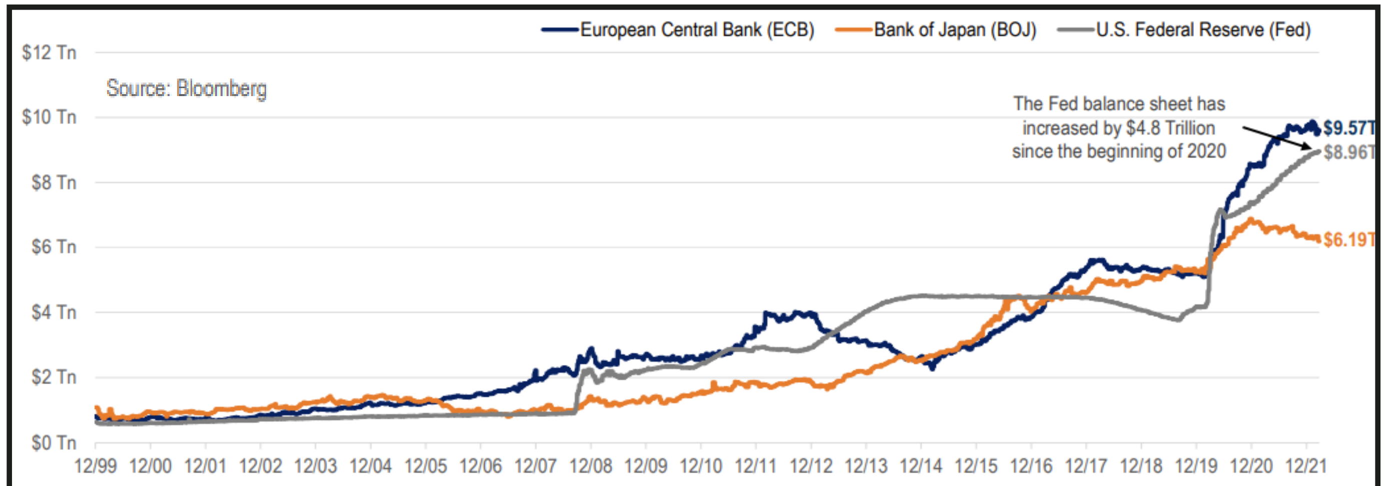
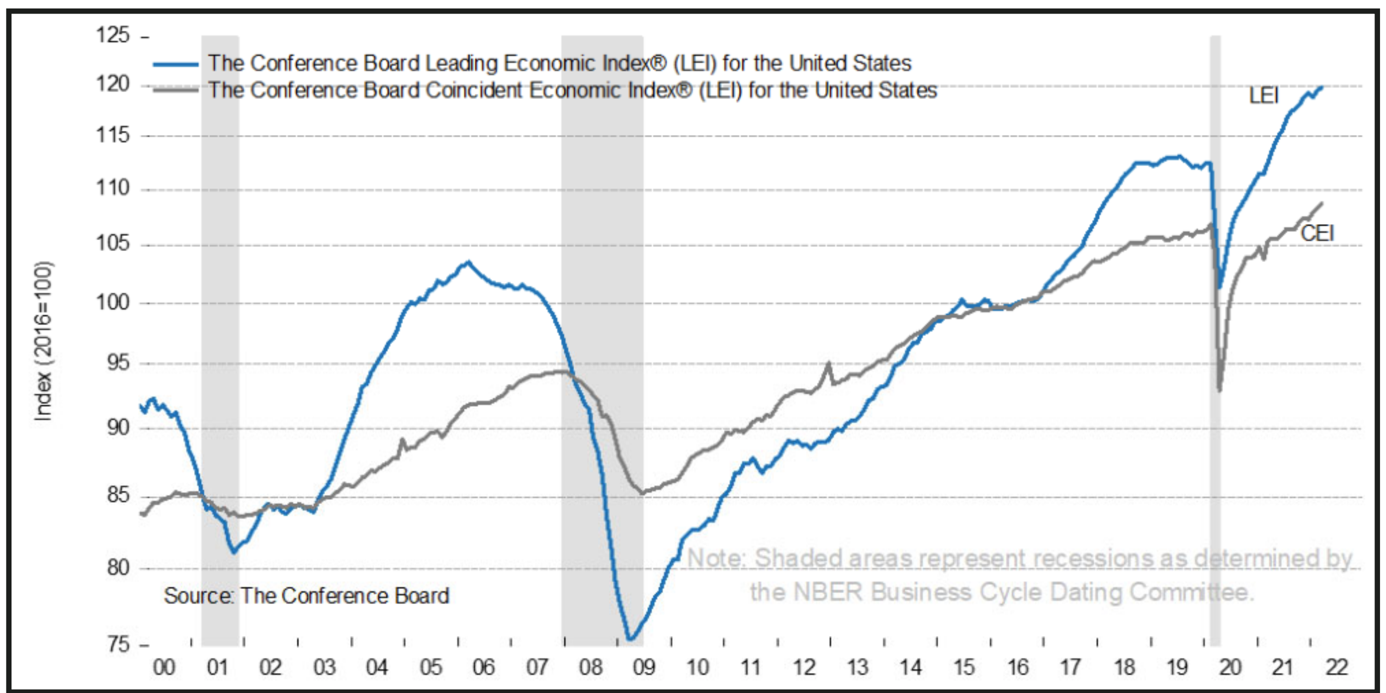
ECONOMY "TO FLOURISH" IN FACE OF RISING RATES

