The Long & Short of It
Quarterly Newsletter
Fourth Quarter 2022

Fed - The Great and Powell-ful

Like the magician from Nebraska in L. Frank Baum's masterpiece, Federal Reserve chair Jerome Powell conducts monetary theater in a grand way. Expectations drive markets and the economy. All the projections, billowing smoke, and loud noise are intended to convince the American public that inflation will certainly and soon be whipped. Surely the Fed would not overdo it again!

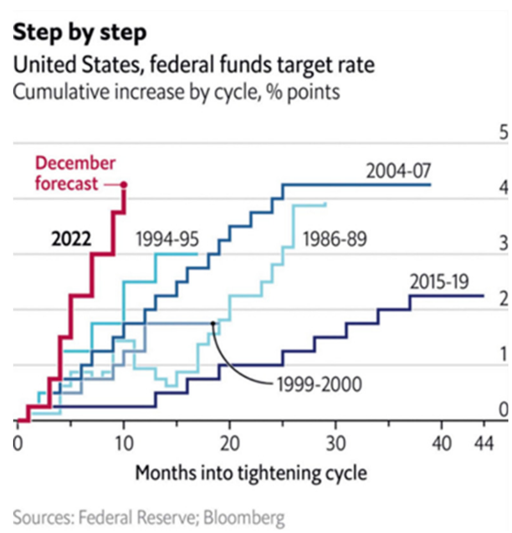
Yet Mr. Powell enabled Congressional spending in what may be the largest fiscal stimulus in world history ($5.2 trillion in pandemic response) by orchestrating what may be the largest monetary stimulus in world history. He then believed the resulting inflation would prove "transitory." In doing so, he disregarded extensive academic literature from the Fed, which cites roughly a two-year lag between monetary policy implementation and its peak impact on the economy. As recently as November 15, Raphael Bostic (president of the Federal Reserve Bank of Atlanta) reminded us that, "A large body of research tells us it can take 18 months to two years or more for tighter monetary policy to materially affect inflation."

Other non-Fed research indicates even longer lags. In "Transmission Lags of Monetary Policy: A Meta-Analysis" (*International Journal of Central Banking,* December 2013), Tomas Havranek and Marek Rusnak state they have:

> *"[…] collect[ed] sixty-seven published studies and examine[ed] when prices bottom out after a monetary contraction.* ***The average transmission lag is twenty-nine months*** *[emphasis ours], and the maximum decrease in prices reaches 0.9 percent on average after a 1-percentage-point hike in the policy rate."*

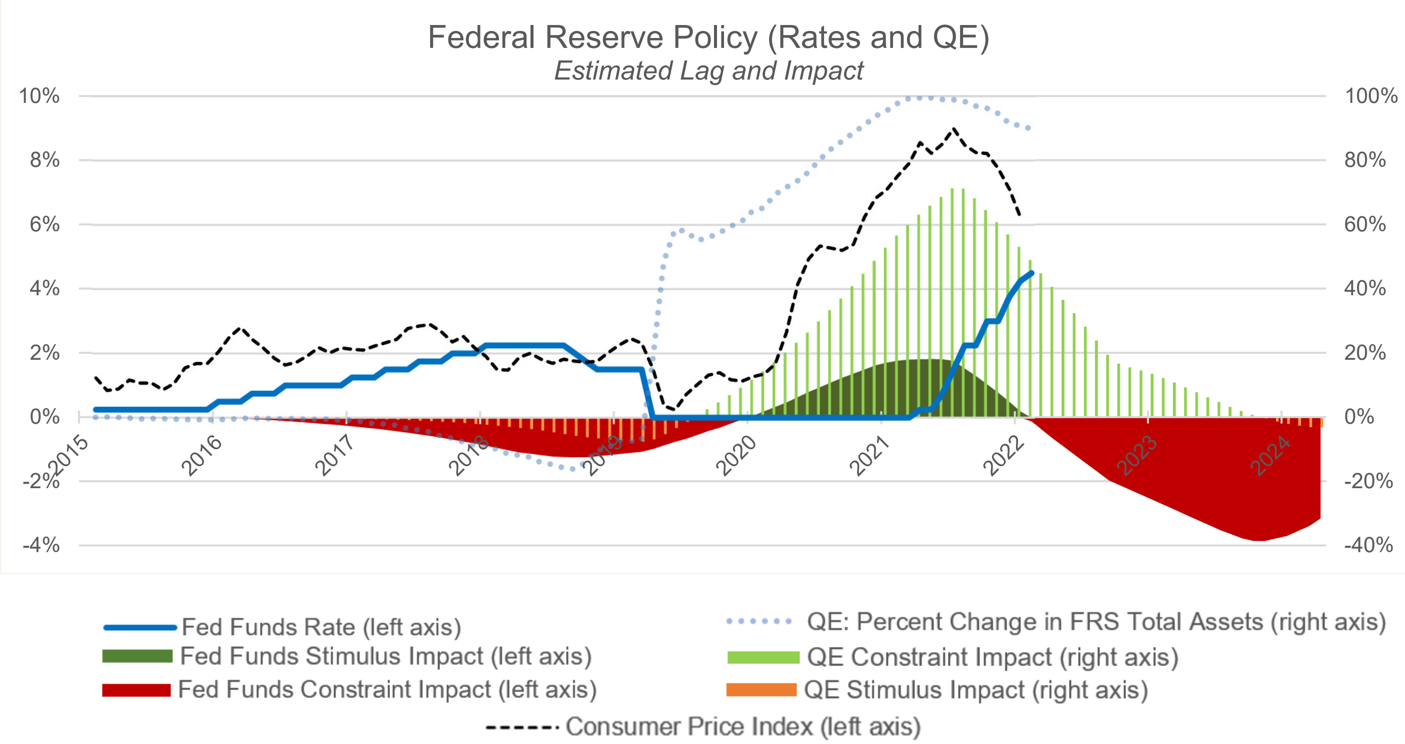
Research aside, it's possible this inflation may still end up as transitory. But its retreat could take a lot longer than Mr. Powell had hoped. Investors will need brains and considerable courage to overcome what their hearts are telling them.

