THE DANA VIEWPOINT

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The Reckoning

The coming actions of the Federal Reserve have now become the key focus and driver of the equity and bond markets. Even though they faced issues during their tenures as Chair of the Federal Reserve, Ben Bernanke and Janet Yellen did not face the issue that Jerome Powell faces now. In March, the S&P 500 dropped almost 13% from its early January high and annualized CPI increased from 7% in December to 8.5% in March.

Over the last quarter century, whenever the markets or the economy encountered a period of stress, the Federal Reserve was able to ride to the rescue by providing liquidity and encouraging investment by cutting rates. During the 2008 recession, the Fed not only cut rates to .125%, but doubled the size of its asset holdings from less than $1 trillion to over $2 trillion. Their asset holdings doubled again to over $4 trillion in 2014, and doubled once more to over $8 trillion by the middle of last year. Annual U.S. GDP is about $23 trillion, and total U.S. debt is over $30 trillion, including intergovernmental holdings. In the last three hiking cycles, Fed Funds peaked at 6.5% in 2000, 5.25% in 2007, and 2.375% in 2019. Whenever the markets have indicated that they cannot tolerate higher rates, the Fed has heeded that warning.

Has there been a downside to an easy Fed? Not in decades. The Fed has been able to cut rates and add additional stimulus to the economy by buying assets. They began by increasing purchases of Treasury securities, then added mortgages, and even supported the corporate bond market through purchases during the COVID-19 crisis. None of these liquidity measures triggered inflationary spikes, providing a seemingly free lunch.

Now the Fed says that it is serious about controlling inflation, and realizes that its actions may cause asset prices to decline and will likely slow economic growth. The market believes the Fed is serious. As of September of 2021, the Fed Funds futures market expected one rate increase by the end of 2022. That increased to three expected increases three months later. By the end of March, the futures markets expected eight quarter-point increases over the next nine months, and now that expectation is closer to ten.

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Can the Fed maneuver through 2.5% of rate increases over the next eight months? We doubt it. Real GDP growth is trending back to the 1-3% per year range. Inflation should pull back as the spike in energy due to the war in Ukraine recedes. There are other constituents in the CPI, such as shelter costs, that will prevent inflation from falling back to the levels of the last decade. Treasury yields are in the 2.5-3% range across the middle of the curve, and long-term market indicators of inflation have not moved above 3%. We believe that the market sees sub 3% Treasury yields as a sign that the Fed will not be able to raise rates to 2.5% this year and may not get beyond 1.0-1.5%.

What will the Fed do if the market or economy falters, or before inflation shows signs of receding? This is the reckoning. No Fed has faced this dilemma since Paul Volker vanquished inflation in the early 1980s. We expect a weakening market or economy to slow or stop Fed rate increases before the Fed Funds rate hits 2%. A better outcome would be indications that inflation was retreating prior to the implementation of all of the currently expected rate increases. Nevertheless, it is a dangerous time, and we will be watching closely and taking necessary action in our managed portfolios as the markets react to Fed actions over the next three months.

Counterintuitively, rates at the longer end of the Treasury curve usually peak at or near the beginning of a Fed-rate-hiking cycle, so most of the pain may have already been experienced by bond investors. Going forward, there is more yield to offset further price declines, and this should comfort bond investors. In the equity markets, the correction has lowered valuations. Economic tailwinds exist from a strong housing market, consumers with low leverage, corporations with strong balance sheets and a tight labor market that should maintain a low unemployment rate and strong wage growth. Consumers are also anxious to resume normal life after COVID-19 and this should keep consumer demand and spending robust.

Random thought: "Fasten your seatbelts, it's going to be a bumpy night" - Bette Davis in *All About Eve*

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