CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

October 30, 2022

# How Things Might Evolve

*The Fed's actions against inflation have not yet caused inflation to begin to fall. In time, it will. However, the process is also likely to involve recession and huge job losses.*

*When Paul Volcker attached and slayed inflation in the early 1980s, the cost was two recessions, deep declines in stock markets and significant unemployment.*

*Jerome Powell emulates Mr. Volcker; the outcomes now may be similar to those of the early 1980s.*

*Despite the unsettling prospects, the pathway to investment gains is not hard to discern.*

**By**

***Jack Mayberry***

In this remarkable and difficult year, the Federal Reserve Board has been the principal actor in matters relating to the bond market, the stock market and inflation. The Fed is likely to continue in that role in the year ahead. So far, the secondary actor has been Vladimir Putin and his war against Ukraine. In this letter, I offer ideas about how things might unfold over the next twelve months.

**First, the background.** The Fed's actions this year arose from the enormous support it provided after the onset of Covid and the 2020 lockdowns. Early in the spring of 2020, in the context of the terrible deaths from Covid, the Fed lowered the short-term rates it directly controls essentially to zero percent and it began purchasing Treasury and mortgage-backed securities (referred to as Quantitative Easing) in an effort to pull the economy out of the shut-down induced recession. Even after inflation began to rise in 2021, the Fed continued its very loose monetary policy, including Quantitative Easing, until early this year, by which time the Fed had purchased some $4 trillion of bonds. Through most of 2021, the Fed and the Treasury Department deemed high and rising inflation to be 'transitory.' By early this year, the Fed recognized that inflation would not simply go away, even as the distortions engendered by Covid subsided. Putin's war caused oil and food prices to rise sharply, exacerbating the inflation problem. Fearing that, if the public came to expect inflation to persist, the expectation would become self-fulfilling, the Fed commenced swift and aggressive monetary tightening. It raised short-term rates very sharply; in the recent three meetings of the Federal Open Market Committee (the FOMC), the Fed increased Fed funds by 0.75% at each meeting. In this week ahead, when the FOMC again meets, it will almost certainly do the same.

**Paths ahead.** The rate of inflation has not yet begun to subside, and Fed governors, and Fed chairman Jerome Powell, have stated forcefully that the Fed will continue monetary tightening until there is clear evidence that inflation is falling toward the two percent level. It is well established that the Fed's actions have variable and lagged outcomes. That is, although the Fed began its tightening in the spring, the effects of its actions have not yet manifested themselves. The Fed's explicit aim is to curb demand for goods and services, thereby taking pressure off prices. Surely the Fed's efforts will ultimately curb, if not crush, demand. The unanswered and now unanswerable question is when the rate of inflation will fall. Moreover, there is every chance that Mr. Putin's war may create more inflation. Consider that Russia announced today that it is withdrawing from the July deal between Russia and Ukraine that permitted Ukraine to export wheat.

**Steps in the process.** In time, the Fed will reduce the rate of its Fed funds increases from the 0.75% per FOMC meeting. Let us call that 'deceleration.' In time, the Fed will pause the rate increases, in order to judge the lagged effects of its previous actions. Thereafter, the Fed may resume the rate increases if inflation is not coming down. Or, if inflation does fall or if 'something breaks,' the Fed will lower rates and begin the cycle of monetary easing. (More on 'something breaks' below.) When all these come about is unknown, but their effects on bond and stock markets is not obscure. Deceleration and pause will both give rise sharp stock market rallies, rallies that will prove as ephemeral as was the rally from mid-June into August this year. But for bonds, deceleration and pause will mark the beginning of a rally in prices (and commensurate decline in yields) that will persist. If, after the pause, Fed resumes rate increases, stocks and bonds will both fall in price. If, after the pause, the Fed begins to cut rates, the stock market again will rally, but again only for a short time. The real bottom of the bear market in stocks will come after significant and sustained rate cuts. As the Fed cuts rates, bonds will continue to rally strongly. Although I do not have room in this letter to put the evidence for my assertions before you, the history of previous cycles of Fed tightening, of recessions, of bear markets in bonds and in stocks, and of Fed easing demonstrates that markets evolve in the manner I describe.

