The Long & Short of It

Quarterly Newsletter
Third Quarter 2022

2022 Is Not 1972

This is not the demand push inflation of the 1970s. Today's rising interest rates and rapid increase in prices are a very different phenomenon. The rise of consumerism—Baby Boomers forming their first households—spurred the inflation of the 1970s. Today's profligate spending by federal government, enabled by the Federal Reserve, has spiked the US inflation rate and the national debt to previously unimaginable levels. Between 1980 and 2021, gross federal debt has increased roughly 300%. The debt levels are becoming so large as to make the economy fragile and outcomes more uncertain than they would be otherwise. Recovering from this episode of inflation will look little like it did in the 1970s.

Like a Government in a China Shop

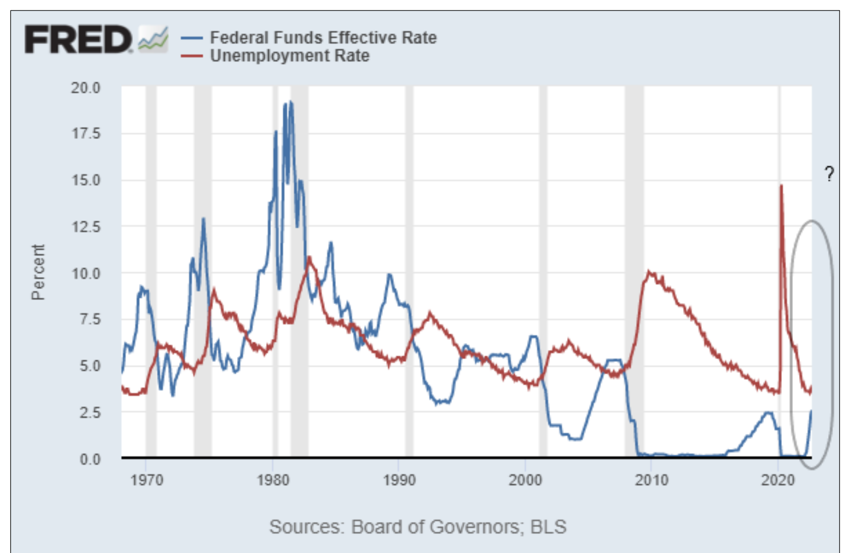
Bigger government is no longer better government. Whether it leans left or right is not the concern here but rather its sheer size, the scope and power of its influence. Omnipresent oversized government is rarely subtle nor without unintended consequences.

Today, each time overextended governments try to change the trajectories of their footprints, investment markets throw a childish fit. Even with the simplest of efforts to curb the size of government, reducing long-term spending and/or cutting taxes as the UK tried last month, the tantrums begin. Like cowed parents who have lost control of their children, government officials (read: considering their reelection) cave in to the spoiled children's demands. Like the Bank of England, the Federal Reserve may eventually be forced to allow inflation to continue in order to preserve liquidity and stability in investment markets. Historically, the phrase "too big to fail" refers to those private companies whose failure would singlehandedly damage the economy. Today, "too big to fail" means the government and the investment markets it dominates. If history is any guide, eventually the money will run out and someone will end up in rehab.

On a Rampage

This cycle, the Federal Reserve failed to tighten early enough. They are now trying to catch up but there is no good way to fix the mistake. As the Fed continues to raise US interest rates, the US dollar strengthens relative to other currencies. A strong dollar impedes everyone who holds foreign currencies while their debts are denominated in US dollars. This is especially important because the US dollar is the world's reserve currency. If the world is a bathroom, then the US is the bathtub and everyone else is the bathroom floor. When the Federal Reserve turns on the tap and provides liquidity, dollars eventually spill over onto the floor, making economies hum with trade and easy money. When the tap is closed, the tub may remain full for a long while but the floor dries up quickly. We will see problems overseas before we see them here.

These things take time to play out. Today, we have only begun to see the effect of the tightening in interest rates that began a year ago. There is a one- to two-year lag between monetary policy's implementation and its ensuing impact. As noted in the chart to the right, historically when the Fed increases the federal funds rate, the unemployment rate increases one to two years later. Recent aggressive interest rate moves will be haunting our economy for the next two years.



Over the last decade, low interest rates made it easy for everyone (individuals, yes, but mostly government and corporations) to take on debt. The recent rapid rise in interest rates has now produced the largest bond bear market in a lifetime. Since today's rates are so high and collateral is falling in value, many maturing or short-term loans will not be rolled over, leaving borrowers unable to secure a new loan or pay off their existing debt. While it feels a bit like 2007, this time the debt is much larger and more in the hands of government and businesses than in housing.

Since 2007, businesses have increased the amount of corporate debt outstanding by 110% while consumer debt has only increased 35%. In fact, companies have been so aggressive about taking out debt that 58% of investment-grade non-financial corporate bonds are rated BBB, one notch above junk. If a recession pushes any of these into junk territory, asset managers whose mandates require safe assets may be forced to sell them quickly, leading to an even greater selloff and further increases in borrowing costs. In addition, because of the regulatory burdens of the Dodd Frank legislation of 2010, there has been a massive shift in investments toward the private market, which is much less liquid than the public market and largely unavailable to meet any margin calls. This will concentrate the selling on a somewhat smaller publicly traded portion of pension portfolios during this recession, adding to the potential selloff.

While the EU and the US are still talking a good game of more rate increases to slow inflation, Japan and the UK have already capitulated and begun to print money again and drop interest rates. Over the last several years, British pension funds with large gilt (bond) holdings borrowed on margin against their holdings. This year as the price of gilts fell, they began to get margin calls. One possible response was selling the gilts at a loss, locking in permanent losses and perhaps causing a cascade of losses as gilt prices dropped further. Instead, the British government printed enough money to buy gilts and push up their price temporarily, allowing the pension funds to deleverage before their margin calls came due. But where did the money for those purchases come from? Not from taxes, as the UK was already running large deficits. It came from printing more money or issuing more debt, mostly backed by printed money.

We should listen very closely to the words of Mr. Huw Pill, the chief economist of the Bank of England, on September 30, 2022: “Yesterday's intervention was not a monetary policy operation. The temporary and targeted character of the Bank's intervention is key to the distinction between financial stability and monetary policy.” That is to say, monetary policy intended to maintain market stability is not monetary policy at all. We expect to hear more of this from central bankers over the next two years. Could an “inflationary market stability” policy become so large one day that it overwhelms the tight monetary policy required to rein in inflation?

As the world’s largest employer and debtor, the US federal government determines the fate of much of the world’s economies. Our government has, for decades, been engaged in an increasingly delicate balancing act. With each cycle, greater instability and greater debt requires a dramatically more accommodative response by Congress and the Federal Reserve to restore stability and growth. With each recurrence, our government becomes exponentially more levered and vulnerable. Paradoxically the response itself will eventually cause more of the instability and the inflation it seeks to control.

Picking Up the Pieces

Investment markets have become treacherous. Volatility levels will be elevated but may provide occasional opportunities due to short-term mispricing. Our goal is to provide solid footing and to preserve the purchasing power of our clients’ portfolios over the uneven terrain of today’s volatile markets. Please call us if you would like us to help you define your path.

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