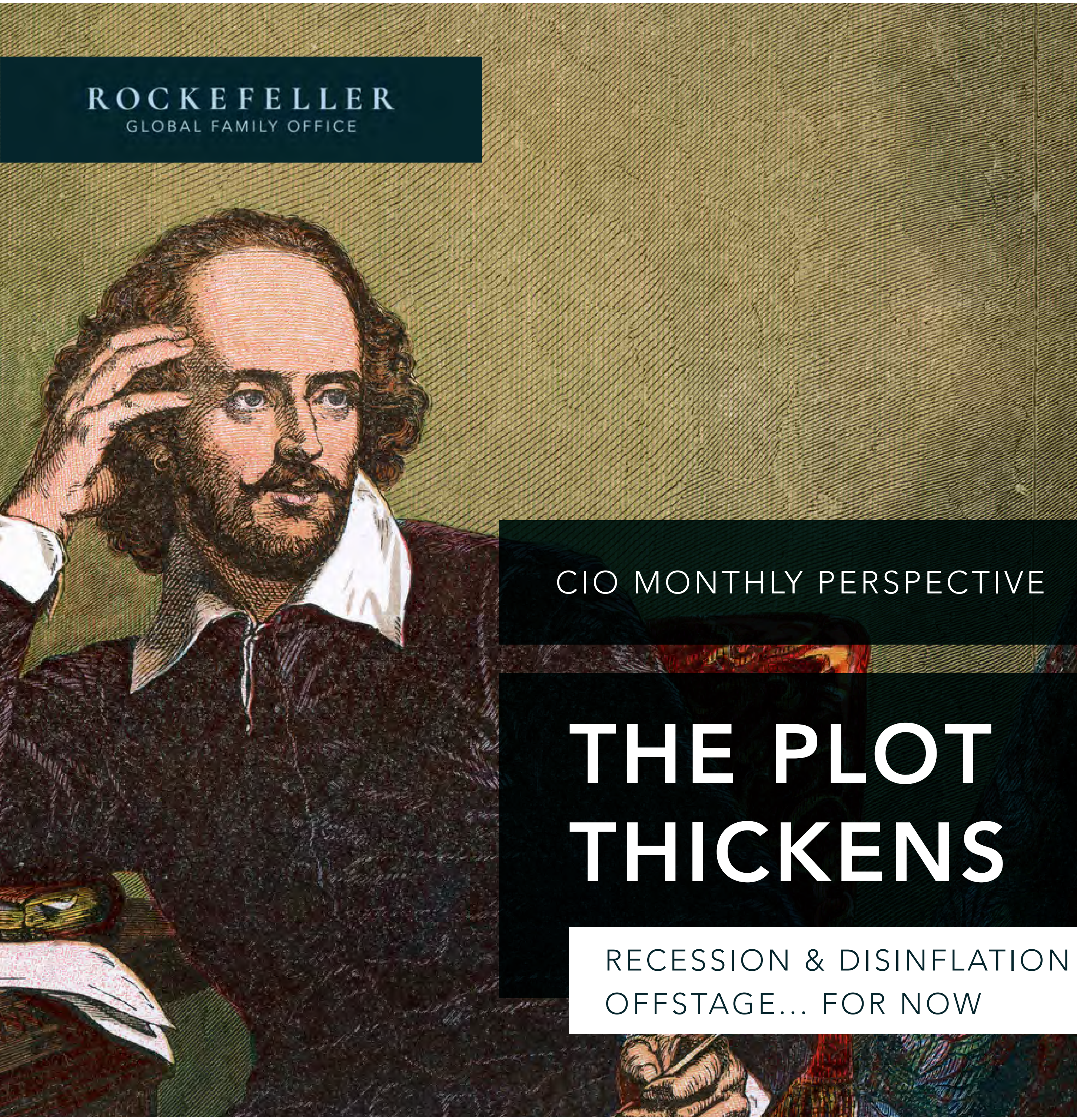

CIO MONTHLY PERSPECTIVE

# THE PLOT THICKENS

## RECESSION & DISINFLATION OFFSTAGE... FOR NOW

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*U.S. Navy officers begin to retrieve the debris of the Chinese surveillance balloon shot down over the Atlantic ocean on February 4.*

*Hopes and good feelings permeated the crisp but warmer-than-usual air in Washington, D.C. on February 1.*

The White House and the State Department were inwardly delighted that Chairman Xi Jinping had agreed to meet with Secretary of State Antony Blinken during his much-anticipated trip to Beijing in five days. Fed Chair Powell was heartened that the disinflationary process had started to take hold with little damage to the job market. He would wind up referencing disinflation 13 times during that afternoon's press conference. Investors were giddy that financial markets were off to a great start to the year on rising expectations of an economic soft-landing and a less hawkish Fed.

