

It's a Topsy Turvy World

We wrote the above MMO title “Topsy Turvy World” two days ago. On cue: the stock market has a massive reversal to the upside. At one point last night, Dow futures were trading below 45,500, this morning they traded over 47,100 – a 1,600 point swing.

Why? President Trump backed off from threatening to bomb energy assets in Iran and mentioned “cease fire” talks in a post online. Up and down oil prices, volatile stock prices, and bond yields, violent moves in gold prices...that’s all part of the fog of war.

But that’s not the only issue investors and policy makers have to deal with. At his press conference last week Fed Chairman Jerome Powell made a surprisingly transparent comment, admitting that many members of the Fed have “no conviction” on how the economy will evolve.

After telling us all that inflation would be “transitory” a couple of years ago, we think Jerome Powell should use this phrase more often. The Federal Reserve was way too loose during COVID and was so because it chose politics over the target of 2.0% inflation.

Powell now claims he’s all for “Fed independence,” but the Fed accommodated huge deficits and COVID lockdowns and only has itself to blame for making politicians angry. Especially now that there are rumors that some Fed members want to “raise” rates into a war and higher oil prices. That makes zero sense and many see it as continuation of Powell’s fights with the President.

But Powell is right, there is a high degree of uncertainty about the economy right now. Let’s start with the Iran War.

The Trump Administration seems less likely to press on for a widespread popular uprising and more likely looking for some sort of military coup by leaders who will throw off the mullahs and commit to the country becoming more friendly with the West. Think President El-Sisi in Egypt, but with oil money. However, with much of the leadership killed or leaving, who the Administration negotiates with is a mystery.

Meanwhile, the hard numbers on the economy are tepid. Real GDP growth for the fourth quarter of last year, which the Atlanta Fed GDP Now model pegged as high as 5.4% back in January, has been revised down to just 0.7%. For the labor market, private payrolls are up 33,000 per month in the past year, but without health care & social assistance private payrolls are down. Manufacturing and retail jobs are both down.

When it comes to inflation, recent figures have been downright bizarre. Producer prices rose 0.7% in February and are up 3.4% from a year ago. But the increase has been led by the services sector, not the goods sector. This is the opposite of what the Fed and many analysts feared a year ago. Prices for goods in the PPI are up 2.5% in the past year, while services prices are up 3.8%. We see a similar pattern for consumer prices where services prices are up 3.1% in the past year while commodity prices are up 1.3%. The effect of tariffs has been much more muted than many feared.

Yes, inflation is still above the Fed’s 2.0% target. However, monetary policy has been relatively tight the past few years after the massive surge in the money supply in 2020-21. In the ten years prior to COVID, the M2 measure of money grew about 6.0% per year with inflation averaging at or below 2.0%. In the past year, M2 is up just 4.3%. The Fed is not too loose right now, which is why chatter about the next rate move being a hike doesn’t make sense.

In the meantime, the stock market has been hit, but not excessively so. Some investors are worried it’s no longer increasing, but at the market close on Friday, the S&P 500 was down a modest 6.8% from the pre-Iran peak back in late January. If these investors are freaking out right now, wait until they get a full correction or even a bear market. In our view, the S&P 500 has been overvalued for quite some time, so although fingers are pointing right now to the conflict in the Middle East, we believe there was substantial downside risk to equities even in the absence of the war.

Yes, the technological progress being made with Artificial Intelligence is impressive. But we think there has also been some AI hype that is overdone in the short-run even though it will be transformative in the long-run.

The Fed’s decision made sense: don’t change the target for short-term interest rates if we don’t know what the world will look like tomorrow. But investors need to remember a couple of important things. Rate cuts, if they ever come, are less important than the money supply. A cease fire in Iran will be positive in the short-run, but we still live in a volatile political world with the Trump Administration fighting the enemies of freedom on multiple fronts. And, finally, stocks are expensive. Don’t ever get complacent, it’s a Topsy Turvy World.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-23 / 9:00 am	Construction Spending – Jan	+0.1%	+0.5%	-0.3%	+0.8%
3-25 / 7:30 am	Q4 Current Account Balance	-\$207.0 Bil	-\$204.2 Bil		-\$226.4 Bil
7:30 am	Import Prices – Feb	+0.6%	+0.4%		+0.2%
7:30 am	Export Prices – Feb	+0.6%	+0.3%		+0.6%
3-26 / 7:30 am	Initial Claims – Mar 21	210K	208K		205K