THE DANA VIEWPOINT

November 22, 2022
Dow: 34,098

Faceoff

The faceoff between Jerome Powell and the U.S. economy continues. At this point, just maybe the economy is gaining the upper hand. Despite four consecutive 75 basis point increases in the Fed Funds rate this year to almost 4%, the economy remains resilient. Treasury yields beyond five-year maturities have moved down aggressively after the most recent report on inflation, and the yield curve is as inverted as it has ever been in the current rate increase cycle. The economy was still able to swing to positive GDP of 2.6% in the third quarter. The monthly employment report has continued to show positive, albeit slowing, growth even as the unemployment rate ticked up slightly. Fed Chairman Powell has said he will not blink and vows continued aggressive rate hikes until the inflation rate reverses significantly and moves back towards 2%.

So, is it wise to cast your lot with Jerome Powell, and take him at his word regardless of what happens to the economy? That would probably mean investing in an intermediate or longer bond portfolio, with the expectation that he will continue to raise rates until inflation is vanquished, regardless of what happens to the stock market and the economy. Ultimately, a Powell win would manifest itself in lower long-term rates due to lower inflation, a much weaker economy, or some combination of both.

Or do you believe that the economy can weather the Powell rate hurricane and remain resilient until inflation begins to decline due to some combination of Fed tightening and marginal economic slowdown? This is often characterized as the "soft landing" scenario. Keep in mind that concurrent economic indicators are at a level consistent with GDP of 3% to 4% in the fourth quarter.

Over the last few weeks, we have had a rally in both the stock and the bond markets, as the S&P 500 Index has moved up almost 11% since October 12 and the ten-year Treasury yield has fallen over the same period. So far this year, the stock and bond markets have typically fallen at the same time, not risen, so let's peel the onion.

The big move in both the equity and the fixed income markets took place on November 10th. On that day, the headline CPI report for October came in lower than expected, the S&P 500 increased 5.5%, and Treasury yields fell 25-30 basis points - huge moves for a single day. So far, that market gain has held up over the following trading days. Many said the market rally was unjustified by such a small move

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downward in a key inflation measure. Shouldn't the market demand far more proof that the inflation dragon was slayed? It is important to note that this sign of moderating inflation was happening at a time when the economy was still rather robust. The housing market has certainly slowed, and there is news of layoffs in the tech sector, but consumer spending is still strong, and the employment market has shown resiliency. This combination of factors is the key. If inflation can turn down while the economy continues to grow, that is the goldilocks outcome where almost everyone wins.

It is also difficult to have a recession or a market correction when everyone anticipates it. Some large businesses are trimming employees, and many are managing their affairs in a conservative fashion, as if expecting a recession. Such anticipation can help avoid excesses caused by optimism that usually builds up before a recession. If companies are leaner, any unexpected pickup in economic activity should result in revenue that creates bottom line profits.

The Fed does not believe we can have a persistent cooling of inflation without weakness in the economy. The October inflation report hinted that just such a combination may be possible. It will take more subdued inflation readings to convince the Fed. With commodities prices, implied inflation in the TIPs market, and crude oil prices all stable to lower, there is reason to be optimistic. In the meantime, we can be thankful that the rally spurred by lower inflation has had staying power and that the increase in interest rates has given savers the ability to earn about 5% in short government and agency bonds.

Happy Thanksgiving to all.

Random thought: "We have two lives, and the second begins when we realize we only have one."

- Confucius

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