

The Advisor

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Market Update -First Quarter, 2022

INFLATION AND THE FED. We could end this quarter's newsletter right there and you would have the market's conundrum pegged to bullseye. However, for the inquiring minds, we will go deeper and hopefully provide some insight to help you understand what is going on in the markets.

The market is repricing risk – both equity and fixed income alike. The reason is inflation (January's headline CPI report at 7% was the highest in 40 years) and the Fed's pivot to tighter monetary policy. Inflation erodes the value of assets and even more so for longer dated assets. The Fed controls the fed funds rate which sets the tone for much of the interest rate environment. One of the Fed's mandates is to promote stable pricing so with inflation running this hot they have communicated their plans to raise rates and end their bond buying program (quantitative easing, QE) in the effort to cool pricing pressures.

For both equity and fixed income markets, digesting the environment we just described can be painful. Stocks in cyclical sectors such as financials, industrials and materials do well because their cash flows and earnings are geared to the present while stocks of companies forecasted to generate the bulk of their earnings further out into the future (think growth, tech or anything with uncertainty) are sold. Again, this happens because higher rates and inflation erode the value of future cash flows so these assets get a discounted valuation, or repriced downward. We said that nicely, in truth, the market has pummeled these stocks. According to Bloomberg, the Nasdaq composite is nearing a record for the number of stocks trading down 50% or more from their one-year highs.

So, what causes inflation? Getting to the root of this question is quite complex but we can turn to economist Milton Friedman who famously said, "inflation is always and everywhere a monetary phenomenon in the sense it is and can be produced only by a more rapid increase in the quantity of money than in output." What a great segue back to the Fed. It's not too hard to reason that due to the central bank's policy, namely QE (often referred to as printing money), the Fed is responsible for the rapid increase in the quantity of money and by extension this inflationary environment. Spoiler alert, the Fed does not print money through quantitative easing (QE). Let's keep going because what comes next is very important to not only understanding the dynamics of what is actually taking place but, as we said above, the conundrum facing this market and the Fed.

The U.S. Treasury auctions off bonds of various maturities. Primary Dealers such as banks (not the Fed) buy these bonds. After the auctions, the U.S. Treasury has cash from the bond sales to fund government operations and the banks have safe, liquid assets in the form of treasuries on their balance sheet. The Fed now gets involved by purchasing the bonds from the dealer banks. The result is balance sheet expansion whereby the Fed puts the treasuries (assets) on its balance sheet and must create a bank reserve (liability) for the transaction. It can appear as though money is being created but it's not, it amounts to an asset swap, an accounting function, no money was put into the real economy. The banks simply swapped out their treasuries for reserves at the Fed.

You may be asking why this theatre? The belief in QE is if bank reserves increase it will encourage banks to put that money to work by lending it out which, by the way, is how money is created and put into the real economy. The challenge is banks are not lending all that much; instead, they are keeping high levels of reserves as well as buying more treasuries to replace the ones they are selling to the Fed. The takeaway for our purposes is QE and a low fed funds rate is an attempt to influence monetary demand; the Fed does not print money into the real economy.

Ok, so now we know the quantity of money has not rapidly increased from the Fed's QE, so where else could it have come from because the inflation pressures are real, there is no denying that and it is

pushing the Fed to act. The answer is found in government fiscal policy – basically, the direct transfer payments to households through stimulus checks, increased unemployment and childcare benefits and many of the Covid loan programs. We are not making a political or value statement about these programs. We are merely distinguishing that the Fed's QE, alone, does not put money into the real economy; however, fiscal policy in the form of direct payments and forgivable loans do.

The other side to this inflation puzzle is output, or supply. The world shut down and supply chains went offline or disappeared altogether. The pandemic changed the way we live, behave and consume and the resulting byproduct is a historic supply and demand problem. The question then becomes, is this structural in the sense a new inflationary regime is in place for the foreseeable future; a persistent increase in the quantity of money versus output? In our opinion, the answer is no. Are we alone in this perspective? Not if you ask the bond market; it is priced through supply and demand (buyers and sellers, not the Fed controlling rates) and it is sending a very different message about future inflation and growth prospects. In fact, as of January 14th, the 5-year / 5-year forward rate (a reflection of inflation expectations on average over a 5-year period starting 5-years from today) was at 2.09%.

Remember earlier we said inflation erodes future value and especially true for longer dated assets. This principle applies to fixed income markets as well. In practice then, you would expect the longer parts of the yield curve (10 & 30-yr bonds) to selloff, pushing yields extremely higher. In reality, there's not much selling. Sure, there's been some upward yield movement recently but make no mistake about it, coming off the highest CPI number in decades, the long end of the yield curve remains very suspicious about the inflation narrative. This means investors, for the time being, are relatively satisfied holding these assets which does not reconcile with the premise that inflation will continue at high levels.

Let's tie all of this together. The world shut down due to a pandemic. Government fiscal policy provided direct payments to households and businesses and the Fed's monetary policy provided a backstop to the economy to stave off a depression. As a result, supply and demand were materially altered and even disappeared. The world starts to reopen and inflationary pressures begin to mount culminating in 2021 at the highest levels in 40 years. Now the Fed is compelled to reverse course and tighten monetary policy in accordance with its mandate to keep inflation under control; but, as we've discussed, they cannot control the supply side, they can only hope to influence the demand side.

If you are thinking this entire set-up is nearly impossible for markets to accurately price, in our opinion, you are correct. The reality is a market willing to hide out in a few sectors and mega-cap titans for safety while throwing the rest out with the bathwater. Covid created too much noise, too much confliction around what is changing and what is not changing in the new world order. It will take patience, some course correction and discipline to navigate these post-Covid waters. Our focus is to continue diversifying across sectors while zeroing in on the companies that continue to be at the center of innovation and the changes taking place in our world. Keeping a long-term perspective is not always easy but it is a must for successful long-term investors.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters. To our other readers, if you would like a second perspective on your investment accounts, please feel free to contact us.

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