The Conservative Strategist

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Don’t fight the Fed. It wants asset prices lower.

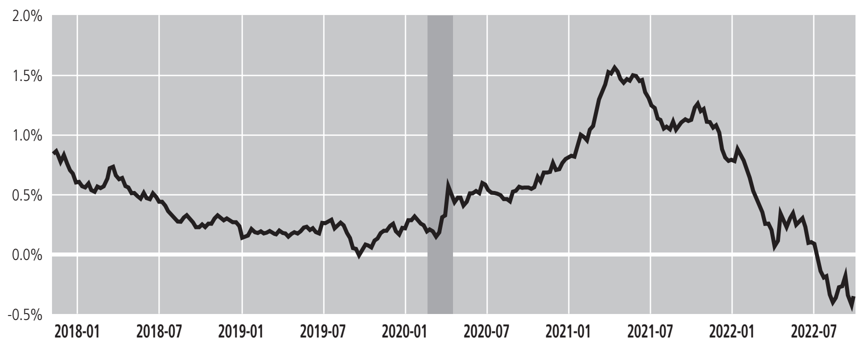
We may be entering the most dangerous phase for markets that we’ve since the 2007-2009 financial crisis. The August numbers clearly show inflation as embedded and persistent. After months of equivocating, the Fed now knows it has to apply strong medicine to send an equally clear message to markets that it means business in bringing prices under control.

Hawkish message

In his August 26 message, Fed Chair Jerome Powell said: “Reducing inflation is likely to require a sustained period of below-trend growth.... Moreover, there will very likely be some softening of labor market conditions.... While higher interest rates, slower growth and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses.”

The unspoken message of these hawkish words is that the Fed would be OK with its anticipated series of interest rate hikes gradually deflating asset prices another 15% to 20%. Why? Because more fully deflating the asset bubble would give the Fed cover to turn around and lower rates should conditions warrant. Easing monetary policy is the primary weapon the Fed has to fight recession, but the danger in doing so these last few years has been a continuing inflation of asset prices. That’s why we have seen Bitcoin go to $65,000, record auction prices in the art market, record real estate prices, the NFT craze, and other sorts of financial nonsense.

Watch the 2-year/10-year spread



One of the most reliable forecasts of recession is the yield spread between the 2-year Treasury and the 10-year Treasury. Normally the 10-year is higher, but when the yield curve inverts (below that zero line) — as it has these past few months, a recession has followed in nearly all cases, with a lag of 6 to 18 months. Source: Federal Reserve Bank of St. Louis

Breathing room

The Fed needs to create room for itself to reverse course should its hoped-for *soft landing* turn into a *harder landing.* But it walks a tightrope. If it tightens too hard too fast, asset prices will plunge and the resulting *reverse wealth effect* will make a deep recession likely. Yet if it does not tighten fast enough, markets will lose confidence in its ability to tackle inflation.

As I show on page 2, the market’s most sophisticated investors are expecting inflation to cool sharply over the next few years and approach where it was before the pandemic. But it’s not forecasting the path of such a decline. And it’s the path that determines the pain or relief investors will experience in coming quarters. ■

The Markets	September 30, 2022	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)		3585.62	-4.92%	-23.95%
International Stocks (Vanguard Index)		14.70	-10.54%	-26.81%
Emerging Markets Stocks (Vanguard Index)		23.20	-10.75%	-24.08%
Real Estate Stocks (Vanguard REIT Index)		26.64	-11.05%	-29.34%
Bonds (30 year US Treasury/Vanguard Index)		3.79%	-9.92%	-28.87%
Dollar (US Dollar Index)		112.17	7.14%	16.88%
Gold (London Afternoon Fix)		$1654.80	-8.93%	-8.36%
Money Market Funds (Vanguard Cash Reserves Fed)		2.78%	0.48%	0.64%*

*change in yield

Portfolio Planning

Inflation looks scary. TIPS investors don't think so.

The economics profession offers all kinds of ways of measuring incipient inflation, yet one of the more reliable forecasts comes not from economists but from bond traders.

It's the yield difference between straight 5-year Treasury notes and the real yield on 5-year Treasury Inflation-Protected Securities (TIPS).

Simple numbers

Let's look at an example, based on the yield today, September 23, 2022.

