Ep110: Inflation and Asset Performance

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PATTI BRENNAN: Patti: Hi, everyone. Welcome to The Patti Brennan Show. Whether you've $20 or 20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Joining me today is the professor Eric Fuhrman, our Chief Planning Officer here at Key Financial.

Today, Eric and I are going to be talking about the topic that's on everybody's minds today, and that's inflation. It's affecting everyone across America and throughout the world. Today, Eric and I are going to dissect it.

We're going to get to the bottom of it and figure out what is causing it? Could it have been avoided? What do we do now? Eric, welcome to the show.

ERIC: Thank you, Patti. Excited to be here. I got to say, these podcasts are a real treat – highlight of my day.

The great part is, normally when I go on family vacations, my wife and kids would have to listen to this kind of stuff because they don't have a choice, but now I get to share it with our listeners today and our clients, so it's a real treat for me.

PATTI: You know, Eric, I don't know what our families would have done if you and I hadn't gotten together, because late at night after everybody's left the office, invariably either, you're coming into my office or I'm coming into yours and we're doing this theoretical brainstorming on what's going on in the world around us and ideally trying to solve all the problems.

ERIC: The hypothetical of that is, too, I don't even try to envision it. You're right. What this podcast does hopefully for our listeners, is give you a seat in the room to those late night conversations that we have – not as advisors, but as investors.

We ponder the bigger questions – like what are the major headwinds and tailwinds that drive the economy and asset markets and factor into our planning? Ultimately, part of this is science, but a bit of it is an art form as well.

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PATTI: You bet. A lot of it is art form. Just so that you all know, these are not just theoretical quick conversations that we have late at night. Afterwards, invariably, Eric and I will put our heads together and put together a white paper. For those of you who might be interested, go onto our website at keyfinancialinc.com.

You will find a white paper that we've prepared that dives deep into this topic and goes through the history of Federal Reserve policy, fiscal policy, and the things that are affecting Americans today.

Eric, first and foremost, thank you so much, you really worked hard on that white paper.

ERIC: It's a joint effort. It's part of curiosity. That's part of the human condition - to always be curious and seek answers to these questions. What's most important in terms of how we come together with these white papers, is to not load them up with industry parlance, but to try and tell a story and tell that around data and visuals.

Ultimately, we're trying to tell a story here that's going to resonate with our clients and our listeners.

PATTI: My favorite visual is on the first page with your pictures. Eric found pictures of a beautiful lake. Serene, gorgeous, sunset picture, glass, water.

On the other side is the same lake where a seven-year-old has probably thrown a rock in the middle of it and it shows the rings and the effect of just one action on that beautiful lake. I think that is a powerful way of telling that story.

ERIC: It's a great analogy to use the lake to illustrate the pre-COVID and post-COVID environment that we're now living through. There is a grain of truth which is that my seven-year-old or my nine-year-old is the person that chucked the giant rock into the lake, as all nine-year-olds would do.

What fun is that, find the biggest rock you can and throw it in there. To me, that instantly resonated as a great visual analogy for the pre and post-environment that we're living through right now and the repercussions of that, the ripples in the lake if you will.

PATTI: You bet. I've got a bunch of 30-year-olds who love doing that also.

ERIC: I guess some kids never grow up.

PATTI: Oh, yeah. By the way, my husband loves doing it, too, so it's something we never outgrow.

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ERIC: Knowing Ed, that doesn't surprise me. He seems like a rock trucker too.

PATTI: Absolutely. All right. Let's go into some of the details on inflation. What makes inflation rear its ugly head?

ERIC: Most models operate on two axes here. That inflation can be caused by what they call demand pull factors or cost push factors. Cost push was what was attributed to the last inflationary surge back in the 1970s.

If you and I are going to break down these things and avoid any economical jargon, anecdotal evidence is a good way to describe this. I think about you and I going through that period of COVID when we're still doing Zoom calls with our clients and so forth to communicate ideas and concepts.

