New Albany
Investment Management

Market Insight

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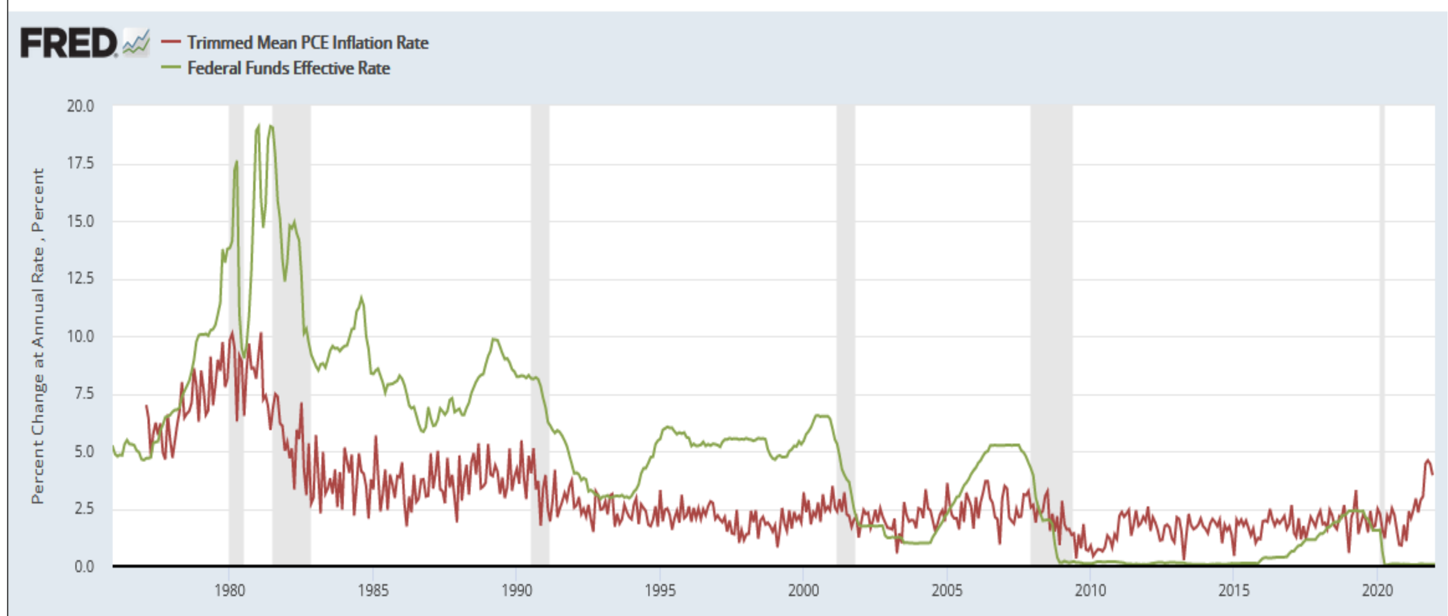
Transitions are Rough, Keep Your Seat Belt Fasten!

The start of 2022 has been quite a wild ride for the financial markets, and the year has only just begun. The furious sell-off in January was a result of a significant paradigm shift concerning the magnitude of rising inflation, slowing economic growth, and tightening financial conditions. Interestingly, each of these changes were thoroughly discussed last year, and each was expected to materialize to some degree this year; but it has been the urgency of the Fed's policy shift that has finally forced investors to come to terms with the reality of these changes.

With the Fed now recognizing inflation as a real threat to economic stability, they plan to finally turn off the massive spigot of liquidity that has been a major prop for the financial markets and economy over the last 14 years. Yes, this is a big change, and the financial markets are just beginning to recognize and transition to this new economic and investment climate. The speed of this transition will very much be dependent on how fast and how much the Fed decides to raise interest rates. **For the markets, this transition will continue to cause bouts of dramatic volatility, and most likely lower returns overall**. Transitions are rough, so keep your seat belt fastened.

