The Long & Short of It

Quarterly Newsletter
Fourth Quarter 2018

The "Powell Call" Option

Today's blend of a slow growth economy and a hyper-communicative Federal Reserve has made Fed-watching all the rage. Gone are the days when investors concerned themselves with an expansive variety of economic data. For example, on January 4, 2019, CNBC reported that "Fed Chairman Jerome Powell sparked a huge stock market rally after he delivered just the message investors wanted to hear—that the Fed will be flexible on policy and it is in no hurry to raise interest rates." One would have never thought this possible just 16 days earlier, when Mr. Powell's Fed raised interest rates and dashed any hopes of a Santa Claus rally.

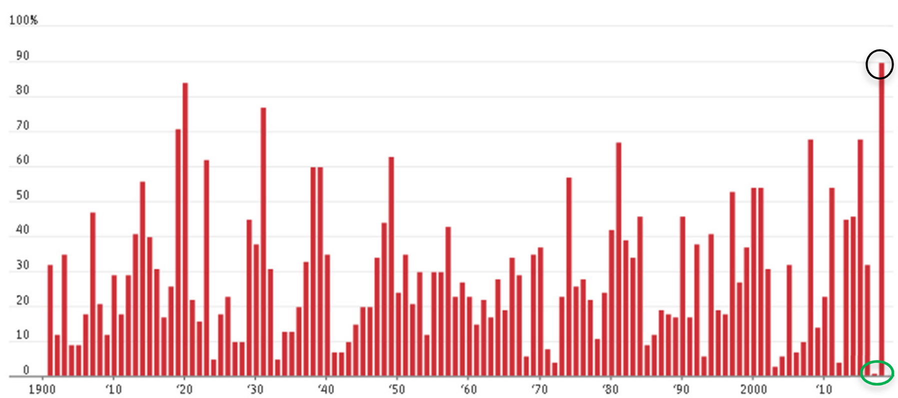
The first instance of the Fed reaching beyond its mandate regarding inflation and employment was October 19, 1987 when the Dow Jones Industrial Average fell 23% in one day. Alan Greenspan, then Fed Chairman, reduced the Fed Funds rate, providing liquidity to the stock market in what came to be known as the "Greenspan Put"—a threshold much like a put on a stock that would protect investors against any further losses. But up until 2018, the Federal Reserve had never restricted the growth of the stock market during a major bull market. Today's Fed appears to have added "preventing bubbles" to its mandate, instituting what might come to be known of as the "Powell Call." It has moved from managing an economy—keeping inflation and unemployment within a range but letting markets go where they will—to managing overall asset values of stocks and real estate. Is this cause for concern? Here are our thoughts.

Redefining Inflation

Inflation is typically defined as a general increase in the price of consumer goods and services. The Fed raises the Fed Funds rate in response to excess inflation. In 2018, consumer prices moved upward but inflation levels never moved outside the targeted range. So why did the Fed raise the Fed Fund rate multiple times? Perhaps, very low unemployment triggered concerns that wages might rise and drive inflation higher. More significantly, if the Fed also considers overall asset values when defining inflation, then this new concept would have tangible consequences for the stock market as well as the broader economy.

After the November 2016 presidential election, increased optimism for economic growth and profitability led the markets higher. A record-low number of asset classes had negative total returns in 2017 (see green circle in chart). In 2018, Chairman Powell and a few other Fed governors asserted the market was overpriced and they would not allow "asset price bubbles" to form or exist. Indeed, they followed through and raised interest rates four times. The result was a record-high number of asset classes with negative total returns in 2018 (see black circle), the worst ever—worse than the bleakest moments of the Great Depression.

Under Pressure
A record share of asset classes have posted negative total returns this year, according to Deutsche Bank data going back to 1901.