The straight 5-year Treasury yields **3.96%**.

The real yield (margin above inflation) offered by 5-year TIPS is **1.58%**.

The difference between the two numbers — currently **2.38%** — is the market's forecast for the average inflation rate over the next five years. It's the rate at which bond investors would be indifferent between the two securities.

So the current 5-year forecast of 2.38% is not much above the Federal Reserve's target rate of 2%. That's good news, of a sort. But the forecast says nothing about the *way* we will see a 2.38% average over the next five years.

Given that inflation over the past 12 months has been 8.5%, the route to 2.4% average inflation could be by way of deflation for a period of time. That could mean a deep recession, which is also forecast by the 2-year/10-year spread (see page 1).

A little more math

If you hold the straight 5-year Treasury, you know your return over the next five years. You will receive 19.8 percentage points of yield (3.96% per year times 5 years). Then you will receive your principal back after five years.

If you hold the 5-year TIPS, you will receive the stated margin over inflation (currently 1.58%) per year for five years. Of course, your total return will depend on the inflation rate over the next five years. Let's assume inflation averages 6% over the coming year. You will then receive 7.58% over that time. To equal the straight 5-year Treasury, you would then need to receive only 12.22 percentage points total over the following four years, or 3.05% per year.

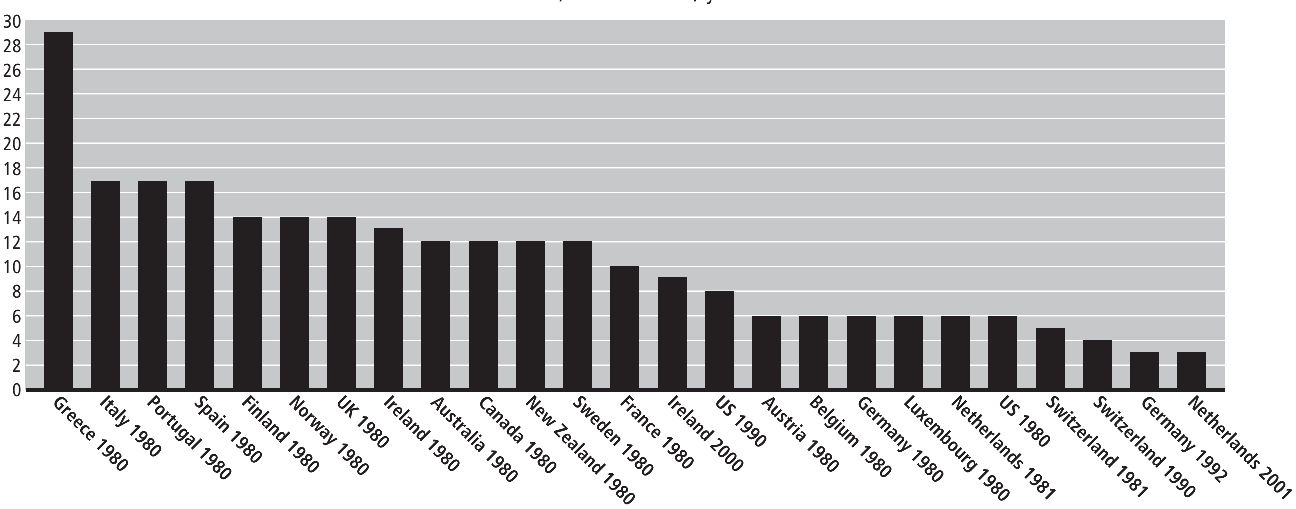
Since your margin over inflation is 1.58%, that means that you win if inflation in the years 2024-2027 averages more than **1.47%** per year!

If inflation persists, TIPS win big

It's entirely possible that inflation reverts to its 2010-2020 levels once the pandemic effects (supply chain shortages) subside, and once the Fed has run its course with its QT (Quantitative Tightening) program. But a lot has to happen for us to see a sub-1.5% inflation rate in these outer years. Meanwhile, TIPS — which were trading at negative real yields as recently as July and record negative yields (-2.5%!) as recently as mid-2021 — are looking like very reasonably-priced inflation insurance today. ■

Inflation down to 2% in 2 years? Don't bet on it.

