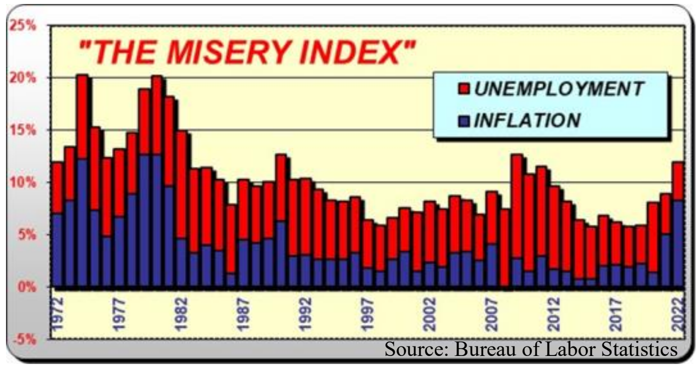
Investment Watch

3rd Quarter, 2022

The Misery Index



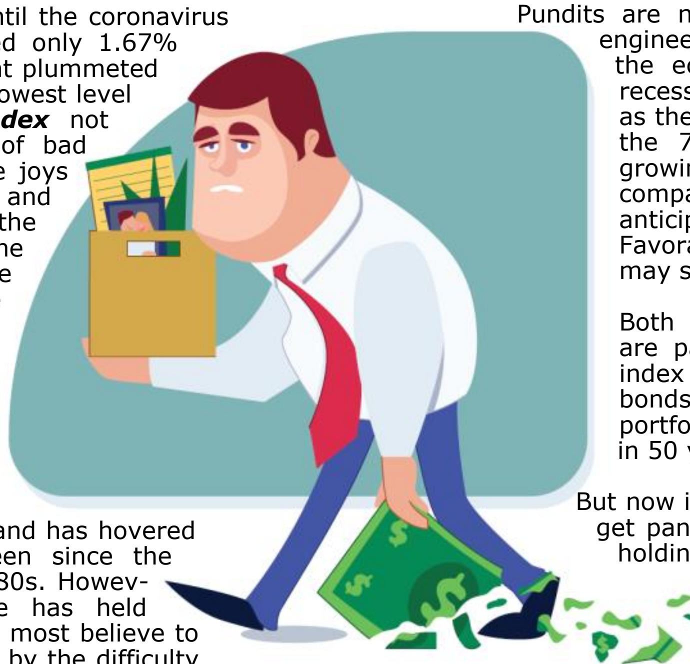
Source: Bureau of Labor Statistics

Economist Arthur Okun coined the phrase ***Misery Index*** to gage Americans' financial suffering by adding inflation to the unemployment rate. Inflation eats away at the buying power of workers' paychecks, but unemployment wipes them out entirely. Today, with full employment, it's the rampant inflation that is the culprit elevating the ***Misery Index*** and tanking our portfolios.

In the early '80s, Fed Chairman Paul Volker squelched double-digit inflation by driving the fed funds rate to a record 20% triggering skyrocketing unemployment reaching 10.8%. Both high inflation and high unemployment drove the ***Misery Index*** to over 20%. As the blue bars in the graph prove, Volker's Fed did tame runaway inflation which tumbled from a peak of over 13%. Volker's Fed triggered two recessions and caused extreme *Misery,* but inflation was tamed and had stayed subdued for almost 40 years...until NOW!

The ***Misery Index*** peaked again in 2009 during The Great Recession. This time the perpetrator wasn't inflation, but rather, extreme unemployment sparked by a global economic meltdown. 8.6 million Americans lost their jobs and their paychecks during that 2008-09 downturn. Taking five years to regain those job losses, economists branded it the *"jobless recovery."*

From the Great Rescission until the coronavirus shutdowns, inflation averaged only 1.67% per year, while unemployment plummeted from 10% to just 3.5%, the lowest level in 50 years. The ***Misery Index*** not only measures the misery of bad economic times, but also the joys of the good. Low inflation and nearly full employment in the six year period before the coronavirus shutdowns were the best of times since the '50s as measured by the low level of the ***Misery Index.***



At the beginning of 2021, inflation was only 1.1% but skyrocketed as the economy reopened from pandemic shutdowns. Over the last 10 months, inflation peaked and has hovered around 8%, a rate not seen since the double digit inflation of the '80s. However, the unemployment rate has held steady at the mid 3%, a rate most believe to be full employment, born out by the difficulty in filling job openings. Inflation is the only culprit for today's elevated ***Misery Index***.

Why has inflation skyrocketed?

⇒ Coronavirus shutdowns stifled production. As the economy reopened, the $6 trillion in massive federal stimulus unleashed consumers' pent-up demand which snarled supply-chains. Too much money chasing too few goods drove surging price spikes.

⇒ Housing demand and prices skyrocketed due to low interest rates, pandemic-related rise in home offices and desire for single-family homes.

⇒ Since Russia invaded Ukraine, food, energy, and commodity prices have soared around the world.

The Federal Reserve is determined to squelch inflation before it becomes embedded in our economic psyche creating an inflationary spiral. Federal Reserve Chairman Powell's hawkish remarks backed up by jumbo rate increases have drove the Fed's interest rates from effectively zero to 3.0%+ in an attempt to restrain Americans' spending spree, slow the economy and curb inflation. It may have started to work. Home prices fell in both July and August, the largest declines since 2009, while commodity prices are coming back to earth with oil dropping from $115 just a short time ago to $82.

Pundits are now debating if the Fed can engineer a *"soft landing",* i.e. slow the economy without triggering a recession. The Fed's record is poor as the only soft landing was back in the 70's when employment kept growing. This time seems similar as companies keep hiring despite anticipating an economic slowdown. Favorable employment conditions may soften any downturn.

Both the bond and stock markets are panicky. The S&P 500's stock index lost 23.9% this year, while bonds, usually the safe haven in a portfolio, lost over 14%, the worst in 50 years.

But now is not the time for investors to get panicky. US corporate profits are holding up much better than expected - estimated to rise 8.1% in 2022. Ultimately, profits drive prices and corporate America has yet to see the negative effects of a recessionary slowdown. Although bond investors have had outsized capital losses, bond yields have risen due to the Fed's action. Bondholders can now expect higher future yields. If the Fed can curb inflation with just a mild recession, unemployment will stay low, and the ***Misery Index*** will record the better times ahead.

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