CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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An Inflection Point Lies Ahead…
...As the Economy Weakens

Inflation falls and bond prices rise. The Fed's inflation-fighting campaign is succeeding.. The US economy is beginning to weaken as reflected in reports from retailers like Walmart.

As the months roll forward, evidence grows that the US economy weakens and the ebullience manifested in some markets cools. A primary indicator of this is the growing strength in the bond market as yields fall and prices rise. In particular, long-term Treasury bonds have been rising in price as their yields fall. This is a strong indication of economic weakness ahead and of the likelihood that the Federal Reserve Board will change its course and begin to ease monetary conditions in the months ahead. As I write, the yield on the 'long bond,' the thirty-year Treasury bond, is 4.56%, down from its recent high of 5.10% and far below the present federal funds rate (the short-term rate directly controlled by the Fed) of 5.25% to 5.50%.

As discussed in previous letters, this 'inversion' of the yield curve, that is, the situation when long-term rates are lower than short-term rates, implies that the economy is weakening. This implication arises from the fact that, while interest rates on long-term bonds are almost always higher than rates on short-term debt, the relatively rare occurrences, like now, when long-term rates are lower suggest that markets foresee a weaker economy in which long-term rates fall. Recent economic data show weakness. For example, as retailers have reported their quarterly earnings, from Walmart on down, most noted that consumers are spending less on discretionary items and limiting spending to food and other essentials.

The Fed is achieving success in its campaign to bring inflation down. In June 2022, shortly after the Fed began to raise the short-term rates it directly controls, the Consumer Price Index had risen by 9.1% over the previous year. As of October of this year, the CPI has fallen to an annual rate 3.2%. It is almost certain to continue lower because the shelter component, which operates with a lag, does not reflect the currently lower level of residential rents. Apart from deflating rents, energy prices are falling, despite cuts in oil production by OPEC and Russia. As I see it, inflation will probably fall below the Fed's target level of 2%. Disinflation and, perhaps, deflation lie ahead. As inflation falls, the Fed's monetary tightening campaign will reverse itself.

By

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Monetary policy tools. The Fed employs three different tools to conduct its monetary policy. The first is to set the level of federal funds, which now stands within the range 5.25% to 5.50%, up from 0% to 0.25% in March of 2022. (When Covid began and the lockdowns ensued, the Fed cut rates to the 0% to 0.25% to stimulate the economy.) A second tool is the Fed's holdings of US Treasury bonds and mortgage-backed securities. For years the level of its holdings was about $800 billion. In the aftermath of the Great Financial Crisis of

2007 to 2009, then Fed chair Ben Bernanke began the purchase huge amounts of such bonds. This is referred to as Quantitative Easing. Pre-Covid, the Fed's holdings stood at $3.75 trillion. With the onset of Covid and the lockdowns, the Fed resumed its Quantitative Easing, such that by March 2022, its holdings amounted to $9 trillion. Beginning in March 2022, the Fed has lowered its holdings to $7.8 trillion. This, unsurprisingly, is referred to as Quantitative Tightening.

The Fed's third tool is what it calls 'forward guidance,' that is, public discussions by Fed officials of its policy intentions. In recent months, the Fed has paused its rate raising, but has insisted that it will keep rates high for a long time. "Higher for longer" is the phrase.

Core's portfolios hold a balanced set of investment assets, whose different elements respond positively to evolving economic and geopolitical factors.

As inflation has fallen, investors have expected the Fed to reverse course and to begin to ease monetary policy again. In time, this will happen, although probably not until inflation has fallen too far or the economy is quite clearly in recession. The recent increase in prices of long-term Treasuries is an expression of this anticipation. Against this view is the increase in prices of some companies that are involved with artificial intelligence. This has brought the Nasdaq index higher. In contrast to the rallies in Microsoft, Nvidia and others, small company American stocks have continued to move lower. Core's portfolios have positions in both long-term Treasuries and in a fund that moves inversely to small company stocks. (That is, the fund rises in price as small company stock prices fall.) These Core positions are gaining in value and will likely continue their ascent.

On the other side of the Pacific, Japan has been engaged in a project to make its corporations act in a manner supportive of shareholder returns. In May of this year, Core began to build a position in Japanese equities; it is now reasonably large and shows strong returns. Similarly, Core has a small position in Indian equities that also benefit from government policies encouraging shareholder returns. Core's position in gold is appreciating; central banks have been big buyers of gold this year. After its invasion last year of Ukraine, America and its western allies froze much of Russia's reserves. These reserves were held mostly in the United States. These actions have probably caused some central banks to realize that holding their reserves in the US is riskier for them than holding gold bullion. Hence such central banks have been big buyers of gold. Core continues to hold a goodly amount of portfolio assets in a government securities money market fund. The fund yields 5.09% and has no credit or investment risk. This fund, apart from providing a good return, will be available to fund purchases of US stocks after another sharp decline in US share prices as happened last year. As asset markets evolve, opportunity is before us.

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