Cases of inflation above 5% in advanced economies, 1980-2020, years to decline to 2%



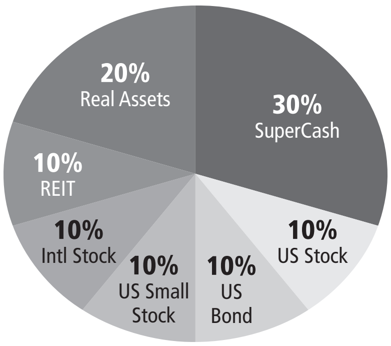
Once inflation is above 5% in advanced economies, it takes on average 10 years to drop to 2%. In fact, there's been no documented instance of inflation dropping to 2% in less than 3 years. That's why TIPS may be a buy here.

Source: IMF, BofA Global Research, Jesse Felder

SuperDiversified Portfolios (SDPs)

Think stocks are volatile? Try TIPS and currencies.

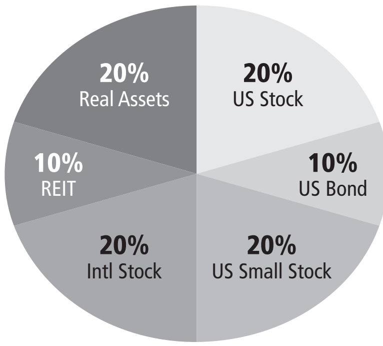
SDP1 *Conservative*



3rd Quarter **-4.71%**

Year-to-Date **-14.23%**

SDP2 *Moderate*



3rd Quarter **-4.65%**

Year-to-Date **-12.95%**

US stocks are down 23% in what is one of the five worst starts ever at the nine-month mark. Bonds have been even more volatile, with their worst start on record as central banks have all done an about-face from loosening to tightening. 5-year TIPS, which reflect inflation expectations, have gone from a record negative 2.5% yield in June 2021 to a 14-year yield high of 1.94% in late September. Currencies have likewise made record moves, with the Euro falling to 96 cents in late September, and the British pound making a 10-cent(!) roundtrip on September 26 while touching its all-time lows against the Dollar.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

A reverse-V quarter for risk assets

Asset Class	Mutual Fund	Performance 3rd Quarter '22	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	-1.80%	-6.03%	Best
	Merger	1.52%	-0.12%	Worst
	Calamos Market Neutral	-0.32%	-7.35%	
US Stock	Vanguard Index Trust 500	-4.92%	-23.95%	
US Bond	Vanguard Long-Treasury	-9.92%	-28.87%	
US Small Stock	Vanguard Small-Cap Index	-2.64%	-23.77%	
Intl Stock	Vanguard Intl Index	-10.54%	-26.81%	
REIT	Vanguard REIT Index	-11.05%	-29.34%	
Real Assets	PIMCO Commodity Real Return	-7.44%	6.16%	

It was a tale of two halves this quarter, with most risk assets rising sharply in July and early August, topping in mid-August, and plunging in the latter part of August and for the entire month of September. Some of the moves were breathtaking. The S&P, for instance, recovered 13.92% in the first six weeks of the quarter, only to turn around and plunge 14.95% in the following five weeks to make new lows for the year. Our *Vanguard LifeStrategy Conservative Growth* benchmark made comparable moves of 5.50% and -9.95% for the periods.

TIPS at a discount

Psst. Want to buy inflation-protected securities at a double-digit discount to their current price? Want to do it with some leverage financed at rates much lower than the yields the securities are offering? And want to invest it alongside one of the richest investors on the planet, at a price below what he paid recently?

Then you may be interested in *Western Asset Inflation-Linked Income Fund* (WIA), a 19-year old closed-end fund which invests at least 80% of its portfolio in inflation-linked securities, with no less than 60% of the portfolio in TIPS.

88 cents on the dollar

The fund currently trades at a discount to its Net Asset Value (NAV) of nearly -12%, a fair bit deeper than its 3-year average discount of -8.74%. This means you're picking up its high-yielding portfolio at about 88 cents on the dollar, amplifying its yield. The stated yield has been just under 6%, but it's under a managed distribution policy that has not kept up with the recent soaring rate of inflation and consequently TIPS total yields.

2022's loss is your gain

The fund, leveraged about 40% at short-term rates, has had a rough 2022 as TIPS yields have soared and prices tumbled. But with the TIPS curve offering real yields in the 1.5% range (or nearly 10% yield including inflation), the opportunity looks timely.