On the same day 1,900 miles away in Billings, MT, residents spotted a floating object high in the sky. With the help of telephoto lenses, it was identified as a huge balloon with solar panels. Well, the rest is history – "balloongate" forced Secretary Blinken to postpone his visit to China, and the Sino-US relationship took a turn for the worse.

China vehemently protested the US military's downing of the "civilian use" balloon and pushed back against the West's condemnation of Russia's attack on Ukraine by announcing a planned summit between Xi and Putin to reaffirm its limitless partnership with Russia. China also floated a 12-point peace plan for the Russia-Ukraine war, which was really aimed at breaking Western solidarity and US hegemony.

Chair Powell and the market's optimism about disinflation was rudely interrupted by a string of hotter-than-expected data on inflation and consumer demand. The jury is still out on whether the data were distorted by a warmer-than-usual winter and seasonal adjustments complicated by COVID-19-induced behavioral changes. Be that as it may, investors were still forced to adjust their expectations, which led to a sharp rise in bond yields, the US dollar, and market volatility. Equities gave up some of January's strong gains.

While the much-ballyhooed China reopening thesis has remained a popular market narrative, "balloongate," the changing currency and interest rate backdrops, and the recent disappearance of one of China's most high-profile billionaire technology bankers have led to some profit-taking. In short, Goldilocks' return has been cut short by renewed macro uncertainties that could last for at least a few months.

# A Literary Whodunit

This year marks the 400th anniversary of the publication of perhaps the greatest work of literature in the English language – a 900-page book measuring roughly 12 ¾ to 13 ⅜ inches in height, 8 to 8 ¾ inches in width, and weighing about 4 pounds and 13 ounces. It features an engraved portrait of a bald man with an oversized head and a small mustache, followed by several introductory letters and poems, and a collection of plays. About 750 copies of this book, referred to by modern scholars as the *First Folio*, were printed in 1623, and 235 are known to have survived in public and private collections. In October 2020, one of the 235 surviving copies was auctioned off at Christie's in New York for $9.9 million.

Compiled by John Heminges and Henry Condell, two actors and partners at the King's Men acting company, the *First Folio* was a collection of 36 plays by their one-time colleague William Shakespeare, who passed away seven years earlier. *Mr. William Shakespeare's Comedies, Histories, & Tragedies* was hitherto an unprecedented corpus of a playwright's lifelong work. It helped to immortalize the Bard from Stratford-upon-Avon, who was not particularly renowned during his lifetime as his passing in 1616 had elicited neither memorial gatherings nor tributes or acknowledgement from London's literary circle.

Eighteen of the plays – including some that later evolved into the world's most staged shows such as *Macbeth, Twelfth Night, and As You Like It* – would have been consigned to the dustbin of history as they had never been published previously.

Roughly 150 years after the publication of the *First Folio*, "Bardolatry" was in full swing as Shakespeare was now widely regarded as a rare genius who was not only a great writer and dramatist, but also a psychologist, historian, and philosopher. However, by the mid-1850s, skeptics started to openly question the incongruity between the Bard's exceptional erudition and his pedestrian upbringing and unremarkable life experience. These doubters, collectively known as anti-Stratfordians, included luminaries such as Ralph Waldo Emerson, Walt Whitman, Mark Twain, Henry James, Sigmund Freud, Sir John Gielgud, and several US Supreme Court justices.

Shakespeare was born in April 1564 in Stratford-upon-Avon, a small market town 90 miles northwest of London. Despite the lack of attendance records from that period, he is believed to have attended the local grammar school. At age 18, he hastily married Anne Hathaway, who gave birth to a daughter six months later. After having twins in early 1585, there was no historical trace of him until he appeared in London's theater scene in 1592. Shakespeare went on to build a successful career as an actor, writer, and part-owner of the King's Men acting company before retiring to Stratford in 1613 at age 49.

