JSB Capital Management, LLC

Pro-active Wealth Management

February 1, 2023

Today the Federal Reserve Bank's Open Market Committee (FOMC) did exactly what most analysts expected and raised their short-term interest rate benchmark (the Federal Funds Rate) by a quarter of a percentage point (0.25%) thereby signifying its shift into a slower pace of monetary-policy tightening. This was the eighth consecutive time that the FOMC has raised interest rates in the last 12 months following another of its nine annual meetings. It brings the bank's target for the federal funds rate to a range of 4.5% to 4.75% while signaling that it still feels it has more work to do to cool rampant inflation.

Fed Chairman Jerome Powell

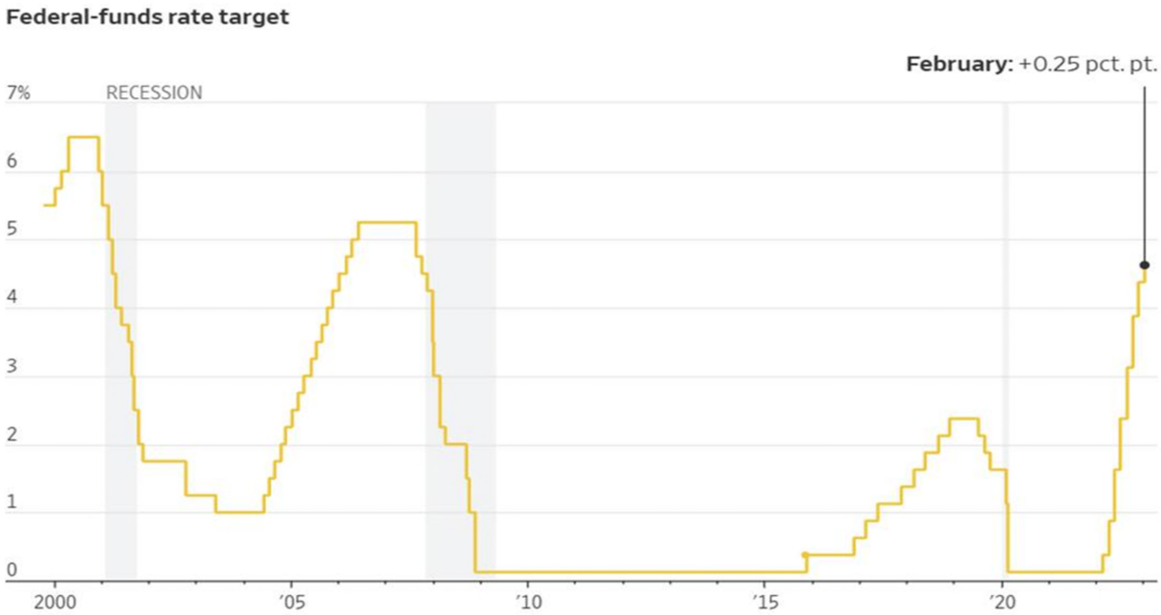
The Fed's decision comes as the central bank stands at something of a crossroads, with inflation still too high but falling, and the economy still strong but moderating somewhat.

In a press conference following the bank's policy change, Fed Chairman Jerome Powell emphasized that while price growth has begun to cool somewhat, the central bank remains unconvinced that inflation is on what he called a "sustained downward path." He further suggested that though the exact path forward is uncertain, Fed officials continue to see the need for "ongoing increases," potentially multiple ones, in the federal funds rate.

Importantly, Mr. Powell repeatedly emphasized that there was a significant data point, specifically the relatively broad Core Services Sector, excluding the housing component, that represented more than half (56% precisely) of consumer spending that was <u>not</u> reacting to the aggressive increases in the short-term interest rates the Fed had engineered. This indicated that the FOMC was going to continue to increase their administered rate several more times before they might pause.

In the statement released just after the rate hike announcement the Fed acknowledged that price growth "has eased somewhat" but that it remains elevated. The formal statement also didn't change language that suggests further rate increases are on the horizon, noting that the committee "anticipates that ongoing increases in the target range will be appropriate."

The current rate hike and past Fed Funds rates are below (the grey areas indicate recessions):



Today's decision represents a move to slow the amount of rate increases to potentially avoid going too far and ultimately tipping the economy into a recession. It also suggests the Fed remains unconvinced that inflation is anywhere near its goal of 2%, and that officials believe they have more work to do in addressing their next rate hike move. The Fed said "the extent" of future interest rate increases would focus on the lags with which monetary policy operates, as well as the cumulative impact of the steps it has taken so far. Many market participants interpreted this as signaling a possible rate hike pause.

