3rd Quarter Report - 2022

(Inflation / Recession)

I hope this report finds you well. It has been only five months since my last report, however, I felt that it was important to update you regarding events that have unfolded since late April and how financial markets have responded to those events. I will, on multiple occasions, reference my 2021 End of year Report. If your hard copy is not handy, we have posted all previous reports on our website, www.eglsederwealth.com. When you log on, please go to the Resources Tab. Once you click on the Resources Tab, then click on the drop-down entitled "Semi-Annual Reports" for easy reference to all past issues. Thank you for your time. I hope to use it wisely.

Due to the complex and nuanced nature of the subject matter contained in this report, there is an abundance of background information that is necessary for me to share with you to make sense of the body of the report. Therefore, the structure of this report will be a bit different from past reports. It will be interspersed with stand-alone paragraphs which may seem unrelated but have been written to provide the information necessary and context for a more thorough understanding of the broader subject matter. Here goes…..

Now vs. 2020

From an analytical standpoint, this year, as compared to two years ago, has been absolutely fascinating. When the Pandemic hit two years ago, as the various governors from the several states began to shut things down, from March through July of 2020, 57.4 million adults in this country found themselves out of work. The previous record for job losses was 9 million people over 18 months when the Housing Bubble burst in 2008. This time around, more than six times that number of people lost their jobs in less than 1/3 of the time. On top of that were many questions, some of which had no definitive answers. "What is a pandemic? What is a Coronavirus? What is Covid-19? Will I get infected? Will we ever have a vaccine? When will the shutdowns come to an end? Will I lose <u>my</u> job?" There were lots of things happening at that time as well as questions about the future that gave most working people every reason to be concerned about their finances right then and there.

This year has been different. We haven't had a pandemic with record job losses. We haven't had a housing bubble burst (fueled by toxic mortgages) which caused catastrophic damage to the economy as well as to the banking and financial system. We <u>have</u> had Ukraine. However, when something bad like Ukraine happens, as bad as it is from a humanistic standpoint, I ask people to take just a moment to focus on their personal finances and ask a simple question: "As horrible as it is from a human standpoint, from a financial standpoint, other than me having to pay more for a gallon of gasoline, is what is happening in Ukraine really going to impact how I live my day-to-day life and how I spend my money?"

For most people, the answer is no. What is so important about that question and its answer is very straightforward and simple: We live in a consumer-driven economy. We consumers spend 70% of all the money. Business and government spend the other 30%. So, in our country, as consumer spending goes, so goes the economy, so goes corporate sales and profits, and so goes (ultimately) the stock market.

But other than Ukraine, nothing bad has happened. People are worried about inflation, they are worried about interest rates, but nothing really bad has happened. At the same time, the two major stock indexes that most people follow – the Dow Jones Industrial Average and the Standard and Poore's 500 Index – have been in decline since March and each has been down more than 20% (meeting the definition of a Bear Market) on two different occasions so far this year. What is going on?

The Federal Reserve: What We Have Been Taught

Regarding basic economics, we have all been taught – and students today continue to be taught – three basic things: In the United States we have business cycles, we have interest rate cycles and when we have inflation, the Federal Reserve quickly raises interest rates to fight that inflation. As a result, this is what we have come to <u>expect</u> the Federal Reserve to do when we have inflation. This expectation is critical to understanding why we have had so much volatility in the financial markets this year. More on this later.

Inflation Over the Past Year and One-Half

As I mentioned in my 2021 End of Year report, with the exception of oil and gasoline, <u>most</u> of the price inflation that we have experienced over the past 18 months is due to supply chain issues. If you think logically, from the end of the Great Recession through February of 2020, globally, the means of production existed to provide you and me with everything that we needed, everything that we wanted, in a <u>timely</u> fashion – we waited for <u>nothing</u> – and producers did so <u>without</u> any meaningful price inflation. These means of production and distribution haven't gone away or changed. They still exist.

Once again, the primary source of the price inflation that we have experienced over the past 18 months or so is due to supply chain issues. The supply chain issues are the direct result of Covid-19, exacerbated by Ukraine (food and fuel) and - believe it or not – China's "Zero-Covid" policy. Unlike the United States, China could <u>force</u> all their citizens to be vaccinated. And yet, they haven't. China will <u>not</u> purchase the effective vaccines created by the West (e.g., Pfizer and Moderna). They continue to try to develop their own. Here we are 3 years later, and China has yet to develop an effective mass-produced vaccine.

