1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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The War against Inflation

Financial Markets

The war against inflation went into high gear this past week. The U.S. Federal Reserve continues to lead the fight, but central banks around the globe have joined the battle. Chairman Powell announced a 75 basis point increase in interest rates on Wednesday, and, more importantly, the tone of his presentation was more aggressive than in the past. We will cover more about monetary policy later, but, suffice it to say, investors around the world got the message and reacted strongly by selling.

The Dow Jones Industrials fell 4.00%, the S&P 500 fell 4.65%, and the NASDAQ fell 5.07%. Fixed income security prices also fell, while the U.S. dollar continued to gain strength.

Economics

The dominant economic news this past week was the Federal Reserve's announcement of another 75 basis point interest rate hike. The size of the increase was what many investors expected, but, as we noted earlier, it was the significant change in Chairman Powell's tone that spooked market participants. In past statements, the chairman held out hope that monetary tightening may still lead to a soft economic landing. There seemed to be much less hope for a soft landing in this presentation.

The fear, of course, is that the economy may enter a wage-price spiral. This occurs when both wage earners and employers expect significant future inflation, and they each demand more in response—laborers demand higher wages, and businesses demand higher prices for their goods and services.

In this battle against future inflation, the Fed faces some new and unique obstacles. The first two are somewhat obvious—the economic dislocations caused by the pandemic and the war in the Ukraine. The problems caused by the pandemic are slowly improving with the passage of time and the introduction of relatively successful remedies. The war in Ukraine is more difficult to address, but, until it is resolved, price pressures on energy and food will remain.

To combat the economic impact of the Great Recession, the Fed introduced a new policy tool—quantitative easing. They reintroduced this tool in 2020 to provide economic support against the economic shock caused by the pandemic. Under this program, the Federal Reserve started to buy long term debt securities rather than the normal money market instruments, which are very short term. The experiment worked when trying to stimulate the economy, but we do not yet know the full ramifications of when the policy is reversed.

The real economy, as opposed to the financial economy, is feeling the effects of higher interest rates to a greater extent. The slowdown is not as severe in the United States as it is in Europe and China. Given the almost universal monetary tightening underway, investors should expect further slowing of the economy.

A lot is happening around the world that will impact both the domestic and global economies. As we have reminded readers, October 16th is a very important date in China. It is Election Day, and the National People's Congress will vote for a president. It is a forgone conclusion that Mr. Xi will

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be reelected again, perhaps for life. The important part is what President Xi will say. We expect a relatively bellicose statement concerning Taiwan and tightened government control of the economy. We believe this to be an ongoing plan of Xi's.

The U.K, of course, has a new prime minister and appears to be embarking on a different economic direction. Tax cuts and government borrowing look to be the order of the day, which is in conflict with the Bank of England's monetary tightening.

Italy is poised to have a very conservative leader, and the U.S. has midterm elections on the way. The midterms will go a long way in showing the direction the U.S. is heading.

Conclusion

Investors are faced with many unknowns, but there are also some positives to keep in mind. The Fed is embarked on an aggressive campaign to combat inflation, which could turn the market. If the economy does go into a recession, history tells us markets do worse a year before a recession compared to during or after. This is not the time to completely bail out on the markets, as reversals can occur quickly.

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