January 7, 2022

The Powell Pivot

Dear Investor:

The recent, somewhat abrupt, change in monetary policy has been dubbed “the Powell Pivot” by many in the financial community. This is really the continuation of the trend I mentioned in my letter of July 10, 2021. Being brief, at that time I discussed the idea that the market felt the Fed was behind the curve and not acknowledging how much the recovery and inflation had picked up. At that time, the Fed began to accept the fact that inflation risks were “tilted to the upside”, and it was time to begin discussing the taper. Now, six months later, we are seeing the Second Act. The idea of “transitory” inflation has been dropped, the pace of the taper has been doubled, and it’s possible we could have our first rate increase as early as March. If you look closely at the numbers, inflation began to pick up as early as January 2021. The 12-month CPI reading hit 4.2% in April, and hasn’t come down since. The last two months, the rate has topped 6%. Readings that exclude food and energy are somewhat lower. While I do see value in considering that measurement, I don’t know that many people who don’t need food and energy. The reality is that millions of hard-working people are paying more for the basic essentials and other things they would like to have to be reasonably comfortable in life. Our Church operates a food pantry, and many patrons have told us how hard it is to make ends meet, and how much they appreciate the extra help.

I think one of the biggest risks we are facing right now as investors is that inflation stays high. We need to get inflation down as fast as possible. I’m thinking in terms of months, not years. Inflation decreases buying power. It leads to lower standards of living, as it’s not possible to keep up with rising prices for goods and services on every side. Businesses and consumers both struggle with this reality. Those without financial assets will be hurt the most. This will increase wealth inequality which eventually leads to more social turmoil. Another issue is inflation expectations. If consumers believe higher inflation is here to stay, those with money (or good credit) will accelerate their spending. They do this because they expect prices will be higher in the near future, so better to buy now. This can be like fanning a fire as the velocity of money increases. It generally leads to more inflation. If we let inflation run away, we will have big problems with the economy.

We know it’s the Fed’s job to try and manage inflation. In 1975, Congress adopted Resolution 133 instructing the Federal Reserve, “… to promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates.” This is the Fed’s Dual Mandate that you often hear about. (I realize that you could consider these three objectives, but it’s always been called the “dual mandate”. We assume that moderate interest rates serve as a backdrop for the two major objectives.) Currently we know that the Fed is in a position where we expect them to raise rates very soon. Their goal will be to slow the economy and bring down the inflation rate. The question is, will they be successful? How high will interest rates have to go to achieve this? Will they be able to lower inflation without pushing the economy into a recession?

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I'm expecting volatility to increase in the market this year as investors try to figure out the answers to these questions. It seems that the risks are higher than what we have experienced in recent years, and those times were bad enough with two major boom/bust cycles. The Fed appears to me to really be on a knife's edge here. At no time in the recent decades were they starting a tightening cycle with inflation already at 5% to 6%. This ups the pressure on them tremendously. It's been a long time since they have had to handle a hot economy. It's very different from the recent cycles. If they move too slowly in their desire to keep the economy and employment rising, they run the risk of inflation continuing to run ahead of them. If they move much faster and more aggressively, they run the risk of the economy hitting a wall out there, and moving into a recession, perhaps a very substantial recession. Along with that, we would expect a very significant drop in the market. Rates that are too high for people to buy houses and cars, etc., can slow things down very fast. In one sense, these are the usual risks they always face, but as I stated, I think these elements are greatly magnified in our current situation.

I do also see some positives that could help the Fed to be successful. One of the big ones is they are considering a very different strategy for their large balance sheet of US Government securities. They are studying and debating the possibility of unwinding a lot of that paper on a much faster timetable than after the Great Recession. I'm not a Ph.D. economist, so I will not claim to fully understand why this is desirable. From what I've read, apparently this will allow them better control over the yield curve, and possibly help them achieve their goals without raising rates quite as high. Also, while I think inflation could run as high as 4% - 4.5% in 2022, we may do better than that. Most economists are convinced that the supply chain bottlenecks have been a significant cause of our current inflation. They are likely right, but you certainly have to include trillions of dollars of relief/stimulus money flowing into the economy. However, the bottlenecks and supply situation are slowly improving, and I think if that continues, we may have better inflation numbers in the second half of the year. That would clearly help take some of the pressure off.

To summarize, there's going to be a lot more concern about how the tighter monetary policy is going to work out. How much headwind the market faces from the rising rates will depend on how fast the Fed moves. Obviously, the faster they raise rates, the stronger the headwind. I think it's very unlikely that we will have returns near as high as the last three years. We could just as easily end up with a flat or down year in 2022. We had three flat or down years in recent times: 2011, 2015, and 2018. It's a normal part of investing that we have to accept to be successful. Only time will tell how this plays out. On balance, it's a good thing that the Fed is moving to confront the high inflation. We look forward to working with you this year and appreciate the trust you have placed in us.

Best Regards,

David E. Keim

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