As it did in response to the financial collapse of 2008/9, central bankers in the developed world slashed interest rates and inflated the global money supply in an effort to preemptively mitigate pandemic-related, economic damage. As you can see in the following image, the world's stock of money has exploded since the onset of the pandemic in 2020. As mentioned in my previous note, this is the DNA of inflation.

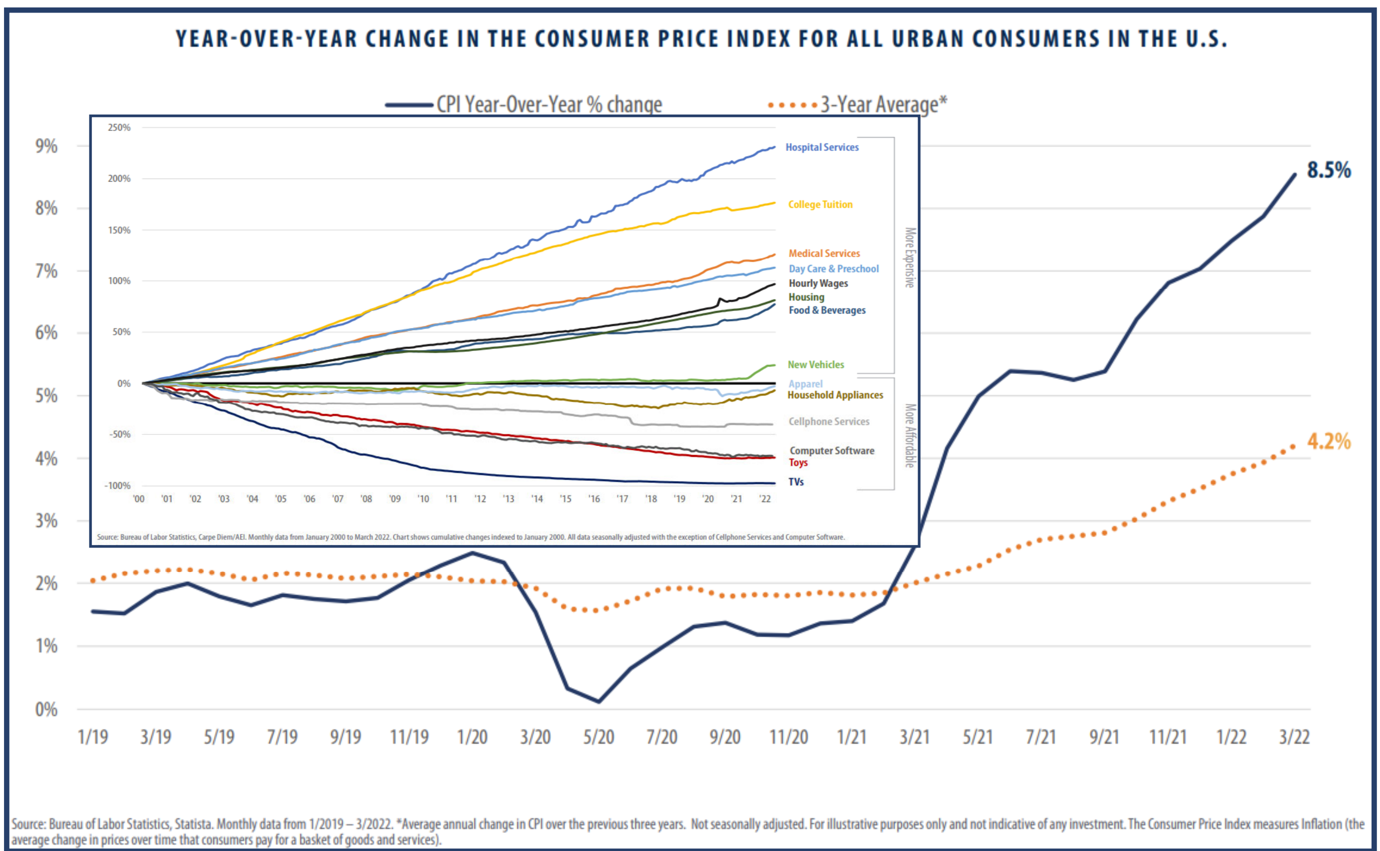


The stimulation effort worked, as shown by the Conference Boards' Leading Economic Index® reaching an all-time high this March. The U.S. will certainly experience another recession at some point, but this particular tea leaf shows no hint of it.