Instead, <u>every</u> time there is a Covid-19 outbreak in China, the Chinese government will shut down that entire town or city. In the U.S., there aren't that many cities with 3 million people.

In China, cities with three million people or more are a dime a dozen. So, if there is an outbreak in a city of 3 million and that city is the only producer of a particular "widget" that is needed by the major global manufacturers of a particular product, that product becomes short in supply. Prices go up. Not because of any increase in demand, but rather due to a reduction in supply.

The good news is that, as a nation, along with many other nations, we are moving past Covid, that being defined as we have the initial vaccines, the original boosters, the new bivalent booster and the new oral antiviral medications for those that become sick regardless of vaccination status. Today – right now - almost everyone that I know is living day-to-day life just like they did before Covid.

While there may be businesses today that, due to supply chain issues, are far more profitable than ever before, supply chain issues are bad for most businesses and have hurt their profits. Businessmen and businesswomen in the United States are working diligently to resolve these supply chain issues. There is a lot of money at stake. Time is of the essence. No living businessperson had ever lived through a global pandemic. Therefore, no living businessperson had ever contemplated or anticipated global supply chain disruptions and their devastating impact on business and profits. For the past 30 years or so, in an effort to lower their costs and increase their profits, many U.S. businesses had "offshored" jobs.

The example I used in my 2021 End of Year Report – part of the section on inflation (I would highly encourage you to read/re-read pages 5-10 of that report) – had to do with the lack of computer chips needed for U.S. automobiles and the resulting lack of supply of cars available to be sold. When things began to reopen in late 2020 and going into 2021 (for most of 2020 demand for cars dropped off the cliff – as did demand for chips for cars) and people began to buy cars again, consumers fairly quickly went through the inventory of cars that existed prior to the pandemic. At that point in time, because chips for cars were scarce and few new cars could be rolled off of the assembly lines, prices of new cars went through the roof, not because of excessive demand, but because of a lack of supply.

During the shutdowns here, while demand for cars (and their chips) plummeted, demand for chips for laptops (so that people could work from home) and video games for kids (who had to stay home from school) went through the roof.

So, Asian chip makers (who now make well over 80% of all global chips), shut down and re-tooled production lines for car chips - not a short process - so that they could make chips (it takes 6 months to make a computer chip) for products that <u>were</u> selling. So, when the inventory of pre-Covid cars was sold, there were precious few chips available to put into new cars. So, the Asian chip makers had to shut down and retool (again) and then, six months later, they began to provide the auto industry with the desperately needed chips.

Here is the good news. Over the past year or so, U.S auto manufacturers have been forming and <u>continue</u> to form joint ventures with the Asian chip manufacturers to build production facilities here to make chips <u>only</u> for the auto industry – no one else. Many other industries have begun to "Onshore" much of the production capacity that had been "Offshored" over the previous 30 years. Supply chain issues are bad for business and U.S. businesspeople have learned a valuable lesson. They will never go through a global supply chain problem <u>ever</u> again. They are working quickly and furiously to resolve these supply chain issues so that they can get back to business – and profits – as usual.

As I mentioned in my 2021 End of Year Report, I anticipate that significant progress by businesspeople towards resolving supply chain issues will have taken place by late Fall or early Winter, allowing for supply to <u>begin</u> the process of catching up with demand. So, the first thing that we should see is the rate of inflation <u>slowing</u> down. When the supply chain issues are substantially resolved, supply will finally catch up with demand, at which point in time <u>unparalleled</u> global competition for consumer spending will begin to bring prices <u>down</u>.

The Federal Reserve

The Federal Open Market Committee (F.O.M.C.) is the committee that sets <u>short term</u> interest rates. The Fed <u>only</u> controls short term interest rates.

The Fed does not set, nor do they directly control long term interest rates such as 30-year mortgages. The people and institutions that make 30-year loans set and directly control long term interest rates, not the Fed. The Fed does have tools that can influence the direction of long-term interest rates (more on this later).

