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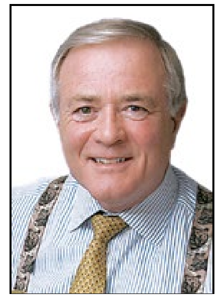
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Bull markets don't die of old age; they are murdered by the Fed

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We have been in a long-term bull market, but now we seem to be coming to the end. An old adage is that bull markets don't die of old age but are murdered by the Federal Reserve. Is that what is happening now?

Looking back, we see the market recovering from deep recessions in the early and later 2000s. When the market was in a deep trough, the Fed worked hard to lift it out of recession. The Fed proclaimed "quantitative easing" as the solution: lowering interest rates, including its lending rates to banks, and flooding the markets with cheap money by buying U.S Treasurys. The Fed forced money into the economy to lift it, while driving the cost of money unsustainably low. Modern monetary theory it was called. Congress added to the huge growth in money supply by creating ever-increasing deficits, funded by borrowing by the U.S. Treasury. The Federal Reserve bought this debt as did China and other countries with massive trade surpluses, such as oil-producing nations.

When the pandemic came, there was even more pressure to have deficit spending.

The budget deficit reached almost $1 trillion in 2019. That was nearly 4.6 percent of GDP, while the historical average was 3 percent. By FY 2020, the deficit was $3.1 trillion and by FY 2021 it was $2.8 trillion (14.7 percent and 11.8 percent of GDP, respectively). In 2022 it was 5.3 percent. As of August 2023, these deficits have accumulated to total about $33 trillion in national debt, which is increasingly being funded at current interest rates, thereby adding to its level. Ten-year Treasurys were yielding less than 2 percent pre-pandemic and fell to half a percent in the depths of the crisis. Currently, the U.S. Treasury must sell a 10-year treasury bond at 4.59 percent.

Increased money supply at minimal cost and massive deficit spending caused inflation to surge. The Fed had to throw the system into reverse. Congress did not and kept on spending. The result is that the market has been flooded with the sale of U.S. Treasurys to fund government spending, but central banks, both the U.S. Federal Reserve and foreign central banks, the buyers of last resort, are disappearing from the market. Janet Yellen, Secretary of the Treasury and former Fed chair, is facing a lack of customers and ever-increasing amounts of debt to be funded.

The Fed persists in its interest rate mantra of higher for longer, and segments of the economy are slowing, notably real estate. Fed Chairman Jerome Powell reiterated his goal of 2 percent inflation, which still seems unattainable, especially given the continuing low unemployment numbers and sizable consumer savings remaining from the pandemic.

Worries emerged that we could see double-digit deficits because revenues collapse in a down economy. So as investors waited for the Fed to break something, investors began to wonder if they had already broken the Treasury market, but no one noticed. Economist Peter Boockvar wrote “things don’t really break here in terms of the U.S. being treated like an emerging market until the dollar breaks. When you see rates rising in addition to the dollar falling, that’s when you’re in real trouble. … Perhaps we will find some very messy way to muddle through (in the meantime). Or maybe we won’t. Last week’s imbroglio with the budget does not augur well.”

September was its usual bad month for the markets. Following data showing the inflation rate rose in August, the Dow Jones Industrial Average fell nearly 0.5 percent, or about 158 points, in the final session of a losing week, month, and quarter for the index.

The Dow ended September lower by 3.5 percent and closed the third quarter down about 2.6 percent. The S&P 500 and NASDAQ continued to perform better. At quarter end, the NASDAQ 100 was up 41 percent from its 52-week lows and the S&P 500 registered a 13.1 percent YTD return. The reason for the delta is the “Magnificent Seven” – the mega-cap tech companies, which have a 43 percent and 27 percent weighting in the NASDAQ 100 and S&P indices. Those seven are Apple, Microsoft, Amazon, Google, Nvidia, Tesla and Meta.

October started on a down note after the House speaker was ousted with the Dow down 1.3 percent, the S&P down 1.4 percent, and the NASDAQ down 1.9 percent.

What should an investor do in this environment? Cash in money market funds looks attractive with yields around 5 percent. Bonds seem to offer a mix of income and defensive qualities, but not protection from inflation. Inflation must be factored into returns, as cash and bonds decline in value because of inflation. So, with cash yielding 5 percent and core inflation still at 4.3 percent, holding cash is just treading water. Equities have historically been the best performers over time, but with more volatility and risk. Our strategy continues to be a diversified equity portfolio, with diversification by sector and company mitigating risk, yet maintaining opportunity for growth. As always, check with your financial advisor before investing.

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