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VICTORIA Capital Management, Inc.

Market Musings

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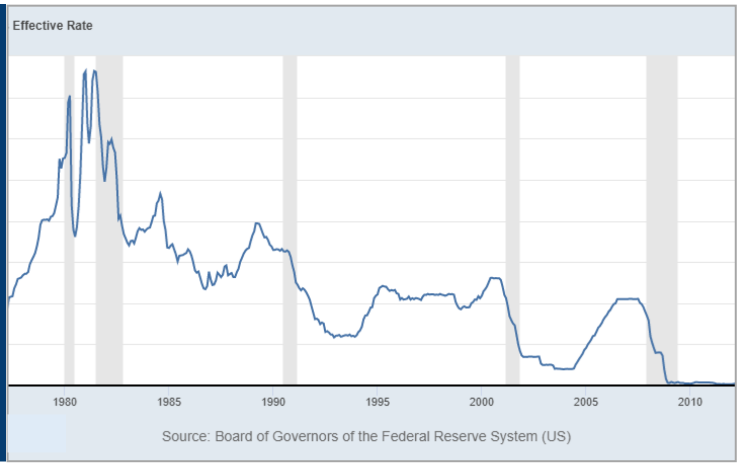
Monetary policy has played an important role in affecting economic growth. Looking at history, there is a good correlation between tighter fed policy and an economic downturn as reflected in the chart to the right that depicts the effective fed funds rate since the late 70s plotted with the recessions (gray areas).



A Change in Monetary Policy

Many financial market observers think that the Federal Reserve has been slow to react to the recent increase in inflation. The expectation is that the Fed will raise interest rates by up to six times this year to combat these price increases. These rate raises are expected to result in an economic slowdown and, in turn, a decline in inflation. As the economy is still recovering from the virus, the Fed has resisted creating an interest rate environment that would trigger another economic slowdown or recession.

Initially the Fed expected inflation to be transitory as the supply bottlenecks dissipated and the supply channels returned to normal. The Fed did not reflect on changes in energy policy that contributed to rising inflation. Once the Fed shifted policy to fighting the prospect of long-term inflation, the outlook for their policy changed; the outlook shifted to systematic interest rate increases at least through the end of 2022. The Fed also appeared committed to reduce the size of its balance sheet by selling holdings of both government and mortgage-backed securities. Each of these policy changes was bound to drive interest rates higher.

A commitment by the Federal Reserve to systematically raise interest rates is likely to produce a problem for the economy, especially one that is just coming out of a recession in 2020 due to the government's response to the Coronavirus. The last time that we experienced an aggressive Federal Reserve policy was rapid increases in interest rates imposed by Paul Volcker, chairman of the Federal Reserve. His policies did tame inflation in the early 1980s but not without the related recession that resulted from rapid rate increases. This time around, the increase is unlikely to be as great as interest rates were well into the double-digit level when Volcker's policies were introduced. Today, rates are near their record lows so any Federal Reserve policies are unlikely to drive interest rates substantially higher.

In late 2018, the Federal Reserve embarked on a plan to raise interest rates. One casualty of that plan was a rapid fall in stock prices (the S&P 500 fell 13.5%). Not until the Fed changed policy by easing did the stock market regain its footing and rallied through the end of 2019. The question is what events could occur that would change the Fed's policy this time around?

"If you want the rainbow, you have to put up with the rain."

Dolly Parton

Market Commentary

Despite restrictive monetary policies and the onset of a war in Ukraine, domestic and foreign stock markets rallied during March. The winners were commodities such as oil and gas stocks in addition to wheat, corn, soybeans, and cotton to name a few. Unfortunately, the gains in March did not lead most asset classes out of the red for the first quarter. Large-caps as measured by the S&P 500 are still down nearly 5% while mid-caps and small caps are down more than 5% year-to-date. Bonds suffered their worst quarter in more than 40 years!! Yields on short-term bonds as measured by the 2-year treasury saw yields rise the most since 1984 to finish at 2.32% up from 1.49% at the end of last year.

41% of the natural gas imported by the 27 nations that make up the European Union is supplied by Russia, along with 25% of the region's crude oil.

(*source: Eurostat)*