Layoffs Are Coming

Article by: Nick Stenger, *Chief Executive Officer, Financial Advisor*
Phone: (630) 912-8295 | Email: nick.stenger@stengerfamilyoffice.com

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Part of the Fed's job when raising rates is to scare the pants off businesses and consumers. When rates are held artificially low for too long, excessive risks can be taken expecting no consequences for insane monetary policy. Ever since 2008 and 2009, the Fed has increased the size of its balance sheet substantially, holding trillions in Treasuries and mortgage-backed securities. Rather than only using interest rates as a tool to fight inflation, the Fed has tried to pump or pull liquidity out of the financial system to manipulate the direction of prices. While raising rates quickly causes its own set of problems, flooding the market with new dollars causes a more permanent problem because over time, too many dollars in circulation reduce the value of those existing dollars.

Pre-2020, the Fed was trying to reduce the size of its balance sheet but had to quickly pivot and increased assets by nearly double from March 2020 to April 2022. Now the Fed is going the other direction and has reduced assets by 5%. At the same time, rates have spiked from near 0% to 5% which should slow the economy significantly this summer. As we've long pointed out, the Fed is watching the labor market like a hawk, looking for signs of weakness. Some economists have said the Fed wants to see unemployment in the 4.5% range before taking their foot off the gas.

In the current hiking cycle, cracks in the labor market really haven't emerged and the job market has remained resilient…until now. Businesses haven't believed Powell until recently and are just finally taking him seriously. The easiest way to stabilize earnings in an uncertain environment is through layoffs. Early data at the end of last year and early this year showed a sharp increase in warehouse inventories, signaling a slowdown in consumer buying habits. Amazon, for example, overexpanded during 2020 thinking the work from home trend would never end. While some remote work will last, a lot of companies are calling employees back to the office faster than expected. As a result, many Big Tech companies that hired too many workers to fill COVID related demand are cutting headcount as fast as cash flow allows. For example, Meta processed a first round of 10,000 layoffs last November before processing a second round of 10,000 just a few months later.

Until recently, it appeared like layoffs would be concentrated in the tech sector. However, McDonald's just announced on April 4th that they will be laying off hundreds of corporate employees. We expect this trend to continue as companies face the reality of higher rates. Many corporate expansion plans become unwise when rates reach the level they are today. High rates tend to hurt small business the most as they tend to pay higher risk premiums for debt than large companies. Further, we expect companies with thin margins to be most at risk in this current environment.

While this all sounds like doom and gloom, we encourage you to stay the course and not panic off your long-term investment plan. Remember, bad news gets priced in before it happens and the market recovers before good news is released. The S&P 500 dropped 20% last year in anticipation of doom and gloom this year which in our view, was somewhat overblown. Rather than try and time the market, we want our clients to have a conservative, long term financial plan that anticipates bad news in advance. We've long recommended retirees hold 3 or 4 years of living expenses in short term investments so withdrawals can be made during these volatile times. For clients still working with a longer time horizon, we believe this is one of the best buying opportunities for many companies trading at dirt cheap valuations.

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Stenger Family Office LLC. 400 E. Diehl Road, Suite 550, Naperville, IL 60563