THE QUOTE AT THE TOP OF THE FIRST PAGE BELONGS TO …

… Fed Chairman, Jerome Powell. Now that the Fed's pandemic-thwarting initiative is complete, the Fed is now focused on taming inflation before its suddenly elevated existence becomes too entrenched or otherwise normalized in the functioning of our economy. As shown in the main image below, the year-over-year run rate of inflation reached 8.5% in March, its highest reading since 1981 and far higher than the Fed's usual, 2% target. In case you have an interest, I've embedded a second image that disaggregates inflation into its component pieces. If it's too small to read, the lines might be used to screen for Macular Degeneration (test one eye at a time).



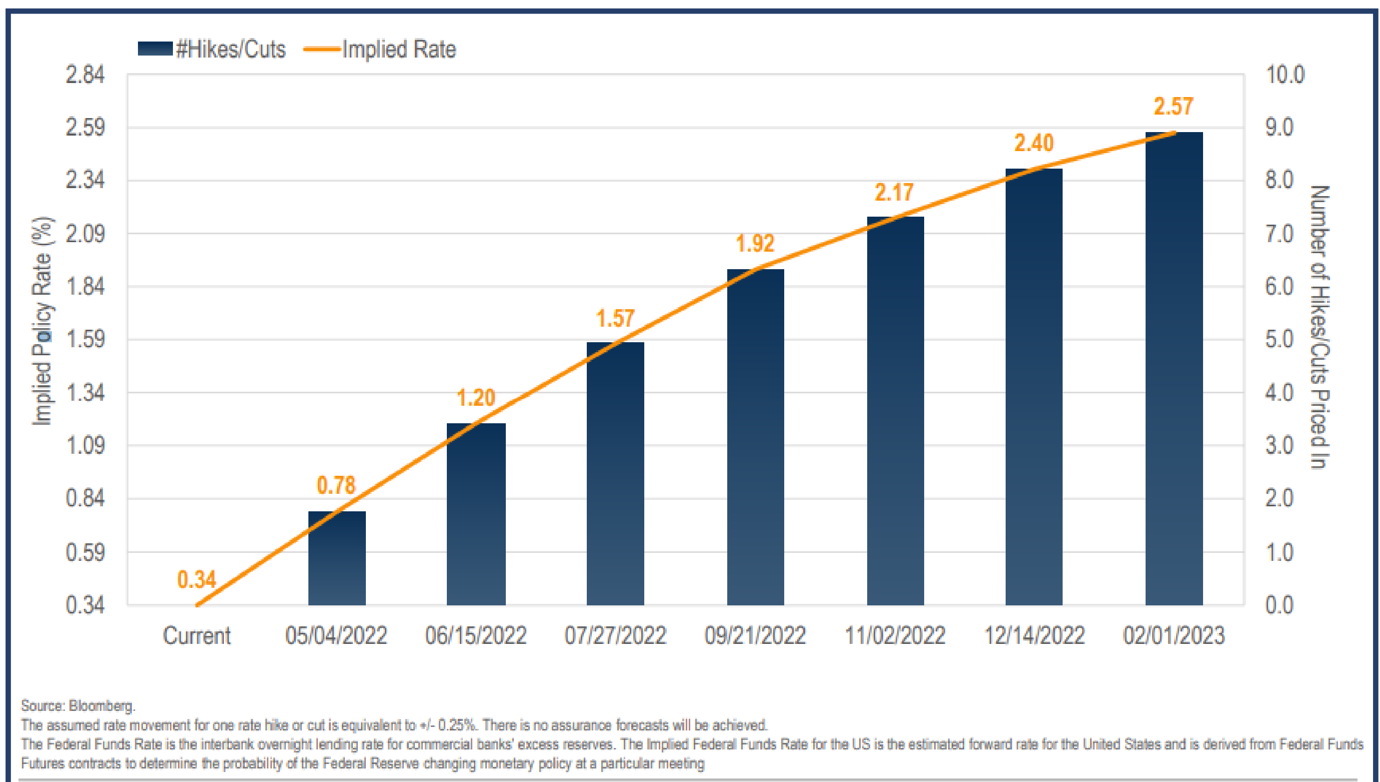
Source: Bureau of Labor Statistics, Statista. Monthly data from 1/2019 – 3/2022. *Average annual change in CPI over the previous three years. Not seasonally adjusted. For illustrative purposes only and not indicative of any investment. The Consumer Price Index measures Inflation (the average change in prices over time that consumers pay for a basket of goods and services).

Like lighter fluid that has puddled around a bonfire that no longer needs rescuing, the stimulus that is no longer needed must now be vacuumed away before it further exacerbates inflation. Otherwise, we'll end up with the economic equivalent of a flash fire. Jerome Powell's Federal Reserve is at the beginning stage of removing some of that excess by raising interest rates and by reducing the size of the Fed's balance sheet. This has investors on edge but if history is a guide, the climate to own stocks may remain hospitable.

