By Prabhu Palani (Chief Investment Officer)

Fed Up!

Sell your cleverness and buy bewilderment. Cleverness is mere opinion. Bewilderment brings intuitive knowledge.

- Rumi (13th century Persian philosopher)

The US Federal Reserve has raised rates 5 times this calendar year alone - 25 bps in March, 50 bps in May, followed by 75 bps in June, July, and September. Mortgage rates have shot up, the housing market has come to a near standstill, and US equities are firmly in bear market territory.

As I write this, the US equity index has just suffered one of its worst monthly declines. In just the month of September, the S&P 500 Index lost 9%, marking a quarterly loss of 5% and a year-to-date loss of almost 25%. Bonds have offered little shelter. The yield on two-year treasury notes surged to 4.24%, an increase of 3.5% this year (bond prices move in the opposite direction of yields, meaning bond prices have plunged).

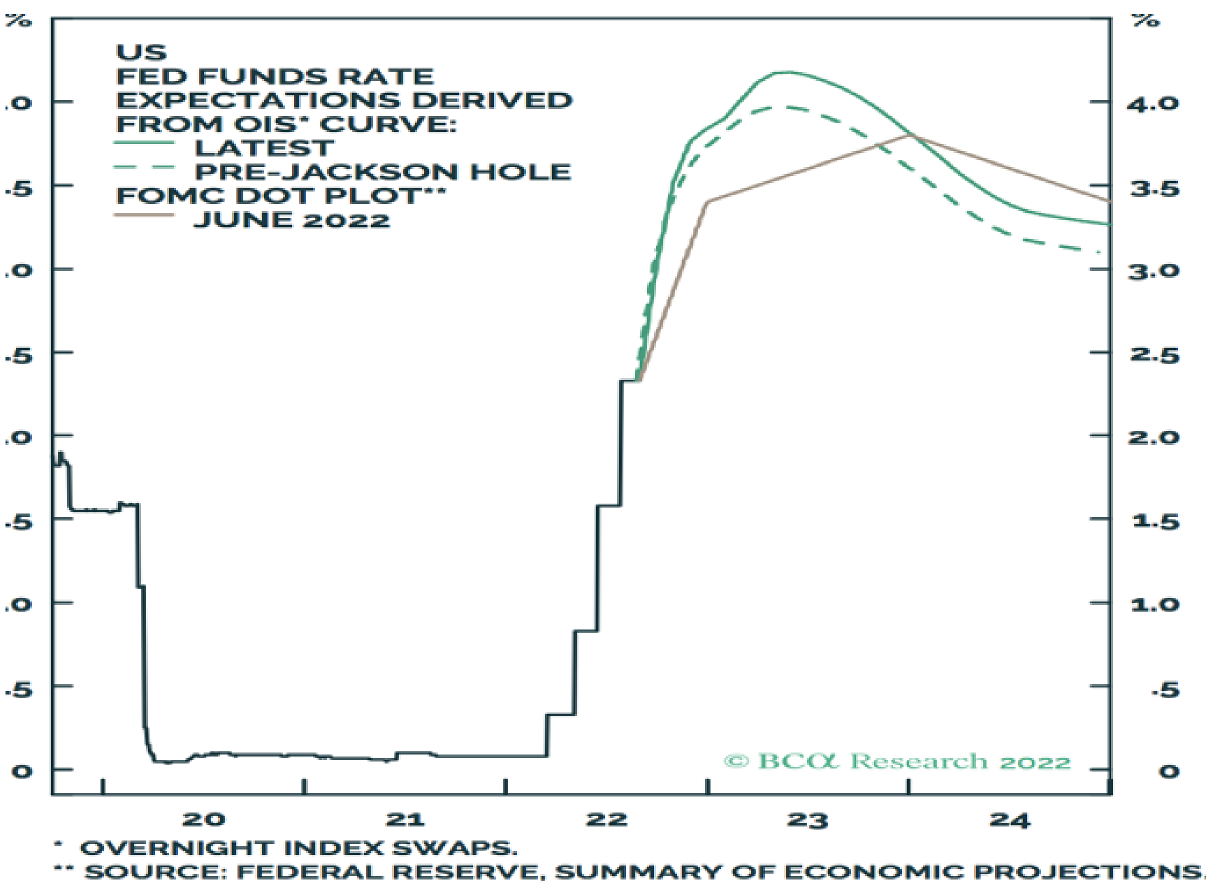
A bewildering host of issues confront global markets. During the dotcom bust, there was one issue that markets had to reckon with, namely overvalued tech stocks. The Great Financial Crisis (GFC) was similarly caused by one major problem, that of overvalued home prices. And in the short-lived recession of 2020, it was the coronavirus. A myriad of issues, on the other hand, plague 2022. High inflation, the Fed's pivot, geopolitics, Chinese real estate, the list goes on and on. One could argue that there is nothing structurally wrong with the US economy. Hence the confounding problems of continued low unemployment and economic resilience. But many small issues can snowball to create a compounding effect greater than one.