So much of these calls are focused on cash flow and what do we hear? We've got this small sample size, but is reflective of the broader population which is, Patti and Eric, I'm not spending money. I don't need any money because we're in the house. We have trips that have been canceled. We deferred spending.

Eventually the economy reopened. All that pent up demand suddenly came flooding back in to the market. What do we hear now? Everybody is planning trips, they talk about where they've been or what they've done.

That to me, that anecdotal aspect tells of the broader situation with inflation as it relates to that demand component.

PATTI: The interesting thing about that is, it's not like they didn't have the money, they had plenty of money. It's interesting to look more universally according to the Department of Commerce, during COVID, there was $2.1 trillion. That's with a T of excess savings that had built up in consumers accounts, etc.

That's over and above what they would have saved if COVID hadn't happened. That's a lot of money. If you think about our economy being a $25 trillion economy, that's 10 percent just sitting there, ready to be deployed once things opened up.

ERIC: It has been. That's part of the story here, right?

PATTI: It sure is. What I also think is interesting is that, that excess savings has come down. It's now 1.3 trillion, still a ton of money that is yet to be deployed.

What does that mean for inflation? Does that mean it's here for a long period of time?

ERIC: I keep going back as we work through this podcast and to envision in your mind that

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imagery of ripples. That is one of those ripples but once that rock, COVID for example, goes into the lake, eventually over time those ripples begin to dissipate. That's what you're seeing.

The pent up savings, the pent up demand is being drawn down, but eventually, that will subside and return to a steady state. I think of that as a way to think about the excess savings that's been used and where it's at today.

PATTI: I might be taking this analogy a little too far, but is inflation like the algae growing underneath that nobody sees quite yet but could fester and create major problems?

ERIC: What are you doing tonight? We can talk about it. That's a deep question. I don't know.

I don't know, but an interesting suggestion. The other dynamic here is that cost push factor. I wouldn't think of inflation as this binary thing that has to be one or the other. The real answer here is, it's a little bit of both which is unique and that's a byproduct of COVID.

PATTI: Let's put that in English. What exactly is cost push? I understand demand, what's cost push?

ERIC: A great example of this would be the 1970s that was also viewed as cost push. This is where the raw materials, the costs involved of production, taking raw materials and turning them into the stuff that people consume. When those costs go up, that creates inflation. Those costs have to get passed to consumers.

When you look at let's say, raw materials like copper, aluminum, lumber, for example, those prices went through the roof when you look at the futures markets for those products. That was an enormous demand for those things. They were in scarce supply at the time and the prices went through the roof.

That raised the cost for builders and anybody involved in production to acquire those things. Now what you're seeing, those prices have come down dramatically for things like copper, lumber and so forth, but now you're seeing the impact of a very tight labor market.

A big impact for any business owner or manufacturer is salaries. Salaries and wages that you pay. Right now you're seeing a dramatic escalation in the cost of labor and benefits, but at the same time you're seeing a dramatic fall off in the productivity of that labor.

Essentially, it's costing you more to make stuff, but you're getting less of it. That dynamic which again, that will work itself out, but that's the other side of the equation here, is that rising cost of production. The demand pull was the first phase and now we're entering the

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second phase which is that cost of production that's now being passed on to the consumer.

PATTI: What I'm hearing is, the impact of the supply chain bottlenecks that were created during COVID were one issue and they are still there although they're getting better. The other impact is the idea of the great resignation or the quiet quitters, people not quite doing as much as they used to do.

Employers are looking to hire more people or to solve the problem to meet the demand that is clearly there.

ERIC: Also, think about the demographic composition of the country. This is a unique tailwind for those like us in the financial advice business, but a very large segment of the most experienced, most productive, most knowledgeable workers are those that are 65.

One of the trends that you see manifest out of the COVID experience is that those people are not returning. There's fewer people and fewer people that are capable of high output, high production that are not coming back to the workforce. They're retiring, but they're still consuming.

