John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday May 25, 2022

The Dow and S&P 500 managed to close up slightly last Friday. But last week was the eight straight down week for both. The decline intensified last week after Fed Chair Powell spoke at the Wall Street Journal's Future of Everything Festival. Powell said the central bank's resolve in combating the highest inflation in 40 years should not be questioned even if it requires pushing up unemployment.

"Restoring price stability is an unconditional need. It is something we have to do. There could be some pain involved.

This is not a time for tremendously nuanced readings of inflation. We need to see inflation coming down in a convincing way. Until we do, we'll keep going."

His remarks threw cold water on the idea that inflation could be beaten without raising interest rates so high as to cause a recession. In the 1970s & 80s interest rates went above the inflation rate before inflation came down. Fear that that is what it will take to beat inflation this time terrified investors. Stocks came down. Bonds went down and even gold fell. Finally last Friday there was some sign that the worst of the stock market selling might be over.

Of course, if inflation comes down in coming months investors will be relieved and stocks will come roaring back.

James Bullard is President of the St. Louis Federal Reserve Bank and a voting member of the rate-setting Fed Open Market Committee. He says the Fed will raise interest rates one half of one percentage point in each of the next two meetings. That will bring short-term interest rates to about 4%.

Bullard added: “In the hall of mirrors aspect of monetary policy, even though we’ve barely lifted our pinkie finger here, we got a lot of market pricing already and so the tighter policy is already in markets.” He also said the economic outlook looks good with above trend growth likely for this year and next.

What Bullard is pointing out is that even though interest rates are low by historical measures they are having an impact on markets. Housing, for example, is slowing because refinancing is no longer so attractive and mortgage rates are up for potential buyers. This is what BNY Mellon was talking about a couple of weeks ago. It isn’t so much the level of interest rates as the rate of change. A rise from near zero to 4% will be a huge change, far greater than the change in the 1970s and 80s. Interest rates were much higher when inflation spiked in the 1970s. Thirty-year home mortgage rates were at 5%-6% in the 1960s. Short-term interest rates were 7.5% in 1971. Yes, they spiked to 11.2% in 1979, and that was above the inflation rate. But interest rates did not even double back then.

If Bullard and BNY Mellon are correct, the quadrupling of interest rates from zero to 4% will slow the economy enough to bring inflation down.

For all the talk about recession and with stock and bond markets tumbling, the U.S. dollar has been quite strong. The Wall Street Journal's dollar index is up 8% so far this year. Against the Japanese yen the dollar is up 12%, against the Swiss franc it is up 10%. A strong dollar makes imports cheaper. And that helps the fight against inflation.

The dollar is strong because our Federal Reserve is raising interest rates more aggressively than other central banks and because the U.S. economy is in better shape than the euro region, Japan and even China. Economists at J. P. Morgan expect the U.S. economy will grow faster than China's this quarter. That is something thought to be impossible just a year ago. Keep in mind that supply chain problems drove import prices up at a double-digit rate for ten out of the last twelve months. That is now reversing as the dollar has gained strength. Imports have gone from being a contributor to unwanted inflation to a help in bringing inflation down.

This is the opposite of what happened in the 1970s. I remember the dollar's behavior back then because I was living in Switzerland and being paid in dollars. The dollar went down and contributed to the rising inflation. Double-digit interest rates did not stop the dollar's decline.

The currency market is sending a very different signal this time. The dollar is strong with interest rates at 3% and likely to get stronger as the Fed raises rates to 4%. This tends to support the Bullard and BNY Mellon view that even though interest rates are low they are rising fast enough to get the job done.

Also, remember Liz Ann Sonders article for Schwab reminding us that the velocity of money is key to inflation. The velocity of money calculated by researchers at the Federal Reserve Bank of St Louis, M2, remains on the floor, far down from pre - pandemic levels. This also makes the Federal Reserve's job easier.

Milton Friedman defined inflation as "too much money chasing too few goods." The velocity of money is a measure of the "chasing" part of his definition. Another measure is loan demand. In the past there was a credit bubble that contributed to the "chasing." This time there is no credit bubble. Loan demand remains subdued.

When you put all the parts together, a strong dollar, slowing housing market, very low money velocity and sluggish loan demand, you can understand why Bullard and BNY Mellon believe the Fed's plan will work and that inflation will be lower in coming months.

The bottom line is that a soft landing is possible. And if that isn't the case any recession will be shallow and short.

Either way stocks will rebound.

I will have the next market review and update for you one week from today on Wednesday June 1, 2022

All the best,

John Dessauer

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