

Positioning Recommendations - April 8th, 2022

“The Fed’s dual mandate is that of arsonist and fire brigade.” - Jim Grant.

A Belated Epiphany

It is my belief, based on years of observation, that if you want to know the truth about government agencies and their actions, listen to retired officials from those entities. Once they have escaped the group-think environment, and are also freed from the straight-jacket of political correctness, they become far more candid... and accurate.

The Federal Reserve is a classic case in point. Numerous former senior Fed members have been blunt in their criticisms of key policies once they have left the Marriner Eccles Building. This includes condemning its biggest initiative, the repetitive quantitative easing (QE) cycles over the last 13 years that have done so much to elevate asset prices and so little to promote real economic growth. (Once again, for an inside take on this, with abundant quotes from many of the Fed officials who supported, often reluctantly, QEs 1, 2, and 3, please read Christopher Leonard’s great book, *The Lords of Easy Money*. It has the appropriate sub-title: *How the Federal Reserve Broke the US Economy*.)

The comments this week by the former president of the NY Fed, Bill Dudley, are what have created my personal “Aha!” moment. In addition to once heading the most powerful of all the Fed’s districts — partially due to its proximity to Wall Street — Mr. Dudley was also a Vice-Chairman of the even more omnipotent Federal Open Market Committee (FOMC). It is that group which actually sets Fed policies and controls short-term interest rates. Actually, in the QE era, it has also exerted enormous sway over long-term interest rates. (This is because the Fed has used the trillions of fake money it has fabricated to buy treasury bonds and government-guaranteed mortgages; this effort has pushed rates well below where they would have been exclusive of the Fed’s constant interventions.)

My epiphany relates to the Fed’s conundrum that I, and many others, have recognized: How can the Fed possibly raise rates enough to catch up to inflation? Being old enough to vividly remember the inflationary 1970s, I can also recall that the much-derided Fed of that era under then-Chairman Arthur Burns managed to get rates up around the CPI level in fairly short order. Admittedly, he rarely pushed them above inflation but at least if price increases were running at 8% he would jack the fed funds up in that vicinity.

Now, can you imagine our current Fed raising rates that much? Neither can I--actually, not even close. But even before my Bill Dudley-induced wake-up-and-smell-the-espresso event this week, it was dawning on me that the Fed doesn’t need to use its interest rate weapons to slay inflation. It just needs to seriously wound the financial markets. (By the way, it will soon also be engaged in only its second- ever double-tightening: selling bonds, the opposite of QE, known as Quantitative Tightening, and hiking rates.)

One of my daily must-reads is *The Closing Print* authored by Jones Trading’s Chief Market Strategist, Mike O’Rourke. He did such a perfect job of summarizing Mr. Dudley’s comments that I thought I would just run an excerpt of his note from yesterday:

“President Bullard’s indication of how far the FOMC is behind the curve dovetails perfectly into

former NY Fed President Dudley's Bloomberg Opinion piece yesterday. The title of the piece says it all, 'If Stocks Don't Fall, the Fed Needs to Force Them.' The focus of Dudley's piece is the easy financial conditions environment, the need for those conditions to tighten to rein in inflation, and that a key aspect of tightening is lower equity prices and higher bond yields. Dudley explains with a candor that exceeds that of any former Fed official we have witnessed, that 'Investors should pay closer attention to what Powell has said: Financial conditions need to tighten. If this doesn't happen on its own (which seems unlikely), the Fed will have to shock markets to achieve the desired response. This would mean hiking the federal funds rate considerably higher than currently anticipated. One way or another, to get inflation under control, the Fed will need to push bond yields higher and stock prices lower.' It is amazing how liberating abandoning the trappings of office can be. Dudley is correct that the FOMC's actions to date have done little to tighten financial conditions. As we noted above, as of a few weeks ago, the Fed was still adding accommodation.

Dudley indicates that the incredible resilience of both the stock and bond market create a reflexive dynamic where the more resilient markets remain, the more tightening that will become necessary. Although the Goldman Sachs Financial Conditions index has risen from its all-time low of December 31st, 2021, it still remains below its pre-pandemic trough registered during the Technology Bubble in December of 1999 (chart below). There has already been a significant amount of pain over the past 6-12 months among the more speculative stocks, but in the 2000-2002 bust many of those names dropped more than 90%. Even young Amazon shares declined 95% from 1999-2001. We believe it is the Fed's lack of credibility fueling the reflexive dynamic that Dudley fears, but the quicker the Fed convinces the market that it is serious, the quicker financial conditions will tighten to an appropriate level."



If you're wondering why a stock market correction, that could easily evolve (devolve?) into an actual crash, would help in the fight against inflation, consider 2008 and 2020. In both of those instances, deflation became at least a brief threat. The 2008 example is particularly relevant because inflation and commodities, including crude, were uncomfortably high right before the market turmoil of that year. In fact, oil actually touched \$140 a barrel in 2008. Adjusted for inflation, that's almost double where it is today.