What has been the overall impact of rate hikes so far on inflation?

One measure of the impact of higher rates is determining the amount of money in the economy. The growth of a very broad measure of the money in circulation is called "M2." This monetary indicator of the nation's money supply is a broad aggregate of different types of monetary assets, including currency in circulation, demand deposits, time deposits, savings deposits, and other near money. An increase in M2 can signal an expansion in the economy and potential inflation, while a decrease in M2 can indicate a contraction in the economy and potential deflation.

The money supply growth rate for December was a negative 1.3% versus a year ago, the **lowest ever** and marking the first-ever decline in M2 based on all data available. The Fed started publishing data on M2 in 1959.

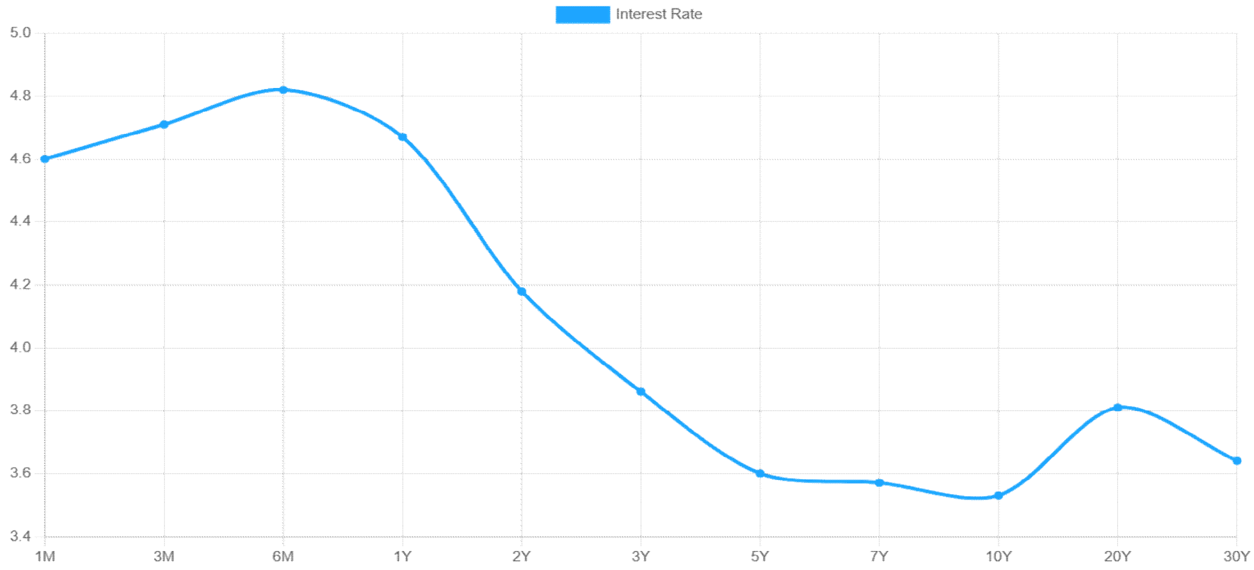
Notice that the spike upwards in M2 corresponding to the flood of government money during the COVID crisis led to the highest inflation rate in 40 years. The subsequent collapse in M2 once the FOMC began raising rates in the middle of last year forecasts a very high probability of a recession this year.

There's another ominous reason that the money supply as measured by M2 is falling to historic lows. The Federal Reserve Bank has also been conducting what is known as "Quantitative Tightening" or "QT" which means they are reducing the size of their balance sheet (or reducing the amount of debt held by the government) fairly aggressively and that takes liquidity (money) out of circulation while concurrently lowering the cash available for banks and other financial institutions to lend. QT puts another significant drag on an already weakening economy.