The interest rate that they adjust – up and down – is called the Federal Funds interest rate. This is the interest rate that banks charge each other for 24-hour loans needed to meet their reserve requirements. All interest rates at U.S. commercial banks – interest paid on your deposits as well as the interest rate that banks charge you for bank loans – follow the direction of the Federal Funds interest rate. The F.O.M.C. has 8 scheduled meetings per year (they can meet as many times as they want on an unscheduled basis, although these meetings are rare). They convene at 8 a.m. on Tuesday morning. They adjourn at noon the next day, Wednesday. At 2 p.m. they issue a press release announcing what they have or have not done and why. At 2:30 p.m. on Wednesday, the Chairman of the Federal Reserve (currently, Jerome Powell) holds a press conference.

In their press releases over the past 18 months, the Fed has correctly identified supply chain issues – which have created the imbalances between supply and demand - as the primary source of the current inflation that we have been experiencing (exacerbated by events in Ukraine and China's Zero Covid policy).

Federal Reserve Policy and Theory

Historically, prior to the Great Recession, the primary tool used by the Fed to slow the economy down or to speed it up was the raising or lowering of the Federal Funds interest rate. Historically, if the economy was growing too fast (which ours is not) and the Fed feared inflation would result, the Fed would quickly raise short term interest rates. Now, that's good for savers because your bank deposits earn more interest. But the theory says, it's bad for borrowers. If you make bank loans more expensive, the theory goes, fewer personal and business loans will be made. If less money is borrowed, less money will be spent. As a result, demand for goods and services will go down, beginning to lower prices as a result.

You then reach a point where employers will see employees producing nothing (or much less) and as a result, employers will begin to lay people off. With more unemployed people without as much income to spend, demand drops, and prices drop further, and the economy slows. Inflation problem solved.

Historically, if the economy was growing too fast and the Fed feared inflation would result, they raised short term interest rates with the specific goal of putting people out of work. As cold as it sounds, there is a reason. Two thirds of the cost of all goods and services produced in the U.S. is one commodity – labor. If labor becomes short in supply, the price of it can go up. If two thirds of the cost of producing something is one item and the price of it goes up, then your profits will go down unless you can raise your prices. Competition may not let you raise your prices, but if you can, you will - and rising prices is inflation.

Conversely, historically, when the economy would slow, Federal Reserve theory calls for the F.O.M.C. to lower short term interest rates. Now, that's bad for savers because your bank deposits earn less interest. But the theory says it's good for borrowers. If you make bank loans less expensive, the theory goes, more personal and business loans will be made. If more money is borrowed, more money will be spent. As a result, demand for goods and services will go up. You then reach a point where the existing workforce cannot meet the demand and employers will be forced to hire more people (who were unemployed with no or much less income to spend) who will now have more income to spend, helping the economy to grow. Problem solved.

The Great Recession – Federal Reserve Theory and Reality Parted Ways

Lehmann Brothers collapsed on September 15, 2008, as a result of the toxic mortgages that fueled the Housing Bubble. This triggered the Financial Crisis, and The Great Recession was the result. This was the worst recession since the Great Depression. Severe damage was done to the economy, as well as to the banking and financial system. Since the turn of the 20th Century, the damage done was eclipsed only by The Great Depression of the 1930's.

Because the economy contracted so quickly after the collapse of Lehmann Brothers, by March of 2009, the Fed lowered (in keeping with Fed theory and policy) the Federal Funds interest rate (for the first time since its creation in 1913) to a target of 0% to ¼ of 1%, where it stayed until December of 2015 – six years and nine months. According to theory and policy, this should have been rocket fuel for our economy, but it wasn't. From the end of the Great Recession until the pandemic in early 2020, our economy struggled to get past 2% annual calendar year growth (2% Gross Domestic Product – G.D.P.). Only a few times did we make it to 2.50% G.D.P. What happened?

We have an aging population. That's what happened. I've talked about our country's (aging) demographics in many of my previous reports. I didn't have a single client – not one – (95% of my clients are retired) who said "Oh my gosh, look how cheap loans are. I can't wait to go borrow and spend some money." My clients tell me, "Scott we worked hard over 30 years to pay off our mortgage. We pay off our credit cards every month. We don't owe anyone any money and it is going to stay that way!"

