Market Commentary

June 2019

There is a Fine Line Between Market Commentary and a Rant…

… and I'm about to go on a full-blown rant, so get ready. Or don't. Tilting at windmills is liberating. Feel free to do whatever you please.

Apparently, the Federal Reserve (Fed) is all that matters to equity and bond traders. How else can one interpret the S&P 500's 2.1% rally on June 4th, sparked only by Fed Chairman Jay Powell's promise to "act as appropriate to sustain the expansion"? What an odd thing to rally on. Did traders think Mr. Powell and the Fed would act inappropriately? Of course, the Chairman was simply saying he was aware of the inverted yield curve, as well as deteriorating trade talks, and was prepared to act. The markets lapped it up.

But investors projected something more into the Chairman's assurance. Markets saw the backstop they craved to protect asset values from the mercurial strategies of an occasionally pro-business President. It's no coincidence Treasury yields dove when U.S. / China trade talks collapsed. Throw in the expanded use of tariffs to achieve political goals (Mexico), regulatory threats on some of the largest and most dynamic companies in the U.S. (via social media) and questionable belligerence against corporate mergers (AT&T / Time Warner) and you have a recipe for some very nervous traders. The problem is the Fed cannot reverse anti-growth policies. These are fiscal and political issues which won't be solved by low rates or quantitative easing.

Now, what easy monetary policy ***can*** achieve is asset inflation – perhaps the only inflation the Fed seems able to influence these days. Which plays directly into what I believe is a growing sense of entitlement on Wall Street: the ideas that *markets drive the economy, not the other way around* and *asset values must be protected at all costs.* Ugh… I mean just ugh. I am not oblivious to the concept stock prices can lift consumer and business confidence and, in turn, personal and capital spending. But if this new paradigm is true, the economy is nothing more than a debt-fueled scheme stuck in a loop requiring never ending stimulus to keep moving forward. No need for companies to create, innovate or evolve. No need for true price discovery on financial assets. And don't even think about letting challenged, over-levered business models go under.

In and of itself, the Fed is not very good at growing the economy. That is best left to inventors, entrepreneurs, skilled labor and management with reliable transportation and legal systems. What the Fed is very good at is supplying liquidity to the financial system. Finance plays an important economic role by efficiently allocating capital to the worthiest ideas and projects. The problem with ultra-low rates is virtually every concept or business can find funding, which tends to lead to bubbles and misallocation of capital.

I truly believe markets have not fully recovered from the trauma of the financial crisis. Investors are skittish over any sign of weakness and demand action. At a 30,000-foot level, there seems no need for the Fed to ease. Unemployment is at 3.6%. U.S. growth has slowed but should check-in around trend growth of 2.5% for 2019. Even after recent steep declines, the S&P 500 and NASDAQ were still up around 10% year-to-date. Yet investors are demanding the Fed spend what little ammunition it has created and ease – now. I will go to my grave believing

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the Fed's extraordinary measures helped keep the U.S. financial system from falling into the abyss. But times are different now. The U.S. banking system is fundamentally strong and investors buying private mortgages, levered loans and high-yield debt should understand they are buying risky investments, not AAA-rated securities.

Well, that was a long way to get to the pressing question: *What will the Fed do at the June 19th meeting and beyond?*

I sense the Fed is less enthusiastic than the market about cutting rates. But let's not overthink things. Eventually, the Fed will cut rates – inflation is low and decelerating, markets are demanding rate cuts and I just don't see the Fed having the fortitude to disappoint. U.S. Bancorp Asset Management (USBAM) anticipates rate cuts, probably an insurance cut in July with another 25 basis points in the fall – which is a less aggressive path than federal funds futures are suggesting – and we are risk managing our investments around these assumptions.

Given its reluctance to act immediately, the Fed likely has two goals for the June 19th meeting: 1) placate market demands for rate cuts, and 2) buy some breathing room to allow for more data accumulation and for the politics of the G20 meeting and Chinese trade talks to play out. Threading the rhetorical needle will be tough, but Chairman Powell has some levers we expect him to pull:

- Use the FOMC statement to softly acknowledge headwinds from market volatility and trade uncertainty. The Fed should drop or change the word "patient" in determining future policy adjustments since it has been associated with rate hikes.
- End balance sheet reduction in June rather than September as currently planned. This is a simple and effective way to convey the Fed's willingness to ease policy and is also the right strategy to keep the banking system – the true source of money growth to better raise inflation – running smoothly.
- Answer every press conference question with the phrase, "If conditions warrant, we will act as appropriate to sustain the expansion." Hey, if something works for you, stick with it.

Discussing rate cuts is a necessary but painful process for USBAM's investment team. We must invest as we expect the Fed and markets to behave, not how we want them to. And as a group, we believe the Fed should stand tall and resist market demands.

Calls for insurance rate cuts really boil down to one simple argument: *Inflation is low so what's the harm?* Inflation is low, but easing monetary policy is not a free lunch. First, by easing to offset the impact of President Trump's tariff and trade policies, the Fed essentially becomes an unwilling accomplice. Easing could embolden the President to burnish his Tariff Man credentials with Japan, Germany and beyond. You know the old adage: To a man with a hammer, everything looks like a nail. Second, bending to market demands for rate cuts confirms the Fed follows the market. Maybe it has always been this way, but if the Fed won't resist with 3.6% unemployment, when will it? Third, lower rates would improve the outlook for lower-rated companies to refinance themselves, while at the same time promoting the further build-up of corporate leverage – a constantly cited risk to the economy. And finally, rate cuts probably won't meaningfully impact inflation and may even be counterproductive. There is a global glut of savings vs. good investment opportunities. The thinking is lower rates will drive more investment, but I am beginning to believe lower rates simply drive savings rates higher, as the retired and near-retired legion is forced to hoard more cash to keep the same level of investment income.

The smart money is saying rates need to fall. Who am I to argue? Perhaps, someone should call Japan and Europe to see how their low-rate policies are working. But again, if you only have a hammer…

Sources:

Bloomberg

Federal Reserve, Chairman Powell's Opening Remarks at the Conference on Monetary Policy Strategy, Tools and Communication Practices, June 4, 2019