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# Newsletter

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**Executive Summary**

We are experiencing substantial market turbulence. There has been a lot of talk about a hard landing and a recession, but history shows that is not always the case.

The Fed tightened significantly in 1980, and there was a recession afterward. The same thing happened in 1994, but there was no recession.

There were also periods of threatened tightening in 2013 and 2018 that sent markets sharply lower.

Today, inflation is the key.

If it remains high, or goes higher, that may result in a hard landing. If it stabilizes, or even lets up a little, we may get a softer landing.

The war in Ukraine and supply chain issues are complicating the picture. They may help, or hurt, the situation.

Importantly, the markets recovered strongly after 1980, 1994, 2013 and 2018. There is no reason to believe that will not be the case this time as well.



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## Turbulence

Here we are. ***Markets are having their worst start since 1970.*** The S&P 500 is almost 20% down from its peak in early January. The bond market had its worst quarter in almost 200 years. Inflation is soaring. The Federal Reserve is raising rates. There is a war raging in Europe. China has all but shut itself down trying to eliminate COVID-19.

Wonderful.

***Now we seem to be at a crossroads.***

***On the one hand, if inflation picks up more steam, the Fed will keep aggressively raising rates to try to control it and the economy could tip into recession later this year or next.***

***On the other hand, if inflation peaks and starts to let up a little, the Fed does not need to act as aggressively and we may avoid a recession.***

We have been here before. In 1980, the Fed aggressively raised rates and we had a deep recession in 1981-1982. But in 1994, the Fed aggressively raised rates and there was no recession.

## Volcker's Hard Landing – 1980

After the Arab oil embargo in 1973 (and the huge hike in energy prices that followed), inflation became a persistent problem for several years and nothing brought it down. By 1980, inflation was at 12.5% and mortgage rates approached 20%. President Jimmy Carter appointed Paul Volcker to become the new chair of the Federal Reserve. Volcker promised to do what was necessary to get inflation under control, even if the economy suffered as a result. Volcker moved quickly and raised the federal funds rate by two percentage points to almost 20% (a rate that has never been equaled).

***The economy entered a serious recession in 1981.*** Unemployment was at 10%. The stock market dropped almost 9% in February of that year. Even though the economy was in a recession, Volcker held the line until inflation tapered off to 5% by October 1982. After a difficult recession, the economy recovered and the stock market entered a period of great prosperity during the 1980s.

## Greenspan's Soft Landing – 1994

In the beginning of 1994, the economy had just recovered from a mild recession in the early 1990s. Then-Federal Reserve Chairman Alan Greenspan became concerned when the yield curve inverted because it might have been a sign of another recession. To fix the yield curve, the Federal Reserve abruptly doubled the federal funds rate from 3% to 6% during 1994. It made seven hikes during the year, including two 50-basis point moves and one 75-basis point move.

As a result, there was a massive sell-off in the bond market (the so-called Great Bond Massacre) in 1994. The market value of bond funds dropped about 10% in the first part of that year. The overall bond market ended the year down about 4% in one of the worst years on record. The stock market sold off about 5% in the spring but bounced back to finish the year about even.

Although there was deep damage in the bond markets, ***a recession was avoided***. The stock market entered another period of great prosperity in the mid-1990s.

## What Kind of Landing Are We in For?

***Federal Reserve Chairman Jerome Powell is determined to get inflation under control – just like Volcker did in 1980. But Powell has a much stronger economy to work with.*** Unlike in 1980, unemployment is exceptionally low, corporate profits are strong and consumer demand is off the charts. Yes, inflation is surging, but nothing like in 1980. Right or wrong, ***Powell believes he has some room to tighten before tipping the economy into a recession.***

***The bond market has been devastated by the Fed's interest rate increases and monetary policy tightening – just like in 1994.*** In fact, the bond market has already moved down further than during the Great Bond Massacre. While there are no guarantees, it seems that the bond market is close to the bottom. The 10-year Treasury rate has recently stabilized right around 3%. Of course, if the Fed announces hikes in addition to the ones already announced, the bond market may go down some more, but that seems unlikely right now.

This period also reminds me of the Taper Tantrum of 2013. At that time, then-Federal Reserve Chairman Ben Bernanke believed an economic recovery was well under way and so announced that the Fed would start to wind down its bond-buying program. The markets reacted violently and were quickly down over 5%, having become used to the easy money policies of the Federal Reserve. Eventually, Bernanke backed off to calm the markets and they quickly recovered later in the year.

This happened again in 2018 when Powell threatened to tighten monetary policy. The stock market swiftly lost 12% of its value and then recovered.

***The point is that we have been here before. Markets are reacting strongly to the Fed tightening monetary policy, but that policy is appropriate given the inflationary pressures we are up against.***

***We have all become accustomed to the easy money policies of the Fed.*** They have been in place ever since the Great Recession in 2007-2009. That is 15 years. Many younger investors and traders have never known the pain of persistent monetary policy tightening. The short Taper Tantrum in 2013 and the brief bear market in 2018 showed us how violently the market can react to a reversal of Fed policy.

Today's volatile markets are like those in 2013 and 2018, ***except this time, there is no turning back***. Inflation must be brought under control. While markets may be having a tantrum, tantrums do not last forever, and they have a way of blowing themselves out.

Forecasting is a dangerous business. As famed economist Ezra Solomon said, “The only function of forecasting is to make astrology look respectable.” That said, here are my thoughts.

Inflation is the key to what happens next – and we may not know which way inflation is trending for a few weeks or months.

If inflation continues to be high, or goes even higher, the Fed will have to move more aggressively to contain it. That may result in a hard landing and a recession late this year or early next year. Under this scenario, the stock market may move down some more. The stock market has already priced a lot of pain at this point, in my view.

If inflation starts to stabilize, or even comes down a little, the Fed may not need to tighten more than it has already announced. Some respected economists think inflation peaked in March, and April’s inflation numbers did show a small improvement. Under this scenario, markets will start to stabilize and recover, and Powell may be able to navigate a soft landing without a recession.

***The two wild cards are the war in Ukraine and the pandemic.*** Both of those issues can make matters better, or worse. It’s difficult to see.

The war in Ukraine is causing instability in food and energy markets. If the war spreads, this may negatively impact the inflation outlook. On the other hand, Putin may seek to end this disastrous war. We will see.

The pandemic is still with us. Currently, China is pursuing a zero-tolerance COVID-19 policy that has its citizens locked in their homes, leaving factories and ports empty. This is negatively impacting supply chains and the inflation outlook. Hopefully, China will figure out how to run its economy during the pandemic. Again, we will see.

It may take a few weeks or months to see what direction we are heading in. But if you are a long-term investor, you know that markets are resilient and they will recover. They did after 1980, 1994, 2013 and 2018. Today is no different. Setbacks should be expected from time to time. It goes with the territory. We will get through all of it.

Your best moves are the following: Evaluate your portfolio for any weak positions that are underperforming their benchmarks. If you have any of those, consider replacing them with a better alternative. Look for opportunities to harvest tax losses in your taxable accounts. Rebalance back to your target allocation. Make sure you are properly diversified. Avoid market timing.

***We should expect increased volatility for the next few months. The markets will likely react to both good and bad news for the time being. The overall trend is difficult to see right now, but it will emerge. It is important to remain patient and disciplined. Persistent long-term investors have been rewarded over time. This time is no different.***

I hope this newsletter finds you safe and well. Please reach out with your investment questions and concerns.

Thank you,

D. Austin Lewis

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