Counterintuitive Thinking

The single best example of counterintuitive thinking that I have ever read about involved the heavy losses of B-17 Bombers during the Allied bombing campaign of Germany during World War II. As you are no doubt aware, all of the B-17 sorties originated from airfields in Britain. The losses of men and planes were very high. On any number of occasions, the sorties were suspended due to the heavy losses. Nevertheless, the Allied military powers believed that the bombings were essential to bring an end to the war. The military brass believed that the B-17's needed to have more armor. The problem with airplanes and armor is weight – airspeed and fuel consumption. So, they hired a Hungarian mathematician, Abraham Wald, to study the problem and to make recommendations regarding the judicious use of armor.

Wald assembled a team, and they literally went from airfield to airfield and as the B-17's would return from their bombing sorties, they would, on a large diagram, draw on that diagram where the holes were on the planes that landed.

So, let's say a B-17 lands with a huge hole in its vertical stabilizer. When the plane landed, Wald and his team would inspect the entire plane and draw on the large diagram where they found the holes.

When they finished their study, Wald was in a large room with this very large diagram. He studied the diagram very carefully and upon reflection said, "We need to put the armor where there aren't any holes." Think about it: If a plane can fly and land with a big hole in the vertical stabilizer, you don't have to put any armor there. Where the diagram had no holes, was where the fatal flack and artillery shells were causing the damage that made the planes go down. Because they didn't make it back, there were no holes to diagram, hence portions of the diagram had no holes. These were the planes that were lost.

Here is Where Things Start to get Interesting

As I mentioned earlier, with the exception of oil and gasoline, most of the price inflation that we have experienced over the last year or so is the direct result of supply chain issues.

The inflation that we have been experiencing is <u>not</u> the result of the economy growing too fast – it isn't: We have had two consecutive quarters of slightly negative G.D.P.

The inflation that we have been experiencing is <u>not</u> the result of consumers spending wildly and lavishly – they are not. By all measures, consumers have been spending normally.

Most of the price inflation is due to supply chain issues. Businesspeople are working to resolve these supply chain issues. When they do, supply will begin to catch up with what has been normal demand, first resulting in the rate of inflation going down and then, when supply catches up with demand, unparalleled global competition for consumer spending will begin to bring many prices down.

Raising the Federal Funds interest rate will <u>not</u> solve the supply chain issues which are the primary source of our current inflation. Businesspeople will solve the supply chain issues. It's like giving the wrong medicine to the patient.

Despite this fact, the Fed continues to raise short term interest rates. Please remember that the Fed has just <u>one</u> primary tool to <u>try</u> to tame inflation and that's aggressively raising short term interest rates**. Doing so will not solve the supply chain issues.** Please remember that what we were taught when we were coming up is that when you have inflation, the Federal Reserve raises interest rates to cure that inflation. That is what they are supposed to do and that is what investors <u>expect</u>.

When I finished my 2021 End of Year Report in late April, the F.O.M.C. had met twice already this year – January and March. In January, they did not raise the Federal Funds interest rate from its target of 0% to ¼ of 1%. In March, they raised rates by ¼ of 1%. When I finished my report in late April, the speculation was that the Fed would engage in a series of aggressive rate increases to "fight inflation", which, subsequently, they have done. Since April, they have had four meetings – May, June, July and September, with rate increases of ½ of 1% in May and then three consecutive increases of ¾ of 1%. The target for the Federal Funds interest rate now stands at 3 to 3.25%. The current speculation is that at their November and December meetings rates will be raised again and the Federal Funds rate could go "all the way" up to 4 %! The result has been…..

Investors are freaking out! (Sorry for using such technical terms). The overwhelming majority of investors believe that a recession is now <u>inevitable</u>! In their minds, it is a forgone conclusion. It seems that now it is <u>not</u> whether or not a recession is going to happen, the question now is whether or not we will have a "soft landing" or a "hard landing".

Because there is a fairly significant time lag between Federal Reserve actions and potential/expected results and because raising rates is not an exact science and because there are so many variables, most investors are now convinced that not only will we have a recession, but that we are going to have a "hard landing". This expectation has been the primary reason for the big decline in the stock market. Investors fear what <u>migh</u>t happen. They seem to disregard what is happening right now and what is most likely to happen in the not-too-distant future.

Where Was the Federal Funds Interest Rate During Our <u>Best</u> Decade of Growth?

