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

May 15, 2022

There Had Been... Nowhere to Hide

As the Fed has become increasingly strident in describing how it intends to raise interest rates and decrease the vast holdings on it balance sheet, stocks and bonds have both fallen in price.

It is well understood that the increasingly sharp rhetoric from members of the Federal Reserve about monetary tightening has been a significant factor behind the sharp selling in asset markets this year. It is also the case that fiscal policy—that is, government income and spending—has tightened markedly. In April, the federal government surplus was a record $308 billion; government spending has fallen by 16 percent from a year ago. The federal government deficit for the current year is likely to be $1.5 trillion less than last year. The enormous emergency spending programs occasioned by Covid that were enacted by the Trump and Biden administrations have come to an end. The Fed was slow to deal with inflation that developed last year and this; in order for it to retain credibility, it has determined to take very strong measures to bring inflation down. Since the 1960s, there has never been such fiscal and monetary tightening as we now endure. The effect will be to stifle demand and will, more likely than not, lead to a recession, perhaps quite a deep one.

Typically bonds rise in price as stocks fall. Although this had not been the case in the early part of the year, in recent weeks the customary increases in bond prices in a bear market has begun. It will probably continue.

As remarked in previous *Core Comments*, a highly unusual aspect of this year's asset market conundrums is that, while stocks have fallen in price, bonds have as well. In most situations, while the stock market falls for an extended period, bonds rise in price. For example, in the bear market occasioned by the Great Financial Crisis from 2007 to 2009, while the S&P 500 fell by 52 percent, long-term bonds rose in price by 19 percent. However, the Fed's insistence that it would sharply raise the short-term interest rates it controls directly caused interest rates, long- and short-term, to rise sharply. But, as the economic consequences of the combined monetary and fiscal tightening have come to be understood, long-term Treasuries, of which Core's clients hold a fair amount, have begun to rise in price and their yields to fall. My strong expectation is that this is the beginning of a process that it will continue.

By

Jack Mayberry

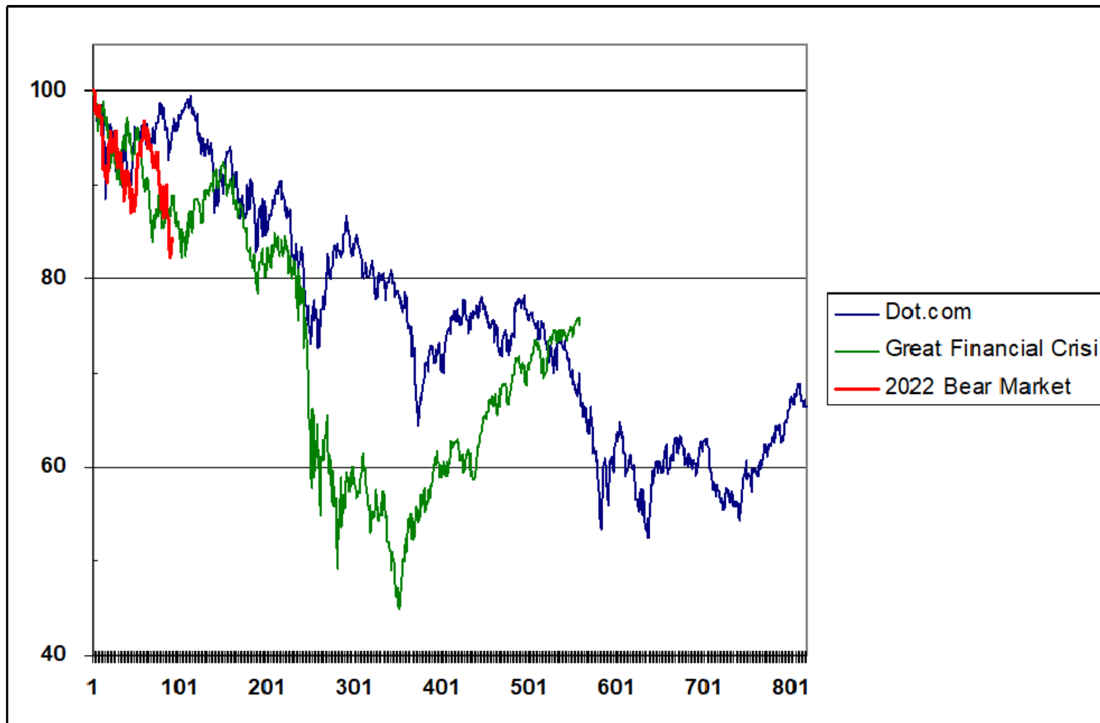
As for the stock market, it has fallen on a weekly basis for six weeks in a row, something we have not seen since the bear market of 2007 to 2009. Both the Nasdaq, full of tech stocks, and the Russell 2000, the index of small US companies, have fallen by 30 percent from their highs in November. At its low this past week, the S&P 500 had fallen by 20 percent. In early 2020, the onset of Covid and the nationwide lockdown brought about a swift 35 percent decline in the S&P. But then, unlike now, came the huge CARES act and the Fed's mighty rate cutting and bond buying. Fiscal and monetary actions were designed to keep the economy from collapsing and they provided a huge tail wind for asset prices. That caused the brief one-month sell off to end and for a sharp rise in in stock prices to begin. That was then, but now the opposite is happening. Fiscal policy is contracting and monetary policy is tightening. Je-

rome Powell, the Fed chairman, told us last week that bringing inflation down will cause 'some pain.' For Powell and his colleagues on the Fed, this statement is both an understated and an unusual admission. The respected commentator for the Financial Times, Martin Wolf, states the dilemma in stronger and more straight-forward terms:

Core has been building a position in a security that rises in price as the stock market falls. This provides opportunity if and as the bear market continues.

> "It is, alas, quite likely that a recession will now be needed to keep inflationary expectations under control. Moreover, even if it turns out to be unnecessary, because inflation just fades away, a recession may still occur, simply because even a modestly tighter policy wreaks havoc in today's fragile asset markets. But the Fed has to sustain its battered credibility on inflation. That is the heart of the central bank's mandate. It must screw up its courage and do what it takes."

Thus, my expectation is that the stock market decline we have seen so far this year has a good deal further to go, both in price and in duration. The chart on the this page illustrates this. It shows that the 2000 to 2002 bear market after the bursting of the dot.com bubble and the 2007 to 2009 Great Financial Crisis bear market fell much more than has our 2022 decline and lasted far longer in time. I have rebased the highs preceding the bear markets to 100 and the X-axis shows the trading days since the highs. To my mind, these are the models to consider, as we assess our response to the ongoing selling this year.



Accordingly, I have been building a position in an exchange-traded fund that is the inverse of the Nasdaq 100 index. It rises in an amount equal to the fall in the Nasdaq 100 and, similarly, falls as the Nasdaq 100 rises. If the stock market continues as it has so far this year, this position will be a hedge against the further declines. Our other equity positions are in the most defensive securities, utilities, consumer staples—think Campbell Soup and the like—and an oil pipeline group.

So far this year most investment assets have declined in price, but there is somewhere to hide. Core has built a hedge that offers protection and appreciation as this bear market unfolds. This will not be simple. As the accompanying chart shows, during the two previous bear markets in this century, there were periods of stock market advances. In those times, a hedge like ours will lose money. My aim is to be alert and careful in this difficult market.

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