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Two wrongs do not make a right

Hindsight is 20/20

In investing, as in life, hindsight is always 20/20. It is easy now to call the turn in the economy when housing prices started exploding. It is equally easy now to suggest that the Fed could have started raising rates gradually in Q4 2021, and we would have avoided these higher than expected rate increases over such a short period.

Capital markets essentially provide the conduit for money to find its way into rewarding risk-taking assets. For that to work properly, the market prefers relative stability and liquidity. Market participants would rather participate in a market that is less volatile than more volatile because they will have greater accuracy in executing trades at or close to the expected price. Volatile markets make prices less reliable.

Market participants also prefer liquidity. The day a market participant decides to buy or sell a security, preferably, it would be relatively easy to find a counter party to the transaction and receive fair market value. The supposition is that there is always a willing and able buyer and seller for the other side of the client's trade. Many would take that as a foregone conclusion in most markets. That is not necessarily the case. Liquidity dries up quickly during periods of financial stress.

At last month's Federal Open Market Committee meeting, current chairman of the Fed, Jerome Powell, announced the third 75-basis point-rate hike in a row. The market was not surprised. What got the market's attention was the degree to which the Fed is projecting the need for tighter monetary policy into the

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future. Meaning, that some observers would argue that financial conditions are already tight enough. However, implementing this may not be entirely necessary. Some point to leading indicator high-frequency market-oriented data. For example, the price of commodities, housing, and goods have already started coming down, thus the effects of a tighter monetary policy are unfolding. Therefore, it is important to ask: what is the Fed looking at? Is the Fed looking at the same market-oriented data that, for example, stock market participants are looking at? The answer is no.

Lagging Data

By his own admission, Chairman Powell referred to the data as by default, lagging. Whereas the market-oriented high-frequency data, such as the prices of assets, the yield on various standard maturities across the yield curve, the relationship between the dollar and other major world currencies, all point towards an environment where tighter financial conditions are already occurring. Inflation data, as well as unemployment are both lagging indicators. The market is concerned that the Fed's focus on these lagging indicators will create a data vacuum large enough for the Fed to continue to tighten financial conditions aggressively, well beyond the point at which it would be necessary to achieve their objective of price stability, i.e., to tame inflation. The risk is real. A Fed policy mistake is, and has been, one of the market's greatest concerns post-WWII because human beings are not perfect.

They say that two wrongs do not make a right… At the September 2021 Fed Meeting, when housing prices were rising at an accelerating rate, as were the prices of goods, food among others, the Fed was looking at the very same lagging data and they may have been complacent. At that time, the view was that inflation was short-term and pandemic-related, or as they put it 'transitory'. Some say the Fed has already tightened enough. The same market signals in September 2021 that were showing an economy that was overheating are now showing a cooling economy. The Fed could have stepped in, but instead, they largely blamed it on supply chain issues related to the pandemic, and later pointed the finger at Ukraine as a source of disruption for energy prices. They saw some initial effects of inflation and chose not to act.

The Fed may be guilty of two policy mistakes. They under-corrected at a time when they should have started tightening monetary policy. Once inflation got out of control with a 40-year high, the Fed had no choice but to act immediately

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and aggressively. Now, they may be over-correcting to the other side. The pendulum has swung from one extreme to the other. The US dollar is so strong on the heels of these rate hikes, that the rest of the world is struggling to keep up.

Patience with the Fed

What is the conclusion? Patience. The market needs to have patience with the Fed. The market needs to accept that the Fed is always a bit behind due to their need for concrete evidence. Investors need to be patient with the market. The market does not like hundreds of basis points of interest rate increases over just a few months. Many would argue that the Fed should have tried to avoid such an unreasonably high rate of change. The market cannot meet this rate of change without a certain degree of short-term disruption.

U.S. Fed Funds Rate 2022

Hence, disruption does not feel comfortable at the time, but it is an effective way to cleanse the market and reset it to a more realistic set of expectations going forward. That is exactly what investors should do now. They should continue to move forward with their most important financial objectives regardless of this temporary period of disruption, of which there will be many more if we are lucky.

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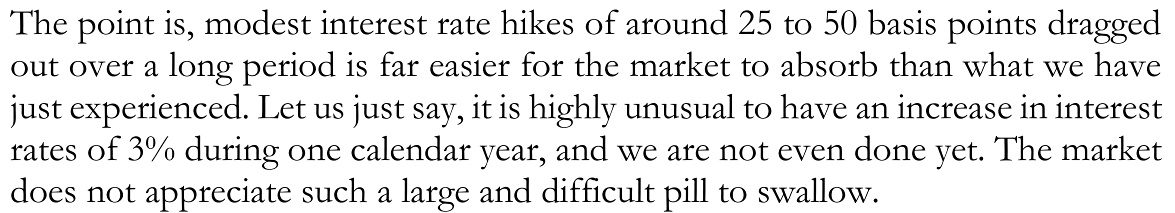

The point is, modest interest rate hikes of around 25 to 50 basis points dragged out over a long period is far easier for the market to absorb than what we have just experienced. Let us just say, it is highly unusual to have an increase in interest rates of 3% during one calendar year, and we are not even done yet. The market does not appreciate such a large and difficult pill to swallow.

In essence, the market needs to see the Fed pivot to at least a more neutral stance and away from its current restrictive stance. The problem is that the Fed will not budge until it has clear evidence that their inflation indicators are coming down and unemployment is rising. Normally, changes in interest rates are essential time-consumers. We just need more time to run out on the clock. We need the economy to absorb these rate increases and show it in the data. Investors should not be deterred from their long-term financial plans. It feels like we are getting close to a balancing point. While this should have been a lengthier and more boring process, the task at hand is no small feat. We are resetting global financial conditions to a post-pandemic world. These things take time, and they are more disruptive when hurried. Patience is a most worthy virtue indeed.

Call/email me for additional insights or for more information.

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