StraightTalk
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Does The Fed Want a Recession?

Just as sure as the summer has turned to fall, so too, the media has turned from "all inflation, all the time" headlines, to those fearing a coming recession. While it is still too early to predict that a recession is the *most likely* outcome for the U.S. economy during 2023, the odds certainly are rising, and it would not be a surprise to any of us if one were to occur. However, all too often, the fear of a future negative event proves to be an overreaction. Speaking of overreactions, Bespoke Research put out a report last month detailing how Fed Chairman Jay Powell was so incensed about the stock market's 19% rally in July that he tore up his speech before the Jackson Hole summit, and rewrote it. The new speech he delivered was the most "hawkish" of his career, and was clearly designed to unnerve markets, and dispel any thoughts of the Fed cutting rates anytime soon. Well…he got what he wanted – a 1,000 point drop in the Dow the following day. He repeated talking points from that same speech after the 75 basis point increase last month, and markets followed course, dropping back to the June lows. This begs the question, "Does the Fed want a recession?"

This evokes my question in the last newsletter, which was, "would you rather have persistent, sustained inflation, or a Fed caused recession?" The answer to both, in my opinion, is that we (and the Fed) would choose recession. It is not – as one dimwitted Senator has already accused Powell of – that he wants unemployment to rise, "throwing people out of work," but that there is no elegant way to apply the brakes to sharply slow down a massive economy without causing some short-term pain.

The two areas that typically feel any slowdown pain first are the stock market, which is always looking forward to economic conditions in the future, and the real estate market, which is leveraged, and therefore impacted by changes in interest rates. At some point, if the slowdown is sharp enough or lasts long enough, the labor markets become affected, as corporations tighten their collective belts to preserve profitability, and layoffs ensue. However, there is a difference between a naturally occurring business cycle recession, and one caused by the Federal Reserve trying to keep a red-hot economy from growing too quickly. We will see next year if we actually get a recession, and if so, how short and shallow it is. However, before we get there, hundreds of millions of words will be written or spoken *predicting* what will happen. Almost all of them will be wrong.

To back up this assertion, let us review the news cycle over the last couple of years. The first and most obvious event that almost no one predicted was the pandemic. Although one was inevitable at some point in our lives, nobody predicted that it would strike in 2020. Moreover, in the worst public policy decision since Herbert Hoover's in the Depression, the concurrent closure of our economy and our schools was not predicted correctly by anyone. Since no one was predicting that closing of the economy, it stands to reason that few accurately predicted a 19% contraction in the U.S. economy, or the stock market declining by one-third in just 33 days. And, I am quite sure that absolutely no one predicted that those losses and the recession that caused them would be completely erased in the following six months. However, countless numbers of experts did predict that the pandemic would cause the end of our economic lives – only to look quite foolish when markets and the economy both recovered robustly.

Taking this a bit further, no one predicted the insanity of January 6th, or that Putin would move militarily into Ukraine just one month later. I seem to remember countless predictions of how quickly Putin would roll up Ukraine – and those all turned out to be flat wrong. While countless millions of words were written about that conflict and its impact on the oil markets, I do not remember a single economist predicting 9% inflation. As successive wave after wave of Covid was using up all the letters in the Greek alphabet, I don't remember anyone correctly predicting Monkeypox. I also can't find accurate predictions about multiple 75 basis point hikes from the experts who watch the Fed, and no one can predict how China will act towards Taiwan.

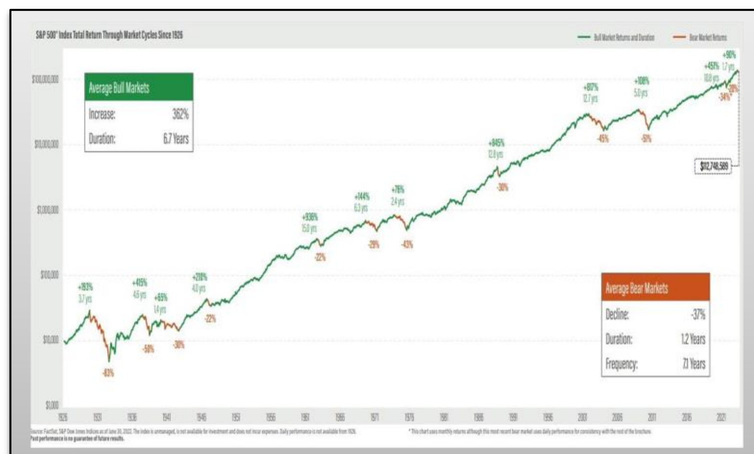
I think you get my point…all of these predictions about when a recession comes, and how long it will last are just wasted ink (or breath) and should be ignored.

