JSB Capital Management, LLC

Pro-active Wealth Management

March 9, 2023

On Tuesday, the Federal Reserve Bank chairman, Jerome Powell, testified to Congress regarding the actions of the Federal Open Market Committee (FOMC) over the last 12 months. Beginning in March last year the FOMC raised their benchmark interest rate, the Federal Funds Rate, 8 times from near zero to a range between 4.5% and 4.75% where it is today.

The aggressive FOMC response to skyrocketing consumer goods price inflation was warranted as inflation in the U.S., as measured by the Consumer Price Index (CPI), rose from a benign 2.5% annual rate to an eye-popping 9.1% in June. Their last rate hike of a mere 0.25% gave markets the unrealistic hope that not only had the Fed "tamed" the inflation bull, but also that the FOMC might actually begin to reverse course and lower interest rates in response to the plunging, high interest rate induced economic slump.

Mr. Jerome Powell, Fed Chairman

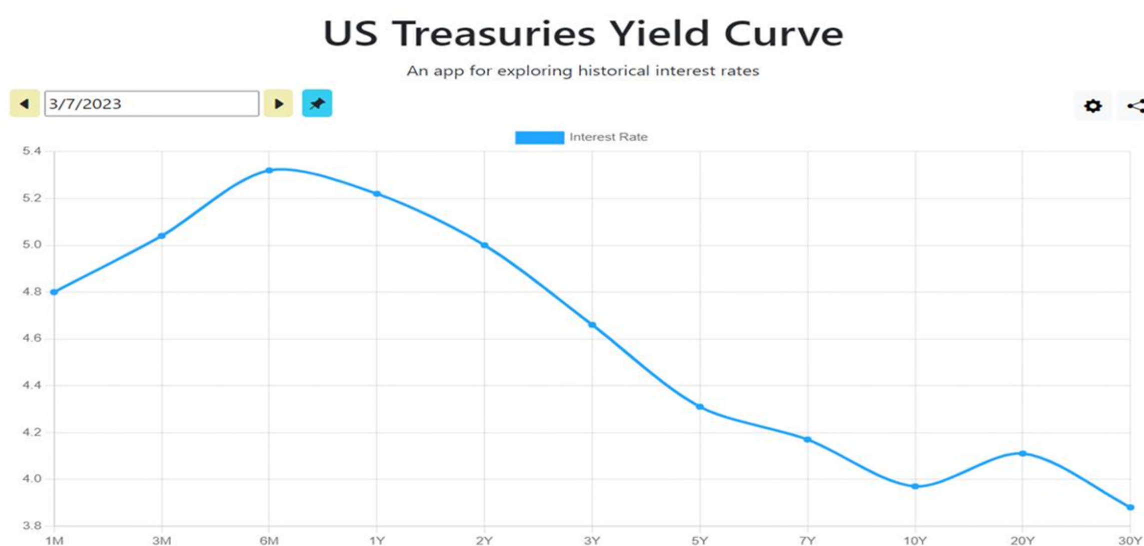
Mr. Powell acknowledged the difficulty of nudging the persistently stubborn inflation rate (around 6.4% currently) down to the Fed's target of 2% annualized and admitted that there's still work to do. What has become known as a "higher-for-longer" approach will likely be necessary and it will certainly slow down the economy and ultimately weigh heavily on the job market. In fact, it has been the surprising, continued strength in the labor markets that has recently provided further fuel for the stock market bulls and their "pivot" hopes, or soon to come interest rate reductions.

Mr. Powell stated "[T]here is little sign of disinflation thus far in the category of core services excluding housing, which accounts for more than half of core consumer expenditures. To restore price stability, we will need to see lower inflation in this sector, and there will very likely be some softening in labor market conditions."

"The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated," he added.