PATTI: In fact, they have a lot of money to consume because they've got the 401(k)s now instead of the defined benefits, instead of a monthly check that they would get from their employer, they've got a big fat balance in a 401(k) ready to be spent.

ERIC: Well, not to mention that they're also the largest recipients of government transfer payments in the form of Social Security and other benefits.

PATTI: That's a good point. The brain drain is definitely going to impact the output and what companies are able to do, because how many people have said to us, "They're going to have to hire two people to do the work that I was doing."

ERIC: You see these numbers. The statistic that's quoted for countries that are aging rapidly like China, Japan and also the United States, is this dependency ratio – the number of retirees to number of workers, and that's rising across most advanced economies.

What we should do is table that. That's a deep subject. That's a more secular trend, so it's perfect to bring people back to the table for another interesting discussion. We got to work it out first on that one.

PATTI: Absolutely. We talked about the very high levels of savings. Those high levels have come down in a dramatic fashion by the way. That's a lot of spending that occurred in the last year or so.

On top of that, debt increased. We're at record high levels of both consumer and

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government debt. What's going on with that?

ERIC: A couple of things there. There is this connection, if you will, that economists have made historically between money supply and output. As the saying goes from Milton Friedman, he was a famous economist that had won the Nobel Prize. He said, "Inflation is nothing more than too much money chasing too few goods and services."

If you look at the pre and post COVID area, you want to look at what's called monetary and credit aggregates. I know, I promise we wouldn't use technical jargon, I apologize. What does that mean? When we look at monetary aggregates, that's things like currency and circulation and the Central Bank reserves. This is money that commercial banks have in the banking system.

Central Bank reserves increased dramatically, currency and circulation increased, but that's not a reflection of inflation. Currency and circulation is people that prefer to use cash and so forth. The vast majority of money creation occurs at the private level from banks.

When banks make loans, there's demand for deposits, things like that. That's where money is created in the system and also, government debt. I don't know if that's the appropriate term, but essentially when the government issues say treasury bonds to fund deficits, I know it's called debt, but that's a form of money that pays interest. That adds to the system.

When you look over this two year period, you had an annualized increase of about 12, almost 13 percent in government debt, which again, that's issuing assets, or currency if you will. Then you had about a 12 percent annualized increase in bank deposits.

The money in the system escalated dramatically and the problem that you have is that the economy at any given time has a natural speed limit. The Congressional Budget Office estimates, what they call the potential output or potential GDP. This is really the maximum output that can be sustained if all the resources of the economy have a high use or being fully utilized.

The problem that you have is when there's a whole bunch of money injected into the system, and now all of a sudden you reopen and unleash this wave of demand, there's only so much that can be made. The outcome there is rising prices when there's an imbalance between demand and how much can actually be produced at a given time.

PATTI: In hindsight, let's play Monday morning quarterback, Eric.

ERIC: That's always fun.

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PATTI: It is so much fun. Let's go back and say, "OK, what should have happened? Why didn't the Federal Reserve act sooner than they did?

We breached their target inflation rate of two percent in the beginning of 2021. Here it is October of 2022 and granted, they've increased interest rates, but is it too little too late?" Why didn't they do this sooner?

ERIC: Yes, that's a good question. The best way I can describe it, we're not in the room when they have these committee meetings, so we only can speculate. I think we can piece together a narrative based on her understanding. It is crystal clear what the Federal Reserve's mandates are. Those are by congressional decree.

If you go back to the Federal Reserve Act of 1913, the goals that are enumerated for the Central Bank is essentially to maintain maximum employment, stable prices, and moderate long term interest rates.

PATTI: Wow, that's a hat trick right there.

ERIC: Yeah, right? You've got...

PATTI: A lot.

ERIC: ...trying to balance three objectives and I think those are good objectives that are within the framework of long term stability to maximize resources and growth. The problem is when you have a crisis, achieving all three becomes a bit aspirational. If anything, it's an impossible trinity to satisfy all three at the same time.

