First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com January 21, 2025

The 60/40 Model and The Elephant in the Room

As economists and financial market forecasters, we are constantly amazed at how so many people analyze, forecast, research, and discuss important topics without ever addressing the elephant(s) in the room.

While this is not the highlight of today's missive, economic research and academic model building is a perfect example of what we are talking about. Economists (especially academics) spend a lot of time working on "General Equilibrium Theory," attempting to build models of the macro-economy where supply and demand are in balance.

While these models are sold as brilliant, they actually do a terrible job. For example, many economists have argued that the US entered a "Great Stagnation" in 1973, when productivity and wage growth slowed.

The question is: Why? And explanations vary. Some say things like "you can see the computer age everywhere but in the productivity statistics" – the argument being that there are winners and losers from technology, but little net gain. Many forecast a coming boom from technology, but real GDP has averaged just 2% growth per year in the past 20 years…about half of its growth rate from 1950-1973.

Others blame inequality, the lack of education, and less powerful unions. Some of these analyses, of equilibrium and economic growth, dip into inefficiencies of the tax system, or certain subsidies, like for agriculture, or the mortgage interest deduction. But none of them deal with the elephant.

The elephant in the room is the sheer size and growth of the federal government. Especially redistribution. In 1965, the year Lyndon Johnson pushed through the Great Society programs, non-defense government spending was 9.5% of GDP. By 1973, it had climbed to 12.5%. It was 15.2% in 2007, 17.5% in 2016 and today it is 20.4%. This growth is astounding.

Think of it this way…if we invent a new technology that grows our output by 10% through greater efficiency, that is basically equal to what the government is taking (20.4% - 9.5%) each year to redistribute as they see fit. Taxation and redistribution rob the benefits of innovation. Yes, of course technology has made us more productive, so why isn't growth stronger? The answer: excess government spending.

None of the General Equilibrium Models that we have seen incorporate the size and growth of government in their equations. That's why they will always be wrong…and debating slow growth will be useless. If we want the Great Stagnation to end we must cut the size of government. Cutting the size of government in half is the most direct path to 4% per year real GDP growth.

This brings us to the 60/40 investment model. For a very long time (maybe centuries) investors have known that diversification lowers risks. At one point a formula for stocks versus bonds was to take 110 minus your age and put that percent into stocks. The older you are the fewer stocks. Some simplified this approach and used a 60% stock and 40% bond portfolio.

But, in the past decade, this approach has hit the wall. After performing well – limiting volatility, while providing solid returns – it fell apart. If you search the web for 60/40 investing, you will find story after story about how this strategy just doesn't work anymore. The question is: Did it stop working because it is fundamentally flawed or did it stop because it was a fad …like stocks doing well in a year an NFC team won the Super Bowl, or "sell in May and go away"?

There is a reason…and that reason is that the Federal Reserve has destroyed it. In 2008, with the advent of Quantitative Easing, the Fed was given the power to pay banks interest on excess reserves (IOER).

What these policies did was separate the money supply and bank reserves from interest rates. It used to be that banks traded federal funds every day. But now banks all have excess reserves…trillions of dollars…and there is no longer a market in federal funds. In other words, the federal funds rate is set at the whim of the Fed. To put it simply, it is price fixing.

Since 2008, the Federal Funds Rate has been set by the people who vote at Federal Reserve meetings. For nine of the past sixteen years the Fed held the rate at near 0%, and for nearly 80% of the time since 2008 federal funds paid less than inflation.

Interest rates are supposed to compensate investors for inflation plus a real rate of return on top of that. So, if interest rates are held below inflation, bond yields (fixed income returns) don't do their job. No wonder the 60/40 model didn't work.

What's wrong with the 60/40 model is that the Fed broke it because it wanted to help fund massive government spending at artificially low interest rates. There is no real monetary policy justification for this. Sure, the Fed will say the old system was fragile. But their system is top-down management. Big government is the problem. The Elephants in the room were all built by government. Fixing that would give the economy a chance, and return sanity to the markets.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-23 / 7:30 am	Initial Claims – Jan 18	220K	**215K**		217K
1-24 / 9:00 am	Existing Home Sales – Dec	4.200 Mil	**4.180 Mil**		4.150 Mil