Before we bring out the crystal ball, a brief explanation on what brought us to this state of affairs is worth repeating. As a consequence of the Great Financial Crisis (GFC), central banks around the world led a coordinated effort to resuscitate a dying global economy. Back in 2008, Lehman Brothers and Bear Stearns had collapsed as had the insurance giant AIG. Goldman Sachs was in trouble and Washington Mutual was seized by the Federal Deposit Insurance

Corporation. Inaction was simply not an option if we were to avoid another Great Depression. Central banks around the world including the Bank of Bernanke rose to the occasion as did the US government. A series of bailout packages, near zero interest rates, and expanding central bank balance sheets (QE or quantitative easing) ensured that a semblance of normalcy was restored in the months following the GFC. While QE or the process in which the Federal Reserve (and other central banks) bought bonds, suppressed interest rates, and injected liquidity into the system greased the wheels of global economies, it also had some unforeseen effects. First, it did a great disservice to savers and those on fixed incomes. Near zero interest rates are not exactly welcome news to retirees and pensioners. Secondly, it distorted asset prices. Assets of every kind increased in value, be it stocks, bonds, vacation homes, Bordeaux futures, or Stradivarius violins. When you have near zero interest rates, you seek yield somewhere, anywhere, and you end up bidding up prices of riskier assets. Thirdly, QE became a dependency-inducing drug. We were lulled into a sense of complacency that high asset prices and benign inflation could be the new norm.