The medicine, the reason why part of the explanation here is that we had 15 percent unemployment. The objective of the prioritization is really to heal the labor markets, which means dropping interest rates to near zero, providing massive stimulus to keep the spending going.

It just takes time, but what we see is that roundabout March of last year. The Federal Reserve also has this objective or mandate of price stability. They define that as two percent annual inflation growth. March of last year, suddenly, price increases exceeded or breached that two percent level, and they kept going higher.

The problem was unemployment was still deemed to be too high, six percent. That desire to let unemployment heal let those prices increases go on for about a year.

The policy response to curb inflation, which is raising rates, which is antithetical to healing the labor markets because higher rates tend to create unemployment, that just came 12 months after the fact. Now, we're trying to play catch up.

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PATTI: You know, it's so interesting. It's a good example of how quickly we forget. I think a lot of the commentators I hear and articles that I read, they forget that inflation was 15 percent. They forget how much people were suffering. There was so much uncertainty at the time. Six percent is still really high.

To give these policymakers a little bit of a break, they've got to make their decisions based on the information they have at the time. They refer to it as being data dependent. What else can we expect them to do? Even then, the data that they receive is historical data. They've got to be forward looking. That's what they do.

They've got to try to anticipate and understand, in the midst of that high unemployment and in the midst of a supply chain backup and a lot of global uncertainty and things, that we're really uncomfortable for a lot of families in America.

ERIC: Ultimately, human beings are trying to solve the problem here. Nobody is clairvoyant and can know. Again, these prescriptions, the medicine that's being used has a lag effect. Knowing how much medicine to administer, when and how long it's going to take, all those things take time, which is why the Fed always reinforces the idea they're data dependent, to see what happens.

Unfortunately, it's an art form. It just can't be precisely estimated. These things take time, and they adjust.

PATTI: Can you imagine what would have happened if the unemployment rate was at six percent, and it just breached the two percent inflation rate, and they decided to increase interest rates by a quarter of a point?

Sure enough, businesses would probably freak out and begin to lay people off. Unemployment will go up to eight percent. Anything can happen at any time.

It didn't happen. Fortunately, people remained employed. Families were able to do the things that they wanted to do, and we do have inflation. The one thing I always look back during these periods of crisis and the immense amount of liquidity that was put into the system, I look back to the financial crisis.

That was a crisis of a different kind. The things that caused so much of the worldwide difficulty was a systemic banking issue. What they did at that point in time because these concepts of quantitative easing had never been done before, so it was slower. It was much more modest.

When businesses were given large amounts of money like AIG. AIG was given a huge loan, but guess what? They had to pay it back, and they did. Fast forward to COVID, we had PPP, same kind of idea. Businesses were given trillions of dollars, but guess what? Businesses

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didn't have to pay it back, so it stayed in the system.

It seems to me they're calibrating. The criticism, if there is one based on what the policymakers' response was after the financial crisis, was that it resulted in much lower, slower growth. We didn't come out of it until 2016, 2017.

Even then, it was very modest, one percent increase in GDP when, theoretically, at least historically, our economy was growing at closer to three. That's a big difference.

This time, with this crisis, they looked back and said, "OK, well, that worked sort of, but it probably wasn't enough, and it wasn't as quick as we needed to do it. Let's try something different," and they did.

They put in massive amounts of money, which they really don't do but that's the perception, flooded the economy with lots and lots of money. It solved the problem. We had a recession, but it was very, very short. Markets recovered. Families recovered. The unemployment rate is now 3.7 percent.

We've got this little problem. It's a side effect, the side effect that is pretty much textbook when you put that kind of money into an economy. That's inflation.

Inflation has ramped up very, very quickly in this calendar year. There's a lag effect to inflation. That's basically what we're dealing with today. It went up much faster and much higher and has stayed higher than the Federal Reserve and policymakers had anticipated. Now they have to deal with the problem, right?

ERIC: Yeah. I think you highlight a lot of wonderful concepts there. If we're going to try and draw a parallel, there was massive stimulus that occurred under the financial crisis in '08 just as there was in COVID.

