Fed Talk vs. Investors

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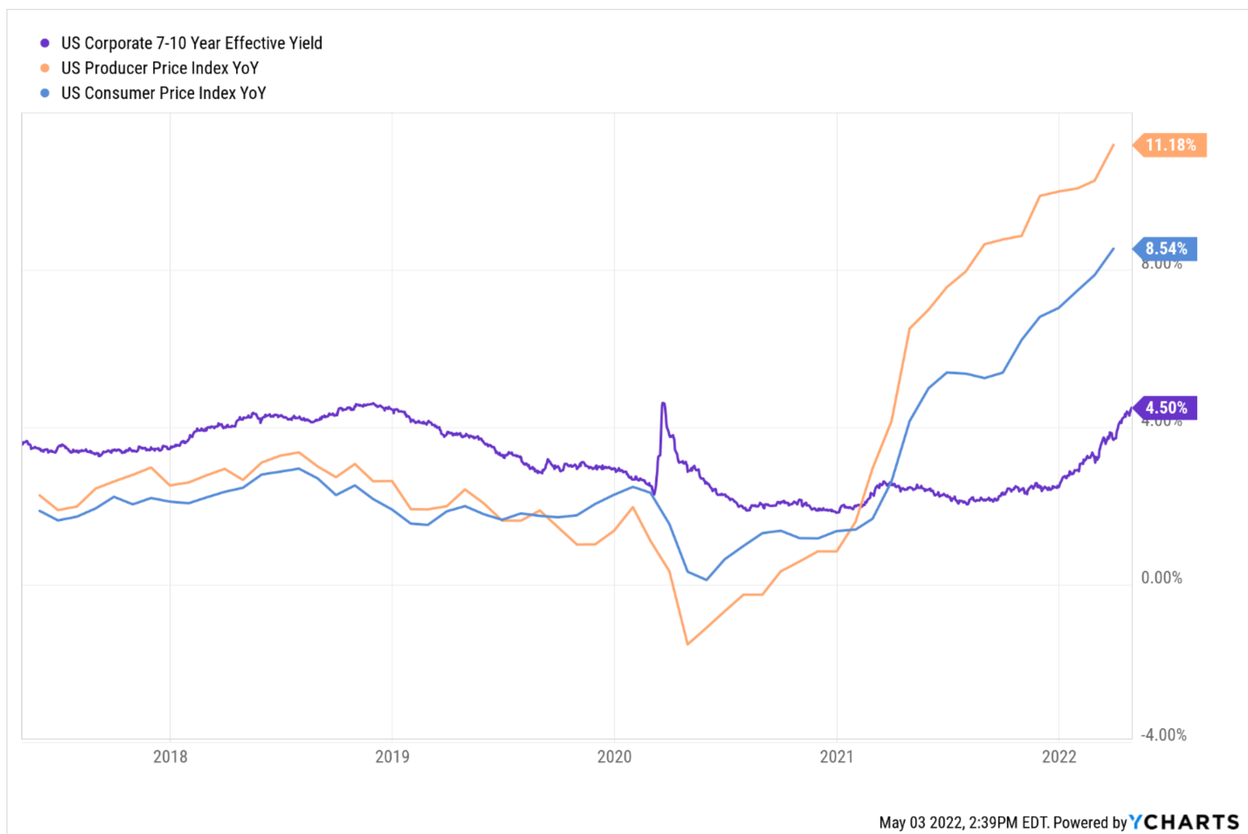
Since January 2021, the last 15 months has shown a dramatic increase in inflation due to a combination of deficit spending, monetization of government debt, and supply constraints. The orange and blue lines below reflect the producer price index and the consumer price index measurements, respectively, on a year-over-year basis through March 31, 2022. The fixed income market did not respond to the higher inflation rates until the beginning of 2022. The purple line shows the US Corporate yield for bonds with maturities in the 7-10 year range.



What can we expect for inflation and interest rates in the future? David Rosenberg, chief economist and strategist at Rosenberg Research, has been making the case since early 2021 that inflation is transitory in nature. Rosenberg believes that consumer demand returned post-pandemic while supply chains increased capacity more slowly.

He also believes that the year-over-year inflation statistics have been distorted due to "base effects." The reduction in demand during the pandemic reduced demand and prices, so when the economy and prices recovered, they looked much higher in comparison to the low base period of the prior year.

Rosenberg believes that "The only thing that's not temporary is this gargantuan debt burden." The amount of debt accumulated by governments around the world will keep a cap on how high rates can ultimately go, because a higher cost of debt service would strain governments and the overall financial system. The basic premise of his argument is that central banks have ultimate control over interest rates.

Bill Fleckenstein, President of Fleckenstein Capital in Seattle, has a different opinion. In an interview with Adam Taggert last week, he offered this opinion of the Fed and the bond market:

> So, over here in America, we have a situation where the central bank has gotten boat loads of inflation. Inflation they didn't expect – they're in denial about. Then, they said it's transitory. Now, they're going to huff, and they're going to puff, they're going to blow the house down. They're going to do all kinds of hot air talking. And so far, they've raised a grand total of 25 basis points.
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> Is QE (quantitative easing) over? We're real close to QE being over. So, what's been the response of the bond market to their poor policy choices of not taking the punch bowl away? And of being wrong? The bond market has backed up a couple hundred basis points, maybe more, depending on what part of the (yield) curve you want to look at.
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> And because, the last 20-25 years, the people that have been trained in finance that don't have as much grey hair as I do, have learned that the central banks are always right. They always get it right. I mean, nah, they might make a mistake, and might have an accident, then they get… in other words, they have tons of credibility. So, they write the narrative like this: the bond market has now priced in twenty rate hikes, or you know ten, or twice as much. Whatever it is, the bond market has priced in what the Fed's going to do. But the Fed's done nothing.
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> So, I submit, that narrative is all wrong. The bond market is not pricing in (rate) hikes. The bond market is revolting. It's voting with its feet. It doesn't want this level of rates given the level of inflation, and economies of the world, and central bank policy. So, if you write the story one way it sounds

like the Fed has credibility. If you write it the other way, it sounds like they don't. Now I don't see why they should have any (credibility).

If you have any questions or comments, please contact me.

Sincerely,
Robert G. Kahl
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