The decade of the 1990's was, hands down, the best decade of growth we have had since the end of World War II. In most years, GDP was 4.5% to 5.5%. As I mentioned earlier in this report, from the end of the Great Recession until February of 2020 we had difficulty getting past an annual growth rate of 2% GDP.

I started in my industry in 1984. I have a good memory and I recall very well our best decade of growth – the 1990's. As I pondered why investors are so freaked out about the Federal Funds rate going "all the way up to 4%" and the inevitable recession that they believe will result, I found myself scratching my head because I distinctly remember that for the overwhelming majority of the 1990's that the Federal Funds interest rate was at or well above 4% for most of the decade. So, to confirm my memory, I did my research and here is where those rates were:

July 13, 1990	8.00%
Oct. 29, 1990	7.75%
Nov. 13, 1990	7.50%
Dec. 7, 1990	7.25%
Dec. 18, 1990	7.00%
Jan. 9, 1991	6.75%
Feb. 1, 1991	6.25%
March 8, 1991	6.00%
April 30, 1991	5.75%
August 6, 1991	5.50%
Sept. 13, 1991	5.25%
Oct. 31, 1991	5.00%
Nov. 6, 1991	4.75%

Dec. 6, 1991	4.50%
Dec. 20, 1991	4.00%
April 9, 1992	3.75%
July 2, 1992	3.25%
Sept. 4, 1992	3.00%
Feb. 4, 1994	3.25%
March 22, 1994	3.50%
April 18, 1994	3.75%
May 17, 1994	4.25%
August 16, 1994	4.75%
Nov. 15, 1994	5.50%
Feb. 1, 1995	6.00%
July 6, 1995	5.75%
Dec. 19, 1995	5.50%
Jan. 31, 1996	5.25%
March 25, 1997	5.50%
Sept. 29, 1998	5.25%
Oct. 15, 1998	5.00%
Nov. 17, 1998	4.75%
June 30, 1999	5.00%
Aug. 24, 1999	5.25%
Nov. 16, 1999	5.50 %
Feb. 2, 2000	5.75%

My memory was correct. For 8 of the 10 years of the best decade of growth that we have had since World War II, the Federal Funds rate was at or significantly above 4% - and yet we still had the best decade of growth since WWII. Only from April 9, 1992, to May 16, 1994, was the Federal Funds rate below 4%.

If the Federal Funds interest rate during the best decade of growth we have had since WWII was at or above 4% for 8 of those 10 years, why would the Federal Reserve raising interest rates "all the way up to 4%" by the end of this year cause this awful recession that the majority of investors today believe is inevitable?

Here is what we know so far:

- The primary cause of our current inflation is supply chain issues, exacerbated by events in Ukraine and China's "Zero Covid" Policy.
- Raising interest rates will not and cannot solve these supply chain issues; businesspeople will solve the supply chain issues.
- The Fed is raising rates anyway in an attempt to lower demand. They can do nothing about increasing supply.
- It is possible that raising rates "all the way up to 4%" might slow down the economy but based on where the Federal Funds rate was during most of the 1990's (at or above 4% for 8 of the 10 best years of growth that we have had since WWII), that appears unlikely.

If you think about it, I'm guessing that a large number of people reading this report probably pay off their credit cards every month, so what difference does it make if interest rates on credit cards go up by 4%? That will not impact your spending! I'm not trying to be obtuse, but if someone does carry balances on their credit cards and they're already paying 18%, will a 22% interest rate really slow down their spending?

Finally, show me a young entrepreneur who has an idea that they want to launch because they think they can make a lot of money - <u>guess</u> what he or she is going to do if the rate on a commercial loan to them goes from 4% to 8%? <u>They're going to borrow the money and launch their idea regardless of the rate increase.</u>

Back to Counterintuitive Thinking

In the U.S., people ages 50 and over own 76% of all the financial assets in the country. Only 56% of adults have money in the stock market. That means that there is a lot of money in this country that will never be invested in stocks or bonds. For most people, that leaves just certificates of deposit – C.D.'s.

Prior to the Great Recession, there was a lot of money in C.D.'s earning 4, 5 and 6%. A large percentage of the population was using this interest income to live. The problem occurred when the Fed dropped the Federal Funds interest rate to a target of 0% to ¼ of 1% when we had the Great Recession. Fed doctrine says that when the economy slows, the way to get it growing again is to lower interest rates to provide an incentive for people and businesses to borrow and spend.

