CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 14, 2022

Inflation, Stocks and Bonds

Remarkable things unfold throughout the world and in financial markets. The panic arising from the ever-higher inflation numbers has been wreaking havoc in stock and bond markets. After last Friday's monthly inflation report that came in somewhat higher than expected, both bond prices and stock prices fell sharply. Then, upon further reflection, both bonds and stocks fell even more sharply yesterday.

There is little question that we are in the midst of a bear market for stocks; the likelihood of a recession rises every day as ever-weakening economic reports come in. Last month, as the rather dire situation—as relates to investing—became clear, Core made a large investment aligned to the stock market's trend, in effect a short position in the Nasdaq 100 index. This investment has done precisely what we have needed: it has risen in price as stocks and bonds have declined. In the last four quite nasty days in the stock market, this investment has risen by 11 percent. Because we have a large position in this security, about 20 percent in most clients' accounts, its appreciation has offset declines in prices of other investments we hold.

Our bond investments have gone down in price, including in the last week. Why do we still hold them? The reaction to the increasingly strident rhetoric from the Federal Reserve about its aims to subdue inflation--by increasing interest rates and by reducing its holdings of Treasury securities—has pulled interest rates higher and bond prices lower across the board. But, given higher inflation rates, market participants now anticipate a series of Fed rate increases that will almost certainly—in my view—put the US economy into a recession. The Fed's expected rate increases along with the much higher prices for gasoline, food and other stuff that we need to buy will have the effect of crushing demand and limiting our capacity to pay for stuff. In the early 1980s, when Paul Volker was the chairman of the Fed and when the Fed put an end to the very high inflation that plagued us then, the US economy suffered through two recessions. Lots of folks lost their jobs and their incomes. One hopes we will not have a replay of those difficult times.

But. For investors, particularly for those with bond investments, Volker's era was the beginning of the golden age. One does not expect such an outcome this time; unlike then, interest rates remain low. However, recessions always bring interest rates lower and bond prices higher. (You can look it up.) And, when stock prices fall significantly during a period when the Fed is raising rates, the Fed takes note and usually preverses its monetary tightening policies. This time? The Fed's credibility has been significantly undermined by the startling increase in inflation. All last year the Fed declared that the increase in inflation was 'transitory.' (So I thought, as well.) Well, 'transitory' seems inapt by now. Because the Fed's primary job is keeping inflation low, it must be very strong now as it endeavors to suppress inflation.

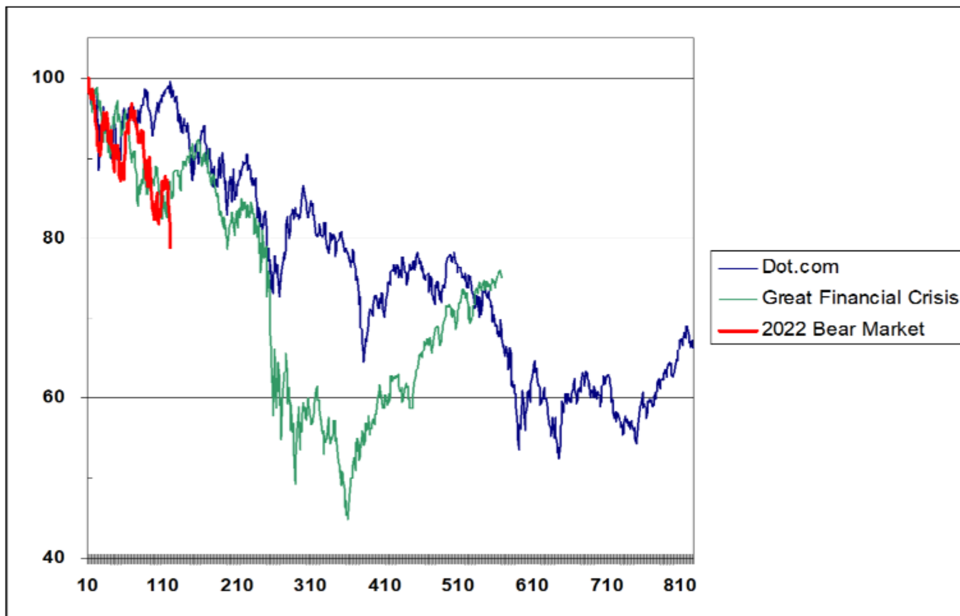
By

Jack Mayberry

The present view is that the Fed will raise interest rates sharply, by one-half percent

or more in coming meetings. (As I write, the Fed's Open Market Committee is meeting. Its meeting ends tomorrow afternoon when we will learn what it has decided.) As this year began, a series of sharp interest rate increases had not been the market's expectation. But as the Fed has declared its plans, interest rates have risen and bond prices have fallen. Note, however, that over the last five decades, recessions have always brought interest rates sharply lower and bond prices sharply higher. As the recession unfolds, stock prices will fall further. We have been witnessing the precursor to this since January. As this drama unfolds in the economy, people will lose jobs and things will become rather grim. At present, the general view is that the economy remains strong and the likelihood of recession is a small one. To my mind, that view is based on wishful thinking and a failure to take note of the increasingly negative economic reports.

In coming weeks and months, we will be reading in the press about all this. In my view, the stock market will continue downwards and the bond market will rally strongly. In the last five decades, the yield on the ten-year Treasury bond has fallen by more than one and a half percent during recessions. Our bond investments will earn good returns for us in coming months. Our stock investments are very small, utilities and oil pipelines. We hold much more cash than in many years. Our large investment—the short position in the Nasdaq—is appreciating well. In a very difficult year for investing, we have useful positions that will provide a good return in a terrible market.



I have updated the chart from last month's *Core Comments* showing how the stock market, as measured by the S&P 500, fares now, as compared to the two grave bear markets earlier this century, the dot.com bear market of 2000 to 2002 and the bear market that accompanied the Great Financial Crisis from 2007 to 2009. (The x axis shows the days since the high in the stock market. I have rebased the stock market highs to 100 to present a comparison of these bear markets.) Of course, in this round, things will proceed differently, but it is instructive to consider the <u>duration</u> of those earlier bear markets. I exclude the very sharp and very brief stock market collapse of early 2020 when the plague struck us and every thing and every body closed down. In response to Covid, both the Fed and US Treasury sprang into action then to tide us over until the plague abated.

The Fed is not coming to the rescue this time: it is banging a nail into the coffin. The support given by the Treasury after the three Covid-related pieces of Federal legislation in 2020 and early in 2021 is in the rear-view mirror. Federal spending is far lower this year than in the last two, while the Fed is tightening the monetary screws. I don't think we get relief from this until the Fed decides it has done enough to put inflation to bed. For now, that lies well in the future. Caution is the watch word now.

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