Why is the outcome inflationary here, and it wasn't there. I think you draw a really important distinction about the nature of the crisis. Every crisis has a unique fingerprint. They are always different. The catalysts they created are different.

If you think back to the financial crisis, the contagion infecting the system was one of counterparty risk. Remember, Bear Stearns and Lehman Brothers folded. A lot of mortgage banks folded. The issue there was more of an institutional contagion. What did the government do?

They provided massive stimulus to large financial intermediaries in the form of loans and even taking equity stakes, which was controversial at the time. Here's the difference. That stimulus was paid back. Those companies paid back the loans, or the government sold their equity stakes. It wasn't a permanent increase.

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If you think about unemployment benefits, there was emergency declarations to extend benefits but not massively inflate them. Those things were in place.

PATTI: They didn't send checks to every family in America, right?

ERIC: Yeah. Fast forward to COVID, now, again, we have this contagion, but the contagion is within the household sector, infecting everyday Americans because they've been thrown out of work. People stopped purchasing. The medicine there, again, same idea, flood the system with money, but how was it executed?

Businesses were given PPP loans to keep people on the payroll. Essentially, that's just more or less stimulus to households, because people keep getting paychecks. What happens with those loans? Most of them were forgiven. They weren't paid back. They were forgiven.

In fact, they weren't even taxed because of a last minute change in the rule which, originally, the program was meant that it would be taxable income, and that wasn't. That just added to the stimulus.

Unemployment benefits were extended and boosted substantially – which kind of kept people out of the workforce for longer than they might otherwise have been. Then there were also direct payments based on income or how many kids you had, direct stimulus.

The difference here is the recipients and then how that program was governed. The stimulus that went to households was not really pulled back out of the system in any way, shape, or form.

You can look at these measurements. M2 is this measurement of broad money supply, which absolutely skyrocketed. Historically, we have an example of this in our white paper. We look back to the '70s. There were three dramatic expansions in money supply, and then within a matter of time again because there's a lag effect, dramatic increase in the consumer price index.

Some people have said the connection there is weaker today than it was back then. There are arguments for and against that, but you see the same thing. If you drop bales of money out of the sky, on the people, eventually nobody's really wealthier, because we haven't made more stuff. You just have more money to spend on the same limited pool of goods and services.

Ultimately, that's what we see here. That's the hallmark of how stimulus was executed here versus the financial crisis and why the same result didn't happen back then.

PATTI: This is not just here in the United States. Inflation is a worldwide phenomenon. Almost

every major nation in the world is dealing with runaway inflation. Yet, I'd be curious and this is something you and I should probably look into what kind of programs did they have over in Europe, in China, in Japan, etc. to cause the runaway inflation that we have, or is ours more severe?

ERIC: There's certainly further study, many more nights of pondering these questions. You're right. As Americans, we tend to think of this as a domestic issue, which makes perfect sense.

If you look at the data in other advanced countries, whether it's Germany, France, Korea, Australia, Canada, all these countries, they all show a very, very similar trend and level of inflation that we have here domestically in the United States.

There's certainly a lot of integration among economies in the world. What could be the cause? The US dollar is essentially the global reserve currency. Most international businesses price contracts and so forth in dollars. There's a dramatic need for dollar.

In essence, maybe there's credit to the idea that the inflation and the US has been exported to our trade partners via the dollar but again, further, it's a great question to ask.

PATTI: It's an important question because the dollar is so strong, and there is a lot of talk right now that because of that, it's pushing these other nations who are also dealing, in the example of Europe and Ukraine, into a really deep recession. Hopefully, it isn't the D word, but it's causing real havoc in their economies as well.

ERIC: Yep. I guess the silver lining is that this has roiled the currency markets because the dollar is strongest it's ever been.

If you want to spend money, go to Canada, Australia, United Kingdom, Britain, because the dollar has strengthened substantially against those currencies, you'll get a little more mileage out of your dollar if you exchange it into those foreign currencies, at least right now.