# Market Watch

| Equity Market Indices[1] | 1/31/23 Price | 2/28/23 Price | MTD Change | YTD Change |
|---|---|---|---|---|
| MSCI All Country World | 648 | 629 | -3.0% | 3.9% |
| S&P 500 | 4077 | 3970 | -2.6% | 3.4% |
| MSCI EAFE | 2100 | 2054 | -2.2% | 5.6% |
| Russell 2000®2 | 1932 | 1897 | -1.8% | 7.7% |
| NASDAQ | 11585 | 11456 | -1.1% | 9.4% |
| TOPIX | 1975 | 1993 | 0.9% | 5.4% |
| KOSPI | 2425 | 2413 | -0.5% | 7.9% |
| Emerging Markets | 1032 | 964 | -6.5% | 0.8% |
| **Fixed Income** | | | | |
| 2-Year U.S. Treasury Note | 4.20% | 4.82% | 62 | 39 |
| 10-Year U.S. Treasury Note | 3.51% | 3.92% | 41 | 5 |
| BBG U.S. Agg Corp Spread | 1.17% | 1.24% | 7 | -6 |
| BBG U.S. HY Corp Spread | 4.20% | 4.12% | -8 | -57 |
| **Currencies** | | | | |
| Chinese Renminbi (CNY/$) | 6.76 | 6.94 | 2.7% | 0.5% |
| Brazilian Real (Real) | 5.08 | 5.24 | 3.2% | -0.8% |
| British Pound ($/GBP) | 1.23 | 1.20 | 2.5% | 0.5% |
| Euro ($/Euro) | 1.09 | 1.06 | 2.7% | 1.2% |
| Japanese Yen (Yen/$) | 130.09 | 136.17 | 4.7% | 3.9% |
| Korean Won (KRW/$) | 1231.90 | 1323.06 | 7.4% | 4.5% |
| U.S. Dollar Index (DXY) | 102.10 | 104.87 | 2.7% | 1.3% |
| **Commodities** | | | | |
| Gold | 1928 | 1827 | -5.3% | 0.2% |
| Oil | 78.9 | 77.1 | -2.3% | -4.0% |
| Natural Gas, Henry Hub | 2.68 | 2.75 | 2.3% | -38.6% |
| Copper (cents/lb) | 423 | 410 | -3.0% | 7.5% |
| CRB Index | 278 | 270 | -3.0% | -2.8% |
| Baltic Dry Index | 681 | 990 | 45.4% | -34.7% |

Source: Bloomberg

Anti-Stratfordians argue that it is inconceivable that a man with a grammar school education from a small town could have acquired the requisite knowledge on so many subjects – law, medicine, navigation, military tactics, diplomacy, history, Greek drama, Italian culture, music, falconry, politics, etc. – to create the exceptional works featured in the *First Folio*. Mind you, people did not have Google or ChatGPT in those days to easily access information; books were quite expensive during Shakespeare's time, and public libraries were not established in England until the mid-19th century.

One assertion disputing the Bard's authorship of the plays in the *First Folio* is the lack of physical evidence. It is improbable that a prolific man of letters from that era would leave no paper trail at all – despite several centuries of searches by researchers, there were no correspondences, manuscripts, or any handwritten works that trace back to Shakespeare.

The only samples of his handwriting are six signatures on legal documents, and there is no consistency among them in spelling and style, leading some to even question his literacy. It is also odd that Shakespeare did not appear to be in possession of any books at the time of his death. His will meticulously detailed the bequest of all his belongings to friends, colleagues, and relatives, including "the second-best bed" to his wife, yet there was no mention of any books, which were valuable items during the Elizabethan and Jacobean eras.

Well, if the man from Stratford did not write those plays, then who did? Most anti-Stratfordians have concluded that it was Edward de Vere, the 17th Earl of Oxford, who was born in 1550, 14 years before Shakespeare, and passed away in 1604.
Edward de Vere met all the requisite traits that anti-Stratfordians said were necessary to have the capacity to create the great Shakespearean plays.

His grandfather and father had long patronized theatrical activities. He was raised by surrogate parents in the household of Sir Thomas Smith, a renowned scholar, diplomat, and parliamentarian. After de Vere's father's death in 1562, he became a ward of Queen Elizabeth I and was sent to live with Sir William Cecil, the Queen's chief advisor. Edward was a man of many talents and interests – he was a jouster, talented poet and playwright, and avid traveler, having extensively explored France and Italy. He was a generous patron of literature, religion, medicine, music, and theater.

