Recession, Stagflation or Soft Landing:
What are the markets telling us and what should we be doing?

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September 15, 2022

So far, 2022 has been a tough year in the financial markets. The bond market had its worst start ever while the stock market had its worst first half since 1970. We had a break in July with a stock rally which continued into the first two weeks of August, but all the August gains were given back as the market is heading down again.

We have become accustomed to bond prices rising when stock prices fall. However, this time both bond and stock prices have gone down together. The bond market drop was caused by a very quick rise in short-term interest rates. Some people blame the Federal Reserve for increasing the Federal Fund Rate which is the interest rate banks charge to lend money to each other on an overnight basis. The reality is the bond market moved quicker than the Federal Reserve and stocks followed. During the 2007-2009 financial crisis, the Federal Reserve flooded the system with liquidity to avoid a second great depression. This was done in the United States and around the world. The central banks were in charge, and they became comfortable using these powers. It worked but the consequence of letting that influx of cash continue for too long is the inflation we are experiencing now. You see it at the gas pump, the grocery store, and in almost everything else we purchase. Meanwhile, we see the value of our investment portfolios going down which adds to the fear and concern people are experiencing.

Inflation is the biggest issue the economies of the world are facing right now. There are numerous arguments as to the cause of inflation, yet the simplest answer is too much money chasing too few goods. The pandemic certainly disrupted the supply chain, employment, and other factors while governments around the world paid out stimulus checks and established other programs to keep their economies running. It worked until it did not and now inflation is here and at a rate we have not seen in 40 years.

Our Federal Reserve wants to create a soft landing by subduing inflation without creating a recession. Unfortunately, history is not in their favor for pulling this off successfully. The technical definition of a recession is two negative GDP quarters in a row, which we just had. Additionally, over the last two quarters we have experienced what is called stagflation which is particularly nasty. Stagflation occurs when inflation is present in a negative growth environment; no economic growth but rising prices.

So, how do we help ourselves through this?

First, do not panic. The investment rule of thumb is to buy low and sell high, but that at this stage many people tend to panic and do the exact opposite. It is much better to have a strategy and be disciplined.

Second, be careful of interest sensitive debt, such as adjustable-rate mortgages and variable lines of credit, as they are vulnerable to changes in lending rates. As interest rates increase, your rate may increase as well. This can substantially increase your payment and ultimately the amount of your debt.

Third, understand risk is a part of investing. Many people believe risk means they will lose all their money. While that could be true, that is not considered investing, that is considered speculation. Risk, as it relates to investing, is how much an investment goes up and down in value on its way to achieving its return. It is important to understand the difference.

Fourth, know your investment goals and your time horizon. Make sure your investments have an appropriate mix of stocks, bonds, and cash for your situation. This helps reduce the volatility of your investments over time. Remember, it is not necessarily a stock market, but a market of stocks made up of several types of stocks. Different classes and sectors of stocks perform differently. Stocks and the market cycle with the economy.

Lastly, know and accept that bear markets are a normal part of investing and of the economic cycle. It is also important to remember, it is not IF a bear market will happen but WHEN will a bear market happen. Investors need to always be prepared. In fact, if a person's investments are well positioned, the goal is not only to survive a bear market but, to take advantage of them. You do this by buying good investments at good prices. As Warren Buffett likes to say, "Be fearful when others are greedy. Be greedy when others are fearful." This strategy can position you for the next up cycle in the market.

So, whether we stay in stagflation for some time, enter a recession, or the Fed manages a soft landing, history is the place to look for calming answers as we always come out of times like these – and we will do so again. The hard part is we never know they are over until we have gone through them and look back. That is why discipline is so important.