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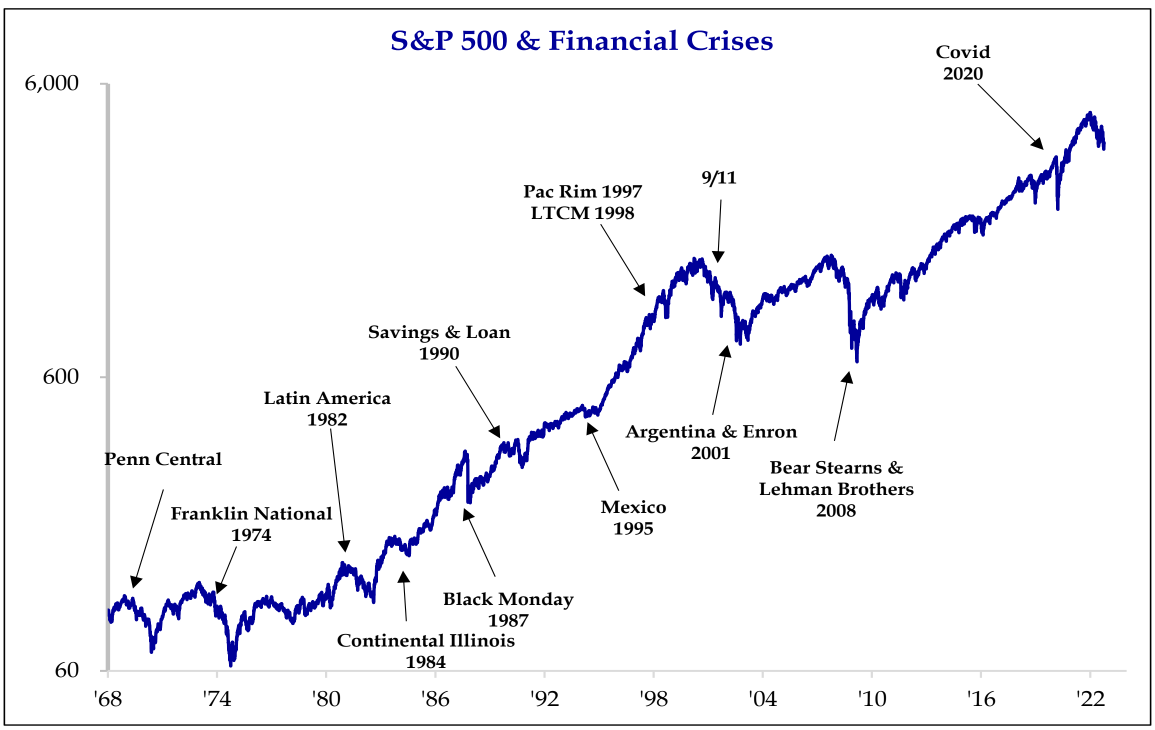
# FED TO FINANCIAL MARKETS: "IT'S NOT ABOUT YOU"

It's not often that you hear a professional investor pine for a financial crisis to bail them out of their long duration, long risk trades. And yet, I must have had 10 such conversations in the past few weeks, so conditioned have investors become to buy the dips when times are good and put serious money to work when things get tough and a financial player gets toe-tagged. Watch CNBC for an hour with the sound on and you'll find no less than three or four people an hour wondering aloud how the Fed could be so foolish as to risk a recession in its pursuit of price stability. It's almost as if money managers are taking the Fed's tightening campaign as both a personal affront and a crime against common sense. Such a reaction is, of course, understandable. After all, the famed "Fed put" was originally deemed the "Greenspan put" after the 1987 crash, almost 35 years ago.