According to Oxfordians (those who believe the 17th Earl of Oxford to be the real playwright), Edward de Vere chose to publish his plays under a pseudonym or anonymously because during his time, it was scandalous for a nobleman to be a playwright – playhouses were deemed to be places where prostitutes, thieves, and vagabonds congregated. Some Oxfordians trace the origin of the "Shakespeare" pseudonym to an occasion in 1578 where Gabriel Harvey, an English scholar, said of Edward de Vere, a one-time champion jouster, *"vultus tela vibrat,"* Latin for *"thy countenance shakes spears."*

In defense of the Bard of Avon, Stratfordians dismiss Oxfordians as snobbish elitists and conspiracists who are no different from "Elvis is Alive" truthers. They claim Stratford's grammar school in the 16th century was adequate enough to prepare Shakespeare for a career in writing, and the Bard could have acquired his vast knowledge through his social network in London. They point to the 1605 and 1614 publications of William Camden, a contemporary of William Shakespeare and one of England's most respected antiquaries and historians, which had listed the Bard as a poet. They also cite the connection between the tragic death of Shakespeare's beloved son, Hamnet, in 1596, and the creation of the character, Hamlet, a few years later as evidence of the Bard's authorship.

The one person that most Stratfordians would never forgive is American writer Delia Bacon, who is credited with originating the controversy in the 1850s. In their minds, Bacon was literally crazy to challenge the Bard's authorship. She became so obsessed with her theory that she even tried to open Shakespeare's tomb for evidence. The public backlash in England was so severe that she suffered a mental breakdown and was ultimately committed to an asylum, first in England and later in Hartford, Connecticut, where she passed away. Perhaps it was the Bard's ghost tormenting Delia Bacon, like what Banquo's ghost did to Macbeth. *"Avaunt, and quit my sight! Let the earth hide thee!"*

***"Avaunt, and quit my sight! Let the earth hide thee!"***

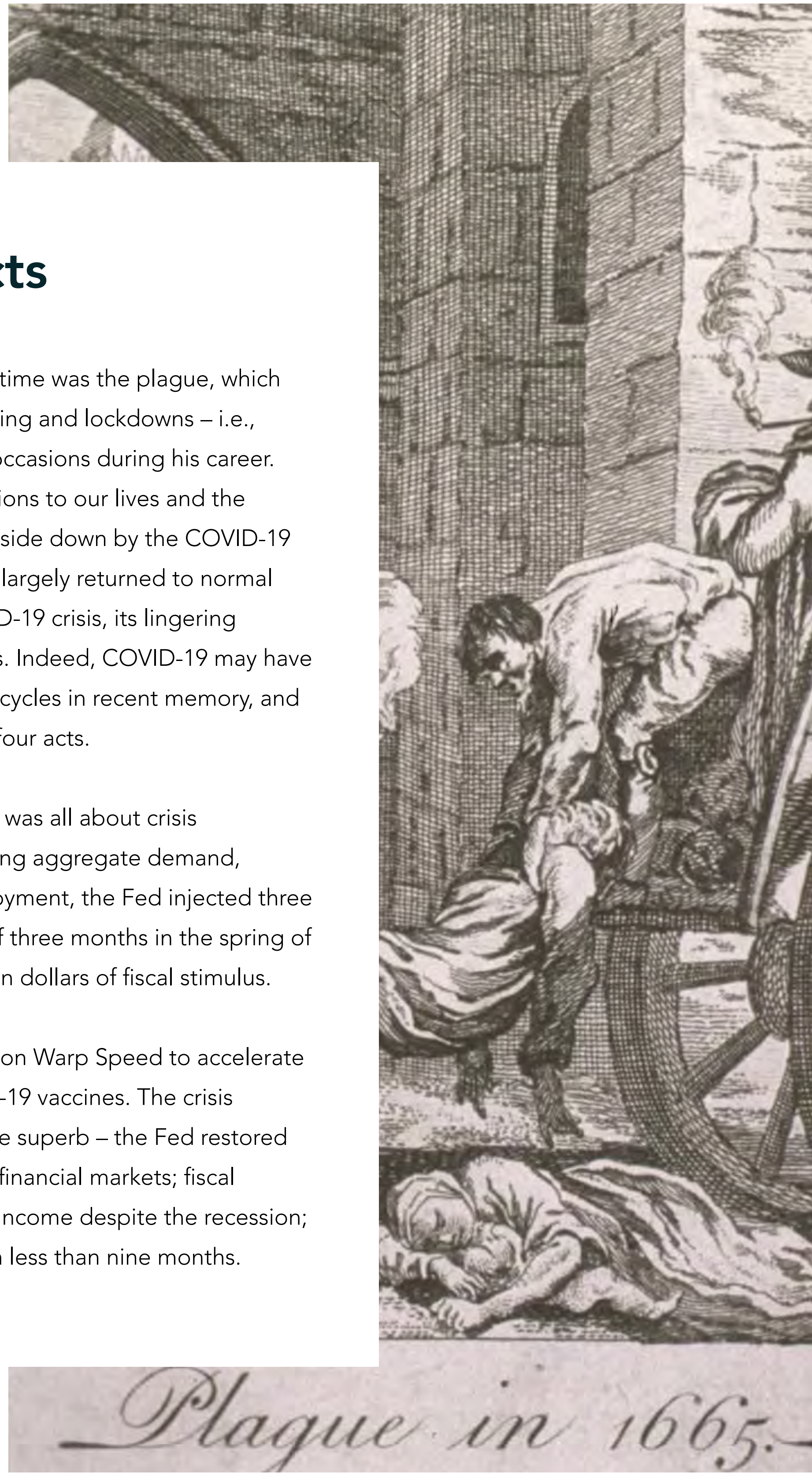
*Daguerreotype of Delia Bacon taken in 1853.*