PATTI: The thing that we've talked about, and you and I have shared this with clients as well, is there's a part of me that looks at myself, looks in the mirror and says, "Should we have seen this? Should we have anticipated then the impact on securities and markets all over the world?"

Yes and no, to a certain extent, we knew going in – and we've talked about it in prior podcasts – that that would be the likely side effect of too much stimulus. At the same point, because after the financial crisis, we were ready and waiting. We were positioning portfolios for inflation that never occurred.

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There is a negative impact there as well in terms of performance of asset prices. It's easy to say in hindsight.

The question is, what is the impact on prices? Let's think about growth versus inflation and the four quadrants that you and I were talking about, and how do we position portfolios accordingly. What do we do? What do we tell people to do?

ERIC: That's a really good question because inflation is transmitted into asset prices, but it's transmitted in a very negative way.

Think about it as if we're going to paint with broad brush strokes. The basic building blocks of any portfolio is going to be probably a core of equities or stocks, bonds, depending on your age and risk tolerance, cash, or something like that.

Those basic building blocks work extremely well for different types of environments. The reason you want to own stocks is because we've been in this expansionary phase of incredible prosperity since the Industrial Revolution and stocks give you the individual a claim on that prosperity, a claim on that production.

The economy doesn't always go up, it exhibits this cyclical pattern. Bonds are the ideal counterweight to buffer that risk and give you an asset that usually performs well when the economy sputters and so forth.

The unique fingerprint of this situation, which is reminiscent of the '70s is that the economy is sputtering, but prices are going up, which is unique.

PATTI: Oh, the old stagflation?

ERIC: Yeah, that's bad for stocks, but rising interest rates and rising inflation is also very, very bad for bonds. The usual relationship that tends to unfold is not unfolding this time. These types of conditions when you think about bonds or stocks, ultimately market participants build in an implicit assumption for expected inflation.

When suddenly inflation is above expectations, that sends the prices of stocks and bonds down. It means that there's not enough return there to compensate for inflation.

Things that do really well in those types of environments are any kind of claims on real assets, tangible stuff like agriculture, raw materials, and those things. They tend to perform very well. They're up 20, 30, 40 percent. One could look and say, "Well, why don't I have commodities in my portfolio?" Valid question from an asset allocation standpoint.

PATTI: Absolutely. Yep.

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ERIC: The problem is, for most of our clients, we are investing for a time horizon that spans decades, life expectancy. If you look at real assets, raw materials, they usually have very, very low rates of return. They go through periods of extreme underperformance and so forth.

They're very good in situations like these if your timing is right, but they're very poor long term investments. They're likely to potentially detract from the portfolio's longer term rate of return.

PATTI: There's huge drawdowns also. It is a really volatile asset class. It tends to be very short lived. It's fine and dandy if you catch it right but very difficult, especially since 1982, we really haven't had inflation. Those asset classes have not performed, whatsoever.

ERIC: Gold went through a 27 year period of decline. That matches most people's life expectancy, so it's not a good asset.

Ultimately, fundamentally, when we think about the drivers of return, raw materials are poor investments. It's the manufacturing process that takes those raw materials and transforms them into something that people want. That is the magic. That is the real value. That's why you own things like stocks.

PATTI: That is a fascinating. When you said that to me the other night, it all made sense. That was the epiphany. Now, I get it. It's the copper and the lumber, etc. It's what we're doing with those things that really create the value. It's more of a speculative asset as raw material, right?

ERIC: And raw materials, right? If it's a grain silo in Nebraska full of corn, or wheat, or a vault full of gold, those things have storage cost. There is a deterioration, an obsolescence, and a cost to holding those raw materials that takes away from the return.

Again, you got to be in the right conditions because, ultimately, you're speculating on price. There's no yield. There's no claim on profits. There's no dividends to these things. It's purely a price speculative investment that requires timing and we all know how hard that is.

PATTI: 27 years is a long time for something to finally work. All right. We're going into the final exam. OK, Eric. Here we go.