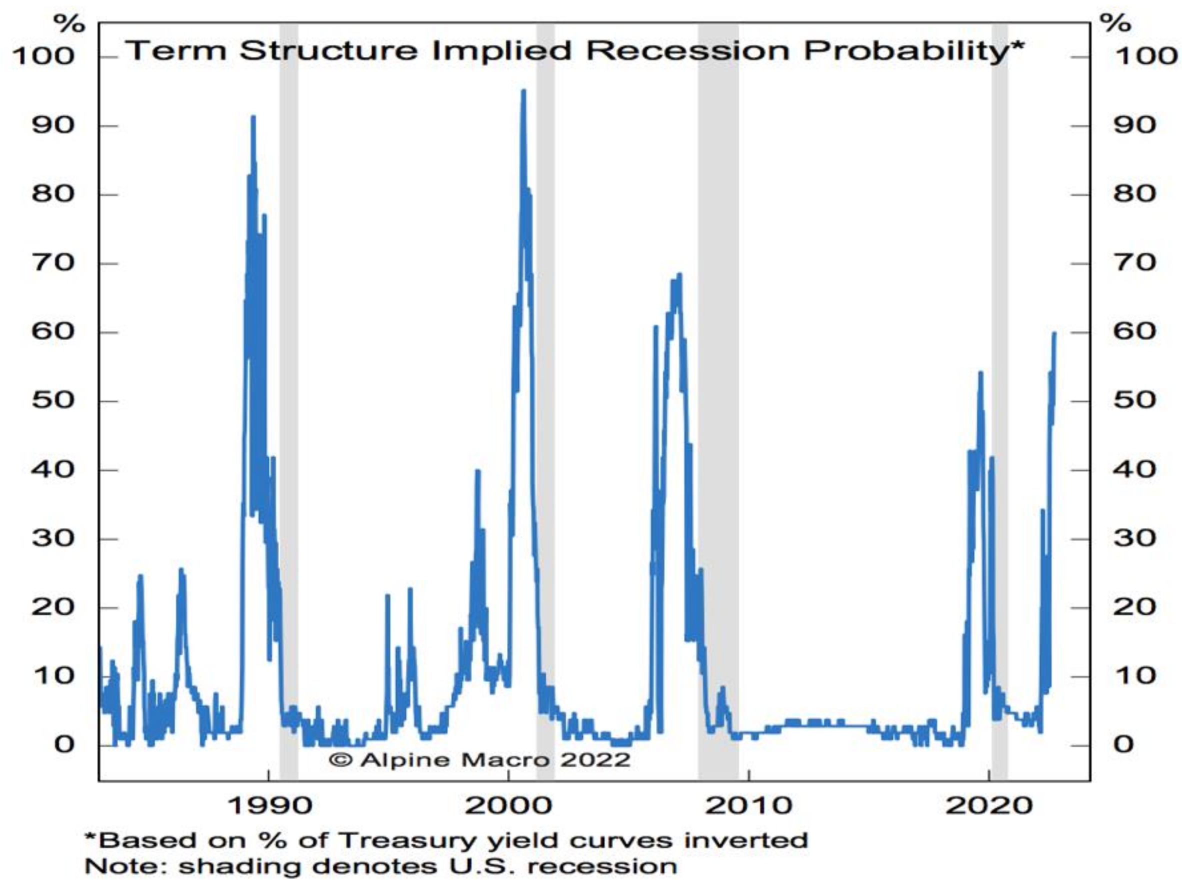
We would have continued to live in fantasy land for longer had it not been for Covid-19. When the global economy came to a screeching halt in March 2020, Central banks resorted to the latest tool in their toolbox, i.e. QE. The Fed's actions were supplemented by unprecedented fiscal largesse in the form of a $5 trillion stimulus check. And that was the straw that broke the camel's back of the fantasy land of forever high asset prices. That last round of monetary and fiscal support finally released the genie of inflation, only made worse by supply chain shortages caused by a cessation of economic activity during the worst months of the pandemic. While it is easy to blame the Fed and the government for its actions, one must say that wisdom only dawns in hindsight. When a patient is dying on the table, the doctor cannot think of the consequences of saving his life.

The Federal Reserve has a dual mandate – maximizing employment while keeping prices stable. Which is the more important goal for the Fed? Without a doubt, it is quelling inflation. Those of a certain age as well as financial historians will know that the Fed lost credibility in the 70s as interest rates soared. Forty-one years ago to the day, on 30th September 1981, the 30-year US treasury yielded 15.2% (no typo here). It took the Bank of Volcker to tame this inflation and if you are a central bank nerd, you will know that Chairman Volcker's actions are legendary. Such legacy is not lost on the Chair's current incumbent, Mr. Jerome Powell. As inflation started soaring (surprising most observers including me), it was now Mr. Powell's turn to act like a prudent Central banker. Raising interest rates is never a pleasant job – an unintended consequence is job loss. But it did help that on November 22, 2021, just as the genie of inflation was escaping its bottle, President Biden re-nominated Powell to a second term as Chair of the Federal Reserve. With his job secure for the next four years, Mr. Powell finally revealed his true hawkishness. What followed was an extraordinary Fed pivot. Even as the market was digesting this change in stance from the Fed, and refusing to fully believe in it, both the Chair and Vice Chair of the Fed have repeatedly warned against taking the Fed's actions lightly. "Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance." "Our responsibility to deliver price stability is unconditional" meaning, *we don't care about rising unemployment or causing a recession*. And if you thought that the Fed's steep increase in the Fed Fund's rate was probably enough, Vice Chair Brainard recently commented, "we are committed to avoiding pulling back prematurely." As the chart below shows, the market expects the Fed to continue increasing short-term interest rates from its current level of 3% to 3.25%.