INVESTORS' PRIMARY WORRY … THE IMPACT OF RATE HIKES

By looking at the pricing of interest-rate-related contracts that trade in the futures market, it is possible to draw an inference about expectations of interest rates in the future. The image below captures some of that inferential reasoning as it pertains to the Federal Funds overnight rate, which is the rate at which banks borrow and lend funds among themselves for a day at a time. The rates of many other loans and financial instruments are tied to, or at least influenced by this key benchmark, so the fact that this rate is set to rise has investors' attention.

To help you interpret this graph, the rate on overnight loans between banks averaged .34% on an annualized basis at the end of March. Data from Federal Funds futures contracts suggests this rate might be around 2.4% by this December and be around 2.57% by next February. Since the Fed has typically raised rates in quarter-point increments, those implied rates of 2.4% and 2.57% suggest about eight or nine quarter-point rate hikes between now and then.



Source: Bloomberg.
The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.
The Federal Funds Rate is the interbank overnight lending rate for commercial banks' excess reserves. The Implied Federal Funds Rate for the US is the estimated forward rate for the United States and is derived from Federal Funds Futures contracts to determine the probability of the Federal Reserve changing monetary policy at a particular meeting

None of this represents an eventuality, but this data does provide a meaningful signal since futures contracts are equivalent to votes cast with money on the line.

PUTTING THOSE RATE HIKES IN PERSPECTIVE

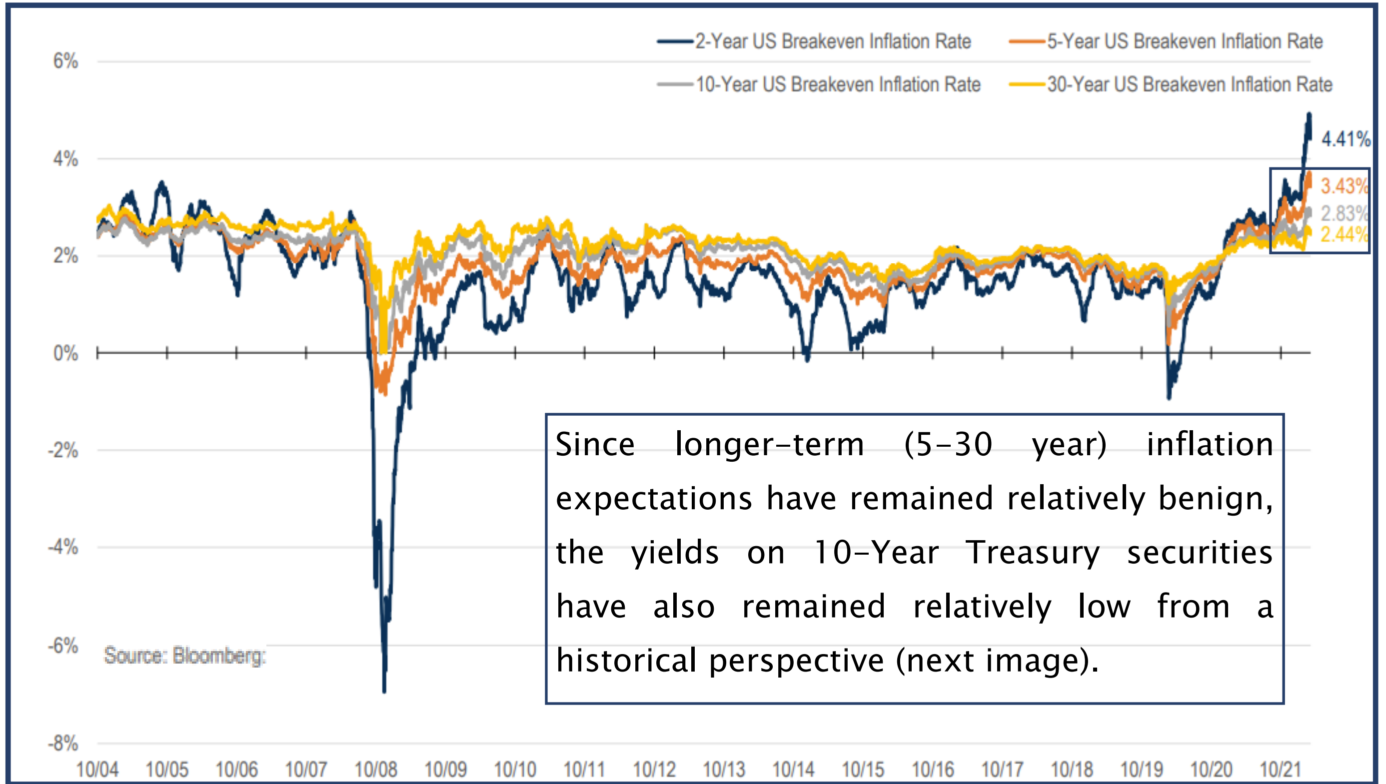
You can't tell by looking at this next graph, but the annual effective rate for Federal Funds overnight rate approximated only .2% per year (arrow) as of the beginning of April. If this overnight rate were to rise to the vicinity of 2.5% as implied by futures activity in the previous image, the benchmark Federal Funds overnight rate would still be quite low by historical standards and Fed policy would still be considered to be quite "accommodative" relative to prospects for economic growth.

