Key Questions

March 28, 2022

What Could Fed Chair Powell Learn From a WWII Hero?

George Mateyo, Chief Investment Officer, KeyBank Investment Center

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

The Federal Reserve (Fed) is attempting to engineer a soft landing by raising interest rates to dampen inflation without dampening the outlook for economic growth and employment. It's a risky maneuver, in our view, that could lead to a recession. But like a famed fighter pilot once said, the Fed should be prepared for both adversity and opportunity as more turbulence likely lies on the horizon.

In the 1930s, the country was reeling from the stock market crash of 1929 and the Great Depression. The decade was punctuated by fragile economies, swift but unsustainable stock market rallies and immense geopolitical tensions (a major understatement). By the time the 1940s arrived, democracy, capitalism and freedom all seemed to be in great peril as World War II engulfed the globe.

US stock prices slumped for more than two years in the 1940s and the mood of the western world was despondent. Unexpectedly, however, in April 1942, well before victory seemed plausible and years before the war was over, stocks reached a historic bottom; investors would never see such low levels again.

One inspiration for the market rally that followed may have been an event known as the Doolittle Raid. Devised and led by Lt. Col. (later Gen.) James Doolittle, the raid on April 18, 1942, was retaliation for the Japanese attack on Pearl Harbor a few months earlier.

The famous attack by Doolittle's raiders caused relatively minor damage, but the psychological consequences were monumental, demonstrating that the Japanese mainland was vulnerable to American air attacks. As one historian noted, "The [Japanese] navy had failed its sacred duty to protect the emperor and the homeland casting a long shadow of a doubt that previously was not apparent." When I was considerably younger, I met Gen. Doolittle, learning firsthand of his heroism and daring accomplishments. The idea of taking off from and later landing on an aircraft carrier in the middle of an ocean especially fascinated me, prompting me to ask, "Which was harder: taking off or landing?"

"It depends on the conditions," he replied. "But regardless, you'd better be prepared for adversity or opportunity in either situation."

There is a lesson to learn from that wisdom today.

Roughly two weeks ago, the Federal Reserve updated its economic projections for 2022 and beyond. In sum, the Fed reduced its outlook for economic growth while raising its forecast for inflation. Consequently, its expectations for future interest rates were also significantly increased. The Fed now envisions inflation rising 4.6% in 2022 (nearly twice that of its prior estimate of 2.6%) before moderating to 2.7% in 2023.

The Fed also forecasts short-term interest rates will rise to roughly 2% in 2022 (versus its prior forecast of 1%, and up from 0.50% currently) and climb to nearly 3% in 2023.

Several days later, in a speech titled "Restoring Price Stability" (code for "squashing inflation"), Fed Chair Jerome (Jay) Powell simplified matters even further: "The labor market is very strong, and inflation is much too high…. We [therefore] will take the necessary steps to ensure a return to price stability."

In other words, Powell is committed to combating inflation and will do whatever it takes to return it to a more manageable level. At the same time, Powell provided his commitment to "preserving a strong labor market" (code for "keeping unemployment low"). Such a balancing act is known as a soft landing. As Powell explained: "The economy achieves a soft landing with inflation coming down and unemployment holding steady."

Is a soft landing possible?

Powell also noted that soft landings have been achieved in 1965, 1984 and 1994. But what he did not say is that today, some things are notably different.

First, inflation is higher, labor markets are tighter and interest rates are lower today versus other cycles. Thus, the Fed may need to be more aggressive. Moreover, while Powell cited three examples of a soft landing, there have been twice as many hard landings – episodes when the Fed raised interest rates too much, causing unemployment to rise and economic growth to fall. Those occurred in 1974, 1980, 1981, 2000, 2006 and 2019. In short, soft landings are achievable, but the Fed's track record of achieving them is mixed.

That said, even though risks are rising, we continue to believe that a recession will not surface in the US in 2022.

We offer the following evidence:

- Interest rates are still low and liquidity is still abundant.
- Wages are expanding, fueling consumers' spending.
- Companies are hiring and rebuilding inventories.
- Financial institutions are healthy and economies are reopening.

Other parts of the world, unfortunately, aren't as well off and the outlook for 2023 overall is murkier, obscured by the uncertain future path of inflation, which will ultimately dictate the Fed's policies.

So, what should investors do?

As the first quarter draws to a close, 2022 could be a year in which relative performance is discussed more frequently than absolute performance. On an absolute basis, nearly all major asset classes are down. But most notably, based on the most commonly used benchmarks, bonds are down more than stocks thus far in 2022.

Said differently, allocating capital in this environment has been very challenging and will likely remain so. But so long as a recession is averted, we continue to believe stocks are more attractive than bonds *on a relative basis,* and we view them as offering better protection against inflation. Real assets offer some diversification benefits, but these investments should be sized appropriately given their inherent volatility. High-quality companies are also preferred, and investors should stay selective and be conscious of entry points.

Like Gen. Doolittle did back in 1942, we will remain attentive to the adversities or opportunities that come our way. We hope Jay Powell will do the same.

For more information, please contact your advisor.

About the Author

As Chief Investment Officer, George Mateyo is responsible for establishing sound investment strategies for private and institutional clients, expanding internal and external research capabilities, and managing the delivery of solid risk-adjusted investment performance.

In previous roles, George spent more than 15 years in investment management and investment consulting, where he acquired firsthand knowledge and insights into the capital markets and the stewardship of investment portfolios for institutional and high net-worth investors.

George received his MBA from the Weatherhead School of Management at Case Western Reserve University and completed additional studies at the London School of Economics.

210714-1142677-1230269490