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"DON'T FIGHT THE FED"

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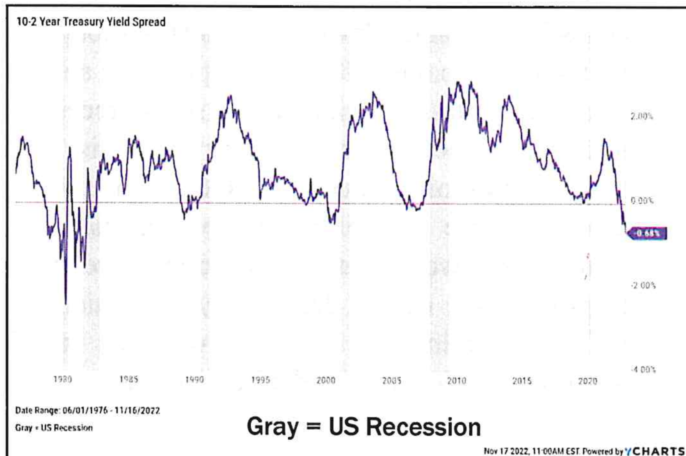
This mantra of Wall Street has been good advice for investors. The following graph shows that when (during the period, 06/01/1976 to 11/16/2022) the Federal Reserve raised rates that the yield curve became inverted (which is when short-term interest rates are higher than long-term rates) and a recession along with a market downturn followed.



Unfortunately, the graph ends in November 2022; however, as we all know the Fed over the last year has been increasing interest rates and the yield curve has become deeply inverted.

WHAT IS A YIELD CURVE?

A yield curve is a graph that shows the interest yields for the same quality of bond (example: US government bonds) for different periods of time (example: 30 days to 30 years).

There are three basic classifications of yield curve.

1. Normal - "a normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time."
2. Flat or humped yield curve - "the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition."
3. Inverted - "is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of an upcoming recession." {Investopedia)

WHAT CAUSED THE PRESENT INVERTED YIELD CURVE?

The primary cause is the inflation brought about by the efforts to fight the Covid pandemic and the excessive spending that followed. The Federal Government spent the money and the Fed created the money enabling the unbridled spending spree. Chairman Powell (Federal Reserve Board) understandably funded the pandemic crisis, but he should have begun to pump the brakes as the crisis began to subside.

He failed to do so and high rates of inflation began to show up. He then started raising rates aggressively. This caused short-term rates to rise rapidly and since early 2022 we have been in an inverted yield curve environment.

Consumers are affected to a large extent by the rising rates, especially on credit cards and short-term borrowing for purchases. Also, it can be dangerous for banks that can be caught in a dilemma from buying long-term government bonds with low rates in a time of rapidly rising short-term rates. This is what happened to Silicon Valley Bank. They bought billions of dollars of long-term government bonds at very low interest rates and when the rates increased, the bonds lost a great deal of value. The bank officers were not worried about the credit worthiness of the bonds, but when depositors began to ask for their money, the bank was forced to sell bonds at significant losses. Eventually, they had to ask

the regulators and the FDIC for help and the bank was defunct.

The reason for all the focus on the inverted yield curve is because it has long been considered a harbinger of oncoming recession. However, there are valid reasons to consider that the inverted yield curve may be throwing a curveball to investors.

1. The stock market has already experienced a significant decline in 2022.
2. The Fed is close to what various of its Board Governors expect to be the peak in interest rates.
3. Employment has been holding up, in terms of jobs creation and low unemployment rates.

Alternatively, there are reasons to bow to the prognostication of the yield curve.

1. The economy is definitely slowing, and corporate profits are declining.
2. The Fed rate increases (put in place last year) usually have a lag time before taking effect.
3. Many companies, especially big tech companies, are laying off thousands of workers. The big problem with not fighting the Fed is to figure out which side the Fed is fighting on! Sometimes they say, "rates are going to be higher for longer." Other times they say that we are within one-quarter to one half percent of their ultimate target. The consensus among the expert analysts is that the Fed will wind up cutting rates three times by the end of the year and may even begin this summer.

According to Reuters: "Washington, March 22 (Reuters) - Federal Reserve policymakers believe beating back inflation may require just one more interest rate hike this year, but less easing next year than most thought would be appropriate just three months ago.

U.S. central bankers see the policy rate, now in the 4.75% - 5.00% range after Wednesday's 25 basis point increase, at 5.1% by year end, according to the median estimate in the Fed's latest quarterly summary of economic projections."

The primary driver of the Fed is inflation. Inflation has been coming down, but it is still a long way from the Fed's goal of 2% which is probably an optimistic target unless we wind up in a severe recession. Additionally, another complicating factor is Opec cutting back on oil production, which is inflationary (especially since US oil production has not been growing which would put downward pressure on energy prices). We cannot definitively say which side the Fed is fighting on, therefore, we must remain cautious and hedge our bets the best we can.

OUTLOOK

The first quarter of 2023 was positive, recovering from the dip in October. That October sell-off was the lowest for the year and represented about a 25% decline. The Fed had been raising interest rates for the greater part of the year and eventually it took its toll on the market. But acceptable earnings in Q4 of 2022 and the prospect of the Fed getting near the end of the rate raising was the basis for this partial recovery.

Going forward, unless there is an unforeseen event (positive or negative), the Fed will play a major role in the market's direction. If inflation remains stubbornly high, then the Fed may actually "go higher for longer." However, if signs of pending recession cause fear and political pressure on the Fed mounts, then the rate cuts may happen sooner and be larger than anticipated.

Our intention at this time is to keep watching for a clear direction and to stay with a mix of ETFs in the energy, defense, dividend payers, and inflation hedges along with value-oriented mutual funds. Also, we are adding to our buffered ETF positions, which give us downside protection while at the same time enabling us to participate in market gains *(see October 2022 newsletter)*.

Unfolding circumstances may alter our stance; but, in any event, we have no intention to knowingly "fight the Fed!"

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