The Crescent Group

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RBC Wealth Management
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July 2023 Crescent Commentary

A Soft Landing? (Washington Post)

Fed Sees Soft Landing for Economy (Financial Times)

Confidence Grows That Fed Can Deliver A Soft Landing for U.S. Economy (Financial Times)

Recently, there's been almost nonstop chatter in the financial media about expectations that the U.S. economy will experience a "soft landing". A soft landing is a scenario where the Federal Reserve is able to reduce inflation without harming the U.S. economy, and the economy continues to grow despite higher interest rates. I did a quick internet search and found the three above headlines. The twist? The headlines were published in June 2000, February 2007, and July 2023, respectively.[1][2]

The point of showing these headlines isn't to conclude that the U.S. will face a hard landing this time around as it did a few years after June 2000 and February 2007. The point of showing these headlines is that no one has any idea what will happen, and we'd be wise to invest accordingly.

Over the past few months, we've seen a return to irrational exuberance in financial markets. Irrational exuberance is a phrase former Federal Reserve Chair Alan Greenspan first used to describe financial markets during the 1990s technology bubble. The financial market exuberance we see today basically means that many investors are behaving as if they know exactly what will happen with our economy. More specifically, they are expecting inflation to continue to fall while our economy continues to grow, with higher interest rates having no negative impact on our economy. Otherwise known as a soft landing. The exuberance also completely rules out the possibility of a negative exogenous event (such as 9/11 or COVID).[3]

But as the above headlines show, not even the Fed Chairman knows what will happen from here. Taking a sober look at the situation, the Fed has had to raise interest rates by one of the largest amounts in one of the shortest time frames in history to reduce inflation. If the Fed were to start reducing interest rates, inflation could begin increasing again.[3]

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Another factor to consider is that interest rates take time to have an impact. If you consider the February 2007 headline above, the Fed stopped raising rates in mid 2006. The first cracks in the real estate market didn't really appear until summer 2007 when the Bear Stearns subprime hedge funds collapsed. And economic conditions didn't bottom out until mid 2009. So it took years to see the full impact of the Fed's rate increases. The same is likely true today. We will repeat that this is not a prediction of hard times. No one knows at this time how higher rates will impact our economy over the next few years. A hard landing, a soft landing, and everything in between are the possibilities.[4]

Given that no one has any idea what will happen over the next few years, the smart thing to do is position your investments to have the best chance of doing reasonably well no matter what happens. A strategy we recommend is what we call a barbell approach to asset allocation. Suppose our economy experiences a soft landing and inflation continues to fall while our economy continues to grow. The Fed can stop raising rates or may even be able to reduce them. We would essentially experience a return to economic conditions we experienced from 2014 to 2021. Investments tilted towards growth would likely continue to do well.

Now suppose our economy experiences a hard landing. We can look to two economically challenged periods over the past fifty years to see what did well during hard times. The first is the 1970s, the last time our nation experienced elevated inflation, high interest rates, and economic stagnation. In 1982, the Dow Jones index ended the year at the same level it did in 1972. You might think that means investors experienced no gain over those ten years. Yet investors who reinvested dividends earned a 69% return over that time period. This emphasizes the importance of companies paying steady and increasing dividends to investors during a time of economic challenge. We can look at what did well during another challenging time for our economy, the 1999 to 2009 time period. U.S. stocks ended 2009 at a lower level than they were ten years earlier in 1999. Yet specific industries with strong and increasing cash flows delivered positive returns to investors over that time period, including Consumer Staples, Health Care, and Industrials. So in order to help protect your assets against future uncertainty, we recommend a strong weighting towards investments paying strong and increasing cash flows to investors.[5][6]

The final piece of the puzzle in successfully navigating future uncertainty is to know thyself. It's natural to become bold and want to take risk during good times like the present, and then become fearful and want to reduce risk during challenged times like we went through as recently as March of this year. The data show that moving in and out of an asset allocation based on personal emotions will hurt you as an investor. Rather than moving in and out of investments based on how you feel, you're far more likely to succeed if you always stick to a sound allocation that's in line with your risk tolerance, regardless of the current market sentiment. We're here to help you do that.[7]

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Sources:

(1) The Financial Times
(2) The Washington Post
(3) Board of Governors of the Federal Reserve System
(4) Reuters
(5) Roger Thomas
(6) Richard Bernstein Advisors
(7) RBC

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