

Picking Fights with the Fed

The famous phrase “Don't fight the Fed” was first coined in the 1970's. Essentially, it was meant to warn investors to keep their portfolios on the good side of the US central bank. Doing so was synonymous with investing in the manner in which the Fed said it wanted investments to be made. The phrase was meant to warn against making investments which questioned the resolve of the most powerful central bank in the world which just happens to control the interest rates that influence the de facto currency of the whole wide world. So, then it makes sense to do what the Fed says do, right?

Well, market participants seem more willing today than they have been at any other time in recent memory to test the mettle of the Federal Reserve Bank of the United States. Small wonder why, the phenomenon known as the Fed Put (since it is more of an idea than an actual entity) got its meaning from the tendency of the Federal Reserve to interpret its mission of keeping the US economy going along smoothly as to make sure that US equity markets marched ever higher, or at least to step in and shore things up whenever US stock markets gapped lower.

This year has brought about a situation in which the Fed Put is being placed in the US central bank's own crosshairs. You see, the Fed got a late start, very late, when it came to recognizing the seriousness of the inflationary threat which the combination of the global pandemic, that begat the rise of work-from-home which brought on a chronic labor shortage meant to the economy of the United States (and, in fact, the world). At one point this year, most likely it was at the Jackson Hole meeting at the end of August, Fed Chairman Jay Powell decided to drive home the point that the Fed had (finally) recognized that inflation was a concern, that there was reason for the monetary authorities to believe that inflation was more of a problem than they had thought before and that they would focus on bringing the inflation rate down, even at the cost of violating the terms of the so-called Fed Put. Now, Powell is not wrong, inflation is high and stubbornly so, and it will take the Fed's determination to raise rates as much as necessary in order to crush core inflation, dominated as it is by service costs, because that almost certainly will require an increase in unemployment in order to slow pay increases throughout the economy but especially in the services sector. Global stock investors are not completely convinced yet, though. Every time a bad inflation number hits the tape, global stock markets selloff, but in a few months' time some pundit comes in to pronounce that peak inflation is past and the Fed must get about the business of the saving the economy which is quite often equated with juicing up the stock market. That is why this year stocks seem to careen from super-selloff mode into baby bull market...and then back again.

Return to Normal:

As US Treasury yields rocket higher heavily influenced by rate hikes from the Federal Reserve, one must keep in mind that we are only returning interest rates to their normal levels. As unnerving as it is to see that the bond market is down 15% in the US on average this year to date, some perspective is called for. While it is fair to say that volatility has shifted upward significantly in bond markets (the MOVE bond volatility index has shown some of its highest values ever this year) it is also necessary to remember the average Fed Funds rate between 1955 & 2020 was ~4.6%. It is only over the last 15 years or so since the Global Financial Crisis that Fed Funds have averaged ~1%. So, normal is where we're headed back to, nothing that should be any more frightening than normal. The average yield on the US 2-year note has been 1% for the past 15 years. However,

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the average yield for the US 2-year note for the last 75 years is ~5%. Today it stands at 4.5%! As US Treasury yields climb representing investors' demand for more compensation in return for holding Treasuries as they face a more uncertain outlook for the global economy, those higher yields on safe US Treasuries make stocks look less attractive by comparison. This leaves investors less willing to pay high multiples to own stocks. This year's earlier downturns were about multiples being mashed as investors reduce the "P" in the P/E ratio, or what they are willing to pay for a dollar of earnings.

Something's Got to Give: Global investors have been visited by volatility before, but for the past decade it has appeared in the form the occasional, violent outburst. That is most certainly not the case right now. The numbers support this phenomenon. Between the volatility of stocks measured by the VIX and the volatility of bonds measured by the MOVE index, volatility is definitely increasing, if only at a slow and steady pace, it is nonetheless increasing. Such volatility makes sense when we combine confusion at the conflict between fighting the Fed and invoking the Fed Put. Today's markets are facing a set of challenges which are easily recognized but which are proving quite difficult to navigate: tighter labor markets, a significant increase in energy costs, a hot war in Europe and a cold war in the Pacific, monetary policy which has transformed from a tailwind to a strong headwind. Globalization was another tailwind multinational corporations could count on for the past 30 years. That is no longer the case. Regionalization will be the mantra for the foreseeable future. There are going to be blocs. Countries choosing to associate as blocs will mean that some countries are going to grow to play a much greater role in their regions as companies around the world reconfigure their supply chains to make sure that they have all the supplies they need in order to make what they sell, whether or not they can send away to China for them. This will help Mexico and Vietnam among other countries.

Finally, we address the US dollar at a 20-year high. There are so many things supporting the dollar, Fed-driven monetary policy sending US rates higher than those countries raising rates and much higher than those countries which are not raising rates. Also, energy policy: the dollar once weakened when oil rallied but now the US is a major producer / exporter of oil and will be the biggest marginal supplier of natural gas to Europe. There is also now a stronger case to be made for non-dollar stocks to outperform because at some point the Fed will stop hiking interest rates and the remarkable rally in the US dollar will end. It must end! When it does end, owning non-dollar assets will become a very good idea for all global investors.

There are many worries which confront global investors today. In fact, they seem almost unending. The fact that seems most salient at this point is that maintaining a long-term perspective and continually practicing one's process is all that seems to work out over time. Buying, owning and holding high-quality stocks which have been purchased at a discount to their fair market value has consistently beaten benchmarks over time. We remain confident that it will continue to do so.