Permission To Land

Dr. Rumack: "Can you fly this plane and land it?"

Ted Striker: "Surely you can't be serious."

Dr. Rumack: "I am serious... and don't call me Shirley."

– *Airplane!* (1980)

Federal Reserve Chair Jerome Powell certainly has his work cut out for him. Cooling inflation without sending the economy into a recession is no easy task. Especially considering that inflation is already running significantly above the central bank's target.

Fed officials think that targeted interest rate increases will cool an overheated economy just enough to tamper price inflation. But even Janet Yellen, former Fed Chair and current Treasury Secretary, said that avoiding recession "will require skill – and also good luck." Which sounds a lot like the predicament facing erstwhile war pilot Ted Striker in the 1980 comedic masterpiece, *Airplane!*

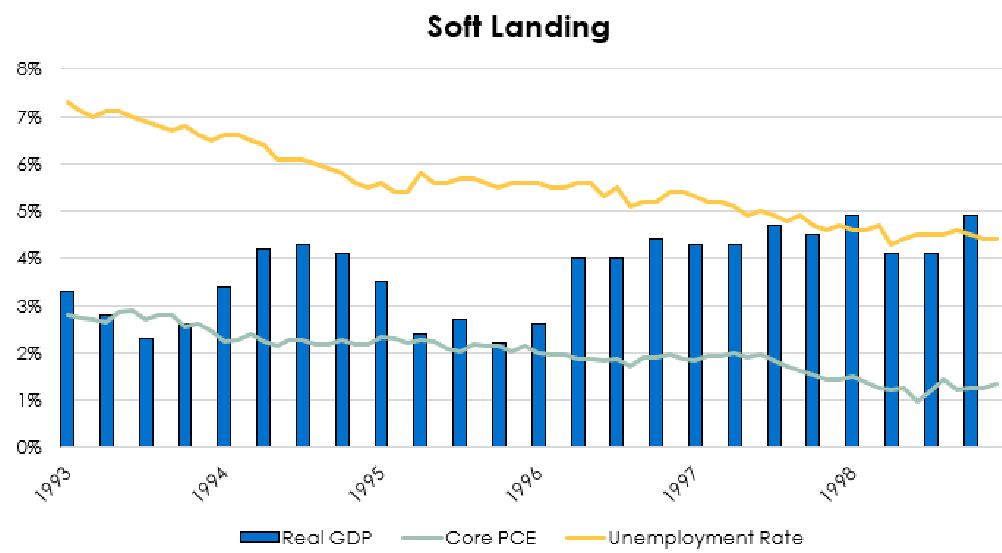
Over its history, the Fed has never been able to cool inflation by 4% - it's current goal – without sending the economy into recession. However, Fed officials can look back at different episodes in history and find reasons for both caution and optimism.

One of the major factors threatening success is that the Fed must combat inflation that's already here, as opposed to inflation that's coming down the pike. Prominent Stanford economist John Taylor highlighted this point when he recently said "This is not the first time in history that they (the Fed) have been behind, but they are strikingly behind. They need to catch up and do it in a systematic and understandable way."

SOFT LANDING

The best case scenario would be for the Fed to orchestrate a "soft landing" for the economy, where interest rate increases tamp down economic demand just enough to cool inflation but not too much that theysend the economy into a recession. This will not be easy, however. Jerome Powell even admitted so himself last month: "No one expects that bringing about a soft landing will be straightforward in the current context – very little is straightforward in the current context."

The Fed has been able to achieve this result in the past (see chart at right), albeit under different circumstances.



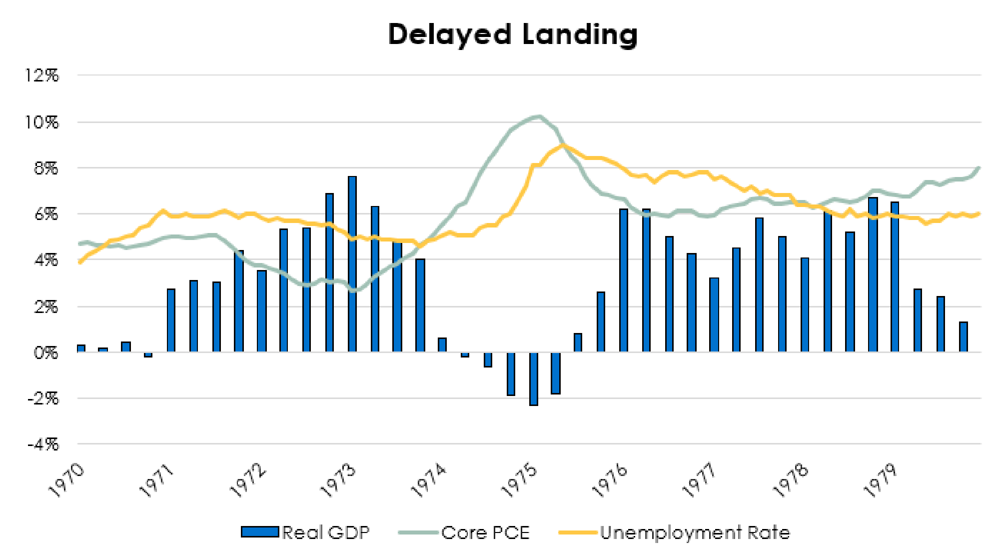
Source: Federal Reserve Bank of St. Louis

In the early 1990's, former Federal Reserve Chair Alan Greenspan hiked interest rates by 3% in 1994 without causing economic growth excluding the impacts of inflation (measured by real GDP) to go negative.

