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Zevin Asset Management
INVESTMENT UPDATE

# A Triple Whammy Tightening and Entering the Danger Zone

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In a previous inflation missive, I commented on powdered milk and toothpaste. The former being an example of a sacrifice families made in the past in response to soaring prices and the latter an analogy. Like trying to put toothpaste back into a tube that's been squeezed, inflation is difficult to rein in once it takes hold. This sentiment rings true today, with the global economy experiencing severe inflation. To put it another way, the toothpaste is out of the tube and authorities are trying to get it back in so that we all don't have to resort to drinking powdered milk.

The onset of the COVID-19 pandemic spurred an unprecedented collapse in global economic activity. Unemployment in the U.S. soared virtually overnight from 3.5% to almost 15% from February to April 2020. Along with mass layoffs and plunging economic activity, many households experienced severe financial instability.

Faced with immense economic uncertainty, authorities responded with both traditional tools and unconventional measures.

### TRADITIONAL TOOLS

- **Fiscal stimulus:** governments provided support to businesses and directly to the unemployed with massive spending toward various relief programs to maintain demand.
- **Monetary stimulus:** central banks slashed interest rates to grease the wheels of economic activity.

### UNCONVENTIONAL MEASURES

- **Quantitative easing (QE):** Central banks aimed to stimulate economic activity by buying various types of longer-term bonds to push down interest rates at longer debt maturities.

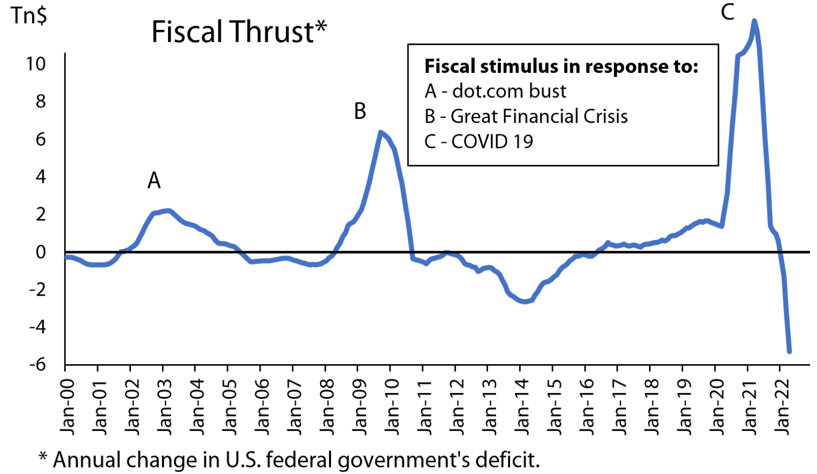
In short, governments and central banks addressed the initial impacts of the pandemic through stimulus, which by design is meant to reverse deflationary trends, prop up demand, and increase economic activity. However, these efforts coincided with significant supply chain disruptions, which impacted everything from industrial commodities, such as lumber, to advanced technologies, such as semiconductor chips. This sudden supply shortage alongside authorities' efforts to prop up demand created a mismatch between supply and demand, spurring inflation. Adding fuel to the fire, Putin's barbarous invasion of Ukraine further jeopardized global supply issues as well as energy and food costs. It's no wonder that inflation soared.

### THAT WAS THEN…THIS IS NOW: A TRIPLE WHAMMY TIGHTENING

There are typically two phases to an inflationary episode. In the first phase, the inflation period, price hikes spur further price hikes in related goods and services. Policymakers react by tightening conditions, ushering in the inevitable second phase, economic slowing, which we're beginning now. However, this time is different and likely more dangerous than in the past, due to combined interest rate hikes, quantitative tightening, and fiscal tightening.

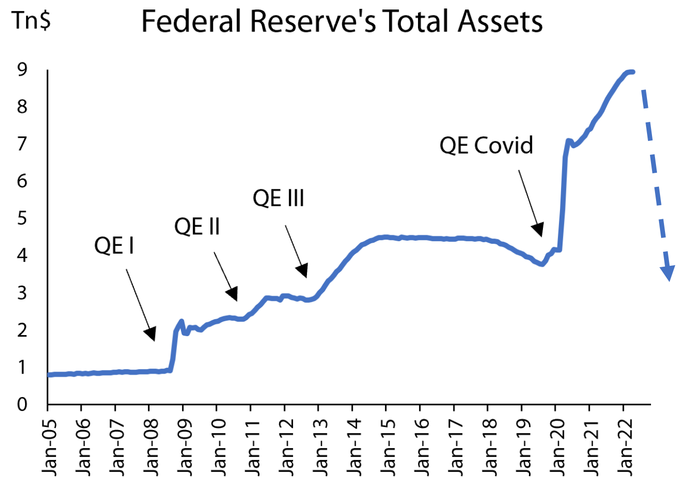
## FISCAL THRUST TO FISCAL RETREAT

From March 2020 to December 2021, the U.S. fiscal response to the pandemic amounted to a whopping 27% of GDP. That is second only to Singapore's spending in response to the pandemic. A common metric to capture this stimulus is shown in this chart, which depicts "fiscal thrust" or the annual change in the U.S. federal government's deficit. The chart clearly indicates the U.S. fiscal stimulus in response to the onset of COVID-19 was unprecedented and has since gone into reverse, becoming extremely restrictive. The immense amount of stimulus previously provided warrants a commensurate amount of tightening, which comes with risks.