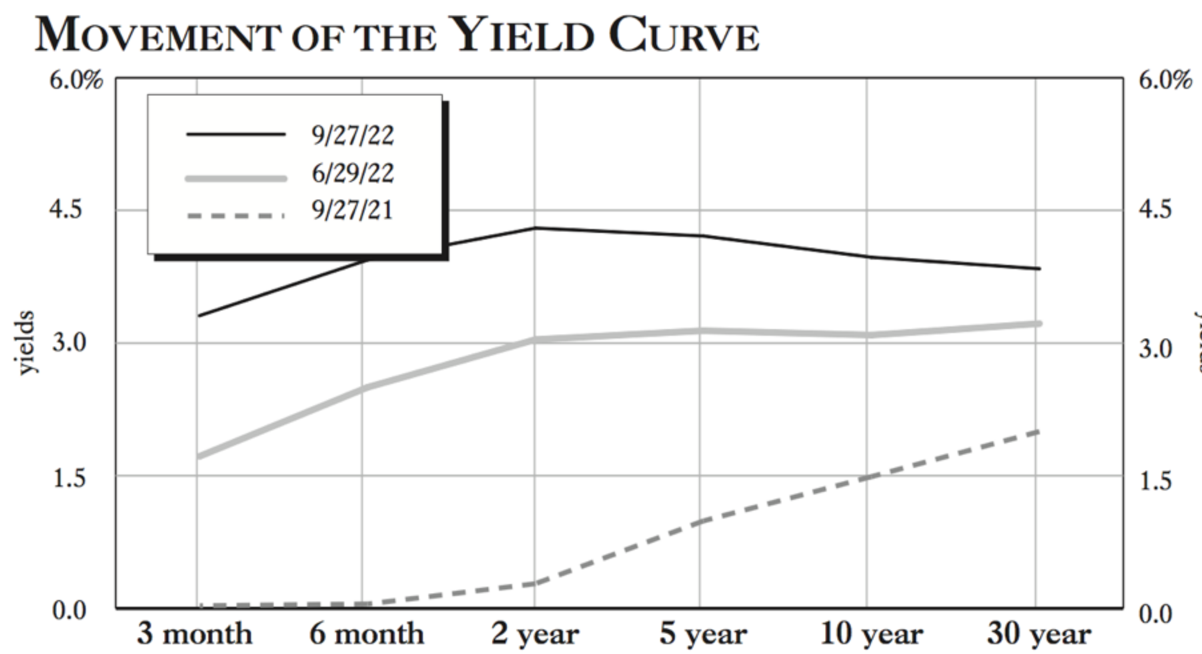
Source: BCA Research

You will also notice from the chart that the Fed Fund rate does start dropping off in 2023. Why would this be? One of the most effective tools that the Fed uses to slow down the economy is increasing the overnight Fed Funds rate. This makes borrowing more expensive and puts the brakes on economic expansion. What the Fed is trying to accomplish is *demand destruction*. If you make it more expensive to borrow money and cause a slowdown in the economy, unemployment will go up and aggregate consumer spending will slow down. And when spending goes down (i.e. demand for goods goes down), prices will also decrease. The average consumer has less money in his pocket, will drive less, eat out less and travel less. And that is one way to reduce $6 gasoline prices in California. However, an unintended consequence of ratcheting up rates so quickly is that it could drive the economy into a recession. Alpine Macro estimates that the odds of a recession have gone up considerably (chart below):



Source: Alpine Macro

Shown another way (chart below), an inverted yield curve has been a reliable indicator of predicting the past 10 recessions. Two-year treasury yields are higher than 10- and 30-year treasury yields, a sign that the market expects the economy to drastically slow down in future.

