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

April 10, 2023

Calmer Waters…For Now

Matters are calmer now than when I wrote last month during anxieties around bank failures here and in Switzerland. The Federal Reserve Board acted promptly and decisively to forestall the depositors' runs on banks that felled Silicon Valley Bank ("SVB"). So far, the Fed's measures have worked. Clear sailing now? Before the all clear can be sounded, a few matters need resolution. A brief list, then a discussion. Commercial real estate problems for banks, the debt-ceiling crisis (or fiasco), and recession. After these discussions, an explanation for the trades last week.

First, recession. A number of previously infallible indicators suggest that a recession in a fairly short time is a certainty. The explicit purpose of the Fed's monetary tightening that began more than a year ago is to weaken demand in the economy, in the expectation that inflation will come down in a weaker economy. Although not all periods of Fed tightening have caused recessions, it is worth noting that this episode is the most severe in four decades. In the early 1980s, when Paul Volcker was the Fed chair and inflation was so high, the Fed raised rates very sharply and to high levels. When Fed funds (the interest rates the Fed directly controls) reached 20%, a recession ensued and the Fed cut Fed funds to 9%. But, inflation did not come down sufficiently, so the Fed raised rates even higher than 20% and a deeper and longer recession began. The second round of extremely high rates and the second recession did, indeed, break the back of inflation. There was pain associated with these back-to-back recessions: national unemployment rose from 5.8% to 9.7%, millions lost jobs. The number of people unemployed was 10.7 million in 1982, millions more than in 1979. Needless to write, the stock market fell very sharply as the Fed renewed its monetary tightening.

I don't cite these statistics to suggest that history will repeat itself. At its peak, inflation in the last year was still far below the levels in the late 1970s and early 1980s. And, although the speed of the rate rises in the last year is quite extraordinary, the Fed funds rate is 4.83%, far below the punishing levels of the early 1980s. But the Fed's monetary tightening always acts with a time lag. We have not yet seen the full economic effects of the Fed's actions in the last year and Fed governors suggest that there is likely to be another increase at the Fed meeting in early May. Perhaps more importantly, Fed governors strenuously indicate that Fed funds will remain at high levels through the rest of this year. Comments by Fed chairman Powell and other Fed governors make it clear that the lesson of the early 1980s is not lost upon them. That lesson, they let us know, is that the Fed began to loosen monetary policy before inflation was really brought under control.

Mr. Powell and other Fed governors suggest that a recession may be avoided or that the economy will have a 'soft landing.' Maybe. But here is one infallible indicator to which I referred above: It is the difference between the yield on the ten-year Treasury note and the three-month Treasury bill. Under normal circumstances, the yield on long-term bonds is higher than on short-term ones; creditors demand a higher rate of return on money lent for a long time than they do for money lent for a short period. However, as I write, the yield on the 3-month Treasury is 4.77%, whereas the yield on the 10-year Treasury is 3.29%. This situation—where long-term yields are below those of short-term --is referred to as the 'inversion of the yield curve.' Such yield curve inversions are infre-

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The inversion of the three month ten year yield is one clear indication that recession is at hand. Other indicators also point to recession.

quent, only eight times in the last fifty years has this yield curve inverted. Each inversion was followed by a recession. Moreover, there have been no recessions, except those following yield curve inversion. This is a pretty good indicator; it is not the only one that points directly to recession. Recession in the short term is, I submit, unavoidable.

Second, the debt-ceiling matter. The United States has a strange law that limits the amount of debt that the federal government can issue. Congress sets a given level without reference to the bills the government must pay nor the revenue that the government receives. At present, US borrowings are pushing against the level last set by the government. To meet the obligations America has, the debt-ceiling must be raised. During Mr. Trump's administration, taxes were cut sharply and spending rose rapidly. Thrice in his administration, the debt ceiling was raised without fuss by Democrats acting jointly with Republicans. However, Mr. McCarthy became the Speaker of the House of Representatives early this year only by empowering a handful of radical Republican members and agreeing to act as they wished. The wish of a number of these Republicans is that the debt-ceiling not be raised, but that spending by the government be cut sharply.

For a long time, the United States has been deemed the most creditworthy entity on the planet; it has never defaulted on its debt; its securities are considered to have no credit risk. There is risk now that the House will not permit the federal government to meet obligations already incurred. Depending upon how this plays out, there can be real havoc in global financial markets and a far gloomier economic outlook. There certainly are simple ways to resolve this; let us hope that our elected officials will act appropriately.

Third, commercial real estate problems. SVB failed because of a massive run by depositors to withdraw their funds, fully $42 billion on the last day it operated. The Fed's response was swift and effective. That problem is no longer before us. However, small and mid-sized banks have loaned huge amounts of money to fund commercial real estate, including office buildings, warehouses, and the rest. Office building owners are in trouble because work from home, at least on a partial basis, seems here to stay. There is far more office space than needed, rents are falling and many building owners are unable to meet the interest and principal payments on their mortgages. Similar problems have spread through other aspects of commercial real estate. As mortgages and other loans come due, the re-financing costs are much greater because interest rates have risen so markedly. Defaults are likely to increase; some notably big borrowers have already handed their keys back to their bankers. Bankers don't wish to take back these keys and seek to delay recognition of defaults. There are limits to how long non-recognition of defaults can go on. Things will get worse in this arena.

Investments during recession. As I have written before, Treasury bond prices always rise during recessions and stock prices always fall. Bond investors anticipate an imminent recession; long-term Treasury bond prices have risen by 17 percent since late October. At present, stock market investors are more sanguine. Although stock prices are down considerably from their highs as 2022 began, they are off the worst levels set in October. These sanguine stock market investors are whistling in the wind; disappointment for them lies ahead.

Recent investment change. As you know, for many months, we have held positions that 'short' the stock market, that is, positions that rise in price when the stock market falls. The larger position is based on the Nasdaq, an index dominated by large tech stocks, Microsoft, Apple, Amazon and Google. The smaller position is based on the Russell 2000 index, an index of small US stocks. Last week, I decreased the holding in the Nasdaq security (symbol psq) and increased the Russell 2000 security (symbol rwm). My view is that the recession in America will hurt the smaller stocks, whose business is mostly American based, more than it will hurt the aforementioned tech giants. We retain our large and quite healthy position in long-term Treasury bonds. Our smaller position in gold performs well; last week it traded at the levels of its all-time highs. Because of the Fed's rate increases, our large money market fund position now yields more than four percent. The outlook for our investments is favorable.

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