When these certificates of deposit matured, investors were lucky to get 1% on a 5-year C.D. – before taxes. If you were earning 5% and now, you're only earning 1%, your interest income dropped by 80%. People don't like to spend principal, so a large number of people – adults over 50 control 76% of all the financial assets in this country and 44% don't have money in stocks and bonds – <u>cut</u> their spending, which did not help the economy to grow – it probably <u>prevented</u> the economy from growing as much as it should have. In reality, the Fed <u>destroyed</u> a large amount of <u>spendable</u> interest.

Back to the Fed raising rates "all the way up to 4%":

According to the Federal Reserve Bank of St. Louis:

In commercial banks today there is $22,690,000,000,000 – that's 22.69 TRILLION dollars in bank deposits.

There is an additional $5,030,000,000,000 – that's 5.03 TRILLION dollars in money market mutual funds.

Between the two, that's a total of $27,720,000,000,000 - that's 27.72 TRILLION dollars.

At 4% interest, these deposits would generate $1,108,800,000,000 – that's 1.108 TRILLION dollars of spendable interest income every year. By way of comparison, according to the Federal Reserve Bank of New York, TOTAL U.S. credit card debt in the 2nd quarter of this year was $887 BILLION.

So, every year – every year - the amount of spendable interest generated by the Fed raising interest rates "all the way to 4%" is 25% greater than the total credit card debt in the United States in the 2nd quarter of 2022. The Fed is creating an enormous amount of spendable interest, which people will spend, which will help the economy to grow, which runs contrary to their stated objective of raising rates to slow the economy down.

Here is What We Know So Far

- The primary source of the inflation that we have been experiencing is due to supply chain issues. Raising interest rates will not solve these supply chain issues.
- While raising interest rates "all the way up to 4%" might slow the economy, based on where the Federal Funds rate was for most of the 1990's, that appears very unlikely.
- Because of the enormous amount of money in commercial banks and money market mutual funds, the Fed raising interest rates "all the way up to 4%' will create an enormous amount of spendable interest income, which people will spend to meet their expenses, which will cause the economy to grow, which runs contrary to the Fed's stated objective of raising rates to slow the economy down.

- Raising interest rates will cause the value of the U.S. dollar to increase in value relative to other currencies, making imports of both raw materials and finished products less expensive for U.S. consumers. This will actually help to reduce inflation here at home.
- The Fed is very aware that the 2 major stock indexes are down by more than 20% and that investors are "freaking out". There is a theory that says that people spend more when they feel wealthier – the so-called "Wealth Effect". On the flip side, the theory says, if people feel less wealthy, they will spend less. Because the Fed can only potentially impact the demand side of the current supply/demand imbalance – and the problem is on the supply side (supply chain issues) – which they can do nothing about – no doubt the Fed is expressly content to see lower stock prices in the hope that this will cause consumers to spend less. Anecdotally speaking, most people I know have not reduced their spending even though their investment accounts are down in value. I would chalk this idea up to a might. The Fed raising rates causing the stock market to go down might dampen the "Wealth Effect" and cause consumers to spend less. I'm not sure that hard data would show this to be the case.

Back to Long Term Interest Rates

As I mentioned earlier in this report, the Fed sets and directly controls only short-term interest rates. They do not set, nor do they directly control long term interest rates, such as 30-year mortgages. As I will explain in just a bit, the Fed does have a tool to influence the direction of long-term rates, but they do not set, and they do not directly control long-term rates. The people and institutions that make these long-term loans set and directly control these long-term rates.

The determining factor for the interest rate that mortgage lenders will charge is the rate of inflation at any given moment in time. If the inflation rate goes up, they will charge more interest on new mortgages. If inflation goes down, they will charge less interest on new mortgages. The reasons are very simple.

When a 30-year mortgage is created, the lender has decided to accept the same monthly payment from you for 30 years – a fixed income.

When you are on a fixed income, your worst enemy is – inflation. Every time you get a check, you can't buy more things – prices have gone up – you can only buy fewer things - so your purchasing power has been eroded. Mortgage companies can't raise the interest rate they're charging you on a 30-year fixed mortgage. But they can increase the interest rate on <u>new</u> mortgages that they create.