In 2022, the Fed raised interest rates faster than at any time in the last 36 years (see chart from *The Economist* at right). After one more raise, likely coming in January, it will also be the largest. To bring inflation down and make policy more effective, the Fed feels it must convince the public it is serious. After getting a late start, Powell projects that he will not be another Arthur Burns. Fed chair from 1970-1978, Burns relaxed monetary policy at the first sign of inflation becoming moderate only to have it come roaring back shortly thereafter; better to crush inflation like the victorious Paul Volcker.



As any hot air balloon pilot will tell you, changing the elevation of a balloon can be a bit tricky. The impact of running the burner or venting the balloon takes from 20 seconds to two minutes to unfold. The timing and magnitude of change are difficult to estimate. It can be unnerving. Two years for monetary policy to unfold seems an eternity. "Difficult to envision" hardly begins to describe the task before us.

Without attempting to be too scientific, we have illustrated the monetary policy lag dynamic with a timeline (next page) that uses Havranek and Rusnak's 29-month average lag finding to relate changes in the federal funds rate and quantitative easing policies with their lagged impacts.

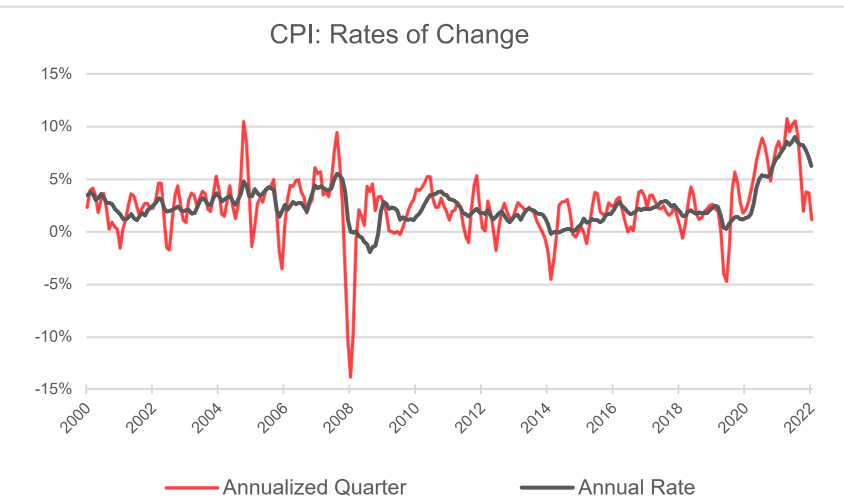


Sources: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average Seasonally Adjusted [CPIAUCSL], Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], and Federal Funds Target Range - Lower Limit [DFEDTARL], all retrieved from FRED, Federal Reserve Bank of St. Louis.

In March 2020, the Fed began accommodation for COVID-19. In March 2022, the Fed began raising the federal funds rate and stopped growing its balance sheet. After December 2022 (last data available), any further increases in fed funds or decreases in total assets will widen and deepen the impact, likely haunting our economy beyond Halloween 2024.