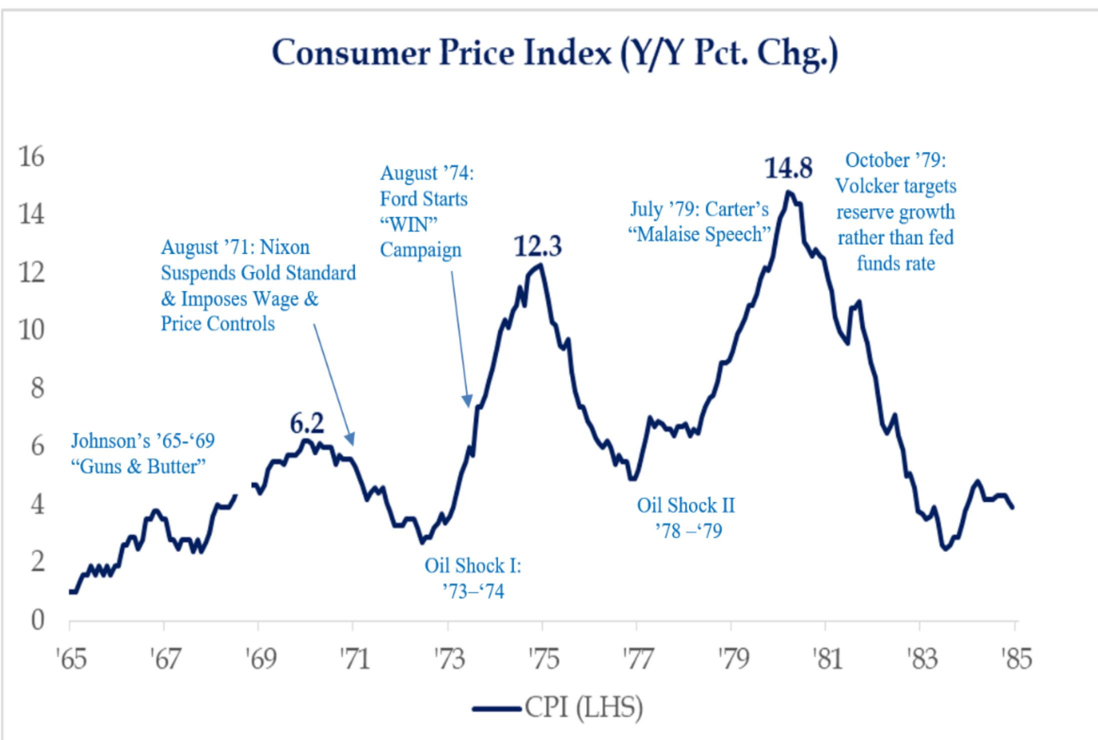
*Investors have been trained to welcome financial crises.*




We, on the other hand, believe it makes more sense now to simply listen to the Fed tell you how it's going to proceed, regardless of whether one believes it to be right or wrong. As in Blackjack, the object of the money game isn't to get 21, it's to beat the dealer.

We must all play the ball as it lies, accepting the world as it is, not as we wish it to be. In the end, it's not about you or your portfolio of secular growth stocks. Today, it seems clear that the Fed is speaking with one voice when it says that it believes its primary responsibility is to bring the rate of inflation down to something approaching its long-term goal of 2%. It should be remembered that Congress did not officially bestow upon the Fed its famed dual mandate of price stability and full employment until the late 1970s. Before that time, legally and practically, the Fed's primary goal was to pursue low and stable inflation.

In our interactions with Fed members over the years, we have learned a few things about the central bank that may not be immediately obvious: 1) it has a strong institutional culture that takes its responsibilities very seriously and is embarrassed when it comes up short; 2) it is largely model-driven; 3) it relies on the Phillips Curve as a general intellectual framework when forecasting inflation; and, 4) it desperately seeks to shield its decisions from political pressure.




*Fighting inflation in the 1970s was a process.*

With this in mind, we think it's unlikely that the Fed will make the mistake of staying too easy for too long twice in a row. Without hard data to support the idea that inflation is getting closer to its target, especially in the labor markets, the Fed is likely to continue to pursue more restrictive monetary policy. Finally, to the extent to which the Fed Funds rate remains deeply negative in real terms, we believe the central bank has a strong incentive to reach what it perceives to be its terminal rate while the economy remains near full employment. Tightening is always unpleasant but never more so than when people are losing jobs. With the unemployment rate currently at 3.5%, the Fed has a chance of avoiding the appearance that its fingerprints are all over potential job losses ahead of the 2024 Presidential election. Increases in the effective Fed Funds rate are far more obvious and public than a decline in the value of the assets on the Fed's balance sheet.

Finally, we think it's important to consider what the ***Fed*** believes would constitute a policy error rather than what ***WE*** believe would qualify as such. Naturally, the optimal outcome for any central bank tightening monetary conditions would be a soft landing in which inflation eases without a recession. ***More importantly, however, we don't believe the Fed would consider it to be a terrible outcome if the economy entered a mild recession if inflation was indeed vanquished in the end***. If one takes Chairman Powell at his word, the most unpardonable sin would lie in repeating the stop and go monetary policy that led to a series of higher highs in inflation of 6%, 12%, and 15% over the course of 13 years in the 1970s.

In short, we believe the Fed, for perhaps the first time in a generation, must be far more concerned about the deleterious impact inflation has on the middle class than the fortunes of wealthy people loaded with financial assets. As a result, we remain cautious on the general price level of U.S. stocks and risk, especially "long-duration" assets that feel the full effect of higher long-term interest rates. Our bearishness is no blood oath. If we got any sense that the Fed was about to get wobbly and declare victory over inflation at any level above its target of 2%, we would go long risk faster than you could say short squeeze. For the time being, however, we believe discretion is the better part of valor.

***Jason De Sena Trennert***

## APPENDIX – IMPORTANT DISCLOSURES

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