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Is What Happened in the UK the "Canary in the Coal Mine" or a Premonition of What Could Happen in the U.S.?

By Gerald B. Goldberg, JD, CIMA, CEO, and Co-Founder

It has been a volatile year for capital markets. We have seen equity and bond markets move lower in tandem and an energy and commodity crisis unfold because of the war in Ukraine and lingering supply chain disruptions from COVID-19. Now, we can add a major central bank—the Bank of England—undertaking an abrupt policy reversal to counteract the effects of ill-timed fiscal policy plans.

Last week, the Bank of England committed to buying long-dated UK government bonds "on whatever scale is necessary" to quell market turmoil caused by Prime Minister Liz Truss' plans to cut the top income tax rate and fund some of the resulting funding gaps with increased borrowing.[1] Markets reacted positively to the intervention from the Bank of England, but these fiscal and monetary moves, seemingly at loggerheads with each other, have the potential to bring about long-term complications and challenges for the UK economy.

On Monday of this week, in a stunning U-turn of fiscal policy, the Truss government abandoned its plans.[2] On the one hand, the abrupt change of policy could be viewed as a stunning defeat for a newly elected Prime Minister. On the other, a rare, courageous course correction following a policy error. For the world's central banks who are no doubt watching, it was certainly an example of the capital markets encouraging a disciplined approach and highlighting the consequences of bad policy decisions.

Monday's policy reversal came after the normally diplomatic International Monetary Fund issued a rare, public rebuke of the powerful member. The IMF had urged Britain to reconsider its fiscal policy plans because "it is important that fiscal policy does not work at cross purposes to monetary policy."[3] In other words, the IMF was warning Britain that now was not the right time to retry the Reaganomics of the 1980s. Reaganomics refers to then U.S. President Ronald Reagan's policy of concurrently cutting government spending and taxes while expanding money supply to combat stagflation—the combination of a stagnant economy and high inflation. Truss' attempts at Reaganomics 2.0 seem unlikely to succeed, considering that

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[1] Wall Street Journal, *Bank of England Buys Bonds in Bid to Stop Spread of Crisis (link)*
[2] Wall Street Journal, *U.K. Government Abandons Plan to Cut Rate of Income Tax for Top Earners (link)*
[3] Reuters, *IMF criticizes UK policy, Bank of England to make big response (link)*

Britain lacks something the U.S. has today and had in the Reaganomics era—a strong currency.[4] Indeed, after Truss first announced her plans, the pound sterling fell to record lows vs. the U.S. dollar.[5]

The Bank of England's experience is emblematic of the tough choices facing the U.S. Federal Reserve as it continues pushing to raise interest rates sufficiently to pull inflation back from 40-year highs while avoiding any undue turmoil to the U.S. economy. Our hope is that the Fed succeeds in its mission to tighten policy, because long-term inflation and the erosion of purchasing power it causes is far worse for the U.S. economy and investors than a comparatively short-lived recession or bear market.

The Road Ahead

The road ahead will be challenging, marked with political rancor and continued market volatility. As the Fed tries to navigate a soft landing, the S&P 500 remains in a bear market, a decline that follows three consecutive years of historically strong returns of 28.88%, 16.26%, and 26.89% for 2019, 2020, and 2021, respectively.[6] Additionally, the war in Ukraine continues to add geopolitical unrest to the global stage as do lingering concerns about China's "COVID zero" policy.

At its September meeting, the Fed raised benchmark rates by three-quarters of a percentage point, the third consecutive increase of that size, and indicated it would continue hiking rates well above the current range of 3.00% to 3.25%. Against that backdrop, Chicago Federal Reserve President Charles Evans said he remains "cautiously optimistic" that the U.S. economy can avoid a recession, absent further external shocks.[7] However, we may already be in recession, according to the latest data from the Bureau of Economic Analysis showing the U.S. economy shrank at an annual rate of 0.6% in the second quarter—the second consecutive quarter of negative gross domestic product growth.[8] So, the Fed's policy options appear to be narrowing.

Three Paths Narrow to Two

In Gerry's Journal from June of this year, *Bear Markets, Recessions, and Opportunities*, we discussed three possible paths forward for the Fed, inflation, and the U.S. economy:[9]

- **Scenario #1: *The Fed Threads the Needle***
  Under this scenario, the Fed gradually raises interest rates and reduces its $9 trillion balance sheet, taming inflation without prompting a U.S. recession as GDP growth remains positive. This scenario is the so-called soft landing.

- **Scenario #2: *The U.S. Enters a Recession***
  The Fed aggressively raises rates and reduces its balance sheet, slowing inflation dramatically. Tighter credit conditions restrain consumer spending and business investment, tipping the U.S. into a recession that brings about a decline in corporate earnings.

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[4] The Economist, *Liz Truss's selective Reaganomics won't work (link)*
[5] Reuters, *Sterling hits all-time low versus broadly stronger dollar (link)*
[6] Macrotrends, *S&P 500 Historical Annual Returns (link)*
[7] CNBC, *Fed's Evans says he's getting a little nervous about going too far, too fast with rate hikes (link)*
[8] Forbes, *Technical Recession Confirmed: Economy Shrank 0.6% Last Quarter, Final GDP Shows (link)*
[9] Gerry's Journal, *Bear Markets, Recessions, and Opportunities (link)*

- **Scenario #3: *Sustained Inflation, Stagnant Economy***
  The Fed fails to break the inflationary cycle, perhaps because it lacks the willpower to meaningfully raise rates or because a reduction in its balance sheet leads to a dislocation in the Treasury Repurchase market, as was seen in 2019.[10]

It's been a difficult summer for Fed Chairman Jerome Powell. The Fed's decision to undertake three consecutive 0.75% rate hikes gives the appearance that the central bank is playing catch-up and is a tacit admission that it was incorrect last year to call inflation "transitory."[11] However, the Fed is also trying to counteract the effects of excessive U.S. stimulus passed during the pandemic. Regardless of the causes of the current high U.S. inflation rate, any hope of achieving Scenario #1's soft landing seems to have faded.

