INVESTOR'S EDGE

The Fed, the economy and the market

What is going on with investment portfolios?

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I've been getting a lot of questions from readers who really want to understand the connection between the Federal Reserve, the economy and the stock market – especially as it relates to their investment portfolios.

As we all know, 2022 has been a very painful year for investors. Stocks, bonds, real estate – you name it – have had their values compressed significantly. The main culprit is the approximately 8.5% increase in inflation. Throw in the economic body blow of the brutal war in Ukraine, and you have a toxic brew for financial assets.

The Federal Reserve has responded by raising interest rates at the fastest rate in history, from 0.25% at the beginning of the year to 3.25% currently. And, as we will discuss, markets have suffered as a result.

So, why is the Fed messin' with my portfolio? Who are these Federal Reserve people and why do they have so much power over my economic life?

Let's shed some light on this.

By way of background, the Federal Reserve was created in 1913 in response to a series of "bank runs" that had occurred in the early 1900s. The goal was to create a centralized banking system that would act as a lender of last resort and better prevent monetary crises, such

"There are two things that can disrupt the business in this country. One is war, and the other is a meeting of the Federal Reserve Bank."

Will Rogers

as smaller banks running out of money.

Over the years, the role of the Federal Reserve has expanded and now has a threefold mandate: to promote maximum employment in the economy, stabilize prices and moderate long-term interest rates. The Federal Reserve has the power to raise and lower interest rates, buy and sell assets from their balance sheet and set the amount of money banks are required to hold in reserve.

As such, the actions of the Federal Reserve have a great impact on the stock market and the economy. An accommodative Fed will attempt to grow the money supply and the economy by lowering interest rates, buying securities on the open market, or lowering the reserve requirement. This makes money easier to get and generally gives a boost to the economy and stock prices.

A "hawkish" Fed will attempt to shrink the money supply and potentially slow the economy by doing the opposite – through raising interest rates, selling securities on the open market

and raising the reserve requirement. This makes money harder to get and generally brings consumer demand down along with the stock market.

Let's look to some examples in recent history for more clarity on this:

In 1997-1998, the Asian Currency Crisis led to a severe slowdown in global economic growth and a plunge of over 20% in the stock market. The Fed responded to the crisis by lowering interest rates three times in 1998 to boost economic activity.

After the dot-com bubble and 9/11 terrorist attacks in 2001, the Fed cut interest rates a whopping 11 times, shortening the economic recession and supporting the financial system.

The Federal Reserve was instrumental during the Great Recession in 2008. It cut rates 10 times and purchased more than $1 trillion in mortgage-backed securities to support the collapsing housing market.

And, as you surely recall, in March of 2020 when the stock market collapsed nearly 40% in less than a month, the Federal Reserve cut interest rates to zero and announced the beginning of a $4.6 trillion monetary injection of liquidity into the financial system. This included the Fed purchasing treasuries, mortgage-backed securities, and corporate bonds which backstopped the economy and stock market.

Today, the economy faces the highest inflation rate in nearly 50 years and global supply chain disruptions. The Fed is responding this time by withdrawing liquidity from the financial system by raising interest rates at one of the fastest paces in history. It is also reducing its balance sheet by stopping the purchase of any new securities.

This is the opposite of the previous examples and basically explains the weakness in global stock prices.

Higher rates hurt stocks by making the borrowing of money more expensive, so firms are less likely to hire, mortgages cost more, credit card balances go up, etc. It becomes a drag on the economy.

So, what is a local investor to do with these Fed people? Really not that much.

As the Wall Street Journal recently stated: "A long-term bet on stocks, even if the market continues to drop sharply in the near future, is the best way to maximize your wealth."

Certainly, there is nothing wrong with trimming or selling select positions, as long as you are not changing your investment plan simply due to market volatility.

Stocks have been the best wealth creating vehicle known to man. So, while you may want to fire Jerome Powell and his Federal Reserve, please don't fire your portfolio holdings.

Keep your nerve.

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