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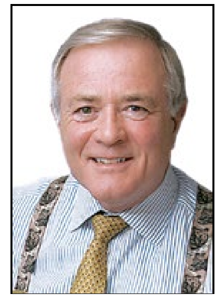
William Rutherford

OP-ED: Policy mistakes past and future? Fed on dangerous ground

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The eyes of the market are fixed on the Federal Reserve as it tries to corral inflation. When inflation first appeared in the fall of 2021, Fed Chairman Jerome Powell said it was transitory, even when consumers dealing with the ubiquitous rising prices of necessities knew better. Now he thinks it is a pervasive evil. If he was wrong before, can it be that he is wrong again? Powell is now firmly lodged in the higher and longer camp of interest rates. He does not want to repeat previous mistakes of Fed chairs easing off too soon and thereby letting the hyperinflation bubble out of the bottle.

Powell is shooting for an inflation rate of about 2 percent, but is that realistically achievable? To do so, he must slow the economy considerably. Hence, he must set a target for interest rates not only higher, but also for a longer duration. In doing so, he risks a hard landing for the economy – even a painful recession.

In the last month of 2022, nonfarm payrolls increased by 223,000 – 11.5 percent above the Dow Jones estimate of 200,000. The unemployment rate fell to 3.5 percent – a decline of two-tenths of a percentage point, but also better than the estimate. The labor participation rate remained static at 62.3 percent, yet far below its 70-year peak of 67.3 percent in 2020. Wage growth was below expectations, with average hourly earnings up 4.6 percent from a year ago but below the 5 percent estimate. Nevertheless, it's a far cry from the 2 percent inflation target. Leisure and hospitality led job gains, followed by health care, construction and social assistance. Is this economic growth good news?

The relative strength in job growth comes despite repeated efforts by the Fed to slow the economy and the labor market in particular. Despite the dramatically higher cost of borrowing and the wealth-dampening effect from the steep decline in investment portfolio values, the consumer so far continues to spend and therefore drive inflation. Spending on home purchases and improvements has been replaced with leisure travel, as consumers make up for the lost COVID years. So, is the good news really good news? The Fed would like it better if the news was not so good.

The stock market collapsed in 2022 under the weight of the largest interest rate hikes in years. The central bank raised its benchmark interest rate seven times in 2022 for a total of 4.25

percentage points to reach its highest level in 15 years. The 2022 rate hike cycle was the fastest – nearly twice as fast as the one in 1988-89. The consequence was the S&P experiencing its worst calendar year performance since 2008, with the first half of 2022 achieving the worst decline in 50 years.

The stock market continues to struggle to adjust to the higher rate scenario. Each time an event occurs that indicates lower inflation, the market surges. Similarly, if the indication is for higher inflation, and therefore higher interest rates, the market stumbles. The market has evolved into a binary code of good news is bad news, and bad news is good news.

As we approached the end of 2022, investors were looking for a Santa Claus rally. While a tepid rally did appear, it was not robust and thus did not cause the Fed to tighten at the 75 basis point rate it had been doing since June, which was a relief to the market. The new year began with reports of a slowing labor market, a pickup in the labor participation rate and slow wage raises – all bad for the economy but good for the market.

With all these stock market gyrations, investors are spooked. I have warned in this column before about a policy mistake. If we can experience a mistake going in one direction, can we suffer a mistake going in another direction? Can the Fed tighten too much. Can it cause a recession. Of course, another mistake is possible, and the Fed's record is not so good. So, investors fret.

Currently the market seems to be absorbing the Fed policy of proceeding with rate increases. Worldwide inflation seems to be moderating somewhat. Supply-chain bottlenecks are easing. But the global economy faces several headwinds. The war in Ukraine remains a large threat to a global economy facing food shortages and energy dislocations. China's struggle to stop the spread of the virus impacts global supply chains and consumer demand from the world's largest economy. And so it goes. The market staggers on.

Because of the fluctuations in the economic reports, the market has had trouble adjusting. Investors cannot find stability anywhere. A coherent investment philosophy is out the window. What is an investor to do? Simply bail out? The correct thing to do is to focus on the long term and stay invested. If the past is prologue, in years to come this time will be seen as one of the best times to invest. Time is on the long-term investor's side. The market is up in many more years than it is down. It is difficult to stay the course, but it is the right thing to do.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.