**Breaking something.** On September 23rd, then British Chancellor of the Exchequer, Kwasi Kwarteng announced significant tax cuts in what came to be called his 'mini budget.' The reaction to those plans was immediate and dramatic: interest rates on British government bonds, so-called 'gilts,' sky rocketed and the value of the British pound declined very sharply. It was instantly clear that the 'mini budget' was deemed impossible. Then it emerged that defined benefit retirement plans in Britain had borrowed gilts and built large leveraged positions. As gilt prices fell, the lenders of those borrowed gilts demanded more collateral for their loans. Pension funds were obliged to sell the borrowed gilts at low prices, causing a downward spiral of prices. The Bank of England, Britain's central bank, had to step into the breach and buy in a short time some 65 billion pounds worth of gilts to stabilize the market.

The new prime minister, Liz Truss, was obliged to fire her Chancellor and she herself had to resign shortly thereafter (thereby setting a record as the shortest-serving British prime minister). The new Chancellor, Jeremy Hunt, and the new prime minister, Rishi Sunak, have undone most of the mini budget and are attempting to restore Britain's reputation for fiscal soundness. <u>The point of this episode</u> is that, out of the blue, we learn that an obscure corner of the market—Britain's defined benefit pension plans—had borrowed huge amounts of gilts when their yields were very low in order to meet future needs. Suddenly, a major central bank must ride to the rescue of institutions.

The Fed's rate increases and aggressive rhetoric about continuing those rate increases may well cause something else to break. Thirty-year mortgage rates in the US have more than doubled this year and now exceed seven percent. As a result, housing prices are falling. Partly because of bank reforms put in place after the financial crisis from 2007 to 2009, liquidity—the ease of buying and selling—in the Treasury bond market has worsened drastically. In September 2019, a brief but serious crisis arose in the repo market, the market for overnight repurchase agreements between banks; the Fed was obliged to provide $75 billion in liquidity for this market every morning for several days. In March 2020, came another alarming dislocation with a similar Fed response. The risk is high that something now unknown will come apart and cause market disruption.

**Core's investments.** In light of these risks and because of the high likelihood of much lower stock prices, Core's investments are essentially three-fold: We hold a significant amount of cash, now yielding about three percent and going higher as the Fed keeps up its rate rises. We have a goodly holding in one- to three-year Treasury notes; these will rise in price when the Fed begins its monetary easing. And we hold short positions in portions of the stock market; these increase in price as the market falls. When the Fed pauses and certainly when it begins to cut rates, we will buy Treasury bonds in anticipation of what will be a very healthy bond rally. As the recession becomes ugly and job losses rise, the stock market will continue its decline; at that time we will begin to take our profits in the short positions. (Have a look at the chart in the previous *Core Comments* and note the declines in the dot.com bear market and in that of the 2007 to 2009 bear market. There is further to go down in our present bear market.) Then, with lower prices in the stock market after the Fed has cut rates sharply, we will have attractive stock market offerings at hand. We will be ready to buy stock market positions. The cycle continues.

*We recently changed our post office box in Sausalito to PO Box 866.*

*We witnessed over the last month a sudden unexpected collapse in the British pound and in the prices of British government securities.*

*This event that brought down the short-lived government of Prime Minister Liz Truss is a stark warning of hidden risks that await us.*

*Market wags have come up with a new phrase to describe the sudden uncreditworthiness of Great Britain, namely the 'moron risk premium.'*

*Stability in British bonds is being restored by the new government, but the episode is a clear warning that other things my break as a result of aggressive Fed monetary tightening.*

*First, bonds will rally as the Fed pauses its rate increases and begins to loosen monetary. The stock market will not end its bear market until well after the monetary easing begins. My expectation is that the stock market has further to fall, after which stocks will offer very good values. We will be buyers then.*

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