The Bond Market as Fearless Forecaster

It's surprising that many market observers have been caught off guard by Mr. Powell's hawkish comments when the reality is he is basically confirming what the fixed income markets have already priced in. Observing the current U.S. Treasury market below:



Every interest rate paid on the 3-month to the 3-year U.S. Treasury debt is currently *above* the Federal Funds Rate (around 4.5%). Clearly the market is expecting and forecasting several more increases in the Fed's short-term benchmark.

Additional Effects from The Fed's Rate Hikes

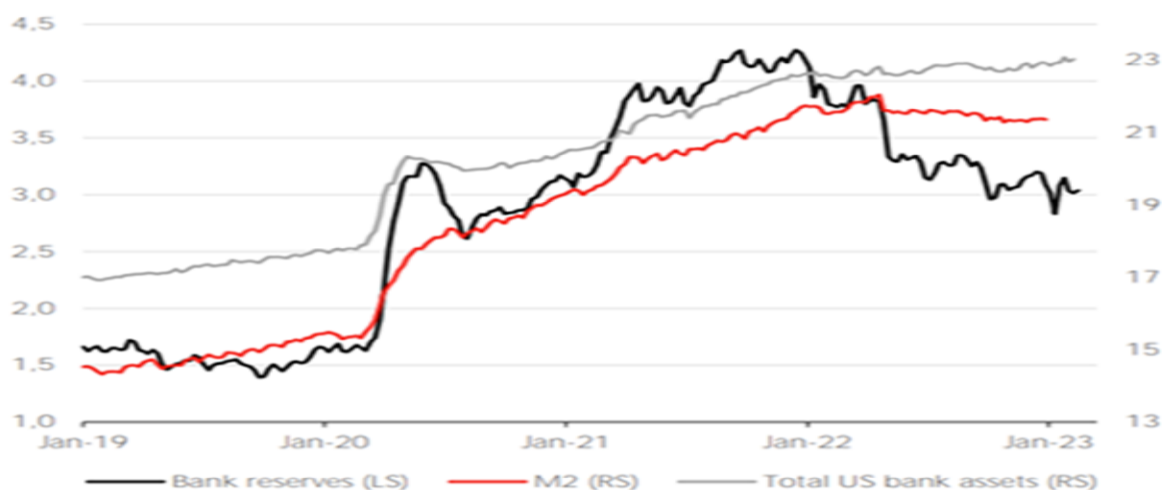
As discussed in an earlier newsletter, the aggressive interest rate hikes by The Fed are dramatically shrinking the amount of money in circulation in the U.S. economy. As shown below, the dollar value (in trillions) that have been sucked out of the economy since January of last year is highly significant. Approximately $4 trillion in bank reserves have been syphoned out of the pool of money that banks have to lend. This reduction of available funds when added to much higher interest rates on all forms of lending (mortgages, auto, credit card, etc.) will undoubtedly lead to a much slower economy.

Money supply growth can often be a helpful measure of economic activity and an indicator of coming recessions. During periods of economic boom, money supply tends

to grow quickly as commercial banks make more loans. Recessions, on the other hand, tend to be preceded by slowing rates of money supply growth.