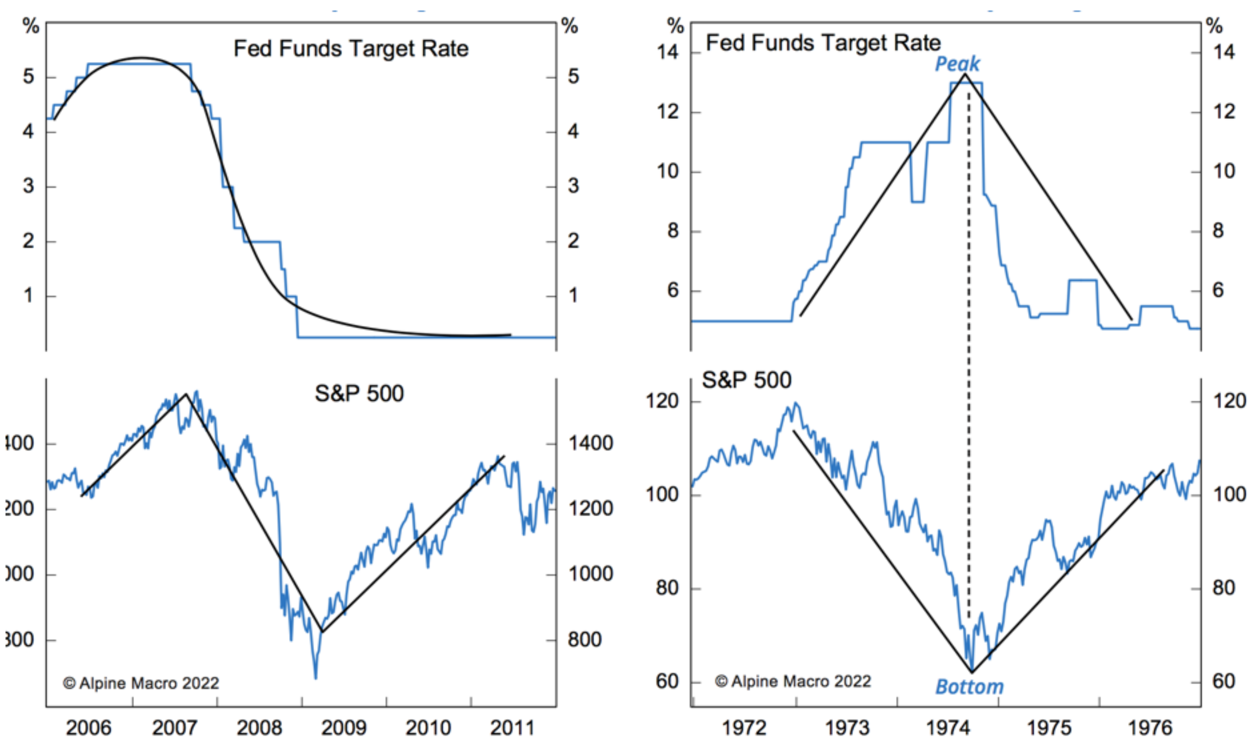


Source: Grant's Interest Rate Observer

The question that naturally arises is this. Why would the Fed want to create a recession? I don't believe the Fed wants a recession. On the contrary it probably hopes to engineer what economists call a soft landing. Enough of a slowdown in the economy to bring down inflation while keeping employment at reasonably healthy levels. In other words, a very soft steering of the US Economy to avoid hitting the iceberg while keeping those champagne flutes steady in first class. Unfortunately, that scenario is possible only when you *anticipate* an iceberg. Once an iceberg has been sighted, you have no option but to slam the brakes. And pray that the consequences of doing so will be minimal.