LONGER-TERM INTEREST RATES DEPEND UPON INFLATION

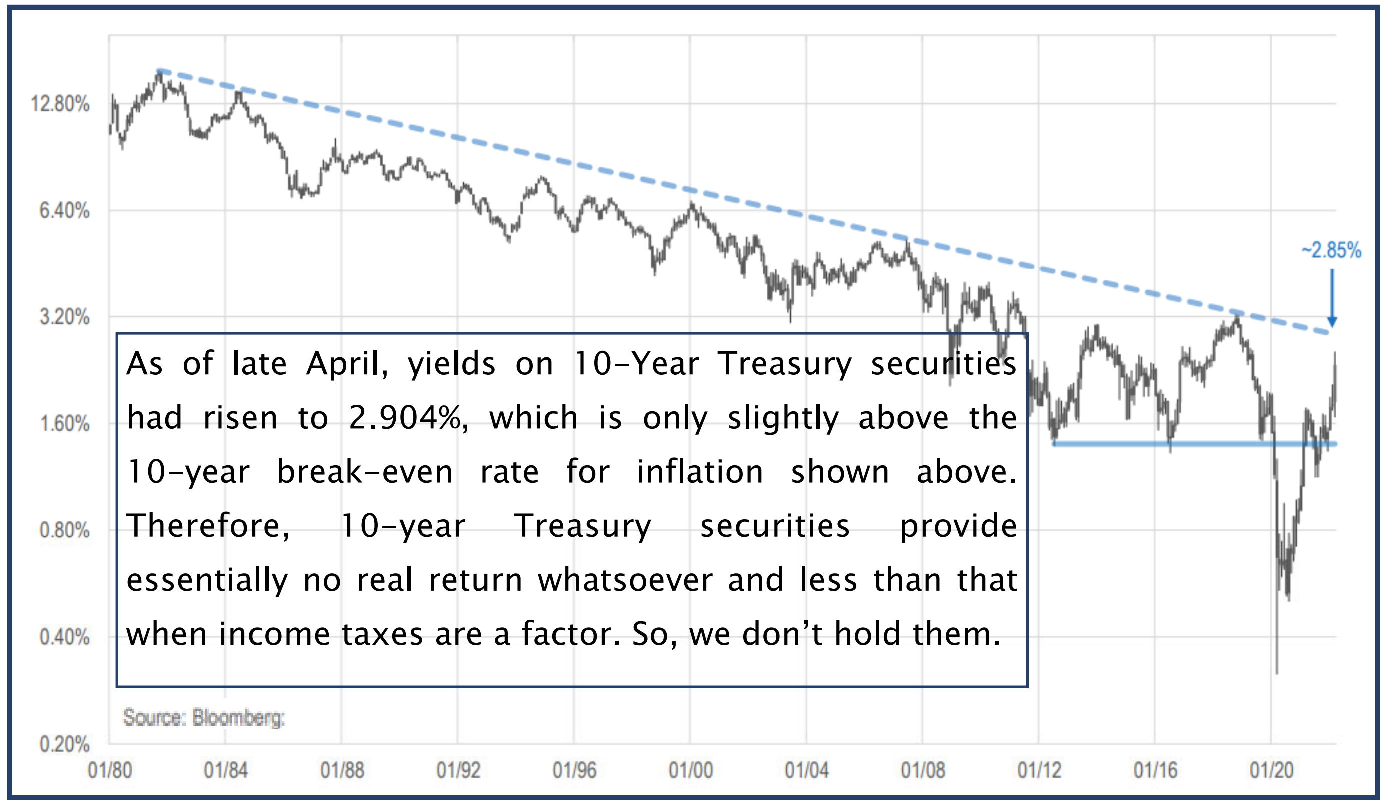
Longer term rates depend, in part, upon expectations for inflation. Similar to how the expectations for future short-term rates can be inferred from futures contract data, expectations about inflation rates over various periods can be derived by comparing the difference in the yield between U.S. Treasury bonds and inflation-protected securities of similar maturity.

As shown in the next image we see that, as of the end of March, the consensus expectation for inflation among investors who have money on the line is for inflation to approximate 4.4% over the next couple of years and to then continue to decline after that. Plenty of prognosticators think otherwise and many think the Federal Reserve has already waited too long to quell the spike in inflation, but at this point hard data suggests that although investors do not expect the Fed to be able to engineer a return to the days of 2% inflation, they do expect inflation to continue to relax as time passes. (Note that the lower inflation rates envisioned for the 5, 10 and 30-year periods *include* the elevated rate of inflation we're currently experiencing.)

