FINANCIAL TIMES

WEDNESDAY, 01 FEBRUARY 2023

OPINION

Markets Insight

End the Fed 'put'

With the entire credibility of central banking on the line, the focus needs to be on fighting inflation

RICHARD BERNSTEIN

The Maytag Repairman was a fictional washing machine mechanic who was lonely because no one ever needed to repair a reliable Maytag appliance. Instead of tools, he carried a book of crossword puzzles and cards to play solitaire to combat his boredom.

For many years, the US Federal Reserve played the role of the Maytag Repairman with respect to inflation. With the expansion of globalisation and the resulting secular disinflation, there wasn't much for it to do to fight inflation. Rather, it could generously ease monetary policy during periods of financial market volatility without much concern that its efforts to save investors might spur inflation.

The repeated efforts to curtail financial market volatility led to the term the Fed "put". Investors viewed the Fed's behaviour as though the central bank were consistently writing a protective put option to limit investors' downside risk.

With perceived guaranteed downside protection, investors rationally took excessive risks because the Fed repeatedly quelled financial market volatility with significantly lower interest rates. Risk-taking often got extreme. There were three significant financial bubbles in the past 25 years — the dotcom boom, the housing market, and the surge in tech companies/growth stocks/cryptocurrencies before recent sharp corrections.

Before the pandemic, some investors were puzzled as to why the Fed was concerned with global warming and climate change. Its dual mandate is a focus on unemployment and inflation, yet it began to wade into the politics of climate change.

A snide reasoning might be that those at the Fed were bored. Much like the Maytag Repairman who had nothing to do so played solitaire, they were looking for something to do during a long period of secular disinflation. It was easy for the Fed's attention to wander to topics such as climate change when secular disinflation was making its job relatively boring.

However, the Fed's phone has recently been ringing. Inflation is back and there has been plenty for it to do. Perhaps reflecting the renewed sense of urgency, Fed chair Jay Powell several weeks ago specifically commented that climate change was not the central bank's responsibility.

Unfortunately, some financial observers and Fed officials don't seem to appreciate the need for focus. Some are advocating pausing rate increases or even lowering rates. Such actions seem terribly premature when the real Fed funds rate has only recently turned positive and inflation remains well above any reasonable target.

Investors have been acting as though the central bank is ready, willing and able to supply the easy money protection of the Fed put. The growing notion that inflation has peaked and the central bank will soon "pivot" to lower interest rates has fuelled a rally so far during 2023 in the riskiest, most speculative assets. Meme stocks are up more than 25 per cent, bitcoin is up more than 40 per cent and the Ark Innovation Fund that invests in speculative tech prospects is up more than 30 per cent. The best-performing US sectors year-to-date are communications, consumer discretionary and technology.

If the Fed put is a thing of the past, history suggests traditional defensive sectors tend to outperform when there is a combination similar to today's tighter monetary policy and decelerating corporate profits. Needs outweigh desires and sectors such as consumer staples, healthcare and utilities typically lead.

Longer term investors should ignore themes that we have derisively called "cute wiener dogs in the metaverse" to focus on the woeful US underinvestment in real productive assets. Potential returns seem attractive from longer term opportunities in public and private sector infrastructure and manufacturing capacity. Few investors seem aware that analysts' bottom-up forecasts show the energy sector could grow earnings more than twice as fast as the technology sector over the next five years.

It is certainly understandable that financial market observers want the Fed to reverse course and write another put option. Much of the financial sector's business has been built on generous and cheap money.

However, the entire credibility of central banking is on the line and the Fed put should end. No one wants a recession, but allowing inflation to reignite could damage the US economy for a decade or more and, in the current volatile political environment, could even destabilise the governments of the US and other nations.

The writer is chief executive and chief investment officer of Richard Bernstein Advisors