

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 18, 2022

Not for the Faint of Heart

As the new year begins, little comfort is on offer. Federal Reserve governors loudly proclaim their monetary tightening plans, the economy appears to be slowing, and stocks are taking it on the chin. Happy New Year?

The Fed released the minutes of its December meeting last week. Inside was a new, rather significant addition to the report and chairman Powell's press conference on the day of the meeting: Not only would the Fed be reducing its purchases of Treasury and mortgage-backed securities more quickly than previously announced, not only might it begin to increase the short-term rates it directly controls as early as March, but, so the minutes report, there is discussion of reducing the assets it holds. This last was news and it was greeted with sharp declines in stock and bond prices.

Did the Grinch steal Christmas? Despite widely asserted views about the strength of the American economy, recent reports suggest otherwise: Retail sales fell by 1.9% in December; November's number was restated lower. Given that consumer spending amounts to about 70% of the American economy, what does this portend? Meanwhile, the personal savings rate (that is, the amount American's save after their spending and tax payments) has fallen below the level that prevailed before the pandemic. In November, it fell to 6.9%; in January 2020, it stood at 7.8%. During the early months of the pandemic, the savings rate shot to 33.8%; it stayed high as the federal government pumped trillions of dollars into the economy. But, with the fiscal gravy train derailed by Joe Manchin, federal largesse is behind us and people appear largely to have spent what is at hand. As for the manufacturing side of the economy, industrial production fell in December. Although I don't claim economic insight or training, it seems to me that if demand and supply are both weakening, we might wonder how robust will be the economy in coming months.

How might markets respond to Fed tightening and a slowing economy?

In the decades after World War II, eighty percent of periods of Fed tightening of monetary policy have lead to recessions. Stock markets do not like recessions; corporate earnings fall; investors become scared; prices go down. At present, expectations for strong further stock market gains and still rising corporate profits are high. Stock prices, measured as multiples of sales of the underlying companies, are at all-time highs; as measured by corporate profits, they have been this elevated less than ten percent of the time. The Shiller CAPE measure, discussed in recent letters, has only been exceeded once in the last century and one half. The Fed, probably to show its resolve to fight inflation, plans to tighten monetary conditions in an environment of historically high stock price and a weakening economy. Hmm....

By

Jack Mayberry

The Fed's resolve will be tested. Fed tightening will almost certainly cause the stock market to fall in price. How will the Fed then respond? In the recent past, we have been given some clues. In December 2018, after its regular Federal Open Market Committee meeting, Fed chairman Jerome Powell stated that the Fed's program of reducing assets on its balance sheet was on 'autopilot.' This comment, plus Fed's decision at the meeting to raise the Fed funds rate for the fourth time in the year, caused a sharp sell off to bring the S&P 500 to a near 20% decline. Before long in 2019, the Fed ceased its efforts to reduce the assets it held and began a series of rate cuts. Before the pandemic emerged, the Fed had begun again to purchase assets. (As discussed in previous letters, in response to the pandemic, the Fed undertook exceptional measures.) My point in reviewing the Fed's 2019 actions is to point out its reversal of monetary tightening after the stock market dive. Might we expect a similar response in 2022 if the promised monetary tightening causes sharp declines? Quite possibly.

Treasury bonds, on the other hand, will find Fed tightening to be a kind of cat-nip. In the very recent market spasms, yields on long-term Treasuries have risen, bringing Treasury prices down. It is possible that higher yields reflect high inflation and fears of persistent and maybe higher inflation. But with slowing retail sales (weakening demand), without more free money from the federal government (even the childhood tax credit has ended), it is hard to imagine that inflation will persist at present levels. The longer-term market indicators of inflation show a reversion toward the low levels that have defined the last decade. Jerome Powell may have stopped using the term 'transitory' to characterize inflation, but, in my view, this has to do with his attempt to establish his inflation-fighting *bona fides*.

The market gives us another piece of evidence about where we are and where we are heading in the level of the Russell 2000 stock index. This index is a widely-followed measure of small companies. (The Russell 1000 is a measure of 1000 large US companies; the Russell 2000 measures the 2000 small companies in the Russell 3000.) These 2000 small companies do not include, of course, the globe-spanning giants like Apple and Microsoft. Instead, they are small companies selling within the US domestic market; they provide a decent look at American economy. At present, it sits 13% below its high and at the level that prevailed last February, before we all became vaccinated.

Lastly, the pandemic. Although the Omicron variant appears not to cause serious illness to those vaccinated and boosted, we still have the Delta variant circulating. Deaths and hospitalizations have risen sharply. Governments--federal, state and local--have no appetite for lockdowns, but also little reason to impose them: People are, once again, being very careful about their interactions with others, avoiding crowded theaters, subways, and the like. What will be the outcome of the pandemic? We shall know in the fullness of time; buoyancy maybe, but maybe not.

All these factors point to the need to be cautious and careful in our investments. After fairly smooth sailing for the markets in 2021, the newly-begun year will likely present more than a little disquiet. Not for the faint of heart.

CORE Comments



CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com