Who's Crying Uncle First?

The Bond Market or Jerome Powell?

by David Walter *April 2022*

The news is all around us: Inflation is going through the roof, mortgage interest rates have almost doubled over four months, pending home sales are down three months in a row, and major stock market indexes are down anywhere from 15-20%.

On the economic side, the index of Leading Economic Indicators in positive mode and employment could not be better.

What gives? Should we worry when everything in the economy looks great? *Yes*. Markets usually change trend to down on good economic news and when monetary liquidity is getting tighter. Stocks of the future like Zoom, Teladoc, etc. are down 80-90% in a year. Bond markets are down 10-30% depending on their duration, and we're at the point where a few Megacap tech stocks like Apple, Google, and Microsoft are in the process of following the rest of the markets down. Commodities and oil continue strong despite currently being in a correction.

Bull markets end in a rounding top formation that can take a couple of years and is greatly affected by tightening monetary conditions. That's where the markets are now. Should Jerome Powell at the Federal Reserve continue to stay the course on tightening, the Megacap Tech stocks have a long way to go down. Of the original FANG stocks, Facebook and Neflix are down 60% and 70% respectively from their peaks. Google appears to be rolling over based on today's decline and Apple is the last holdout. Apple reports earnings tomorrow.

Markets have recently been very volatile with an overall declining trend. Technology, the strongest sector of the last ten years, has declined the most. We've had a number of scary plunges in the major indexes over the last few years. Each one seemed like the dagger to the heart of the markets. Those plunges did not mark the end. Why? Because the Federal Reserve cried uncle each time and came to the rescue by keeping the monetary spigots open.

This time may be different. So far, the Fed has only raised short-term interest rates 25 basis points, or one-quarter of a percent. Various players at the Fed, like Jerome Powell and Jim Bullard, have made a lot of noise about the need to hike rates a significant amount going forward. The rise in market rates has happened not because of action by the Fed yet, but by the Fed jawboning interest rates up.

As expressed in the past, I have doubts about them following through on their words. Market declines thus far lead me to believe that the Fed will stop sometime this summer, both with words and action. What matters most, is does the Federal Reserve still have control over the bond market? Will macro factors like war and oil prices prevent them from that control.

In the meantime, the ten-year treasury rate has almost doubled. How is that possible? It's possible because market trading by institutions, hedge funds, big banks, and the like control those rates through their trading activities. I've spoken about the modern market structure numerous times in the past. Just the way sectors like commodities were totally out of favor up until last year and momentum stocks ruled the roost until then, markets often go to the extreme because of the impact of algorithmic trading and hedge funds' strategic trading models, gamma trading (i.e. try to figure out what that means).

Everything has a fair value. Small-caps, new era stocks, commodities, and basic materials are selling at bargain prices. They can still go lower, but their five-year outlook is great. At the same time, should the rise in interest rates be real for the long term, the big winner. If the trend in inflation and interest rates is for reals, the aforementioned sectors along with large cap value will outperform over the next ten years.

There will always be opportunities along the way. That means having a willingness to buy good quality companies and sectors that are out of favor while selling popular sectors when sentiment turns and macro forces suggest changing strategy.