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

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The Fed and Inflation

The interplay between inflation reports and expectation of Federal Reserve Board policy continues. This interplay directly affects prices of stocks and of bonds. Throughout the autumn, Fed Governors were consistently making the point that the Fed Funds rate, which is directly controlled by the Fed and which is the principal determinant of all interest rates, would stay 'higher for longer.' In December, in his press conference after the Fed's rate-setting meeting, Fed chairman Jerome Powell seemed to pivot from the 'higher-for-longer' message and looked ahead to lowering interest rates. This pivot was based upon the continuing decline in inflation and, as perceptions of inflation changed, so did expectations about the timing and the extent of Fed rate cutting.

On Tuesday of this week came the monthly report on the Consumer Price Index, the most widely followed measure of inflation. It showed that inflation in January, as measured by the CPI, had fallen by 0.1% less than expected. An observer from far away might consider the discrepancy between the expected and the reported to be utterly insignificant; the trend of lower inflation readings continued. However, the traders of stocks and of bonds are not observers from far away. They regarded the report as decidedly poor. Large declines in prices of both stocks and bonds followed. The most striking example was the action in small company US stocks, as measured by the Russell 2000 index. It fell by four percent on the day! (Happily, Core's clients have a modest investment in a security that is the inverse of the Russell. It rose in price by that same four percent.)

How does a 0.1% miss in expected CPI numbers lead to such a stock market decline? Before Tuesday's very sharp selling, the stock market had been rising, with little interruption, from its recent October lows. It was ripe for a dose of bad news to knock it back--or so it seems. The bond market was similarly disturbed. The yield on the 2-year Treasury note rose by 19 basis points (0.19%) and the 10-year yield by 14 basis points. Bond prices, which move inversely to yields, fell. These are big moves for one day. (On Wednesday, there was a partial reversal of Tuesday's big moves.)

I do not typically write about single day trading activities and I do not intend to begin doing so. My point in raising the issue is to show both the interplay of inflation and Fed policy, and the market's obsession with these issues. During its monetary tightening designed to lower inflation, which began in March 2022, the Fed raised Fed funds from the range of 0.00%-0.25% to 5.25%-5.50% by July 2023, where it remains today. This is the highest level for Fed funds in more than twenty years. During this period, inflation has indeed fallen and is approaching the Fed's target rate of 2%. It appears that much of inflation's dramatic increase was caused by pandemic-related problems with supply changes and the like. And so far, at least, the Fed's extreme monetary tightening has not slowed employment or the general economy in a significant way. The endurance of relatively low unemployment as the Fed has tightened the screws and the continuation of economic growth are both surprises to most economists. The expectation, which I shared, was for both an increase in unemployment and a general decrease in economic activity.

By

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The 'headline' reports of economic activity—the GDP report—and of employment—the monthly non-farm payrolls reports--both are quite positive. It may well be that these reports overstate both numbers. Without getting too deeply in the weeds, allow me to point out that, as for general economic activity, the Gross Domestic Product (GDP) report is much brighter than the related Gross Domestic Income (GDI) report. As their names imply, the GDP measures what the country produces and spends, the GDI measures what is earned. Normally, these two measures align very closely. This is not the case now. Whereas GDP is up by about three percent in the last year, GDI is essentially flat. The present disparity between these numbers is the greatest in three decades.

Why is that? Probably because American consumers are spending a good deal more than they earn. The personal savings rate has fallen to 3.7%, less than half the savings rate in pre-Covid times. Credit card debt is increasing significantly. Thus, a good deal of the spending that exceeds income is accounted for by borrowing. This is probably unsustainable. Probably the rate of spending, as measured by the GDP, will fall.

As for employment, although labor force participation, that is, the numbers of people at work, is high and although unemployment remains low, there are some troubling below-the-surface numbers. In the recent year, the number of full-time workers has decreased by about one million, while the number of part-time workers has increased by roughly that amount. The recent employment report, widely cheered by all hands, showed that the average work week declined by a meaningful amount, an amount that essentially offset the sparkling number of newly created jobs.

My negative interpretations of GDP and employment may prove not to be terribly meaningful. Time will tell. It does cause me to temper my enthusiasm for the recent reports, widely greeted with ebullience.

Artificial Intelligence. In the last year and more, the promise for the future and, in part, the actuality of the present, have been framed by artificial intelligence (AI). It has affected stock market in a big way, in that the companies deemed to have the most likelihood of fulfilling the promises of AI have enjoyed outside gains. A prominent example is Microsoft, which has funded Sam Altman's OpenAI, the private company that created ChatGPT. Microsoft's stock price has risen by about 60 percent in the last year to become the most valuable public company in the world, surpassing Apple. Microsoft is now worth more than $3 trillion.

Although all the very rich tech companies, including Apple, Amazon, and Alphabet (i.e., Google's parent company), are active in AI work, the poster child is Nvidia. It has become the dominant supplier of hardware and software used in AI applications. In short order, Nvidia has become, this week, the world's third most valuable public company, after previously mentioned Microsoft and Apple. The appreciation of its stock over the last year, some 240 percent, makes Microsoft look like a sleepy old company. Core has taken a modest position in Nvidia for clients. Next week, Nvidia will release its quarterly earnings; we will learn how well it has been doing and how its executives foresee the period ahead.

Other investments. Core's other equity investments, in Japanese stocks, Indian stocks and a US pipeline company are faring very well in this young year—though not if measured by Nvidia standards! Our long-term Treasury bond position, though well up from lows it plumbed in October, is down so far this year. Tuesday's CPI news took wind out of its sails. The uncertainties around the Fed's prospective monetary easing present a challenge. Monetary easing will strongly bolster the prices of Treasury bonds, but when will that come? The Fed's meeting next month is likely to resolve some of these uncertainties. With all this said, our portfolio positions are ahead this year. May the appreciation continue.

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