Two major differences between then and now are that 1) the unemployment rate is already exceptionally low, signaling a tight labor market, and 2) inflation (measured by the change in prices of personal consumption expenditures excluding food energy, or "Core PCE") is already embedded in the economy.

DELAYED LANDING

The main obstacle to executing a soft landing might be the fact that inflation is already here. As John Taylor pointed out, the Fed is behind the curve in terms of preventing inflation, thereby compicating its policy response.



Source: Federal Reserve Bank of St. Louis

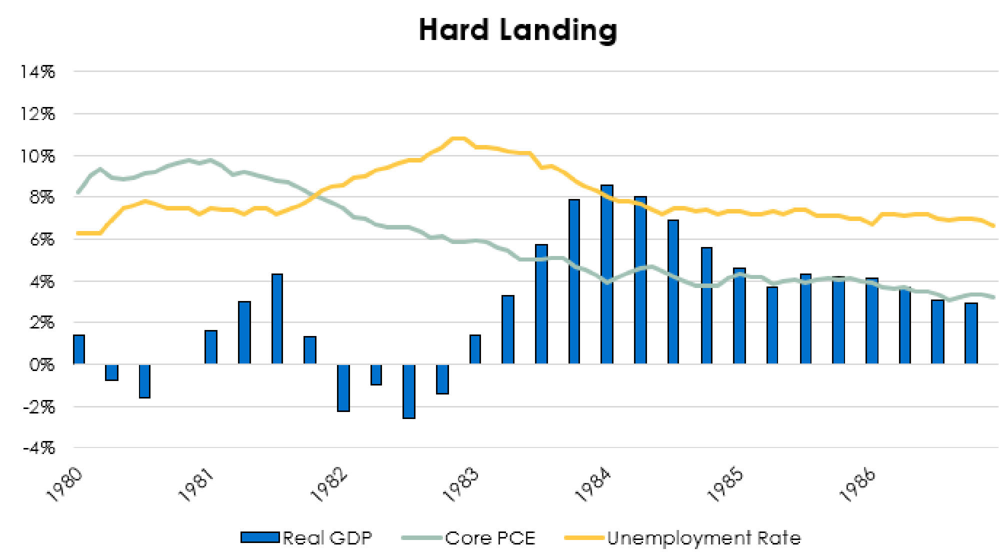
Historically, the Fed faced a similar set of circumstances in the mid-1970's. The policy response then was to raise interest rates at a measured pace in the hopes of avoiding a "hard landing."

As you can see in the chart on the previous page, this course of action didn't quite work out as planned. Inflation remained high (and actually increased), the economy experienced a recession, and unemployment rose. While the Fed was able to avoid forcing the economy into a severe recession, the underlying problems were not resolved.

HARD LANDING

Following the "delayed landing"discussed above, Federal Reserve Chair Paul Volcker decided that the only way to contain inflation would be to dramatically rise interest rates. So, that's exactly what he did.

By June of 1981, Volcker had raised the Fed's federal funds rate to 20% (!).



Source: Federal Reserve Bank of St. Louis

As you can see in the chart at right this spike higher in interest rates was able to halt inflation, sending the Core PCE lower, but at the price of forcing the economy into a double-dip recession that saw the unemployment rate jump from around 6% to over 10%.

The long-term economic gains evenually outweighed the short-term pain, but there was still a fair amount of hardship along the way.

Given the degree to which inflation is outpacing the Fed's 2.0% target, it seems unlikely – but not impossible – for the Fed to engineer a soft landing. Especially when considering that the Fed will also be looking to shrink its ~$9 trillion bond portfolio along the way.

Despite the challenges facing the Federal Reserve, we continue to believe that the macroeconomic picture is likely to be one of positive, yet moderating, growth (excluding the negative Q1 GDP report, which we view as an aberration caused by certain timing issues) combined with elevated inflation – a set of circumstances we've dubbed "moderate resilience". As such, we will continue to focus on "value" and "quality" as this economic cycle matures.

Stock market volatility, thus far, has largely been due to valuations resetting lower rather than a significant deterioration in the fundamentals. Throughout the past year, we have trimmed "riskier" assets in client portfolios (stocks and alternatives) to maintain a relative balance with lower volatility securities, like fixed income and hedges against market volatility.

We have become slightly underweight equities in general and we continue to favor "value" and "quality" within the large-cap domestic market. We've also taken steps to become more defensive in terms of our sector weightings in our individual equity portfolios. We also prefer developed markets over emerging markets, due to better insulation from the negative impacts of inflation.

In the fixed income area, we remain focused on higher quality credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates.

Within the alternative market segments, we have maintained an emphasis on "real assets" (think commodities and, to a lesser extent, real estate) as a hedge against the potential for continued inflation. We maintain an overweight to the diversified alternative sector as a hedge against market volatility.