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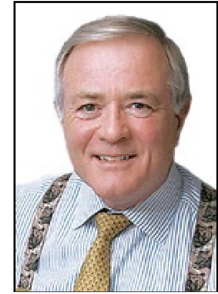
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OP-ED: Where do we go from here?

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Where have we been and where do we go from here?

Where is here and how did we get there?

There is a toxic brew of rising inflation and a slowing economy. It could be called stagflation.

The U.S. economy, guided by Federal Reserve policies, has lurched from one side of the boat to the other. It appears as though the Fed is unable to chart a straight line of growth, so when encouragement is needed, it does too much, and when a slowdown is needed, it also does too much.

The financial crisis of 2007 to 2009 was caused when the Fed, following an easy money policy, overheated the economy. Then, as a result of too much stimulus, inflation predictably followed. A reasonable dose of inflation is OK; the Fed itself has set a target rate of about 2 percent per year. But the Fed overshot their target by a wide margin and inflation slipped the bounds of the Fed and ran wild. We are in a similar, although not yet as extreme, situation today.

Then and now, easy money policy resulted from a desire to have a robust economy. Back then the housing market was stimulated by ultra-loose mortgage lending standards under Fed chairman Alan Greenspan. Variable mortgage rates promised cheap interest rates. Recently the approach was to bring interest rates to near zero, with mortgage rates reaching historic lows. Perhaps, in the background, there was a desire for low interest rates to make the increase in the national debt from the massive fiscal stimulus of the COVID lockdown easier to service.

Whatever the reason the result was cheap money and runaway inflation.

The Russian invasion of Ukraine has exacerbated inflation with logistical bottlenecks caused by the war interrupting supplies and raising the price of oil and food dramatically.

Faced with the recent rise in inflation, the Fed has charted a policy of very high interest rates in an effort to curtail demand and, therefore, economic activity. A recession or even worse could result from these policies. The question is: does the Fed have control of the economy? At the moment, it appears that they do not. The last time something like this was attempted was by Paul Volker, then Fed chairman. Mr. Volker saw runaway inflation and set out to break inflation by raising interest rates. Interest rates rose to a very high number and inflation was halted, but at a terrific cost to the economy. However, as inflation was curbed, the market bottomed and fully recovered its prior peak in just 83 days.

Now, once again faced with inflation, the Fed wants to seriously tighten the money supply and seriously raise interest rates to slow the economy. The result, so far, has been the worst start to a year for the equity market since 1970. Not just equities, but virtually all asset classes have suffered.

The Nasdaq composite is down about 30 percent in the first six months of this year. Individual stocks are worse, in some cases breathtakingly so. Is there any good news here? It would be accurate to say, there is none. Well, the price earnings ratio of S&P stocks is about 15.4 percent, just a bit below its 15-year average of 15.7 percent, so stocks are cheap right? Could they get cheaper? According to Fact Check, analysts expect that S&P companies will have double-digit earnings growth in the third and fourth quarters of 2022. But other investors are wary, saying that the Fed may have to act even more aggressively if inflation remains high.

Stocks are cheaper than they were, but they may not be cheap.

The Fed says their business is not done, and we can expect more of the same until inflation buckles. Does the economy have to buckle too? Federal Reserve Chairman Powell suggests that he is prepared to see the economy suffer in order to contain inflation. What does that mean for the economy, the markets and households?

Already, models such as the Fed's Atlanta forecasting model, are pointing to no year-to-year increase in U.S. Gross Domestic Product. Other indicators also suggest difficult times ahead. Since the markets are based on the profitability of companies comprising the markets, an investor can infer that the markets will be under pressure. If the economy suffers another flat or negative growth quarter, we would meet the definition of a recession: two quarters in a row of negative growth. Not until inflation slows and the markets suffer, can we expect any relief from inflation. So, both investors and households will have to tighten their belts. Unless of course the Fed changes course and begins to loosen the money supply, or inflation appears to be losing its grip. Then, depending on how much damage has been done to the economy, one can expect that the economy and markets will resume their upward trajectory.

While markets are down, they have yet to show the panic selling that usually accompanies the end of a bear market. If history repeats itself, we have further down to go.

In the meantime, the wise move is to stay the course, invested in a diversified portfolio of companies with earnings. As one sage investor once said: you make your money in bear markets, you just don't know it at the time.

Expect a volatile market on the way, but stay the course.

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