# A Play in Four Acts

A recurring crisis during Shakespeare's time was the plague, which led authorities to impose social distancing and lockdowns – i.e., forcibly closing theaters – on multiple occasions during his career. It was hard for us to fathom the disruptions to our lives and the economy until our world was turned upside down by the COVID-19 pandemic in 2020. While the world has largely returned to normal three years after the onset of the COVID-19 crisis, its lingering impacts are still being felt in many ways. Indeed, COVID-19 may have created one of the biggest boom-bust cycles in recent memory, and the cycle is still unfolding like a play in four acts.

Act I of the play took place in 2020 and was all about crisis management. Confronted with collapsing aggregate demand, crashing markets, and surging unemployment, the Fed injected three trillion dollars of liquidity over a span of three months in the spring of 2020, and Congress appropriated trillion dollars of fiscal stimulus.

The White House also initiated Operation Warp Speed to accelerate the development and rollout of COVID-19 vaccines. The crisis management response turned out to be superb – the Fed restored investor confidence and turbocharged financial markets; fiscal stimulus led to an increase in personal income despite the recession; and mRNA vaccines became a reality in less than nine months.

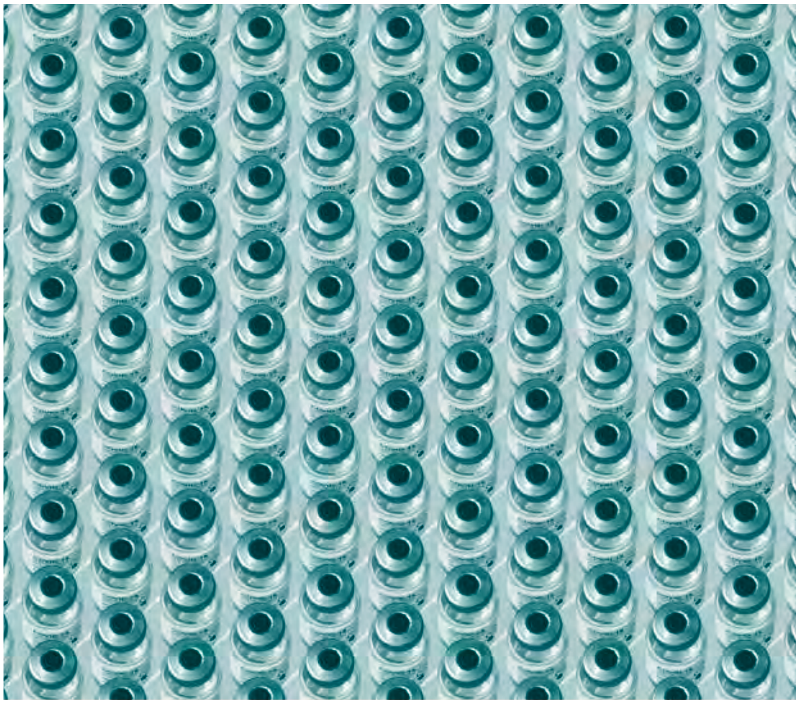



*Engraving depicting victims of the Plague in 1665 being carted away.*

Act II of the play was about overstimulation in 2021. While the US economy was clearly positioned to re-accelerate with the arrival of COVID-19 vaccines, the Fed decided in December 2020 to increase its pace of quantitative easing to a minimum of $120 billion per month, and Congress further perfected the art of profligacy. To wit, during the depth of the COVID-19 crisis in the spring of 2020, the US government paid each qualifying adult and child $1,200 and $500, respectively. In early 2021, with the economy normalizing rapidly and the jobless rate sliding, Congress dished out $2,000 per qualified adult and child. The overstimulation led to rising inflation, which the Fed had dismissed as transitory for most of 2021. It was not until November 2021 that Chair Powell decided to retire the transitory inflation narrative.