Scenario #2 remains a possibility and would bring recession and short-term pain but would provide a clearer long-term path to equilibrium for the U.S. and global economies. As such, this is the scenario that most investors with a long-term time horizon should hope occurs. Scenario #3 would happen if the Fed loses the courage of its conviction. For example, if the Fed resumes bond purchases to support capital markets or slows rate hikes in response to political pressure before inflation was reigned in to target levels, undermining prospects for long-term economic prosperity. The UK and Bank of England's actions to avert a major financial crisis is as an example of Scenario #3 playing out in the UK.

The Fed must proceed carefully to avoid having to likewise perform a complete about-face with its monetary policy. We support the Fed taking strong measures to rein in inflation. However, if it overshoots the mark, it may find itself having to engage in vertigo-inducing policy reversals that could exacerbate confusion and volatility in capital markets. Accordingly, while Scenario #3 would potentially ease near-term capital market concerns, if current inflation is not tamed, it could lead to far greater problems down the road.

Our Advice Remains: Focus on the Long Game

Amid the dramatic headlines and market volatility, it is important for investors to avoid catastrophizing and imagining that these are unprecedented times. This is indeed the *normal* ebb and flow of the capital markets, as surely as the sun rises and sets each day. To put the current bear market in context: Since 1980, the stock market has declined more than 20% about once every five years with the average downturn lasting 16 months and producing a 35.1% decline.[12]

So, the current S&P 500 decline of more than 23% is certainly uncomfortable, but it is also far from unusual. As I have written before, for long-term investors that have prepared their portfolios for the cyclical nature of capital markets, this too shall pass.[13] While we wait, it's important to remain stoic and maintain perspective. As former U.S. President Harry Truman once observed, "It's a recession when your neighbor loses his job; it's a depression when you lose yours."

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[10] Federal Reserve, *What Happened in Money Markets in September 2019? (link)*
[11] CNBC, *El-Erian says 'transitory' was the 'worst inflation call in the history' of the Fed (link)*
[12] MarketWatch, *Stocks crashing? No, but here's why this bear market feels so painful — and what you can do about it (link)*
[13] Gerry's Journal, *This Too Shall Pass (link)*

According to data from the National Bureau of Economic Research that was analyzed by Forbes, there were 33 business cycles between 1854 and 2009. Within this analysis period, economic expansion lasted, on average, 3.2 years, recessions averaged 1.5 years, and the average full business cycle lasted 4.7 year.[14] Given that, investors should continue to match short-term assets against short-term liabilities and long-term assets against long-term liabilities while maintaining sufficient liquidity and looking for opportunities to dollar-cost average. It is vital to avoid being forced to sell long-term assets that have depreciated (such as stocks) to meet short-term needs (such as living expenses or major purchases.) Accordingly, we continue to recommend that most clients keep cash to cover at least 6 to 12 months of expenses at any given time.

We Continue to Look for Opportunities

For investors with a long-term perspective, the uncertainty of today's market also provides opportunity. The following are a few of the areas we are monitoring.

> **Fixed income is more appealing as yields rise.** After a decade of low yields as a result of accommodative monetary policy and quantitative easing, many market observers had been rethinking the role of core fixed income in portfolios. However, at the end of September, yields on the benchmark 10-year U.S. Treasury topped 4.00%, a 12-year high. As the Fed continues raising rates, that trend should continue.
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> **Dividend stocks can provide income.** When yields rise, dividends should also rise as companies typically want to offer a premium above holding Treasuries in return for the added risk of holding equities. This continues to be an area we are monitoring as interest rates rise and companies work to navigate this new landscape of rising rates and rising borrowing costs.
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> **Alternative assets can add diversification and mitigate the impact of inflation.** Investing beyond the traditional public stock and bond markets can provide investors with other potential sources of return while adding portfolio diversification. For example, floating rate private credit (where the owner receives a variable rate of interest) can be beneficial during periods of rising rates. Investments in infrastructure, both domestically and overseas, are often structured with cash flows that can mitigate some of the negative effects of inflation.

Closing Thoughts

The coming months will provide a test for the Fed and for central bank independence. As the Fed continues to raise rates and mid-term elections loom in a polarized U.S. political environment, we will be closely monitoring whether Fed Chairman Powell has the conviction to remain aggressive on inflation.

For the long-term well-being of the economy and markets, we hope so. In our view, it is worth enduring the short-term pain of slaying the inflation dragon in exchange for longer-term stability. Market conditions such as these are a good time to connect with your Wealth Advisor to review your personalized wealth

[14] Forbes, *Recession Is Overdue By 4.5 Years, Here's How To Prepare (link)*

management strategy, your strategic asset allocation, and your liquidity needs. Especially during challenging market environments, we are here to guide you, your family, and your wealth.

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