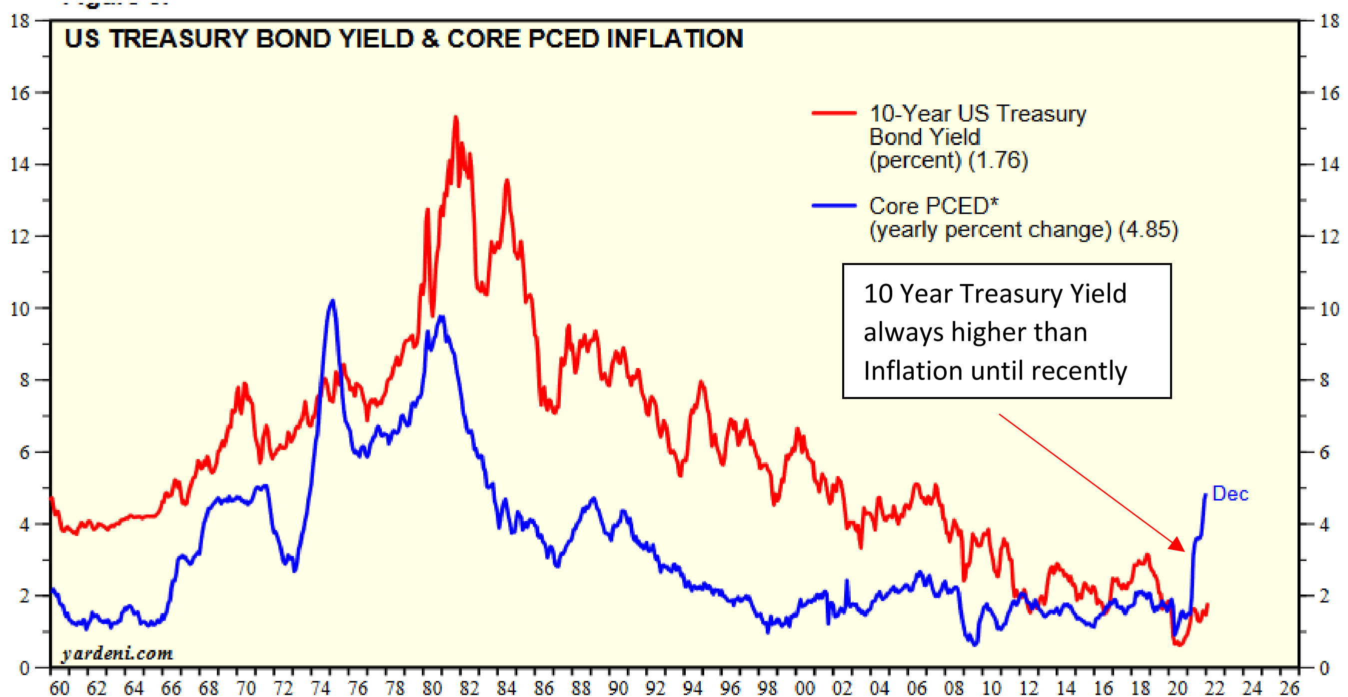
Though history does not repeat, it can provide perspective to evaluate the current situation and the potential path ahead. The new economic environment may look similar to the 1970's and 80's where inflation remained stubbornly high, interest rates were significantly higher, and real GDP growth and stock market returns were quite volatile. Let's take a look.

Interest Rates & Inflation: The chart below shows inflation as measured by the Personal Consumption Expenditure (PCE) and the Fed Funds rate since 1975. The gray vertical lines note periods of recessions. **Notice how the Fed Funds rate had to rise ABOVE the rate of inflation before inflation declined. And each time it rose significantly, a recession ensued within 12-18 months.** Today, the current PCE rate is 4.9% (red line) and the Fed Funds rate is 0.0% (Green line). If history is correct, the **Fed Funds rate would need to rise by over 500 bpts (5%) to just meet the current inflation level!**



Cost to Borrow: While the Fed Funds rate affects only short-term borrowing, it also influences the level of long-term rates, which in turn impacts both consumers (mortgages and car loans) and businesses (corporate borrowing). The best gauge for longer term borrowing cost is the US 10yr Treasury rate which is the base rate from which the cost of credit is determined.

