Advisors Capital Management

Year End Q&A

| Dr. Alan Greenspan, Senior Economic Advisor | January 2023

Popular thought seems to be that a recession is required to bring down inflation. Do you think that is the likely outcome?

A recession does appear to be the most likely outcome at this time. While the last two monthly inflation reports did show a deceleration in the rate of price increases, it does not change the fact that prices are still increasing. Indeed, official inflation numbers could remain tame in the near term owing solely to the methodology by which they are measured, most notably housing costs. However, I don't think it will warrant a Fed reversal that is substantial enough to avoid at least a mild recession. Wage increases, and by extension employment, still need to soften further for a pullback in inflation to be anything more than transitory. So, we may have a brief period of calm on the inflation front but I think it will be too little too late.

As Chairman, did you fear recession as much as some do today? Or did you consider it a normal part of an economic cycle?

I don't know that "fear" would be the right word. Economist Paul Samuelson once quipped that the stock market had predicted nine out of the last five economic recessions. Unlike stock markets, it is not the job of the Federal Reserve to fearfully anticipate recessions. The Federal Reserve Act mandates that the Federal Reserve conduct monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." This requires that the Fed act as a moderating force upon animal spirits so that the economy neither overextends during bouts of euphoria nor descends into panic during times of stress. As an economy built on creative destruction, there will certainly be retrenchment from time to time.

The Twitterverse runs wild with theories that the Fed could "break something." What does that mean to you?

The "long and variable" lags with which the effects of monetary policy are transmitted could lead to any number of scenarios in which unforeseen consequences of monetary policy spiral out of control. Only three months ago, alarm bells were ringing that the U.S. dollar may be appreciating too quickly and could cause "something to break". This was caused, in part, by the divergence in monetary policies being conducted by the Federal Reserve versus the central banks of the other reserve currencies. That risk has receded, but it demonstrates how even sound domestic monetary policy can lead to global financial stress.

How long does it take for interest rate hikes to filter through the economy?

There are so many factors that determine the speed with which monetary policy effects are transmitted that it would be impossible to give a precise answer. It truly depends on the prevailing economic conditions at the time. For example, one positive surprise I have alluded to in a previous article is the resilience of the domestic consumer. I noted that the excess savings they were able to accumulate during the pandemic allowed them to continue spending even as interest rates were steadily increased. In short, if you have excess savings to spend down, and therefore do not need to borrow, then rising interest rates will have a much more muted effect on your purchase decisions initially and it will take longer for the effects of interest rate hikes to filter through to the economy. That is just one of a multitude of facets that affect policy lag.

What is the risk of lowering interest rates too quickly?

The most obvious would be that inflation could flare up again and we would be back at square one. Furthermore, this could potentially damage the Federal Reserve's credibility as a purveyor of stable prices, especially if the action were seen to be taken merely to protect the stock market rather than in response to truly unstable financial conditions. For that reason alone, I do not expect the Federal Reserve to loosen prematurely unless they deem it absolutely necessary, for example to prevent financial market malfunctioning.

This is the most volatile the market has been since 2008. Do you expect it to continue in 2023?

I do not expect 2023 to be as volatile. We went from a Federal Reserve that expected inflation to be transitory to one that deemed seven consecutive rate increases over ten months necessary to tamp down inflation. That is a total increase of 4.25 percentage points in the federal funds target rate, with more expected to come. Add in the massive amount of uncertainty generated by the war in Ukraine and I believe 2022 would be a tough year to top with respect to market volatility.

Do you have any thoughts on the collapse of FTX and the crypto market in general? Do you expect contagion?

I do not expect the fallout from FTX to spread beyond the cryptocurrency/NFT space. Based on the information that has come to light so far, the collapse of FTX was not a result of lax risk management, inadequate accounting procedures, or some feature inherent to crypto – it was purely fraud. With respect to the wider crypto universe – I view the asset class as too dependent on the "greater fool theory" to be a desirable investment. Fortunately, although FTX and firms like it have increased marketing of their products in recent years, the lack of any noticeable widespread market reaction to FTX suggests that they are still fairly concentrated in the hands of a relatively small subset of investors. Moreover, the differences we observed in the aftermaths of the popping of the tech bubble and the popping of the housing bubble showed clearly that credit-fueled asset bubbles create far more contagion when they ultimately deflate. There does not appear to be a significant amount of leverage dedicated to the cryptocurrency/NFT space at this time, so I do not expect contagion to spread very far beyond this particular asset class.

Covid-19 was unpredictable. Are there other black swan event you think about?

The black swan event I think markets, and really the world at large, ought to be most worried about is some kind of conflict erupting between China and Taiwan. I noted in a previous article that, owing to unfavorable demographic trends, China may have reached the height of its economic influence for some time. All the while, Xi Jinping has methodically consolidated power and made himself essentially president for life. He has been fairly candid in his intention to eventually bring Taiwan back into the fold, and he may begin to feel his window is closing. I venture he would view it as a blemish on his legacy were he to leave it undone. Taiwan has shown no willingness to acquiesce to Xi's plans and so the conditions for some type of conflict in the near future are there. The sheer amount of world trade that currently flows through that region, and the number of semiconductors fabricated by Taiwanese firms upon which the technologies we enjoy rely, make any conflict a potential nightmare scenario.

> Alan Greenspan served five terms as chairman of the Board of Governors of the Federal Reserve System from August 11, 1987, when he was first appointed by President Ronald Reagan. His last term ended on January 31, 2006. He was appointed chairman by four different presidents.