Act III of the play started in early 2022, with the Fed determined to take away the proverbial punchbowl from investors. Four-decade high inflation forced the Fed into the most aggressive hiking cycle in forty years. Rapidly rising interest rates pressured asset valuations and resulted in double-digit declines in equities and bonds in 2022. Chair Powell repeatedly cautioned that the battle against inflation would entail some pain, and that the Fed would raise the Fed funds rate above 5% and keep it there for an extend period.

Today, with the upper bound of the Fed funds rate having been raised to 4.75%, the Fed may be within months of wrapping up the tightening cycle and concluding Act III, assuming many of the disinflationary forces remain undisrupted. This most aggressive tightening cycle in four decades will set the stage for the fourth and final act of the play, the Landing – a softish or a harder economic landing. It remains to be seen if Act IV will feature an economic and financial Tempest ahead, or if Chair Powell gets to triumphantly claim, “All’s well that ends well.”



*Vaccine vials being prepared for shipment.*

# Changing Scripts

At the start of 2023, the consensus among investors and corporate executives was that the Fed's hawkish tightening cycle would lead to a mild recession in 2023, as the tight labor market and relatively healthy consumer balance sheets should cushion the blow of the Fed's aggressive interest rate hikes. Investors were also sanguine that inflation would decline rapidly, which would enable the Fed to end its tightening campaign in the spring and even reduce the Fed fund rates by 0.5% in the back half of the year.

However, a series of stronger-than-expected economic data in February have suddenly forced investors and policymakers to tear up the earlier manuscript for the final scenes of Act III and reimagine what may transpire in Act IV. In a nutshell, the US economy has re-accelerated in early 2023, and inflation has turned out to be stickier than expected.

The upside economic surprises include the January payroll report (517K new jobs vs. 189K expected), strong rebounds in the ISM Services Purchasing Managers Index (55.2 vs. expectation of 50.5), and January retail sales (3% month-on-month growth vs. 2% expected). On the inflation front, the Consumer Price Index (CPI), Producer Price Index (PPI), and the Fed's preferred inflation gauge, Personal Consumption Expenditure Price Index (the PCE Deflator) all came in above expectations in January, with the latter two uncomfortably higher than consensus.

These data prompted several Fed officials to warn of potentially higher terminal Fed funds rates for the cycle, and investors have quickly raised the peak Fed Funds rate expectation from 4.9% at the start of February to roughly 5.4%. The rapid yield decline at the start of the year was reversed with the 2-year Treasury yield surging from early February's intraday low of 4.03% to new cycle and 16-year highs around 4.83%. Rising US Treasury yields have reversed the US Dollar Index's months-long decline, although most investors still expect the greenback to head lower later in the year. The backups in yields and the US dollar wound up making equities cough up some of the strong gains from January.

The key questions for investors are whether the recent strength in the US economy has materially increased the odds of a soft-landing, and if this strength makes it more difficult for the Fed to bring inflation down to the desired range of around 2%. The market consensus appears to be yes to both, which has led to increased volatility in February, especially in the Treasury market.

The sidewalks of New York City's busy avenues are once again filled with residents, office workers, and tourists.

# A Winter of No Discontent

Coming off December's holiday activities, January and February are typically off-season months for travel and retail spending. On a non-seasonally adjusted basis, retail sales in the US typically decline month-on-month by roughly 20% from December to January, followed by a low-single digit sequential decline from January to February. However, retail sales in January 2023 were off to a strong start as the sequential drop from December was merely 16.2%, which was seasonally adjusted to a strong 3% month-on-month increase.

Part of the strength in January retail sales came from an easy comparison, as retail sales in December 2022 were rather soft – up by only 7.9% month-on-month, trailing December 2021's 8.7% and the 12.8% average increase from 2009 through 2022. Another factor was the unusually balmy weather to start the year. According to the National Oceanic & Atmospheric Administration, January 2023 was the 6th warmest January on record for the contiguous US.

Seven states in the Northeast experienced the warmest January on record, and New York, Pennsylvania, and Indiana had the second warmest one on record. It was so warm that the output of US utilities underwent the biggest month-on-month decline on record, with the data going back to 1938. Instead of feeling barren, tedious, and limping about winter as Shakespeare had depicted, people in the Northeast were out enjoying the balmy weather – shopping, dining out, and even golfing. The warm weather also helped industries such as transportation and construction, which often get disrupted by freezing temperatures and snowstorms.

