CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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A Different Year...
...This is not 2021

The Federal Reserve prepares to tighten monetary policy after its long period of extreme monetary accommodation in response to the pandemic.

Financial markets do not like the Fed's plans, but the Fed feels it must act dramatically to deal with inflation.

As I see it, a new bear market for stocks is beginning to unfold. Although it is always clear after the fact when a bull market ends and a bear market begins, it is much harder to identify this as it happens. Typically, the formation of a top to a bull market is a drawn-out affair taking many months, punctuated by periodic sharp selling sprees and sharp recoveries. (The very deep and swift decline of February and March 2020 as the pandemic began did not demonstrate the extended topping process. It was sudden, caused by fears about the new and alarming pandemic.) Some stock market indices (e.g., the Russell 2000 index of small company stocks) show a year-long topping process; the primary indices like the S&P 500 and the Nasdaq show the same over the last three and six months. One observes a significant increase in day-to-day price volatility since the new year began, another indication of a bear market and a sharp contrast to the quiet and smooth ride in 2021.

The Fed, the Economy and Bonds. The Federal Reserve is almost certain to begin raising the short-term interest rates it directly controls at its next meeting in mid-March. Comments by some Fed governors in recent weeks suggest the possibility that the Fed may then raise the Fed funds rate by 0.50%, rather than the typical move of 0.25%. Others suggest that the rate may rise at each of its seven Federal Open Market Committee (FOMC) meetings until the year end, pulling Fed funds up by 1.75%. Moreover, the Fed has promised a swift end to its buying of Treasuries and mortgage-backed securities and the beginning of the process of reducing the amount of such securities it holds. Thus will end Quantitative Easing and begin Quantitative Tightening.

Neither stock markets nor bond markets like the Fed's plans and the prices of bonds and stocks reflect the discomfort. As discussed in last month's letter, with the release of the minutes of the December FOMC meeting during January, stocks fell sharply. A recovery from the deep sell off began near the end of January, but rolled over late last week on news of still-higher inflation and the US warnings of an imminent invasion of Ukraine by Russia.

By

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The Fed's announced plans are rather dramatic, no doubt because of its sense that it must demonstrate resolve to deal with high inflation. However, it seems unlikely that the Fed will be able to nor will it need to tighten monetary conditions as much as now adumbrated. Firstly, although Mr. Powell and Janet Yellen, the Treasury Secretary, no longer describe inflation as transitory, it probably will roll over and head back toward the two percent annual range that has prevailed over the last decade and more. Secondly, as the Fed raises interest rates, as it ends its purchases of securities, and as it begins the process of decreasing the amounts of securities it now holds, the economy will weaken and the stock market will suffer. During Mr. Powell's tenure as Fed chair and in Ms. Yellen's tenure that preceded his, the Fed has paused or stopped or reversed its efforts at tightening monetary policy, partly because of disruptions in stock markets. The Fed's mandate does not, of course, include support of stock markets, but such actions by the Fed over recent decades have persuaded observers that the Fed is not indifferent to significant stock market declines.

The pandemic has caused an unprecedented series of changes to previously normal economic activity, with government-imposed lock downs, individual actions to safeguard health and reduce risk, and disruption of supply chains, by which goods travel across oceans and continents. And, unsurprisingly, the normal reports of economic activity have become garbled and less useful. That said, significant reports show an already slowing economy. Retail sales have fallen in recent months and supply-chain bottlenecks are easing. Real (i.e.,inflation-adjusted) final sales have only increased at a 1.7% rate over the last three calendar quarters, a sharp decline from normal levels. To put it differently, demand is weakening as supply increases. Inflation will decrease because of this, without the Fed's efforts to crush inflation. There is every possibility that the Fed's tightening will push the weakening economy into recession. This will certainly aid the process of lessening inflation, but at a cost of hardship and unemployment for many people.

Bond markets have weakened, even during the periods of stock market selling. This is unusual and it probably will not last. The Fed's actions are likely to cause further economic weakening, which itself will cause Treasury bonds to rise in price.

An unusual aspect of the last several weeks of stock-market selling has been the concurrent weakening in bond markets. Typically, bonds gain in price (and their yields fall) in periods of stock market weakness. In these last several weeks, however, against the drumbeat of Fed warnings about raising interest rates, bond prices have declined. As a result, the large bond positions in Core's clients' accounts have also fallen in price. This is unsettling but, to employ the now-abandoned Fed term, it is most likely 'transitory.' As the economy weakens, pushed by the Fed's actions or on its own, Treasury bond prices will rise. Weakening economies, particularly recessions, cause Treasury bond prices to rise and their yields to fall. We will see this in coming months.

The move to 'safe-haven' investments will be a further tail wind for Treasuries and gold.

Russia, Ukraine and Flight to Safety. Until the end of last week, financial markets appeared to ignore the risks posed by Russia's threatening actions along Ukraine's border, presumably on the notion that diplomacy would smooth troubled waters. At the end of last week, as US officials warned that an invasion was imminent, markets turned attention to Russia and Ukraine. Markets demonstrated typical action then: stocks fell sharply while Treasury bonds and gold rose equally sharply. Gold, Treasury bonds, the Japanese yen and the Swiss franc have long been regarded as safe havens in times of such nervousness. One can hope that the worst will not unfold in Ukraine, but this is certainly an usually dangerous geopolitical period. We will see more volatility in financial markets and more flights to safety.

Core's investments. In the context of January's stock market sharp decline, I reduced Core's clients' equity holdings and raised cash. If things unfolds as I anticipate and if things worsen in Ukraine, we will be able to put this cash to good use by purchasing equities again at lower prices than now prevail.

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