

The Fed has boxed themselves into a corner and are now in an entirely untenable place as a result of past policy actions. They had plenty of opportunities to stop QE when the economy roared back after COVID lockdowns, but instead maintained pumping excess liquidity while real interest rates went increasingly negative. Inflation data is now giving them little choice other than to hike rates while at the same time reducing bond purchases. The damage done to the economy will likely feel like self-inflicted wounds when reviewed in hindsight.

Fed policy today reminds me of the great Phil Collins song, Land of Confusion. Look at some of the lyrics from the song:

There's too many men, too many people  
Making too many problems  
And there's not much love to go around  
Can't you see this is the land of confusion ?

Recessions are part of the business cycle and a healthy way for the economy to eliminate excesses without experiencing a more catastrophic depression. When the next recession hits, the imbalances created by Fed policy will make recovery far more complicated. Given the prior recession ended in April 2020, we normally would not expect another recession to occur prior to mid-2024. Watching the yield curve over the last month suggests the next recession might come much sooner. If the Fed follows through on their plan to hike short term rates, with some analysts predicting four hikes, we will likely see long duration rates fall on slower economic activity by consumers. A prominent recession indicator over the last many decades is an inverted yield curve, and we could see that happen in 2022.

There is also a lot of confusion about policy surrounding the pandemic. There are countries removing all mask and vaccine mandates while others are increasing restrictions. Some states have eliminated COVID restrictions while others, like New York, are requiring all employees to be vaccinated simply to go to work. It seems clear that the about 30% - 35% of people who are not yet vaccinated are not going to get the jab. A significant number of people who received the initial jab are hesitant to keep taking booster shots as the efficacy of the vaccine against Omicron is uncertain. Nobody knows if and when the next variant will come and how it will impact the economy and ability for people to move about freely.

Lastly, geopolitical risks are creating uncertainty at a very bad time for the Biden Administration, whose approval rating is hovering in the low 40's. Even the mainstream media has turned on the President with NBC's Chuck Todd recently stating that Biden is 'no longer seen as competent or effective.' When the Administration's supporters publicly criticize the President, he appears weak and vulnerable when dealing with foreign policy. The timing of Russian aggression into Ukraine suggests Putin feels emboldened and given his track record, he will press the issue as far as he believes he is able. Geopolitical risks, whether Russia or China, are often the subject of worry but seldom materialize into market moving events. The chance current unrest results in disrupting the markets is elevated, as many investors simply need a reason to sell and sit on the sidelines given the shift in Fed policy.

We are definitely living in a land of confusion with not much love to go around. There are too many people causing too many problems for investors to be comfortable remaining long only in equities as the markets retreat. Volatility spiked in late January with the VIX index topping 30 for only the third time since February 2020 when news of the pandemic first hit. Traditional safe havens like Treasury bonds have done little to provide protection against equity risk as interest rates are slated to move higher. Real estate is softening based on the last four months of the Case Shiller index and interest rates have barely moved off the floor. Gold is traditionally considered a safe haven and inflation hedge and has held up well as stocks have corrected. It takes courage to be a contrarian in times like this, but there is a compelling argument to hold very long duration Treasury bonds -- 20 or 30-year maturities -- right now. If the long end of the curve moves lock step with the short end it would not be a good trade, but if higher short-term rates lead to higher financing costs and consumers reduce spending we will have a recession, and long-term rates should fall back to cycle lows.