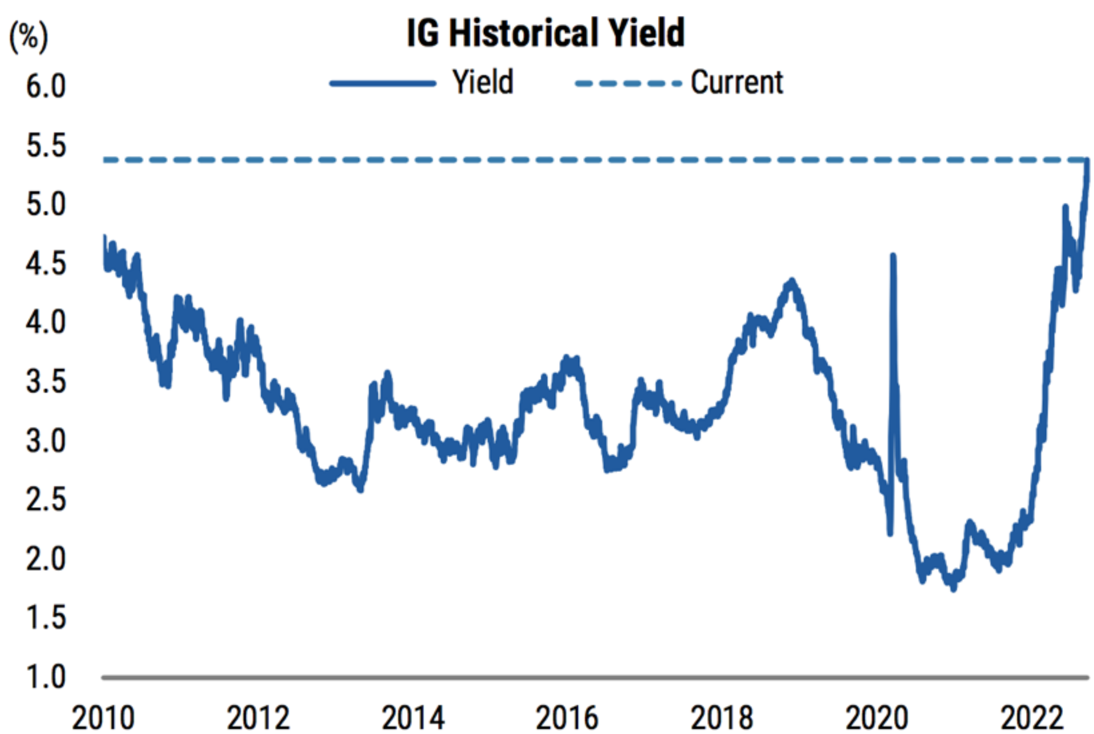
Today the Federal Reserve is in a similar position. The unintended consequences will be a steeper than expected drop off in consumer spending (two-thirds of the economy) but also a profits recession that the markets have probably not fully accounted for. Stock prices trade as a multiple of future earnings, and when those earnings drop, stock prices follow. The coming quarters will bring nasty earnings shocks to the downside. The consequences of successive 75 basis point hikes will play out over many months. How much more downside is left in US equity markets?

BCA Research shows that a prime driver of US stock price performance has been both high sales and rising margins. Neither is expected to continue. A moderate recession and falling asset prices should be expected. My own view is that any uptick in stock prices will be closely linked to the Fed cutting interest rates or at least an anticipation that such cuts are imminent. The Fed's rhetoric of higher interest rates will eventually change and that might well be the bottom of the current bear market. This view is supported by Alpine Macro, which makes a distinction between the current *inflationary* bear market versus the 2001 and 2008 bear markets which were *deflationary*. They argue that in a deflationary bear market prices don't bottom till interest rates reach a cyclical low. On the contrary, in an inflationary bear market like the 70s, all it takes for stocks to rally is a peaking of interest rates.



Source: Alpine Macro

One of the most interesting opportunities in the current environment is at the front end of the yield curve. If you remember, at the beginning of last year, the 10-year treasury was yielding a mere 93 basis points. If you bought a 10-year note at that time you were guaranteed to make less than 1% a year. Today, while the 10-year will give you a guaranteed 3.76% in return, the 6-month T-bill and the 1-year T-bill yield 3.95% and 4.03% respectively. While the 10-year note suffers duration risk (the risk that as rates go up further, prices will go down and therefore you will suffer principal loss), no such risk attaches itself to Treasury bills, as long as you don't redeem within its short-dated maturity period. If you are willing to take on some credit risk, yields can get even more attractive.



Source: Morgan Stanley

Where does all this leave us? If you are a long-term institutional investor, you can opportunistically buy the dips. Market timing is fraught with difficulty and a scarce skill. Enthusiastically buy short-term bonds. Rebalance your portfolio. Take advantage of fire sales not available to retail investors in secondary markets and private equity.

If you are a retail investor, I hope you trimmed your tech exposure earlier in the year. Stay cautious. Enthusiastically buy short-term bonds. Manage your expectations going forward. Your time horizon is not indefinite. The impending economic slowdown may well sow the seeds for the next bull market by forcing the Fed to cut interest rates.

Regardless of the type of investor you are, remember that investing is not about cleverness. It is about patience and temperament. Successful investors are those who know their risk tolerance, liquidity needs, and skill sets, and build their portfolios accordingly.

That should make Rumi proud.