INFLATION EXPECTATIONS OVER VARIOUS TIME PERIODS



TREASURY YIELDS REMAIN LOW, DESPITE SPIKE

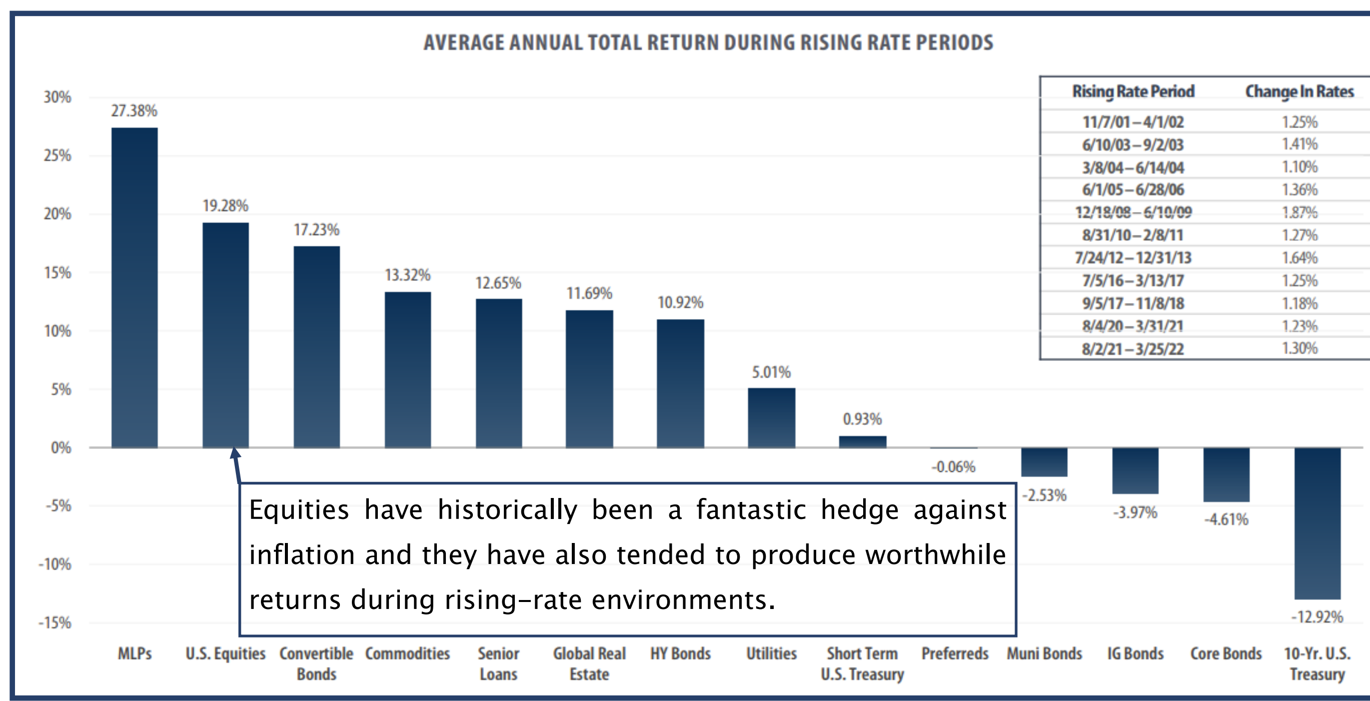


IMPLICATIONS OF RISING RATES BY ASSET CLASS

Rising rates are tough on most types of fixed income securities, especially those bearing longer maturity dates, such as 10-Year Treasury securities which, again, we do not hold, at least not directly. (Nor do we hold shorter-term Treasuries). However, we do hold investment grade ("IG") bonds and municipal ("Muni") bonds to provide portfolio stability, income, liquidity, and to serve as a reserve that could be liquidated to buy equities if other investors sour on them enough.

For the most part, the fixed income portion of portfolios I oversee make good use of high-yield ("HY") bonds and senior loans, which would show up in most any fund whose name includes the term "floating rate." High-yield bonds and floating-rate securities are well suited to rising-rate environments as long as financial stresses don't become severe, which is currently the case. We also make good use of debt securities that are convertible into equity, i.e., "convertible securities," because this asset class has a history of providing investors with an asymmetrical risk/reward experience that has skewed to investors' collective favor.

I used to include master limited partnerships ("MLPs") in the portfolios, but virtually everyone complained about having to wait for the dreaded K-1, so I quit using them. Commodity exposure is one asset class that's lacking in portfolios I oversee, but that's because they tend to be cyclical and because they generate little or no income.