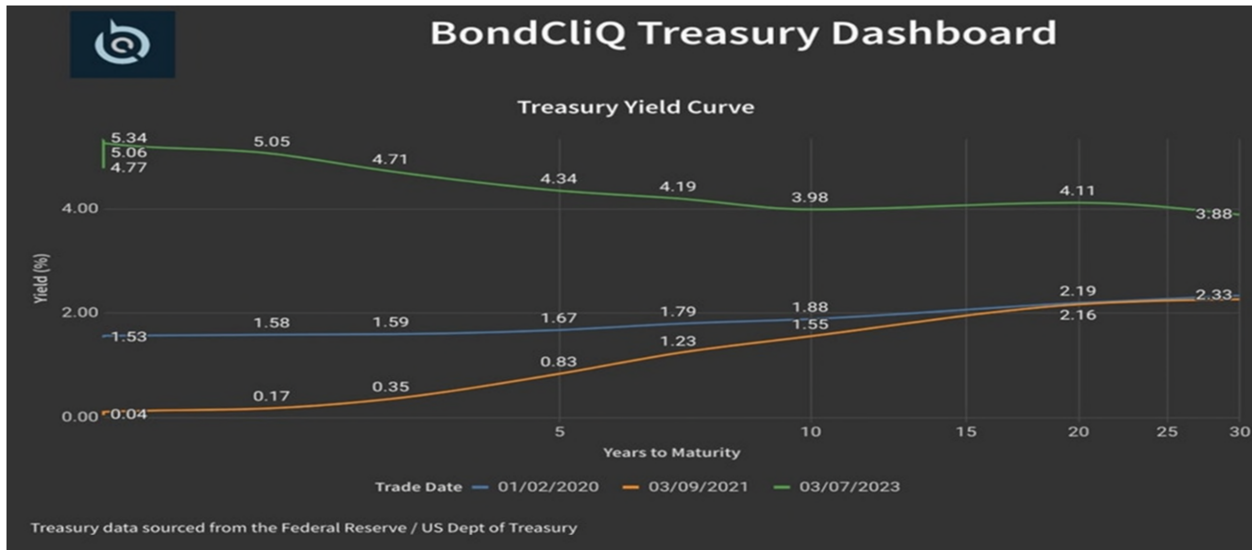
Money supply growth fell again in February, falling even further into negative territory after turning negative in November 2022 for the first time in twenty-eight years. February's drop continues a steep downward trend from the unprecedented highs experienced during much of the past two years (the **red** line). Since April 2021, money supply growth has slowed quickly, and since November, we've been seeing the money supply contract for the first time since the 1990s. Money supply (M2) virtually **never** contracts.

Increasingly higher interest rates incentivize investors (and consumers) to cash out of higher risk stock investments and rotate those funds to lucrative, short-term interest-bearing investments. The important question is: will the declining money supply ultimately lead to a recession, and if so, how deep?



Revisiting the Inverted Yield Curve

In addition to the graph above of the Treasury debt interest rate plot, another way to look at the “inversion” or abnormal condition when short-term interest rates are significantly higher than long-term rates is shown below:



Notice that the **yellow** line shows the relationship between short-term rates and long-term rates from just two years ago. A six-month Treasury Bill only paid around 0.2% annually. Today, the same Bill pays 5.2%! If one goes out to the ten-year Note, it is currently yielding only 3.9%. That equates to a difference (spread) of over 1%. (This relationship is represented by the **green** line.)

Most economists and market analysts closely watch spreads on the yield curve between the two-year and 10-year Treasury notes, which is referred to as the "2/10 spread." The 2/10 spread first inverted around July 2022, just four months after the Fed began to increase the Fed Funds rate in March.

The 2/10 spread reached negative 103 basis points (1.03%) on Tuesday – the largest inversion between those securities since September 1981 when the economy was deep in a recession as the Fed was raising interest rates to tamp down rampant inflation – and it widened to about 107 basis points (1.07%) on Wednesday.

What Does It All Mean?

The combination of an aggressive Fed raising interest rates to heights not seen in decades, the dramatic plunge in the amount of money available for economic growth and business stimulation, and a backdrop of the best indicator (historically) of recession, an inverted yield curve, forecasts a slowing economy and a likely continuation of a bear (stock) market.

A. Consumption decreases, individuals save rather than spend with very high short-term interest rates as a magnet and investment projects are stalled as their costs rise.
B. Asset prices of real estate and stocks which inflated under zero interest rates decline significantly.
C. Deflated asset prices “squeeze” the equity capital of households, businesses, and banks too.

D. Loans made under ever inflated asset values become difficult to service and lead to defaults which further tightens bank's lending standards.

The action of the stock market this week appears to be signaling a scenario like the one described above and that might also include very stubborn inflation as well.

The Federal Reserve Open Market Committee meets again in less than two weeks and the market will likely continue to anticipate an aggressive hike in rates which means lower stock prices for now.

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