Rodney's Take

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The Storm Before the Calm

There's nothing quite like being on a sailboat in the middle of a race when the wind falls to a dead calm ahead of a storm. The boats begin to drift with the tide. All you can do is watch the black clouds approach and wait for the rush of wind and rain. That is, if the storm actually arrives. Often the storms skirt by, providing no relief from the heat and no burst of wind, although eventually the normal breeze returns.

The financial markets seem to live this process in reverse.

Investors try to anticipate changing metrics, like the value of the dollar and interest rates, which leads to outsized market moves ahead of concrete economic news. Last week, the Federal Reserve released the minutes from its March FOMC meeting, which showed the members contemplating reducing the central bank's balance sheet by $3 trillion over three years while raising short-term interest rates. The central bankers expect to raise rates at every meeting this year and possibly will hike rates by 50 basis points at a meeting or two on their way to an overnight rate of 2.75%.

But here's the thing. The Federal Reserve stopped adding to its balance sheet only the week before the March meeting and has raised rates exactly one time in this new tightening cycle. What if they wave the white flag long before they've reached either goal? What if world events and slow or falling economic growth at home cause the FOMC members to change course? It looks like we're starting to live through the economic storm which will arrive long before the calm.

If the Fed actually shrank its balance sheet by $3 trillion over three years or even $1.5 trillion over 18 months, it would cause massive shifts in the markets. The lack of buying support in the Treasury and mortgage-backed bond markets would push long interest rates significantly higher, driving up borrowing costs for everyone from first-time home buyers to Uncle Sam. That's real economic pain, the kind that we haven't felt in the U.S. in more than 15 years. The same goes for pushing up short-term interest rates.

The Fed started pushing rates up gently in 2015, and then started reducing its balance sheet by a mere $50 billion per month in 2017. The changes were part of what caused the equity markets to convulse at the end of 2018. Seeing the light, the Fed stopped reducing its balance sheet in 2019, started lowering rates again, and eventually bought more bonds. This was before COVID and the snarled global supply chain and long before Russia invaded Ukraine and brought about sanctions.

The central bankers don't seem to have a high tolerance for economic pain. What happens when store shelves go bare for lack of goods from a partially locked down China, energy prices climb when Western nations stop releasing oil from strategic reserves, and food prices climb due to fertilizer, wheat, and corn shortages due to sanctions and falling Russian and Ukrainian production? Excess demand will not have created any of these situations, so demand destruction, the only tool available to the Fed, won't change them, but it will make life miserable.

People who buy food, pay interest on credit card debt, and buy gasoline will feel the heat. People who spend large chunks of their monthly income on such items will feel the most pain. Those without offsetting gains in real estate and other inflation-favored assets will go further in the hole. It doesn't take much analysis to see that the Fed's suggested path won't, or even can't, achieve the Fed goal of reducing inflation without substantially lowering the standard of living for millions of people already near the bottom rung of the socioeconomic ladder.

Expect discussions of higher rates and a shrinking Fed balance sheet to continue through the summer, but it's likely that by the end of the year the bankers will be singing a different tune. With recession in the air and high inflation hanging around, stagflation will be the word of the day. The bankers likely will take a pause in their tightening cycle, bringing on the calm as they try to avoid more of the storm.

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Got a question or comment? You can contact us at info@hsdent.com.