Remember, inflation is far more insidious than a couple of quarters of flat lining growth in our economy, particularly when there are still almost two jobs open for every one worker looking. Yes, unemployment may rise some, the markets will test your patience for a few more months, but *we must extinguish inflation*, because it is a cancer for our economy, for the purchasing power of our currency, and for our long-term financial goal plans.

Notably, in August of this year, the U.S. Postal Service announced an increase in the price of a “forever” stamp to 60 cents. A two-penny increase in today’s world may not seem like much, but it’s the cumulative increases in prices that matter to our long-term well-being. Try to remember that in 1953, Americans could buy a haircut for 60 cents, see a movie in theaters for that amount in 1958, eat a McDonald’s quarter-pounder for that price in 1972, or ride the NYC subway for that cost in 1981. Of course, today it is hard to find anything to buy with just 60 cents, and everything listed above costs a multiple of that price – and that is with inflation averaging just 3.5% over that period. Doubling or tripling that rate of inflation would accelerate those price increases exponentially, something we cannot afford.

So, the Fed will stand on the brakes as long as is necessary, and if history is any guide, they will actually do so for too long. This means that I not only expect a recession, but also expect to see the Fed cutting rates before the end of next year. However, at the end of the day, whether we get a Fed caused recession or not is largely irrelevant to the success of your long-term plan and the invested portfolio that supports that plan.

Do any of you think that the fund managers we have engaged in your portfolio are surprised by the Fed’s course of action? Likewise, don’t you intuitively know that last year’s capital gains distributions were a result of money being reallocated from tech-forward “stay at home” companies, to those that will prosper in the more normal environment of the coming 3-5 years? The daily decisions of what to buy when and at what price, are exactly what we have hired them to do, and if we sell “until things feel better” we lose their collective expertise. CityWire reports that at the end of July, mutual fund cash levels hit 20-year highs. In other words, your fund managers took money off the table at the end of a one month, double-digit gain, in order to redeploy that money in the coming months. All we need to do…..is to let them do it! Resist the siren song to “do something” until things feel better – for that is the worst thing you can do in a bear market. No one ever rushes to close the barn door after the horse gets out. The better plan is to have faith that *this too shall pass*, and to remember that there is a natural rhythm to recessions and recoveries. When inflation does pull back (which could be sooner than many expect,) that has historically opened the door to sustained growth and market gains. Recessions can be painful, but they serve to clear out excesses, and set the stage for a healthier economy and market afterward. On the chart below, which tracks the U.S. stock market from 1926 to June of this year, look for the declines in red. You will need your glasses to do so, *but they are all there*. The market declines in the 1970s before you were really investing, the crash of 1987, 9/11, the Global Financial Crisis of 2008, the pandemic of 2020, and this decline. They don’t look so scary when viewed in context of the long term increases of the green line, do they?



History is also useful in tracking the emotions around the market’s long-term upward trend. We are watching the whole world flee stocks, and none of us knows when the selling will end, but history shows that when it does, it can turn quickly. Try to remember what happened when the market bottomed after the panic in 2008 – the S&P 500 went up seven-fold over the next 13 years. Try also to think of the sharp reversal from the Covid bottom of 2020, when that same index doubled in 18 months. Warren Buffet famously said, *“Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold.”* Well…..this is the second time in this decade, and you may not get another chance. Now is a time to hold fast and ignore the headlines, not to panic and damage your plan. The long-term future remains bright.

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