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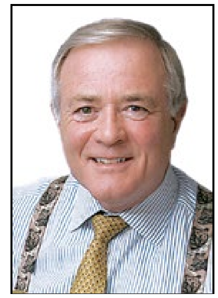
William Rutherford

OP-ED: Will the Federal Reserve save or strangle this market?

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Bull markets don't die of old age. According to an oft used axiom, "they are murdered by the Fed." The Federal Reserve has to get its policy just right in order to avoid killing the market. The problem is that getting it just right – like for Goldilocks, "not too hot, not too cold" – is akin to a fairy tale.

Coming to the end of a long-term bull market the Fed faces many challenges in carrying out its dual mandate of full employment and inflation control. Fed Chair Jerome Powell addressed this in his recent report on the vote by the Federal Open Market Committee (FOMC) to increase interest rates by 50 basis points, saying the Fed governors will continue to evaluate employment and inflation data before they commit to the timing and amounts of future raises.

Currently, inflation is running much higher than the Fed target rate of about 2 percent, yet its tools for fighting inflation are limited. With inflation running hot, the Fed has opted for a moderately aggressive interest rate policy, with more rate increases forecast. Such actions are challenging to the market and threaten economic growth. Without the rate increases, however, inflation will go unchecked.

Inflation can be a serious threat to the economy and economic growth, as history has shown. Runaway inflation, such as seen by Germany in the late 1920s and early 30s, can have serious social and political dislocation effects in a country. Revolutions have been fought over the price of bread. The resulting political instability has allowed demagogues to come to power.

Government spending is a strong contributor to inflation. The only thing the Fed can do about government spending is jawbone, which is not very effective. The government's legislative branch, on the other hand, has a strong incentive to spend on things such as defense, health care, infrastructure, social welfare, education and many other programs that tug at the purse strings. Getting reelected is the first duty of every elected official. Presidents also have a strong incentive to appease their constituents. Deficit spending is often the result and is inflationary.

But the piper must be paid. The Fed is left to tame inflation by tapping on the economic brakes. This balancing act has the effect of slowing the economy. It could lead to stagflation: economic sluggishness while inflation runs hot.

Adding to the burdens of the Fed is the virus, which has been very damaging to the economy, so rates cannot be raised too much. Although the virus seems to be abating, it has an ugly habit of bouncing back. Currently, its rapid-fire spread in China has shut down production of important components and goods in almost all sectors. Related logistical disruptions contribute to inflation and slow world economies, with reports of widespread shortages. When the availability of goods and services suffers, inflation will follow.

With the Fed facing a full plate of problems, Vladimir Putin senses an opening for his plans for Russia. He wants a greater Russia restored to its former glory. With western nations led by weak leaders, Putin sees a moment in history and starts a war of aggrandizement.

This war further complicates the Fed's challenges. Who can win such a war? In a war, each side believes it can win, or that it must win, so the sides keep on fighting to the last man. What Putin thought was going to be a blitzkrieg (lightning war) has turned out to be a slow slog (war of attrition).

The U.S. is in a better position to win a war of attrition, if it retains the political will to fight. The Ukrainians have shown such determination. Russia, inspired by its victory in WWII (largely thanks to intervention on its behalf by the U.S., though that is probably not taught in Russian history books), also expects to win. The cost to the world and the world economy is enormous and will be of long duration.

What does this mean for the U.S. economy? It almost certainly means more inflation – and therefore more efforts to fight inflation, which means higher interest rates to slow the economy.

It could mean reduced government spending, although that is doubtful because spending cuts are not conducive to incumbent politicians getting reelected, which, remember, is their number one job.

Does it mean a recession? The economy will probably slow, but not tumble into depression. Government spending will remain strong. Interest and money supply policy, in the form of asset purchases and future rate reductions, could still be supportive, as the Fed has bought back some dry powder with recent interest rate increases and tapering of bond purchases.

The jobs market remains strong, with unemployment near a 50-year low of 3.6 percent. Consumer spending remains strong, growing at a 3.7 percent rate, after adjusting for inflation. We should get through this challenge if the Fed does not overplay its hand.

As painful as it seems, this is still a good time to be invested with a long-term outlook. With mortgage rates still at historic lows, it remains a good time to borrow and invest in hard assets that will increase in value during inflationary times – for instance, homes in the right locations. Recognize that loans for such assets will be repaid in future inflated dollars.

I also favor U.S. growth equities, although admittedly these have been beaten up of late. I believe that looking back one to five years from now, this will be seen as a good time to buy. The time to buy is when others are selling.

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