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

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Jerome Powell Explains

The Federal Reserve Bank and the Treasury have not entirely mitigated all the dire economic effects of the pandemic, but they have certainly kept asset markets thriving.

Housing prices have risen sharply in the last year. The stock market has appreciated despite the very sharp recession.

The effects to date are just fine, but what comes next? The bubble in housing prices in the first decade of this century ended badly. Previous extremes in stock market valuations have always come to sharp and unhappy endings.

Core is investing very cautiously.

By

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The headlines tell us that the stock market keeps making new highs, that inflation is high and rising, and that the economy grows rapidly. The reality is different: The economy is slowing—demand is falling as retail sales have decreased for three months. The Treasury bond market is rallying, the stock market is stalling and the recent high inflation readings are pandemic-related distortions to economic activity. Covid is the cause. The question for investment managers is what changed in last eighteen months to bring about such an increase in asset prices during a very deep--albeit short--recession while the once-in-a-century pandemic unfolded.

When America and the rest of the world realized that a terrible disease was spreading through the world in the latter part of February and early March in 2020, we entered 'lock-down.' Shops closed, cities and countries stopped activities, people stayed at home, economies contracted, and stock markets fell sharply. In America and other rich countries, governments and central banks swiftly sprang into action.

What was different this time? In the previous century, when a significant decline in stocks unfolded, the <u>unvarying</u> pattern was for a recovery in stock prices, before a 'test' of the former lows that might take prices well below the first level decline. After that successful or unsuccessful test of the first lows, the entire bear market would, in time, come to an end and a new bull market would commence. In this instance, both the federal government and the Federal Reserve immediately recognized the scope of the problem and acted. The Fed opened the spigots of money creation and began to buy $120 billion of Treasury and mortgaged-backed bonds each month. Congress passed, during Mr. Trump's last year in office and during Mr. Biden's first, a series of huge transfers of funds from the federal government to people.

From the investment point of view, the actions of the Fed and the government turned things upside down. Instead of a 'test' of the first round sell-off lows of March 23, 2020, we had a straight-up rally--a rally that has persisted without the 'invariable' (until this time) re-test of the first-round lows. The lesson, I guess, is that things follow historical patterns--until they don't. In this last year, a new pattern has formed itself: Deep recession be damned. Sharp declines in stocks be damned. Federal Reserve fire fighters sprang into action and asset markets stayed afloat.

Where do things stand now? Noting that historical patterns do not repeat, I suggest that the following may unfold: Valuations of stock prices are beyond insane at present. By many measures of stock values, things now are more extreme than at any time in the last century and one half, except for valuations at the turn of the millennium, that is, at the dot.com bubble. But we may point out that from the high point in August 2000, the S&P 500 fell by half to the lows in October 2002, that is, from 1530.09 to 768.63. Ouch! This and other measures of stock market valuations suggest that the next movement for stock prices is to the south.

Against the various valuation measures of stock prices, we must point to the Federal Reserve Bank. Jerome Powell and his colleagues at the Fed have continued the purchase of $120 billion of Treasury and mortgaged-backed securities each month. The idea is to counter the effects of Covid-related problems. As we now observe, because of the Delta variant and the significant numbers of Americans who resist vaccination, the American economy is slowing. Without official lock-downs, it is pretty clear that, across the country, peoples' actions have slowed down. Things may well slow further.

Mr. Powell spoke on Friday morning, giving the key-note address to the annual Central Banks pow-wow at Jackson Hole. Mr. Powell discussed inflation at some length, concluding that the recent high levels of inflation are transitory, the result of pandemic -related disturbances. He did not dismiss recent high readings and indicated that the Fed would examine incoming inflation data closely, prepared to adjust policy as needed. He made the point that Fed efforts to contain inflation operate with a lag of a year or more. If, he pointed out, recent high readings turn out to be transitory, as he expects, restrictive monetary actions taken now would slow the economy and adversely affect employment after the temporary price increases had dissipated.

Mr. Powell outlined the risks that Covid and the Delta variant present. He discussed the process by which the Fed may remove some of its pandemic-related support.

The Fed has a dual mandate, as established by Congress, stable prices and maximum employment. He indicated that the Fed has achieved one of its two targets already, namely the inflation one, and that substantial progress in the employment goal has been achieved. As Mr. Powell put it, "[w]e have much ground to cover to reach maximum employment.... The unemployment rate has declined to 5.4 percent, a post-pandemic low, but is still much too high, and the reported rate understates the amount of labor market slack. Long-term unemployment remains elevated, and the recovery in labor force participation has lagged well behind the rest of the labor market."

If further progress is made in coming months, says Mr. Powell, by the end of this year the Fed may begin slowing its $120 billion per month of Treasury and mortgage-backed securities purchases. Several Fed governors in recent weeks have said they are inclined to stop or to slow the rate of the Fed's asset purchases presently. Mr. Powell had been silent on the subject until he spoke on Friday. On several occasions during his speech, Mr. Powell discussed the increasing risks posed by the Delta variant. This is, of course, the big unknown for the Fed and for all of us.

Although Mr. Powell did not make the point, it worth remarking that the monthly data releases of many economic indicators have shown changes up and down never before experienced. Given the broad shut downs of economic activity in the early part of 2020 and the huge federal payments that began in March 2020, it is not terribly surprising to see such variation in the numbers as they are reported. Consider simply this: the CARES Act of March 2020 gave rise to the distribution from the Federal Treasury of $2.2 trillion; the CRRSA Act of December 2020, pushed out another $0.9 trillion; then the American Rescue Plan of March 2021 distributed $1.9 trillion. Staggering sums. The fiscal response to the pandemic has been $5 trillion so far. The Fed's monetary response has been the anchoring of Fed funds at just above 0% while it has purchased another $4.2 trillion of Treasury bonds and mortgage-backed securities. (The Fed now holds $8.3 trillion in assets on its balance sheet, a nearly ten-fold increase since 2007 as the Great Financial Crisis commenced.)

Our investments. Given all this, we continue to invest cautiously. We retain our large investments in high-grade bonds and gold. Our modest equity investments are in growth-oriented investments and in defensive ones. The action in the US stock market in recent months reflects slowing demand in the tilt to long-duration, growth sectors and to defensive areas. The remarkable aspect of this pandemic period is the influence that the Fed's actions have. We can expect the Fed's influence to persist.

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