So, the recent increase in mortgage rates was caused by the inflation that has resulted from the supply chain issues that we have experienced which were caused by the Covid-19 pandemic. As the supply chain issues are resolved by businesspeople – the Fed can do <u>nothing</u> to help resolve supply chain issues (the Fed can only try to impact the demand side and as we have learned, they have very few tools to accomplish this goal and their effectiveness is somewhat questionable and might lead to results that run contrary to their stated objectives) - and the rate of inflation begins to go down, then mortgage rates will begin to go down. When we get back to the Fed's stated goal of 2% inflation, it would not surprise me if mortgage rates went back down to 4%. This leads me to discuss the Fed's ability to influence the direction of long-term rates, which will also help to reduce <u>demand</u>, which is once again the <u>only</u> side of the current supply/demand imbalance that the Fed can <u>try</u> to modify.

Quantitative Easing

The Federal Reserve has at its disposal a tool to influence the direction of long-term interest rates. It was created by the Bank of Japan (Japan's "Fed", if you will) more than 25 years ago and has been used by the Bank of Japan consistently – year in and year out – for the past 25 or so years. Please review the first 3 pages of my 2014 End of Year Report where I first discussed Japan's use of "Quantitative Easing".

Quantitative easing was used for the first time by the Fed in response to the Housing Bubble having burst and the resulting Financial Crisis and Great Recession. It was used to achieve several objectives: First, to inject enormous sums of money into the banking and financial system (which were on the brink of collapsing) to ensure their continued functioning and secondly, to help bring mortgage rates down. Housing and related businesses account for 25.2% of our country's entire economic output (GDP). It is the single largest sector of the U.S. economy. The Fed wanted mortgage rates to go down to increase activity in the most important sector of our economy.

What is "Quantitative Easing"? The Fed creates "digitally" the trillions of dollars that they need to implement the strategy of Quantitative Easing. Quite literally, someone at the Fed sits down at a computer terminal and creates a book entry in their system and inputs the amount of money that the Fed needs, and they press a button and "voila", the money suddenly appears – it has been created <u>digitally</u>. A year or two ago, Chairman Powell was interviewed by *60 Minutes.* In this segment he talks about how the Fed creates money *digitally*. I recommend going online and watching the interview.

With this newly created money, the Fed can cause long term interest rates to go down. With this newly created, massive sum of money, they buy Treasury bills, bond and notes as well as mortgage-backed securities. On top of the normal demand by investors in these markets, the Fed creates enormous additional "artificial" demand for these securities, sending their prices up.

As prices paid for <u>existing</u> bonds and mortgages go up, because the amount of interest that they pay never changes, the stated yield or interest rate goes <u>down</u>. Let's say that a bond that will mature for its face value of $1,000.00. It will only ever pay to its owner – whoever that is - $50.00 per year. The initial yield or interest rate is stated as 5%: $1,000.00 x 5% = $50.00.

Due to increased demand, let's say that the price of that bond goes up to $1,250.00. The amount of interest that the bond pays will never change – it still only pays $50.00 per year. When you do the math, the stated yield or interest rate drops to <u>4%</u>! $1,250.00 x 4%=$50.00.

Because housing is the largest segment of the U.S. economy, when the pandemic hit and the shutdowns began and the record massive layoffs ensued, the Fed engaged in the largest campaign of Quantitative Easing ever used by the Fed to promote activity in this most important sector. The result: Mortgage rates dropped from 4% to 3%, causing a dramatic increase in activity in the housing market. Because rates dropped from 4% to 3%, people buying homes suddenly had 25% more money to spend on houses for the same monthly payment. (Please see pages 2,3 & 4 of my 2021 End of Year Report).

The Fed started this new round of quantitative easing when the pandemic hit and every month until June 1, 2022, they continued to purchase treasuries and mortgage-backed securities. During this time, according to the Federal Reserve, the Fed purchased 76% of <u>all</u> the Federal debt that was issued!

Starting on June 1, 2022, the Fed began to reduce their holdings. This is accomplished by ending <u>new</u> purchases and as previously purchased securities mature, <u>not</u> rolling them over to buy new securities. Prior to this decision, when such a security purchased with digitally created money matured, they would roll it over to buy new securities. This would allow the artificial demand to continue, keeping prices as high as possible under these new inflationary conditions. By letting these securities mature, artificial demand will be reduced, helping to keep prices and mortgage rates about where they are.

