The Federal Reserve and Its Fight Against Inflation

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By Brian Luster

A Difficult Pill to Swallow
This week the Federal Reserve raised the federal funds rate by 75bps from 2.5% to 3.25%, reversing its July guidance of a slowdown in the pace of tightening. The futures markets believe the Fed will continue to remain aggressive until inflation comes down, suggesting that by the end of the year, interest rates will rise to 4.25%-4.5%. In fact, the Fed's forward guidance affirms this view with their own Summary of Economic Projections suggesting year end interest rates of 4.50%, rising to 4.75% by year end 2023, and then falling back to 4.00% in 2024.

Given the continued strength of the labor market, the Fed is essentially creating a government policy meant to cause unemployment to rise (they expect it to rise above the 4% "natural" rate of unemployment) and economic growth to fall, all in the name of fighting inflation and protecting the "value of the currency". That's a difficult pill for most investors to swallow.

Why Hurt the Economy?
When inflation gets out of hand, the Fed typically gets blamed. In this case, that probably isn't fair, as US inflation was overwhelmingly the result of the pandemic (supply chain disruptions), the fiscal response (government stimulus spending) and the Russian invasion of Ukraine (and its impact on food and energy prices).

While the Fed was most certainly late to intervene, inflation pressures are now falling. They just aren't falling as fast as the Fed would like (CPI has fallen from 9.1% in June to 8.3% in August). This is largely due to continued wage inflation and owners equivalent rent (a fictitious figure that measures what homeowners would have to pay to rent the home they actually own). Yet while many Americans are finding it more difficult to live from paycheck to paycheck, not having a paycheck is far worse, and that is exactly the outcome the Fed seems to be trying to achieve. Chairman Powell suggested that they will not stop until growth is running below trend (GDP < 1.8%) and inflation is back to 2%.

Continued Volatility and Recession
In the short-term, we expect continued volatility throughout the remainder of the year and perhaps into early 2023. The dollar is likely to continue to strengthen (currently it is at its 20-year high), job openings and economic growth are likely to decline, and inflation will continue to decelerate, leaving the economy teetering on recession as we approach 2023.

At that point, the Fed is likely to pause to see how the economy handles higher interest rates. We don't think they are going to like the answer, as high mortgage rates and a strong dollar hurt housing and exports respectively, and fiscal drag continues to slow consumer spending (driven by the nearly $2

Trillion year over year decline in deficit spending). Next year will likely be a year of very slow, if not negative growth.

The Silver Lining

If we are correct, pressure will build on the Federal Reserve to provide stimulus by cutting interest rates and suspending Quantitative Tightening in the latter half of 2023. This could return the economy to an environment of low inflation, slow growth, and low interest rates – supporting US equities and fixed income prices – a surprisingly attractive backdrop for the intermediate to long-run, reminiscent of the decade following the financial crisis. While this may not be the most exciting time for individual families, it could be a very profitable time for investors willing to put their capital to work in the equity markets today.

In fact, this is what the Fed seems to be trying to accomplish, and why they are willing to accept rising unemployment (of approximately 1.3 million job losses) and higher rates to "protect the currency" from inflation. Chair Powell suggested during his most recent press conference that only when prices are stable (inflation is 2%) can we have the long economic expansions (9-10 yeas in duration) that this country has come to expect.

In the short-term, we would suggest investors DO NOT FIGHT THE FED. Investors should continue to maintain an overweight to short duration fixed income and defensive equities with a bias towards value. Short duration equities are those that have positive earnings and dividends, and do not need to borrow money to grow and become profitable in the distant future. As economic growth slows, earnings will adjust downward, putting negative pressure on valuations of more growth-oriented companies.

The Mid-Term Election Bounce

It is also worth noting that mid-term elections are coming in November, and the markets tend to perform very well in the 12-months following a mid-term election cycle. As you can see in the chart below, the S&P 500 has historically corrected by an average of 17.1% in a mid-term election year. Over the following 12 months, however, the S&P has rewarded investors with a 32.3% average return. Whether or not we reached our market bottom on June 16 of this year, or we retest those bottoms again, this certainly implies there is significant opportunity for equity investors over the coming year.

Midterm Years Tend To Bottom Later In The Year And See Larger Corrections
S&P 500 Index Peak-To-Trough During A Midterm Year

Year	Date of Low	Peak-To-Trough	S&P 500 Index Return Return 1-Year Later
1950	7/17/1950	(14.0%)	30.9%
1954	8/31/1954	(4.4%)	43.9%
1958	2/25/1958	(4.4%)	36.3%
1962	6/26/1962	(26.4%)	32.7%
1966	10/7/1966	(22.2%)	33.2%
1970	5/26/1970	(25.9%)	44.5%
1974	10/3/1974	(37.6%)	34.6%
1978	11/14/1978	(13.6%)	11.3%
1982	8/12/1982	(16.6%)	57.7%
1986	9/29/1986	(9.4%)	40.6%
1990	10/11/1990	(19.9%)	28.8%
1994	4/4/1994	(8.9%)	14.3%
1998	8/31/1998	(19.3%)	37.9%
2002	10/9/2002	(33.8%)	33.7%
2006	6/13/2006	(7.7%)	24.5%
2010	7/2/2010	(16.0%)	31.0%
2014	10/15/2014	(7.4%)	8.7%
2018	12/24/2018	(19.8%)	37.1%
2022*	6/16/2022	(23.6%)	?
Average	August 14	(17.1%)	32.3%
Median	September 4	(16.3%)	33.5%

Source: YCharts 8/19/2022 *Low for the year isn't official, as the year isn't over yet.
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Concluding Remarks

The volatility over the next year will be a function of how quickly we return to 2% inflation, and the length and depth of the corresponding recession as the economy readjusts to slow growth, lower than expected earnings, and higher interest rates. Excess demand for labor is all that is keeping us out recession for the moment, and we are only one shock away from entering an economic recession in 2023. Yet time in the market remains a more prudent strategy than trying to time the markets. While the short-term may present volatile outcomes for investors, it's worth reminding readers that simply missing the 5 best days in a bear market over the past 25 years would have resulted in 2% lower annual returns. Those that attempt to avoid expected volatility by increasing their exposure to short-term fixed income, or cash alternatives, will have to be right twice – identifying when to get out of the markets, and then when to get back in. This is not a reasonable strategy, especially for those that do not need to rely on taking large distributions from their portfolios in the next 1-2 years. Instead, we believe maintaining a globally diversified portfolio with a defensive tilt is a more appropriate way to weather the Fed's pathway toward returning us to a prosperous period of low growth, low rates, and low inflation.

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