Venting the Balloon

The rate hikes this summer were steep enough to affect prices quickly. While the Consumer Price Index (CPI) annual rate of change for the year ending December 31, 2022 was 6.5%, the month of December was down 0.1%. For the six months ending December 31, CPI rose only 0.9%, which equates to an annual rate of 1.8%, just below the Fed's targeted range of 2%. The fourth quarter saw CPI rise at an annualized rate of only 1.7%. The chart at right illustrates this rapid deceleration. Similarly, the Producer Price Index (PPI) dropped to an annualized rate of -17.6% during the quarter ending September 30.

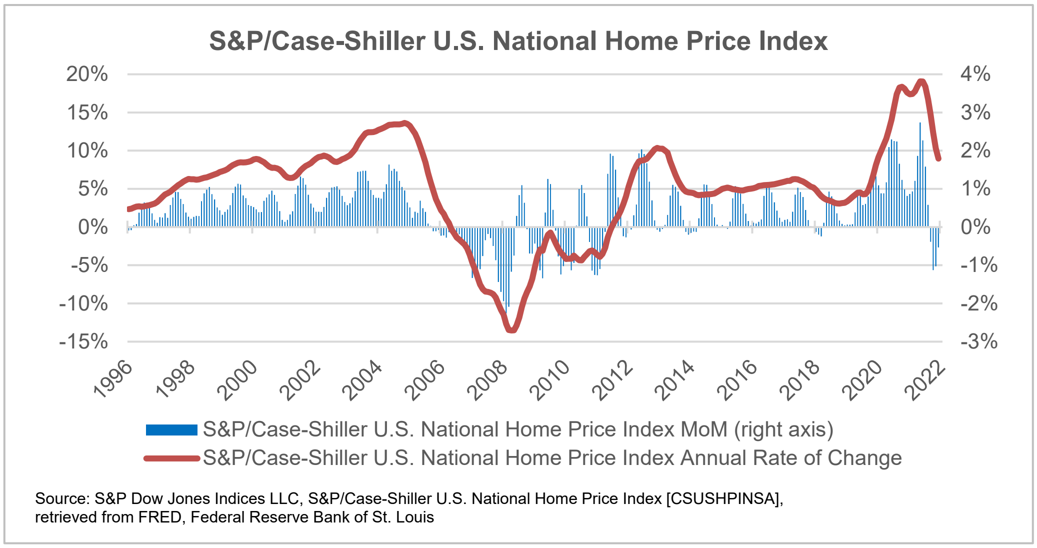


Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average Seasonally Adjusted [CPIAUCSL], retrieved from FRED, FRB of St. Louis.

Of course, it will take another six months for the published annual rates to reach targeted levels, but with the Fed engaged in one of the most restrictive policy stances in history, the month-to-month data (i.e., what is actually happening in the economy today) is already close to targeted levels. Will inflation still be running hot in late 2023? 2024? Doubtful. There is a significant probability of inflation dropping below target and it may take housing, manufacturing, services, employment, and the stock market with it. The Fed will eventually reverse course but the stimulus required to reverse the damage may be remarkable.

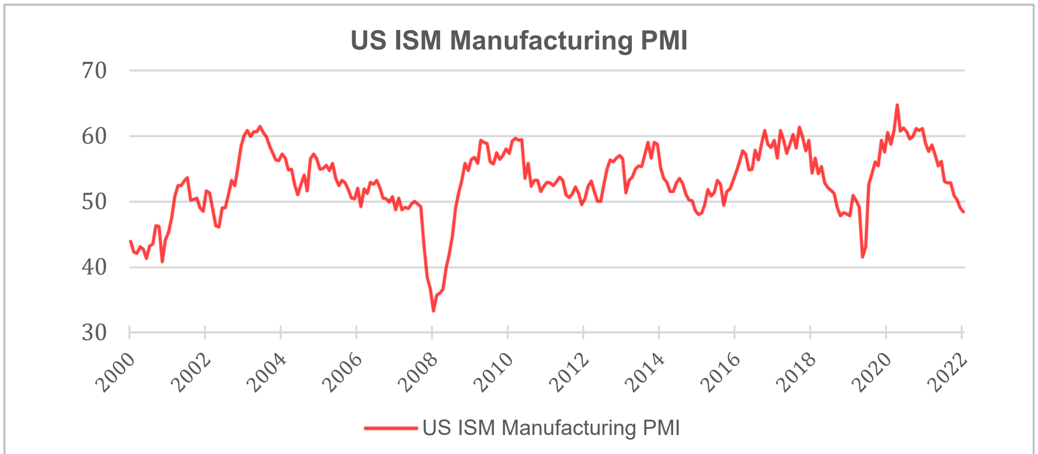
A Cooling Climate for Stocks

Hammered by rising interest rates, home prices have dropped each month from this past July to October. Over the third quarter, home prices dropped at an annualized rate of -10.8%. Despite those declines, the year-over-year home price increase remains at 9.2%. Given the steep rise of 10.4% in 2020 and 18.9% in 2021, a decline of -10.8% leaves current prices a bit bubbly. However, with no indication the Fed will relent soon, we expect further downside.



