

May 23, 2020

## Don't Fight the Fed ...Really?

The hoary rule in investing is not to fight the Federal Reserve, meaning one should follow the direction its actions point and avoid investing against the Fed's policies. The Fed has, as discussed in recent letters, initiated unprecedented and powerful efforts to mitigate the damage from the Coronavirus-induced bear market and recession (or depression--too early to tell which). As we have observed, after the initial plummet in stock prices from February 19th to March 23rd, the stock market has delivered a significant rally and made up a good deal of lost ground. The flow of economic reports in the last month has shown a collapse in economies without precedent since the Great Depression, but stock investors appear to be looking across the canyon of economic desolation to the return to pre-Coronavirus economic growth and corporate profits.

*Terrible economic collapse but a rising stock market. What gives?*

*The correlation between economic activity and stock prices has been essentially zero in the last two months. Typically there is a fairly strong positive correlation between the two. That correlation will return.*

A significant explanation for the stock market's partial recovery is the prompt action of the Fed and the expectation of future Fed responses. Over the week-end of May 16 and 17, for example, Jerome Powell, the Fed's chairman, told us that the Fed has more ammunition if needed to fight the problems. Alas, the Fed can deal with liquidity matters, but not solvency. That is, it can enhance the flow of money through the system, but it cannot provide capital to companies threatened with insolvency caused by the collapse in demand for companies' products or services. (It must be said, however, that the Fed is trying to overcome its inability to provide capital by buying a broad array of assets, including, indirectly, junk bonds. Its purchases lift prices in commercial debt markets, enabling companies that are otherwise uncreditworthy to raise capital in debt markets. This is a close cousin to providing capital to weak companies.)

Economic fundamentals are simply dreadful, but the stock market ignores them. (Try reading economic reports from around the world every morning, if you want to become depressed early each day.) Corporations announce lower profits from the first quarter, but the stock market considers this yesterday's news. It is said that the Fed and the Congress will tide us over until things are back to normal. In this letter, I make two points, firstly, that the Fed does not always win in fighting bear markets, secondly, that a resumption of what was normal activity in pre-Coronavirus days will not come soon.

**By**

***Jack Mayberry***

The simple point first: in each of the bear markets and recessions of 1981 to 1982, 2001 to 2002, and 2008 to 2009, the Fed cut the short-term rates it directly controls quite dramatically. In the 1981 to 1982 period, while the Fed cut rates by 45%, the S&P fell by 28%. In the dot.com problem in 2001 to 2002, the S&P fell by 50% while the Fed was cutting rates from 6.5% to 1.75%.

Then, in the financial crisis and deep recession in 2008 and 2009, the Fed cut rates from 5% to 0.5%, while the S&P fell by 58%. One can fight the Fed.

How soon will things return to pre-Coronavirus normal? The stock market ignores this, but the return to normal will be a long time coming. America and Europe are ending locks-downs in different ways in different places, but the ability and willingness of folks to resume former activities will be absent. Many workers have been 'furloughed' or temporarily put out of work; will their former jobs and former incomes be restored? Certainly not for all of them. Income has been lost; the dangers of closeness to others with whom we are not in quarantine are foremost in the minds of everyone. Many will not be able to spend and even more will be unwilling to spend in the way they had before Coronavirus. Already the savings rate has reached multi-year highs; companies and individuals now understand the need to put money aside against the risks that Coronavirus shows us. This will dampen economic activity; the recent bankruptcy filings of JC Penney, J Crew, Neiman Marcus and Hertz are only a start; more are to come. China provides a bit of a road map for this, in that it suffered first, locked things down first, then began reopening first. Although industrial production and the like in China have approached pre-Coronavirus levels, spending by consumers has lagged significantly. Supply has resumed much faster than demand.

*Long-term Treasuries and gold have out-performed the stock market by miles in the last year. Further out-performance lies ahead as the bear market continues.*

**Core's Investments.** The strong rally since March 23rd is impressive--and so have been other bear-market rallies in past. It is disconcerting for an investment manager--myself--to watch from the sidelines as this rally unfolds. It requires patience and resolve about one's views, while one recognizes that one's judgment may be wrong, to resist jumping into the stock market game. One is helped in two ways: firstly, that our investments in Treasuries and gold have continued to appreciate since the stock market's lows in March, such that a typical Core account has earned another 4% since the March low and that Core's accounts have risen by more than 22% in the last twelve months. The second reason to avoid stocks is to review once again the way that bear markets in the past have unfolded. There are always big counter-trend rallies in bear markets, such as we now experience. These are followed by longer and deeper declines. Bear markets persist and disappoint the hopeful. They end when optimism about the future is entirely supplanted by despair. We are nowhere near that point: sharp rallies on the hopes of treatments--Remdesivir on April 17--now on hopes of vaccines--Moderna this week--are indices of optimism not the expression of despair.

Given the views expressed above, how should we evaluate our investments in long-term US Treasury bonds and in gold? These both have provided very good returns for us since we first took these positions well over a year ago; the question is what lies ahead. Deflationary forces arising from the weakness in demand for stuff, as discussed above, will cause Treasury bond prices to continue to rise. Not forever, but for now. As for gold, our other large investment, it must surely continue to rise and probably for a longer time than our Treasuries, because of the long-term peril that the fiscal and monetary expansion cause. In the medium term—a year or so, until Coronavirus matters are in hand—the deflationary forces will be the larger ones. After that, the huge increase in the money supply that the Fed has provided—never before seen at this scale—creates the significant risk that currencies, including the US dollar, will weaken sharply against the price of gold.

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**CORE**Comments



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