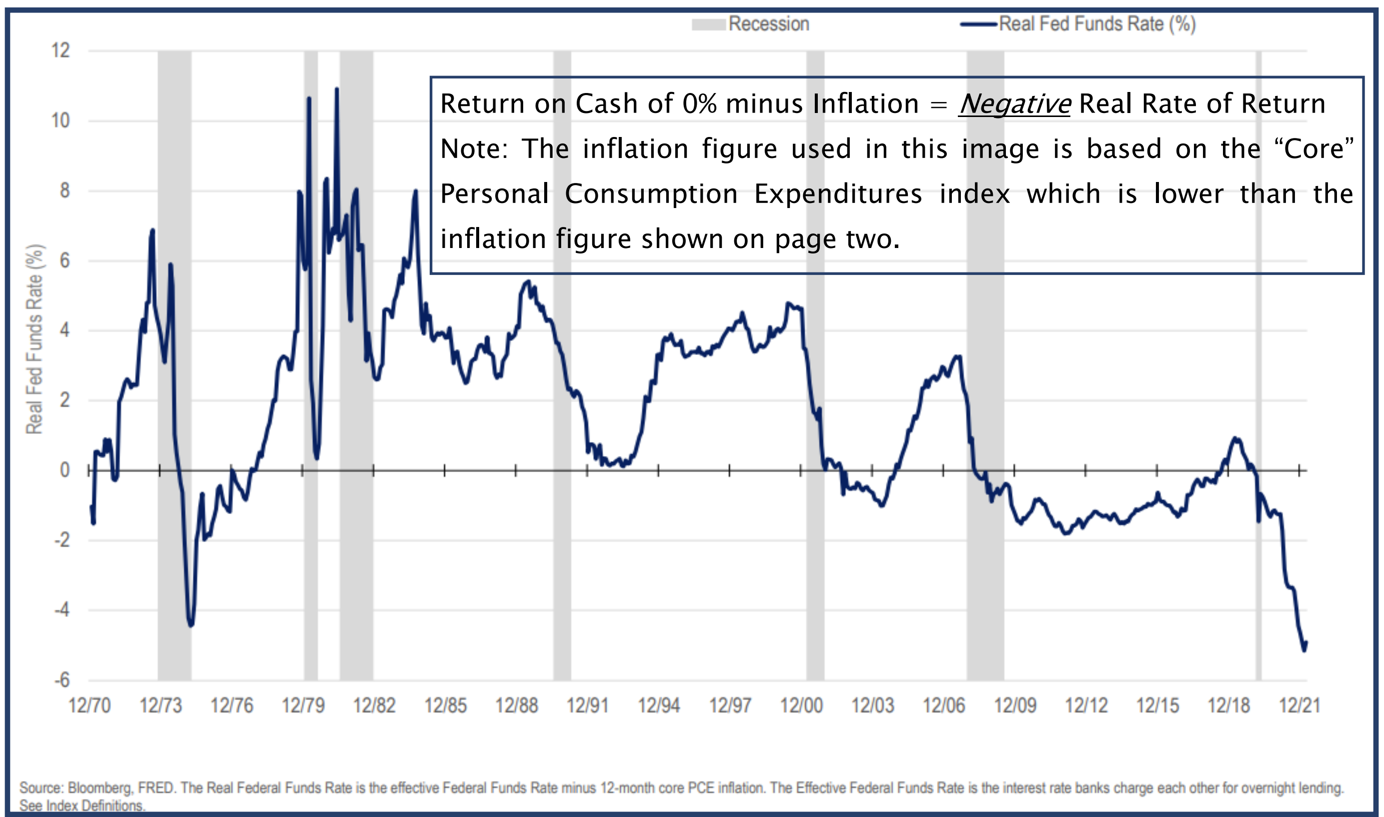
Rising Rate Period	Change In Rates
11/7/01 – 4/1/02	1.25%
6/10/03 – 9/2/03	1.41%
3/8/04 – 6/14/04	1.10%
6/1/05 – 6/28/06	1.36%
12/18/08 – 6/10/09	1.87%
8/31/10 – 2/8/11	1.27%
7/24/12 – 12/31/13	1.64%
7/5/16 – 3/13/17	1.25%
9/5/17 – 11/8/18	1.18%
8/4/20 – 3/31/21	1.23%
8/2/21 – 3/25/22	1.30%

THE COST OF HOLDING CASH

In response to Russia's special operation in Ukraine and other global turmoil, folks sometimes express a preference to hold cash. It makes sense to hold some cash, but if the goal is to ensure that the funds are FDIC insured, please know that the "DIDC" money fund that resides in almost every account I oversee is already FDIC insured to $2.5 million which is 10 times the usual coverage limit. This is so because this fund is structured to spread cash in excess of the usual $250,000 limit across as many as 10, FDIC-insured institutions.

If the goal is to hold cash to avoid sustaining investment portfolio losses, that posture would have made sense during the late 70s and early 80s when short-term interest rates were far higher than the rate of inflation (as a result of a previous Fed effort to wring inflation out of the U.S. economy), but I think better alternatives exist in our current environment where inflation far exceeds short-term interest rates.