# To Pause or Not To Pause?

The San Francisco Fed published a research paper in October 2016 on the effects of weather on jobs. It concluded that "unusually mild winters can have immediate, and potentially lingering, impacts on local and even national economies." Based on data from 1990 through 2015, the researcher, Daniel Wilson, observed something that is applicable to the current environment:

*"Local employment growth increases with the average temperature within the month. This is true in all four seasons, but especially in the spring. However, the initial employment boost from temperature is largely transitory: Negative effects of lagged temperature lead to roughly zero cumulative effects over a four-month period. The pattern of the boost from higher temperatures in the current month, followed by a payback of reduced employment growth in the next two or three months, is especially pronounced for the spring and summer."*

Based on these historical patterns, the current weather-induced economic strength could result in some reversal later in the spring. However, would our esteemed Fed officials take the transitory strength into consideration, or have they been so traumatized by the word "transitory" that they would choose to ignore it?

The upcoming Federal Open Market Committee (FOMC) meeting on March 21 and 22 will likely be a market moving event, as the committee will release a new Summary of Economic Projections, which includes forward guidance on the Fed funds rate. With the market's inflation expectation for the next twelve months having risen from around 1.6% in January to 3.41% by the end of February, failure to raise the target Fed funds rate commensurate with the market's rising economic expectations would be taken as a greenlight to the market to go risk on, which may wind up stoking higher inflation.

However, with interest rate hikes having long and variable lags, Chair Powell and the doves on the committee must be worried that further rate hikes beyond what they had intended could damage the chance of a soft-landing. Prior to the recent string of upside inflation surprises, Chair Powell was becoming more hopeful of a soft-landing, as he repeatedly cited disinflation in his post-FOMC meeting presser on February 1.

In fact, many were puzzled and frustrated by his refusal to push back against the indisputable fact that financial conditions had turned much easier by late January. Well, Chair Powell's seeming imitation of Hamlet – the lack of decisiveness and conviction in his verbal communication and body language – may reflect his inner penchant for an imminent pivot to neutral, or his inclination as a consensus-builder to not upset his more dovish colleagues on the FOMC. Conspiracists can even postulate that Chair Powell may have been subconsciously condoning the easing of financial conditions as inoculation against the deleterious impact of prior rate hikes that have yet to be felt. To the chagrin of market participants and policymakers, the newfound strength in the economy and a couple of stickier-than-expected inflation readings have complicated the Fed's decision-making and macro-outlook.

# The Landing

It is quite rational for investors to raise their hopes for a soft-landing based on stronger-than-expected economic activity in early 2023. However, some have gotten so carried away that they started floating a "no landing" scenario where the economy would keep on growing at a healthy pace despite the Fed's tightening.

This "no landing" narrative will end up being shot down like the Chinese spy balloon as no one should be naïve enough to believe in the death of business cycles. The debate over landing scenarios boils down to whether the Fed's most aggressive tightening in four decades can bring inflation down to acceptable levels without triggering a recession. I seriously doubt it.

The Fed's war on inflation can be viewed as a battle being fought on three fronts: goods, shelter, and core services excluding shelter. Disinflation appears to have taken hold among goods as a result of inventory clearance and rapidly improving supply chain dynamics. Higher mortgage rates and rising inventory of unsold new houses and apartments have already softened shelter costs – home prices and rents – in the real world. Chair Powell is now focused on taming inflation in core services excluding shelter, where wages play a big role as the  sector is more labor intensive.

The strength in the services economy and the extremely tight labor market is a double-edged sword. They support the "this time is different" argument which postulates that the US economy can withstand the most aggressive tightening cycle in four decades due to the structural labor shortage. Optimists hope that tightening will lead to material declines in job openings but not in actual employment.

On the other hand, the structural labor shortage will likely keep wage inflation above the Fed's comfort zone, leading to a tighter-for-longer monetary policy environment aimed at eventually weakening the economy and the job market. Given the extremely tight labor market, I have a hard time buying into the "immaculate disinflation" narrative – sizeable declines in wage pressure and inflation without a material loss of jobs. This sanguine narrative would have to rely on either a meaningful uptick in worker productivity or more people joining or returning to the workforce.

Productivity improvements rely on more advanced use of technologies which will take time to deploy – ChatGPT and similar artificial intelligence programs will play a role over time, but not immediately. Ironically, a return of the workforce could be realized with steep drops in asset prices, which would force some retirees, housewives and househusbands to look for supplemental income.