Yet, by early 2009, as markets kept circling the drain, "de" replaced the "in" when it came to inflation. This near-death-experience for the financial system prompted, of course, the launch of the very first QE. Is a serious bear market guaranteed to happen again? There's no such thing as certainty when it comes to stock and real estate prices but I do think there are couple of particularly vital sentences above, to wit: "Investors should pay closer attention to what Powell has said: Financial conditions need to tighten. If this doesn't happen on its own (which seems unlikely), the Fed will have to shock markets to achieve the desired response."

My personal twist on this is that I believe both the economy and inflation will prove more resilient to Mr. Powell's own sudden epiphany — his desire to be the second coming of Paul Volcker. Ironically, this comes after years of him acting like the Anti-Volcker. The stock and property markets — especially, office buildings, in the latter case — are a much different story.

My suggestion is that you re-read Mike O'Rourke and Bill Dudley's comments, at least once, if not twice. This may be the best investment advice you get this year.

Likes / Dislikes

LIKE

The category of two- to five-year maturity BB-rated corporate bonds is worth focusing on now, in my view. The yields on these have vaulted close to what I think could be the “new normal” inflation rate of 4% to 5% (once the global supply chain opens up again; sadly, I don’t see that happening anytime soon). This an area where doing some serious research can pay off by targeting those companies that are likely to be jumped up to investment-grade (BBB-rated or higher) by the rating agencies. This creates an automatic price increase that can serve to offset the downward pressure from rising rates.

- Large-cap growth names at a reasonable price
- Certain international developed markets, especially Japan
- Publicly traded pipeline partnerships, i.e., MLPs and other mid-stream-energy securities.
- Gold-mining stocks
- Gold
- Silver
- Swiss franc
- Select international blue chip oil stocks
- Oil field services companies, particularly those well exposed to the Permian Basin
- Short-term, investment-grade corporate bonds
- One- to two-year Treasury notes
- Emerging market (EM) bonds in local currency (focusing on stronger countries, particularly in Asia)
- Large-cap value
- High-dividend equities with *safe* distributions
- Most cyclical, resource-based stocks
- **BB-rated corporate bonds**
- Canadian REITs
- South Korean Equities
- Certain “Virus Victim” equities, such as refiners, homebuilders, and select retail stocks
- Investment-grade, floating-rate corporate bonds
- The higher-quality mortgage REITs
- Floating-rate bank loans
- Copper producers
- Healthcare stocks
- Capital spending-related companies, mainly focused on the U.S.

NEUTRAL

Note the addition of utility stocks to this section. Actually, giving them a neutral rating is a tad on the generous side considering their low yields and expensive valuations, especially in a rising interest rate environment. However, utilities have broken out to a new multi-year high which precludes a negative rating based on my methodology. Be on alert, though, should they go much higher and be ready to start a dollar-cost-averaging disposal campaign if you have much exposure to this sector. You will likely be reading a more direct “take profits” message from me soon in this regard

- Uranium and uranium producers
- Renewable yield cos
- Intermediate-term, investment-grade corporate bonds, yielding approximately 4%
- Mid-cap value
- Emerging stock markets; however, a number of Asian developing markets remain attractive
- Emerging market bonds
- U.S.-based Real Estate Investment Trusts (REITs)
- Canadian dollar-denominated short-term bonds
- Traditionally “safe” sectors, such as Staples and Utilities
- Virus Victors
- Small-cap value
- European banks
- **Utility stocks**

DISLIKE

Due to both the rally by growth stocks since mid-March — which has, admittedly, partially reversed — and the market concerns expressed in the main section of this *EVA PR*, I think small- and mid-cap growth positions should be reduced. In fact, I’d suggest a major reduction for those heavily exposed to these areas. Of course, the best time to have done so was last year when I was repeatedly cautioning about the Crazy Over-Priced Stocks (COPS), many of which fall into the mid- and small-cap growth styles. A very long list of those have been absolutely pummeled, but I think there is more pummeling on the horizon (note what’s happened to two of my picks-not-to-click, AMC Entertainment and GameStop, of late).

- Cash
- The Indian stock market
- A wide range of high-income securities, including preferred stocks
- Intermediate-term Treasury bonds
- Small-cap growth
- Long-term treasury bonds
- Long-term, investment-grade corporate bonds
- Most municipal bonds
- U.S. dollar
- Many semiconductor tech stocks
- Mid-cap growth
- Lower-rated junk bonds
- Green energy stocks
- SPACs
- Most new issues

- Most of the popular Reddit/WallStreetBets meme stocks still have material downside; despite that, they are far below their 2021 totally irrational highs.

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