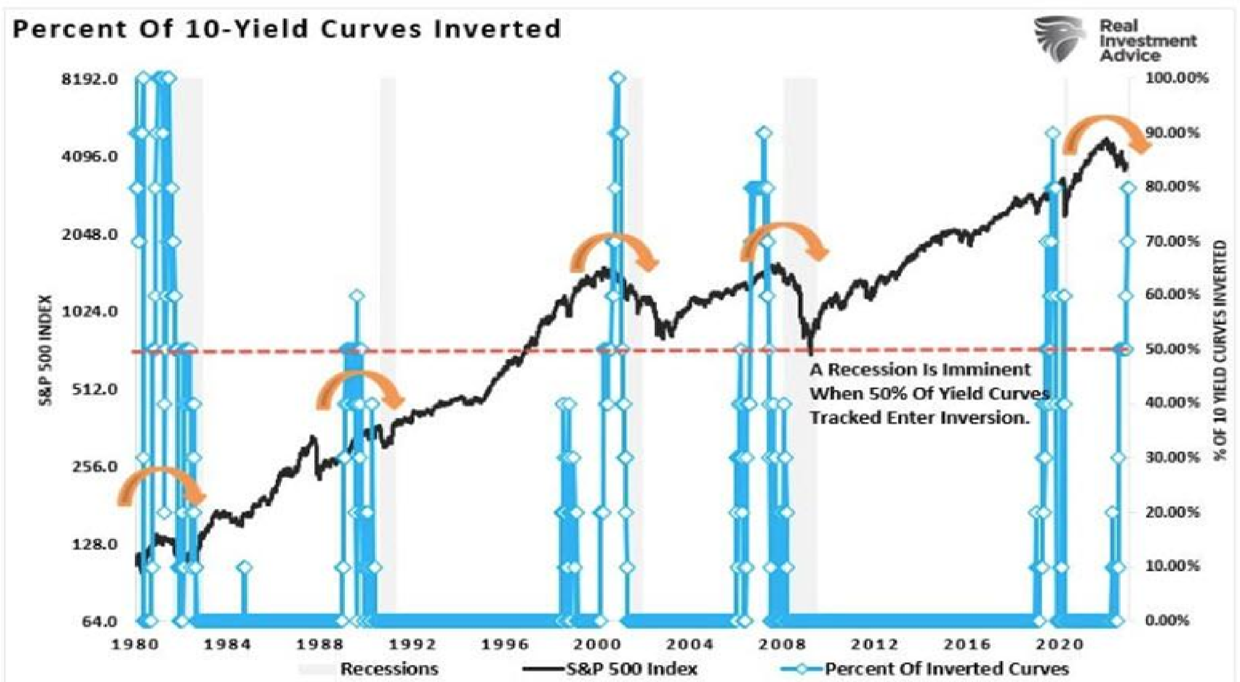
In the last, more detailed newsletter sent out on January 18th there was a description of another very important economic forecasting tool. That discussion is reprinted below for emphasis.

History's Best Predictor of Recession

The last chart below depicts the current situation of short and long-term U.S. Treasury interest rates known as the "Yield Curve." Most noticeably, the interest rate an investor receives from the shortest maturing Treasury debt (4.6 to 4.8%) is much higher than the interest received from the longer-term debt (the ten-year debt being the benchmark at 3.5%). This condition is known as an "Inverted Yield Curve," and it forecasts very negative economic conditions ahead.



Since 1980 the Yield Curve has inverted 6 times and all six times a recession followed rather quickly thereafter, usually 6 to 12 months after. The current Yield Curve has been inverted for about 6 months now.



What is going on in the stock and bond markets?

Toward the end of last year, the overall stock market reached its low water mark for the year because it was reacting to the aggressive interest rate increases by the Fed. Shortly thereafter, the stock market began to rally partly because investors began to anticipate that the Fed might slow its rate increases perhaps sooner than expected and that would remove uncertainty over the future rate outlook. Markets like certainty, and the market rallied into the year end.

Markets have also been cheered by news that inflation and wage growth may have peaked last year, which could make the Fed more comfortable in pausing rate increases. However, since the FOMC met in December, economic activity has been mixed. For example, consumer spending, 2/3rds of the economy, moderated significantly, manufacturing activity also weakened a great deal, and companies began to announce aggressive layoffs first in the technology sector, but now more broadly across all industries. Employment statistics have been contrary indicators by remaining strong.

Meanwhile, investors in the bond markets have preemptively begun to expect that the Fed will actually cut interest rates later this year as a result of the sharp slowdown in economic activity that lowers inflation faster than policy makers expect. Note that the "yield curve" shown above is not only "inverted," but also the interest rate paid to investors in the ten-year and longer maturities is indicative of a market that is expecting much lower inflation and a Fed interest rate cut. That seems to be unrealistic looking at economic history and the Fed's own words.

The stock markets were very volatile just before and after the Chairman's press conference. Most investors took Mr. Powell's comments to be more conciliatory that he has been in the past which led to the broad market averages rising from their lows and closing higher on the day. Investors were also enthused by the Bank of Canada's announcement of a pause last week after eight consecutive hikes, something they hope is a prelude to a similar decision by the Fed.

Nothing today changes the overall strategy outlined in the January 18th newsletter. Most signs point to a significant economic slowdown if not outright recession this year and the portfolios reflect that forecast.

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