CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 14, 2022

Grinding Toward the New Year

The Fed grapples with inflation. Its process involves the constraint of economic activity.

This is good for bonds, but bad for stocks. The announcement later today by the Fed and Jerome Powell's press conference should shed more light on this.

By

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The bear market now approaches the end of its first year as measured by the S&P 500, and is already into its second year, as measured by the Nasdaq, which peaked in November 2021. A pattern is emerging, whereby a decline over a period of weeks is followed by a recovery for a few weeks. The recovery falls short of the previous high and another decline begins, taking the market below the low of the previous decline. Then a modest recovery, then a further decline and so on. In this pattern, long established in bear markets, declines make successively lower lows and the recoveries make successively lower highs. In the present round, after a new low in mid-October, the market rallied to the end of November. As December began, the stock market rolled over and began another trip down. The graph on the next page illustrates the course of the S&P this year.

Markets respond to the stream of new economic reports, to decisions by the Federal Reserve Board and to speeches by Fed governors. As has been the case all year, the high level of inflation—the highest in decades—has been the biggest factor guiding the Fed, which is determined to lower inflation to the former levels around two percent per year. There is decent evidence that inflation, though still very high, has reached its peak and is moving lower. Tuesday's report of the consumer price index was another data point in the slowing of inflation. As Jerome Powell, the Fed's chair, and other Fed governors speak, they insist that they will continue to raise the short-term interest rate it directly controls until evidence is strong that inflation will return to the Fed's target rate around 2 percent per year.

The Fed's actions directly restrict economic activity by raising the cost of credit. When the effects of its restrictive actions are fully experienced in the economy, it is likely that we will be in a recession and that unemployment will have risen. Demand for goods and services will have fallen; with that falling demand, the rate of inflation will have declined. It seems to me that the Fed is likely to succeed in its inflation-crushing endeavors. However, the timing of that success is quite uncertain. We will have some more insight into this later today. The Fed's Open Market Committee holds its every-six-week's meeting as I write. This afternoon, it announces its action, after which Mr. Powell will hold a press conference. The expectation is that the Fed will raise the Fed funds rate by 0.50%, after four successive 0.75% increases in previous meetings. Thus, the Fed will probably decrease the rate by which it raises rates, but it may well communicate its intention to raise rates higher and to keep them high for longer. We shall see.

One effect of the Fed's effort to cause economic activity to slow is the likelihood of higher bond prices. In my last *Core Comments,* I put forward the expected path for the economy and for the bond and stock markets. I noted that bond prices

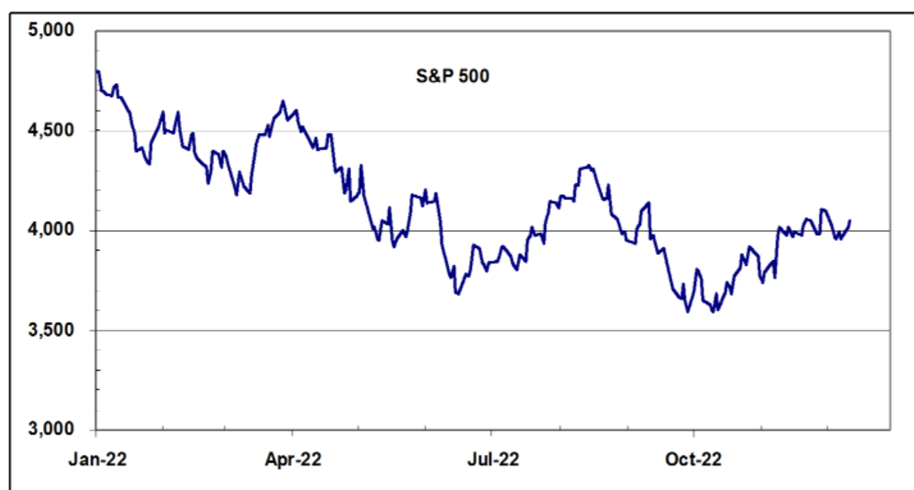
We recently changed our post office box in Sausalito to PO Box 866.

What may break as the Fed tightens? Time will tell, But the Bank for International Settlements has revealed a hitherto obscure, but massive, amount of debt in the system.

$65 trillion of obscure debt.

would begin to rise as the economy weakened while stocks continued to fall. From late October into early November, Treasury bond prices reached their lows for this year. There is no certainty that there will not be another sell-off in bonds, but it seems quite likely that over the next six to twelve months, bonds will rise in price and their yields will fall. In anticipation of this rally, Core has begun to buy long-term Treasury bonds. As noted in previous letters, bond prices have always risen and bond yields have always fallen as the Fed tightens monetary policy and as the economy weakens. There is no reason to think that this time will be different.

But as the Fed does its work, the economy's weakness will cause stocks to fall further. Based on past experience of Fed tightening, recessions and bear markets, the stock market may well continue to step lower for months to come. During recessions, stocks generally fall by forty to fifty percent and more. We may be no more than half way to the bottom, as suggested by the charts I have shown in previous letters this year.



Something could break. A new potential problem was revealed very recently by the Bank for International Settlements (BIS), a bank in Basel owned by many of the world's central banks. It announced that there is some $65 trillion in 'hidden debt' in foreign exchange (FX) derivatives markets. The debt is not revealed on the balance sheets of the borrowers; it provides collateral for FX transactions. $65 trillion is a lot of debt; it is three times the annual gross domestic product of the United States. It appears that it is largely held outside the United States. Thus, should problems arise, the Fed could only deal with it via arrangements it has with a handful of other central banks.

It is impossible to know what kind of risk this presents. It calls to mind the unexpected collapse in the British pound during Liz Truss' brief and ill-starred stint as prime minister. Recall that in that incident, we suddenly learned that a hitherto unknown form of investing by British pension funds nearly caused the collapse of several institutions. The Bank of England, Britain's central bank, was suddenly required to reverse its monetary tightening policy and pour money into the system. The British pound fell to $1.03, from $1.35 where it began the year; stock markets, including ours, fell sharply. Ms. Truss's government collapsed.

Dangers lurk in obscure places. Britain's new government, lead by Prime Minister Rishi Sunak, has restored sense and stability in Britain. Whether this newly discovered $65 trillion of debt causes a problem remains to be seen. We can expect the Fed and other central banks to be alert. The lesson is that the long period of ultra-low interest rates, now well in the rearview mirror, has given rise to risks unknown in previous times. Cautious investing remains in order

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