Alongside Bill Gates

The largest owner of WIA and its slightly racier sister fund WIW? *Cascade Investments*, the investment vehicle for Bill Gates. Mr. Gates has been a long-time owner of the fund, and has recently accumulated nearly a million more shares well above current prices.

WIA trading at a reasonable discount

Average, low, and high monthly discounts for WIA in past three years, as of 9/26/22

DISCOUNT	2020	2021	YTD
Average	-9.68	-5.56	-10.43
Low	-4.15	-3.32	-8.52
High	-13.24	-9.93	-12.60

WIA's recent discount of 11.92% was a hair off its low of 2022, lower than any monthly discount in 2021 and only a point and change from its lowest monthly discount of the last three years.

Source: Morningstar

SEASONAL STRATEGY

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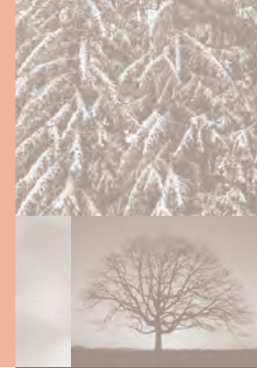

Social Security: Delaying makes dollars — and sense

Social Security recipients will receive a fatter monthly check starting January. It's anticipated that 2023 payments will be on average 8.5% higher than this year's, owing to the high rate of inflation this year. It's the largest increase in decades. It's also one of the best arguments for delaying Social Security payments as late as possible.

Inflation protection

Unlike every commercial annuity available today, Social Security benefits are indexed to inflation (to be precise, to the CPI-W, or Consumer Price Index for Urban Wage Earners and Clerical Workers). If the CPI rises 8.5%, so do your benefits, albeit with a one-year delay. The lifetime protection against inflation that Social Security offers, the so-called Cost of Living Adjustment, or COLA, is invaluable, and argues for maximizing the overall benefit.

You can start taking Social Security as early as age 62, but you will maximize your monthly payment if you wait until age 70. Every year you wait means approximately an 8% larger monthly paycheck — compounded. As the chart shows, the difference between taking Social Security at 62 and 70 can mean a near-doubling of monthly payments. And if you choose to work between ages 62 and 70 while delaying, your added income can contribute to a near-doubling of payments at age 70.

The tradeoff

Of course it's a tradeoff: You give up current benefit payments in exchange for higher payments for the rest of your life. But in most cases, your breakeven age — the age at which you would receive about the same benefits if you started early or late — is about 79 to 83, which is actually lower than the average life expectancy of a healthy 60-something. Delaying is an especially good deal for women, whose average life expectancy at age 65 is age 86, while 65-year-old men are expected to live to age 83.

And remember, it's joint life expectancy that is relevant here, because benefits last until the second spouse dies, and the surviving spouse receives the higher of the two benefits. Joint life expectancy is typically a few years beyond the average of the two spouses.

Nothing like it

Aside from the sheer numbers, Social Security is the only available form of inflation-protected longevity insurance. In one package, you get protection against outliving your money and protection against inflation. There's nothing else like it in the financial world. Even if a private product should arise, it won't have the backing of the full faith and credit of the US government.

Guaranteed income vs. portfolio withdrawals

A healthy retirement income should balance market-dependent sources of income (systematic withdrawals from your portfolio) with guaranteed sources of income (steady paychecks from Social Security, and perhaps rental income and annuities). The former supply upside, while the latter provide longevity insurance, stability, and consistency.

In most plans, investors are light on the guaranteed sources of income — another reason to delay Social Security benefits. Doing so will bolster the guaranteed income side of your retirement income plan. This may aid planning for later life by making you less dependent on the stream of withdrawals from your portfolio. ■

Getting paid to wait

Typical Social Security benefits estimates for a high earner at early retirement (62), full retirement (67), and late retirement (70). Figures are based on working until target ages at current income.

AGE	MONTHLY	ANNUAL
62	$2,308	$27,696
67	$3,236	$38,832
70	$4,110	$49,320

Social Security benefits rise about 8% for every year of delay, and a little more if you are continuing work while you delay. The above age 70 benefits are 27% higher than at full retirement age of 67 — and 76% higher than at age 62.

Source: Social Security Administration