ERIC: I'm starting to sweat over here. I'm nervous.

PATTI: How quickly do you think that the Federal Reserve can realistically bring down inflation and what's the outlook for say, the next year?

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ERIC: Got you. I'm terribly human and lack a crystal ball here. Nobody knows for sure. We are all operating an element of a fog here to define these kinds of things. We can rely on survey data, on empirical data in terms of how assets are priced to look at this.

There's a couple ways we can do that. For example, the Federal Reserve, as part of their duty beyond monetary policy is to collect market intelligence.

They work through their network of primary dealers and other financial intermediators, and they give them monthly surveys to see what participants think about things like employment, growth and also inflation.

When you look at these surveys of these major financial centers, what you tend to see is that inflation is likely to be between five and six percent for this year, but they expect that long term over the next couple years, it will be anchored closer to two to three percent.

Right in our backyard, the Philadelphia Federal Reserve Bank of Philadelphia conducts the oldest macroeconomic survey called the Survey of Professional Forecasters.

You see a similar trend there, every quarter they make forecasts. Their long term expectations two, three years out, anchors inflation around a much lower steady state of two to three percent. Those are surveys. What does the market say?

There was a development back in 1997, when the treasury unveiled what are called Treasury Inflation Protected Bonds. A regular treasury bond is priced with expected inflation. What participants think inflation will be, that's billed into the yield. Treasury Inflation Protected Securities by contrast adjust the principle for actual inflation.

You can compare the difference in yields and see what the market is forecasting inflation to be. If you look at a five year treasury and a five year TIPS, acronym for Treasury Inflation Protected Security, it would say that the market is pricing an inflation five years out at around about 2.3 percent or so.

These things change on a regular basis and they do adapt, but it doesn't suggest that inflation is predicted to be this thing that will not be resolved in 5 or 10 years and that we're in this permanent state. Eventually, when that inflation comes down, I don't think it has to get to two to three percent, I think just that news or observation will be favorable for prices.

PATTI: Financial connections...

ERIC: Financial assets.

PATTI: It's interesting because we are seeing it here day after day in just talking with our clients.

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They are already pulling back. They are canceling the renovations on the house. They are not going away as they had hoped that they would be able to do.

They are not spending as much money. They see their statements and they think, "Oh boy, can I really afford this?"

ERIC: Do I have to go back to work?

PATTI: Yeah, exactly. Fortunately, we've planned literally for this environment. We assume that these things are going to happen, and we manage the portfolio accordingly so that people don't have to be a victim of something that is cyclical.

I don't want to understate it or I don't know what the word is, but it is a big deal. At the same point, it's nothing that we haven't seen before, and that's important. The Federal Reserve knows what to do, and boy, are they very clear, they are not fooling around.

I appreciate the fact that they are being as aggressive as a Federal Reserve has ever been in the history of their dual mandate. They've never gone this high this quickly, but they're not fooling around. They want to squash this bug before really becomes a problem and they will.

Eventually, I believe it's going to be effective, and we're already seeing the impact. The question on everybody's minds is, are we going to end up in a recession?

ERIC: Is this for bonus credit?

PATTI: Yes, it is. Absolutely.

ERIC: To your point, as investors, there's no single indicator that is going to tell you. We have to form a mosaic of different indicators to read the pulse of the market. They would all suggest that if we're not already there, we're heading into a recessionary environment.

Things like the University of Michigan Consumer Sentiment Index, lowest reading ever since the index started.

PATTI: Time out. The interesting thing about that is, that has been awful all year. I don't know whether it's correlated or there's a causation effect, but the sentiment numbers have been awful all year starting in January.

Sure enough, GDP didn't grow. In fact, we had two back to back quarters of negative GDP. Now theoretically, the powers that be have not declared an official recession, although it sure feels that way right now.

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ERIC: All the indicators, the inverted yield curve, inflation, rising interest rates. Usually when you go into a tightening cycle that does not portend an expansionary set of conditions 12 months out, it's pretty typical when you have tightening conditions. You see banks tightening credit standards right now.