The chart below shows the path of the US 10yr Treasury Yield (red line) and Core Inflation (Blue line) since 1960. Notice, the **10yr yield has almost ALWAYS been ABOVE the inflation rate**, and often by as much as 2% points until very recently. Today, the 10yr rate is 1.76% and PCE inflation is 4.85%. So just to normalize financial conditions, borrowing **cost should be at least 300-400 bpts (3-4%) higher than where they are today and would push home mortgage rates to near 7%!** Clearly a rise in rates of this magnitude would bring on a full-scale recession.



Can Inflation come down without a recession? History has not been kind in this regard and shows that rising interest rates were the primary tool to bring inflation under control. But this time around, thanks to the Fed's engineering, there is another VERY powerful tool that can be used. The only concern is that it has never been used before.

The VERY BIG ELEPHANT in the room: The Fed's balance sheet. Since the 07-08 financial crisis, "the Great Recession', the Federal Reserve has been using their balance sheet as a tool to control liquidity, and indirectly interest rates, through large scale bond purchases. Buying bonds reduces the debt load that the financial markets would otherwise have to absorb. Fewer bonds in the financial system induces higher prices/lower interest rates, and explains why long-term interest rates have remained historically low.

The chart on the next page shows the **expansion of the Fed's balance sheet from $900 billion in 2007 to over $8 trillion today.**

Federal Reserve's Balance Sheet: 2007-2022

From 2008-2014, (6 years) the Fed purchased nearly $3 trillion in bonds. The effect was interest rates stayed very low and allowed the economy to grow moderately. During this time inflation continued to stay quite low, below 2%, for several reasons. But the primary reason was the slack in the labor markets and globalization of the world economies.

Since 2020, (18 months) the Fed purchased an additional $4 trillion in bonds to shore up the credit markets during the pandemic crisis. **Although the 'crisis' is over, the enormous amount of liquidity remains in the system, and this time around, inflation has caught fire.** Yes, it first started with supply chain issues, but has been compounded by huge increases in demand spawned by excess fiscal and monetary stimulus. Never in modern history has there been this much stimulus poured into the economy in this short of time. Even the Fed admitted the use of the balance sheet tool is a relatively new concept! (Oh My!) The perfect storm is upon us. Now, with more permanent changes in the labor market structure compounded with exceptionally tight labor supply, continued disruptions in supply chain because of the ongoing endemic, and huge pressure on energy (due to Russia/Europe tensions) **inflation is becoming well entrenched.**

In sum, history has shown that **once the inflation genie is out of the bottle, the only way to control it is through much higher rates, which ultimately induces a recession.** Perhaps this time could be different? **Can inflation co-exist with economic growth? Only if growth can outpace inflation.** And therein lies the debate for the road ahead.

Transitions are rough, messy, and often quite uncomfortable. The markets must adjust and recalibrate. This takes time and often provokes a lot of volatility. The good news is the economy is still quite strong, some of the supply chain issues will resolve soon, and, most importantly, companies are adaptive and resourceful. These factors will help soften the transition to more freely operating markets and economy.

Market Outlook: Expect continued large swings in the market, +/- 20% or more through this year as the market follows the Fed's initiatives of reining in inflation. The Fed will be reactive, not proactive which means at times their policy will be soothing to the markets, and other times a big frustration. The Fed will follow the data points, and data is volatile month to month. Net, we are entering a new market environment that will provide both great opportunity and risks.

Portfolio Strategy: The first week of January we reduced the 'beta' exposure in stocks through rotating some of the more aggressive Growth sectors into more stable Value sectors. The total amount of stock exposure currently remains the same for now. If we do see large swings in the market, stock and/or style (Growth/Value/ Small/Large) may change. On the bond side, duration remains short in anticipation of rising short term rates. Once rising rates have been fully priced into the yield curve, duration will be extended.

These are my thoughts. Please continue to reach out with your questions and concerns.

Best Regards,

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