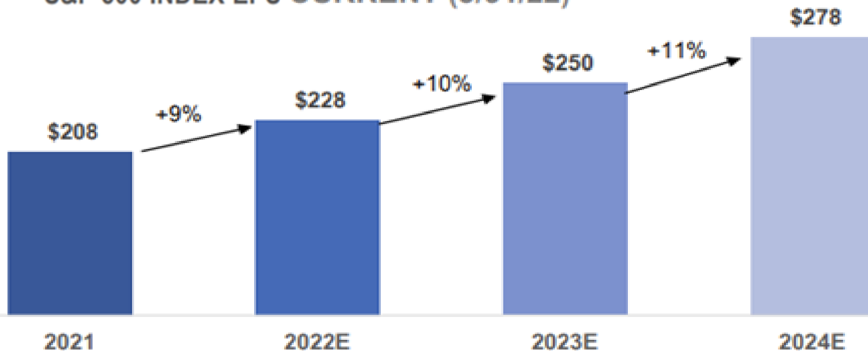
As of the end of March, the "real" (after inflation) return realized by holding federal funds for a year would have been materially negative. Since inflation is a necessary evil in the system we have, it generally makes sense to hold no more cash than needed.

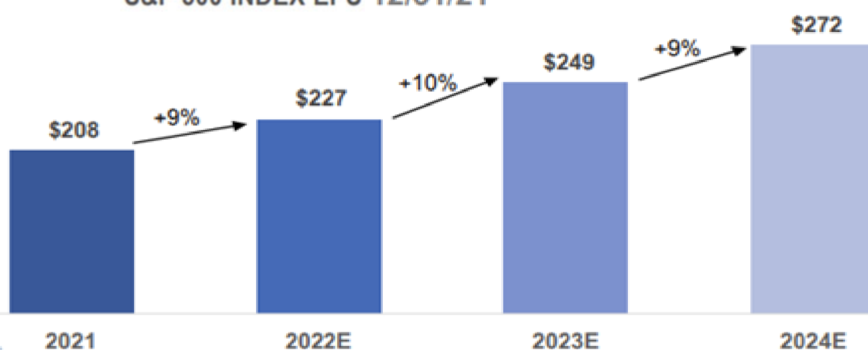


Despite the Fed threatening growth by raising rates and tackling inflation, consensus earnings estimates for the S&P 500 have actually *improved* since the end of 2021 which is always a reassuring sign.

And while war can inflict tremendous human cost, the impact on the capital markets has been decidedly less severe, as shown, below. The bond market will be tough for a while, but the investment climate is still constructive.

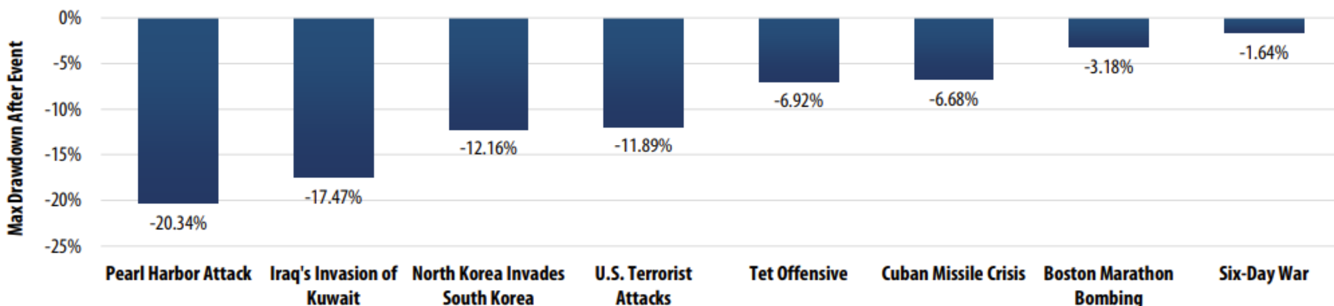
– Glenn Wessel





Source: FactSet. 2022-2024 numbers are consensus estimates.

Geopolitical Shock	Event Date	1-Day Return	1-Year Return	Max Drawdown	Days Until Bottom	Days Until Recovery
Russia Invades Ukraine*	2/24/2022	1.50%	-	-	-	-
Boston Marathon Bombing	4/15/2013	-2.48%	19.49%	-3.18%	4	14
U.S. Terrorist Attacks	9/11/2001	-5.01%	-13.75%	-11.89%	11	30
Iraq's Invasion of Kuwait	8/2/1990	-1.19%	13.66%	-17.47%	71	187
Tet Offensive	1/30/1968	-0.54%	15.43%	-6.92%	36	69
Six-Day War	6/5/1967	-1.64%	19.36%	-1.64%	0	1
Cuban Missile Crisis	10/16/1962	-0.31%	30.91%	-6.68%	8	17
North Korea Invades South Korea	6/25/1950	-5.27%	20.03%	-12.16%	19	59
Pearl Harbor Attack	12/7/1941	-4.15%	3.70%	-20.34%	142	304



Past performance is no guarantee of future results. Source: Ken French Data Library. Ken French data library uses the CRSP database. Universe includes all New York Stock Exchange (NYSE), American Stock Exchange (AMEX) & NASDAQ stocks. Returns are market-cap weighted. *2/24/2022 data is from Bloomberg and represented by the S&P 500 Index. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. An investor cannot invest directly in an index.

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