All those things are trying to restrict the blood flow to the body here when it comes to credit and this inflationary effect. What's important to understand too is, think about recessions of the past, whether it was 1980, 1990, the one from 2000 to 2002, the financial crisis. The market response is totally different in every recession.

A recession is a binary thing. We're either in expansion or we're in contraction, which is a recession. In 1980, I think the market was down 6.8 percent. 1990, down a little bit. 2000 to 2002, was then 44 percent.

Just because we fall into recession, it doesn't answer the most important question I would want to know, which is how long is the selloff going to last and how deep is it and how long is the recovery?

Unfortunately, every recession has a different fingerprint when it comes to how the market responds in terms of how deep it goes, how long it takes and how fast it comes back. We don't know. Ultimately, it's never going to answer that question even if we're very certain about a recession occurring.

PATTI: The one thing that we do know is whatever the market does, it does it before the economic reality presents itself. The market's been going down all year anticipating that beginning of next year we're going to end up in an official recession.

The question then is, if we have a recession, is the market predicting it's going to be a bad one lasting a long period of time, or is it going to be short and shallow? That's the thing. Market was awful in September and the beginning of October, just the first couple of days, it's up hundreds and hundreds of points. Close to seven percent in two days. Crazy.

ERIC: You paint an interesting, behavioral aspect of the market, because for investors, a common thing we get is if you're sitting on cash or if you're worried and you want to make the portfolio more conservative, usually that's going to happen at the wrong times.

Most people are comfortable investing when things go from good to great because they perceive it as safe, but that's when there's probably more risk in the market. The best returns happen when things go from bad to not so bad.

These are those extreme emotional points in the market where typically the thing that your gut is telling you to do is probably the worst thing you can possibly do. We don't know how long it goes, but typically these inflection points usually occur when we're

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experiencing great emotional distress.

PATTI: Absolutely. For those of you who have an investment plan, have a real financial plan, this is not the time to abandon it. Stand by your plan. It doesn't work every time, but it will work over time. That is the most important message that we can give you. We don't know how much longer this is going to last.

We don't know how quickly inflation is actually going to come down. We're confident that it will. We believe that the policymakers have the tools to reduce the cost of living in America today. That's clear to me. The question is, how does the market perceive it and how much longer is the disruption in asset prices going to last?

We have to also remember that markets are basically a bunch of opinions. It's people believing that a company is worth more or less than the current price. That's what a market is. Real estate's the same way, bonds trade exactly the same way.

We have to understand that this is going to fluctuate based on what's happening in the world and the latest apocalypse du jour. This has been a great conversation, Eric, about inflation, markets, and what people should do. Is there anything else that you'd like to add?

ERIC: No, as you highlighted, having a plan in place is so important. That's something that mores our investment strategy and our view to think long term. When we go through periods like this, you have to have a sanguine view to get through them.

They are difficult, but an investor is an optimist at the end of the day, because that is a belief that the future will be better than it is today. That's why you make the investment in the first place whether you recognize that or not. All of you out there that have a well diversified portfolio, stay patient.

Ultimately, you're expressing a view of optimism. So far, that hasn't been a bad bet in the past 200 to 300 years.

PATTI: It's been a great bet. It has been a phenomenal bet, as has this time spent with you, Eric. Thank you so much for all the work that you put into the white paper. Please feel free, go to our website at keyfinancialinc.com, get this white paper. There's a lot of juicy stuff in there that we weren't able to cover today.

The most important thing is, remember, this is temporary. We're going to go through difficult times like this. It is temporary. Things are going to get better eventually. We can't be sure when it's going to happen, we just believe it is going to happen. Thank you so much for joining us today.

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Thank you, Eric Fuhrman, for all that you do and all that you bring to the table each and every day. You're amazing. Thanks to all of you for tuning in today. I'm Patti Brennan, Key Financial Wealth Management with wisdom and care.