# Don’t Dismiss The Yield Curve

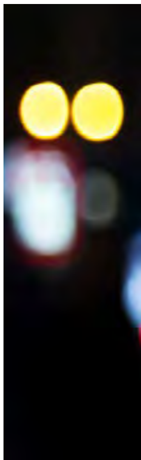
Rather than buying into the “this time is different” narrative, I am sticking with the tried-and-true leading indicators – e.g., 7 consecutive months of year-over-year decline in the Conference Board US Leading Index Ten Economic Indicators, and the most inverted yield curve in more than 4 decades – which still point to a recession as the most likely landing scenario. A yield curve inversion occurs when interest rates for shorter-term US Treasury notes (typically 3-months to 2-years) rise above those for longer-dated notes (e.g., 10-years), which is unusual and signals the market’s concern that the Fed’s monetary policy is too tight. For decades, a yield curve inversion has been widely viewed as a reliable precursor to recession.

Interestingly, as seen in past cycles, some strategists and economists are once again dismissing the predictive power of inverted yield curves. Similar to the movement in some schools to cancel the works of Shakespeare for being outdated and politically incorrect, it is short-sighted to ignore something with proven value simply because it does not fit one’s narrative. Indeed, yield curve inversions have preceded every recession since 1960, though some occasions had rather long lead times that stretched to nearly two years.

One of the most ill-advised debunking of the signal from yield curve inversion was by none other than former Fed Chairman Bernanke in March 2006, when he gave a speech titled “Reflections on the Yield Curve and Monetary Policy.” With the yield curve having gone in and out of inversion since late December 2005, Bernanke sought to assure the market that the economic outlook was fine and cautioned against being “misled when a favored variable behaves in an unusual manner.” The yield curve wound up staying largely inverted until June 2007.

Chairman Bernanke had repeated his upbeat economic assessment throughout this period until April 2008, when he finally conceded during a congressional hearing that a recession was possible. However, he also defiantly added that recession was a term defined by the National Bureau of Economic Research (NBER), and that he was “not yet ready to say whether or not the US economy [would] face such a situation.” That autumn, the US economy wound up crashing in the worst recession since the Great Depression (excluding the brief but sharp pandemic-induced recession in 2020). To add insult to injury, NBER announced belatedly on December 1, 2008, that it had determined that the recession had started in December 2007.

The moral of this story is to not ignore the signal from the yield curve and to be patient with the gradual unfolding of a boom-bust cycle, which can play out over an extended period of time with bumps along the way. To wit, the onset of the yield curve inversion in late 2005 had preceded the eventual recession by 23 months. It’s also a lesson about the importance of being humble in macro analysis. Bernanke—who was recently awarded the Nobel Prize for his crisis management of the Great Financial Crisis—and hundreds of PhD economists at the Fed turned out to be no match for the wisdom of the crowd expressed through the yield curve.



# What is Past Prologue

In closing, this pandemic-induced play in four acts has frustrated investors and policymakers with dramatic twists and turns, and the final landing phase could usher in even higher volatility. As former Treasury Secretary Larry Summers observed recently, the US economy's coincident indicators looked "very strong," but a variety of leading indicators have been "more troubling."

In the face of these strengthening coincident indicators and hotter than expected inflation of late, Chair Powell may have no choice but to be more hawkish than he guided last December. However, additional tightening may further compound the lagged damage to the economy and deepen the eventual recession. Such is the policy quandary that the Fed finds itself in, much like the tragic heroes in Shakespearean plays.

While Treasury bond yields can still move higher in the coming months, I would suggest taking advantage of the recent backup in Treasury yields to accumulate longer-dated Treasuries and federal government agency bonds, as the upcoming recession will likely cause bond yields to fall below current levels to generate capital gains in addition to interest income.

The risk to this strategy is if inflation remains elevated in a no-landing or stagflationary environment where bond yields wind up rising sustainably higher. The no-landing scenario will be transitory as the Fed will just have to tighten further to force a landing. The latter, a stagflationary environment, cannot be a stable equilibrium as our highly leveraged economy will crumble under the weight of sustained and elevated interest rates. The ensuing crises will likely crush aggregate demand and animal spirits to usher in a period of deflation.

In other words, elevated interest rates and high leverage cannot coexist for long. Interest rates have to head lower either as a result of "immaculate disinflation" or recession-induced demand destruction. Unfortunately, since the Korean War, every episode of elevated inflation (i.e., the core CPI above a mere 2.5% threshold) coupled with a tight labor market (unemployment hovering around cycle lows) in the US was followed by a recession within 18 months, which sent inflation lower and unemployment soaring. As Shakespeare (or Edward de Vere) wrote in *The Tempest*, "What is past is prologue."

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