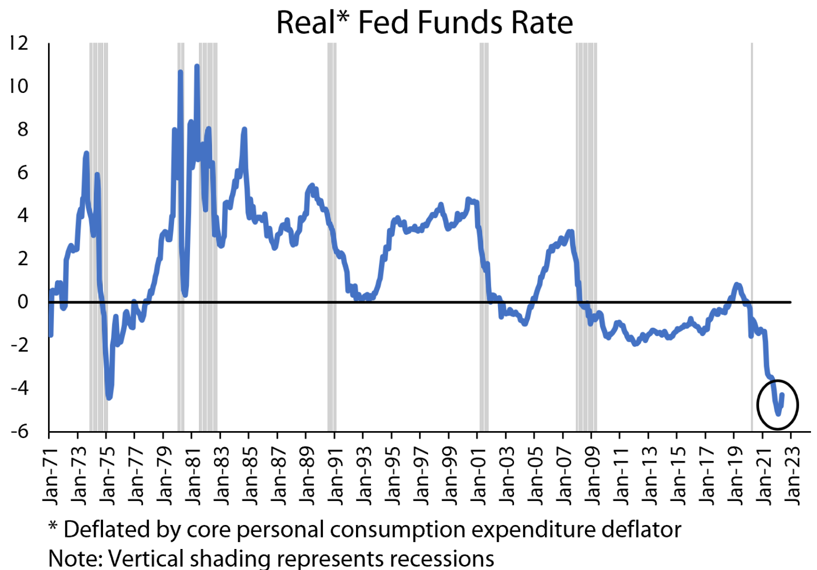

## QUANTITATIVE EASING TO QUANTITATIVE TIGHTENING

During the Great Financial Crisis of 2008–2009, the U.S. Federal Reserve employed the highly unusual and unproven technique of quantitative easing to inject additional stimulus into the moribund economy. In three distinct quantitative easing programs (labeled as QE I, QE II, and QE III), the Fed bought fixed-income assets in order to push down interest rates beyond the very short-term overnight lending rate. Before the Fed could fully unwind these positions to remove the artificial stimulus, the pandemic hit in 2020. The Fed then employed another QE program, doubling the size of its balance sheet. Recently, the Federal Reserve has signaled an aggressive unwinding of these positions beginning in June 2022. While QE programs had the intended effect of reducing interest rates, comparable quantitative tightening (QT) is expected to lift borrowing costs and provide another form of restrictive policy.




## STANDARD MONETARY POLICY TIGHTENING

The U.S. Federal Reserve has also embarked on standard monetary tightening with a 25 basis point increase in March followed by a 50 basis point hike earlier this May. The central bank has seemingly stolen a page from Paul Volker's playbook (the former Fed Chairman who successfully killed inflation in the 1980s by aggressively raising interest rates). Unfortunately, that tightening cycle culminated in a double recession in the early 1980s, something which the Fed and other central banks are obviously trying to avoid this time around.




Over the last 50 years there have been seven recessions, as indicated in this chart, each was preceded by rising interest rates coupled with a positive real fed funds rate. Some combination of much higher interest rates and much lower inflation would

result in this restrictive policy stance and historically this has been a necessary and sufficient condition to induce a recession. While the real fed funds rate currently remains firmly in negative territory, it has clearly bottomed, and the Fed's telegraphed intentions imply it will continue to push higher, therefore creating another element of risk for the U.S. economy and financial system.

## BOTTOM LINE

The U.S. has experienced an incredible surge in inflation with the reopening of economies following the COVID-19 induced lockdowns. Numerous factors contributed to inflation's reemergence, and now three tightening measures are acting simultaneously to reverse it. Never before has an economy experienced a period of aggressive interest rate hikes, quantitative tightening, and fiscal tightening all at the same time. The U.S. economy is in a fragile position, emerging from the 2020 recession and the ongoing disruptions of the pandemic, while also facing this triple whammy tightening. Our portfolios have not been immune from volatility. We continue to believe we own best-in-class businesses that can weather market turmoil and deliver satisfying returns over time. We have rebalanced our bond portfolio to be better positioned in bonds producing more income and we are actively researching new stock investment opportunities as we navigate these unique economic conditions.

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