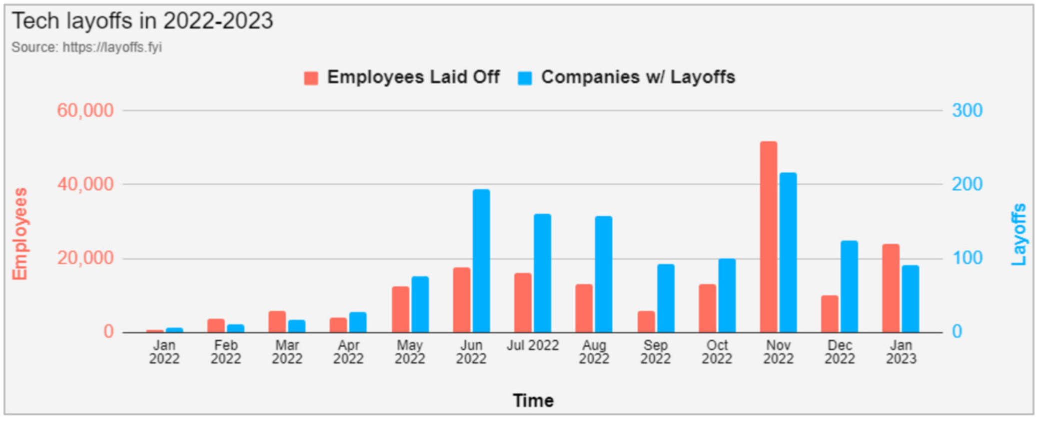
Source: S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis

Manufacturing has also begun to contract. As reported by the Institute for Supply Management (ISM) on January 3, 2023, the Manufacturing Purchasing Manager's Index (PMI) dropped to 46.2 (below 50 indicates contraction). On January 6, 2023, the ISM Services PMI followed suit, flipping from expansion to contraction.



Source: Institute for Supply Management, downloaded from ycharts.com

Lastly, technology sector layoffs are on the rise. On January 4, 2023, Salesforce announced the layoff of 8,000 employees (10% of its workforce) and Amazon announced it would cut 8,000 more jobs in addition



to the 10,000 announced in November. Layoffs grew rapidly in 2022 (see chart at right) and 2023 is already off to a brisk start.

Trust the Research. Fade the Emotion.

Investing is difficult. At times it is simple but success is rarely easy. One of the wisest maxims is to follow the research and fade the emotions. Some of the most successful trades are the most gut-wrenching. It is especially challenging, when bad news is driving an investment lower, to step into the breach and buy at the bottom when no one else will. It is equally difficult to sell a huge winner near the top. Quite often, the news that moves an investment does not last or turns out to be a rumor. If the move takes the investment to levels that research cannot support, one should act, especially if it feels difficult.

Recessions are a normal part of a long-term growing economy and can actually provide some long-term benefits to the health of an economy. While there is plenty of wishful thinking that we can avoid a recession, or that any recession should be mild and brief, the research we see says otherwise. It always feels awful to point out a greater than average probability of a bad economic outcome. It also can be dangerous, as recessions are the exception, not the rule. Of course, the professional who errantly predicts a bad outcome is considered a nattering nabob. Worse yet, he or she will be seen as the one who yelled fire in a crowded theater. Thankfully we do not have enough people in our theater to create a rush so we are not worried about that. Yet we do take our fiduciary responsibilities seriously. Moreover, our clients have asked us to prioritize risk management as much as return enhancement.

The research looks quite negative for the economy. Emotionally it feels bad. What to do about it, knowing that investments do not always follow the economy or act as one expects, is a trickier thing still. Nevertheless, we will not shy away. We are not pessimistic. We are following the research, fading the emotion, and maintaining optimism about where that will lead for our clients.

Celebrating 25 Years

While one cannot know that Mr. Powell will preserve, maintain, and improve the reputation of the Federal Reserve, rest assured that we at Robinson Value Management will be working hard to preserve, maintain, and improve the purchasing power of our clients' portfolios. As of December 31, 2022, Robinson Value Management, Ltd. and its predecessors have managed client investments for over a quarter of a century. We are very appreciative of our clients and the trust they place in us to implement a process for them with something as important as their savings. We will continue our commitment to offer personalized, high-quality advice; to be transparent; and to work to earn their trust by placing their needs first at all times.

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