Over time, natural market forces will take back control of prices and rates – just like it was prior to the pandemic and mortgage rates arrived at 4% through non-artificial market forces.

As an interesting footnote, the money that was created digitally to buy these bonds and mortgages, when these securities are allowed to mature without being "rolled over", the money that was created out of the thin blue air returns to the ether from whence it came. "Poof". Gone.

The Fed made this decision – please remember that they can only impact the <u>demand</u> side of the economy's supply/demand imbalances – because they want less activity (demand) in our country's largest and most important economic sector – housing. Over time, this should help to dampen inflation, which is what they are trying to do.

Two More Things That Are Likely to Help the Economy Grow (Not Slow Down)

- There are twice as many job openings as there are unemployed people. This suggests that hiring will continue at a solid pace.
- Over the past 14 months, from 8-1-21 to 8-31-22, U.S. businesses have created a record average of 438,000 net new jobs a month for the past 13 months. Today, there are 5,694,000 more people working – who now have income to spend – than there were on 7-31-21.

As a footnote, as of the end of August, there are now <u>more</u> people employed in our country than there were just before the pandemic began.

A Few More Words About and Directly <u>From</u> the Fed

As we have learned, the Fed can only try to impact the <u>demand</u> side of any supply/demand imbalances that might exist at any point in time. Additionally, they have precious few tools at their disposal to impact the demand side. Furthermore, the efficacy of these tools is far from certain and in some instances those tools might actually cause results that run contrary to what theory says they should accomplish.

To reinforce these points, let me offer direct quotes from Chairman Powell at his most recent press conference on Wednesday, September 21, 2022:

"So how do we get rid of inflation?....We have to get supply and demand back into alignment, and the way we (the Fed) do that is by slowing the economy (demand side). Hopefully we do that by slowing the economy and we see some softening in labor market conditions and we see a big contribution from supply-side improvements and things like that."

There you have it directly from the Chairman of the Fed. Everything that we have just discussed. The Fed is doing everything that they are supposed to do to try to slow demand, with a distinct acknowledgement that the problem right now with the supply/demand imbalance is on the supply side – which the Fed can do nothing about.

On the second page of this report, I talked about what we learned that the Fed is supposed to do when we have inflation and how that has firmly set our expectations of their actions and the final results – which is for the Fed to cure all inflation problems. Because it has been over 100 years since the last global pandemic (when the economy was completely different than it is today), we have never before experienced inflation due to global supply chain disruptions. It will be the resolution of supply chain issues by businesspeople that will be the primary cure for our current inflation, not the Fed.

The Fed continues with their limited (and under the circumstances mostly impotent) policies. Despite the limitations of those policies in our unique circumstances, there is tremendous value to the Fed continuing their efforts and it has to do with investor expectations. As "freaked out" as most investors are about what they believe will be an inevitable "Hard-Landing" recession, just imagine how freaked out they would be if the Fed was doing nothing. If, by the end of the year the Federal Funds rate goes "all the way up to 4%" and subsequently the rate of inflation begins to slow due to businesspeople resolving supply chain issues (allowing for supply to begin to catch up with demand), it will create the appearance, once again, that the Fed has done their job of taming inflation.

The good news is that the supply chain issues will be resolved. It will take some time, but it will happen. Inflation will be brought under control as a result. When investors believe that our current inflation will be brought under control – we may still be having inflation – but when they believe that the taming of inflation is inevitable – that's when the buyers will step into this market and prices will begin to recover. In the interim, prices for shares of many good businesses are very low and I will continue to buy shares of these businesses for you.

"If you don't know where you are going, you'll end up someplace else."

Yogi Berra

I hope the information contained in this report has been helpful. Uncertainty can be very stressful. I hope that I may have provided some clarity regarding what is happening in the financial world and therefore some certainty.

As always, I thank you for the privilege of your time. I hope it was well-spent.

Yours most sincerely,

Scott W. Eglseder

Note: Unless otherwise indicated, Bloomberg is the source of the information contained in this report. All indices are unmanaged, and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges or expenses. Past performance does not guarantee future results.

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