CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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The Fed's actions over the last two decades have been the biggest factor in bond and stock markets.

Beginning in 2008 and 2009, it cut the rates it controls directly essentially to zero. And it began massive purchases of Treasury bonds and mortgage-backed securities.

After Covid with its disruptions, inflation, quiescent for years, began to rise rapidly. Beginning in March 2022, the Fed reversed course and began to tighten monetary policy dramatically.

By

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What has the Fed Accomplished?

Beginning in March 2022, the Federal Reserve Board (the Fed) began tightening monetary policy to bring inflation back to its target rate of 2% per year. The disruptions of Covid, lock downs, relief programs from the Federal government, both during the last year of Trump's administration and during the first months of Biden's, caused inflation to rise from the quiescent levels below 2% to the disturbing level of 8.5% year-over-year by March 2022. Having earlier described the increase in the inflation rate as 'transitory,' Fed officials realized that they must act decisively to deal with a level that kept rising.

The background. From the time of the so-called Great Financial Crisis of 2007 to 2009, the Fed had kept very low the short-term rates it controls directly. During the second decade of this century, the Fed tried, in a somewhat hesitant way, to 'normalize' rates from those extremely low levels. Periodic market and geopolitical disturbances caused the Fed to stay its hand. Then came the lock downs occasioned by Covid and the sharp and swift contraction of the economy. Back to near zero rates once again.

As the economy began to recover in the latter part of 2020 and in 2021 after Covid lock downs ended, the Fed kept rates low and its monetary policy very loose, fearful that more disruptions lay ahead. As 2021 began, inflation was only 1.4%, but, as people resumed their activities, the economy began to recover and inflation began to rise. By year end of 2021, inflation stood at 7.0%, as measured by the Consumer Price Index (CPI).

The general view given by the Fed was that inflation was 'transitory.' It is hard to criticize that view and easy to understand why the Fed kept monetary policy very loose, with low interest rates and a continuation of the policy 'Quantitative Easing' (QE). This involved the Fed's purchase of Treasury bonds and mortgage-backed securities, a project designed to keep interest rates low and to stimulate economic activity.

It appears, in retrospect, that the Fed maintained its loose monetary policy for rather longer than necessary. It is likely that the accelerating inflation of 2021 and the first half of 2022 was caused in part—but only in part—by the Fed's loose monetary policy.

The Fed's actions. As noted above, in March 2022, the Fed changed policy and began to tighten monetary conditions. Until 2009, the assets on the Fed's balance sheet amounted to about $800 billion, a level more less consistently maintained year after year. Under then Fed chair Ben Bernanke, the Fed initiated QE in 2009. In an essentially straight line—with some interruptions—the Fed's assets increased ten fold from 2009 to early 2022 to an astounding $8.9 trillion. But then the Fed reversed policy, both by raising short-term rates and reducing its holdings. The Fed funds rate stood at 0.00% to 0.25% as 2021 ended. In March of 2022 the rate rises began. Now Fed funds are in the range of 5.25% to 5.50%. Most of the increase took place in 2022 when the Fed engaged in an historically aggressive rate-rising campaign. It has reduced its assets to $8.1 trillion as I write. (The reduction in assets is called Quantitative Tightening, or QT.) This combination of rate increases and QT is, in fact, the most restrictive Fed monetary policy since the early 1980s when Paul Volcker, as Fed chair, crushed inflation and caused two reces-

sions. After the most recent meeting of the Fed's Open Market Committee last week, when the Fed funds rate was left unchanged, Jerome Powell, the present Fed chairman, made clear that the Fed is not finished with its monetary tightening policy, despite the decrease in the rate of inflation. (The CPI stands at 3.7% and is heading lower.) Although the Fed may not raise short-term rates much further, it intends to keep them at these high levels for some time. It projects only 0.50% decrease in Fed funds next year.

Despite its dramatic monetary tightening, the US economy has remained reasonably strong, so far.

But the effect of the Fed's actions always acts with long lags. Although the US economy has avoided recession, one almost certainly lies ahead.

We shall see.

Effects on the economy. So far, the Fed's monetary tightening has not caused much of a slow-down in economic activity. Employment levels remain high and economic growth continues at a modest rate. It is well-known that the Fed's actions affect the economy only after significant lags in time. The average period from the Fed's first rate hike (remember that's March 2022) to the beginning of the recession that follows is 22 months. If this round is to be an 'average' one, we might expect the recession to begin at the end of this year or the beginning of 2024. However, most reporting on the matter of the Fed's tightening and its economic effects ignores history and suggests that the economy will only experience a 'soft landing,' and not a recession. The present 'soft-landing' view will, in time, probably be seen as a bridge to the recession that lies ahead.

My view is that this extremely aggressive period of Fed tightening will certainly cause a recession. After the lag. The lag may soon be over; it may not be over for some months, but the briefest look what happens when the Fed is as determined to cut inflation as it has been in these last eighteen months will persuade you that a recession looms.

How the bond and stock markets react. As the Fed has persuaded the markets that it will keep monetary tight for a long time, bond yields have risen and their prices have fallen. The stock market anticipated the rate rises and made its all-time highs as 2021 ended and 2022 began. The S&P 500 fell by 25% from its all-time high on the first day of 2022 to the October 2022 low. From that low it has risen, buoyed by the chatter about the shiny-bright new thing, Artificial Intelligence. The Fed's actions seem to have been forgotten in the dazzling light of ChatGBT, at least until recent weeks when stocks have resumed their decline.

What lies ahead. History guides us, as follows: Fed tightening of the scale we have observed in the last eighteen months always leads to recession. Recessions always cause bond prices to rise and bond yields to fall. Stock prices always fall in recessions.

Core's portfolios. The portfolios Core manages hold a large position in money market funds, enjoying the 5% yield on short-term investments. We are happy to harvest that yield; it also provides dry powder for investment opportunities ahead of us. Our portfolios hold a substantial position in long-term US Treasury bonds. For these, of course, there is no credit risk—the United States does not default on its debt. The prices of these bonds have fallen this year as the markets have absorbed the Fed's determination to keep rates 'higher for longer.' Come the recession, the prices of these bonds will rise dramatically. Core's portfolios hold a modest position in an exchange-traded fund that moves oppositely to the price of American domestic stocks. It is making money for us in recent months and it will do very well as the recession unfolds. We also hold positions in oil pipeline companies and in Japanese and Indian stocks. Both Japanese and Indian markets are low priced as compared to US stocks and the governments' actions in both countries offer meaningful support to these markets. We are well ahead in these investments.

In conclusion, this has been a difficult period for investing. The last year and more of the Fed's actions and the last three years of the Covid period have been unusual, to say the very least. The path forward that I foresee is well supported by historical precedent. I expect healthy investment returns.

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