Monetary Policy Back in Focus

July Market Note

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In 1992 during President Clinton's first run for the White House, James Carville coined the phrase "It's the Economy, Stupid!" The country was in a recession and the economy was one of the dominant issues at the time. Today, the economy is still a dominate factor in elections and with the populace in general, but I think if we were to channel Carville today, he would say, "It's the Fed, Stupid!"

The Economy and The Federal Reserve

Many would consider the focus of the economy and the Federal Reserve to be intertwined, but there are nuances. Economic success is determined by sustainable growth, the Fed mandate is price stability and full employment. In most instances, their interests are firmly aligned, but the Fed unlike the economy, is always attempting to guess what comes next and get ahead of it.

Recent commentary coming out of the Federal Reserve leads many market strategists to believe the Fed will cut rates by twenty-five basis points at the end of July. Some are calling for interest rates to be reduced by as much as fifty basis points. With economic growth relatively stable and unemployment at historically low levels, the Fed is positioning any cuts as "insurance".

There is precedence for a proactive reduction in interest rates. As implied by Fed Governor Richard Clarida in recent comments, both in 1995 and 1998 the Federal Reserve cut interest rates by seventy-five basis points as a preemptive measure to ensure the economy would not falter. The rationale for rate cuts then and now are the same; provide support during a time when the economy is still relatively strong, but the rate of growth is contracting.

Every Action Has a Reaction

However, every action has a reaction and decisions by central banks are not immune to this law. When monetary policy eases, risk assets have a tendency to increase in value as lower interest rates provide an accommodative environment for the credit markets, equities, and commodities. When monetary policy contracts or tightens, the reverse is true.

We only have to look to the fourth quarter of 2018 and the year to date returns of the capital markets for evidence of this dynamic. Last year the Federal Reserve was in a tightening mode and consequently equities barely managed avoiding a bear market. Shortly thereafter, the Federal Reserve dialed back the rhetoric and recently signaled the possibility of rate cuts. The result? The markets are at or near all-time highs.

This leads investors to a quandary.

Okay but Not Great

Valuations for almost all asset classes are at historically high levels. The rate of growth for corporate profits are anticipated to contract in the 2nd quarter, geopolitical risk is increasing, and domestic policy is dysfunctional at best. Bottom line; things are okay, not great, but the markets are trading as if things are perfect.

Allocating capital in this environment is challenging at best. If we look back to the 1995 and 1998 periods, risk assets rallied after each subsequent rate cut beyond what fundamentals would reasonably support. If history is any guide, it is not outside the realm of possibilities that we experience a similar dynamic with most asset classes trading above what investors would consider reasonable valuations. The market rally could be substantial as the fear of missing out pushes more investors into the markets becoming a self-fulling prophecy. Again, if history is any guide these periods tend to end badly.

The question becomes, *"How do you effectively manage risk when excessive risk is being rewarded for artificial reasons?"*

Manage Risk and Maintain Balance

Be patient in the allocation of cash, don't be afraid to take profits, and rebalance back to your long-term allocation. Expanding on this we would recommend understanding what you own and what each holding's purpose is in your overall allocation. Managing risk becomes a process of maintaining balance.

Don't ignore the warning signs. We are not market timers, nor do we believe we have the ability to effectively predict market turns, but that doesn't mean we should blindly allocate capital to a static model or assume what worked in the past will work in the future. Sometimes you need to examine your underlying premises and if appropriate adjust to changing conditions.

According to Jim Grant of Grant's Interest Rate Observer, over $13 trillion in global debt now trades at negative interest rates. If German Ten-Year Bunds are trading at negative interest rates, investors are either:

a) Betting that things get a lot worse, interest rates subsequently decline further, and their current bonds will increase in value or
b) They are willing to pay their sovereign\bank to hold their money on the hope they at least get most of their principal back

In either case, the credit markets are signaling things may not be that great in the global economy at the same time stock markets continue to hit new highs. Someone is right and someone is wrong. Short-term stocks may win, but long-term bonds usually prove to be right. In that environment, our objective is to minimize downside risk when possible, participate to some degree in the rallies and never forget, to effectively manage risk you have to be willing to be a bit of a contrarian.

We hope you are enjoying the summer and look forward to speaking with you in the days and weeks to come regarding your personal portfolio.

Best Regards,
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