Note: Returns are in U.S. dollars. Data for 2018 are as of mid-November.
Sources: Deutsche Bank; Bloomberg Finance LP; GFD

Domestic stock indices ended the year with mid-single digit losses. Europe, Japan, and emerging markets fared worse, averaging losses in the mid-teens. China's Shanghai Composite fell nearly 25%. Commodities, gold, and crude oil all declined, as did junk bonds, corporate bonds, and bonds with longer-term maturities. The only bright spots were the dollar (up 4.3%), cash, and very short-term US Treasury bonds. And yet, an inflationary "asset price bubble" remained (and remains) undefined. Does the Fed use a valuation multiple? Claims by experts? The media? Will this lead to monetary policy led by public and/or political opinion as to whether the market seems cheap or expensive? Where does it all end?

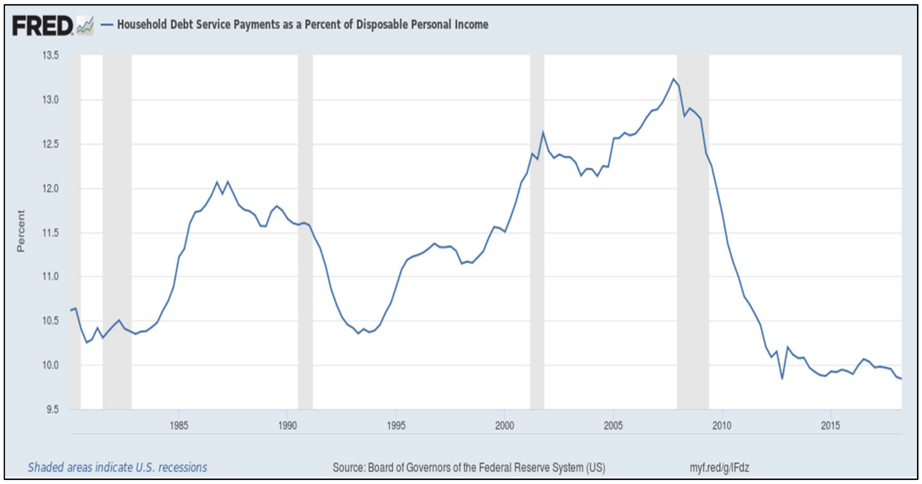
The Grinch Who Stole the Christmas Rally

There were many other factors involved in the market's decline this quarter. However, we can't help dubbing Chairman Powell "the Grinch" for repeatedly responding restrictively to the perception that stock prices were too high. As the Fed continued to raise rates, seasonal market weakness worsened in the early fall, a time it typically recovers in normal years.

December results stunned market veterans with their poorest showing in stock market history, hindered in no small part by the "Powell Call." But it didn't take long for Chairman Powell's heart to grow and restore the spirit of Christmas with his abrupt January 4th announcement that the Fed would "be patient in deciding whether or not to continue raising rates."

It's Not All About the Fed

Some find the Fed's interventionist policy distressing, believing the Fed should stick to its mandate without so much creativity or heavy-handed activism. We actually agree with Chairman Powell that asset price and debt bubbles make recessions deeper and longer-lasting than necessary. However, ten years of extreme monetary policy by the Fed has certainly fostered a culture of investor risk-taking and fueled any bubble that may exist. These days, ever so communication-oriented and media-savvy, the Fed seems obsessed with moderating economic cycles at the expense of policy stability. Perhaps it should keep in mind that policy stability and normalcy are of value as well.



Unlike many investors, we are not all-consumed by the Fed and its evolving definition of inflation. There are many other factors to consider. Regulatory reform and a business-friendly administration may improve prospects for long-term growth, but the beneficial impacts of fiscal stimulus and tax relief are shorter-term in nature. Earnings grew rapidly in 2018 but should now slow to a more sustainable level. After the recent drop, equity valuations are much closer to normal. While the government and corporations appear fully leveraged, the American consumer's debt payments as a percent of income have been on a sharp decline since 2009 (see chart).

It's possible that wage increases will arrive and drive improved consumer confidence and increased consumer debt and spending. Given that consumer spending makes up 70% of economic activity, this could fuel one last healthy leg of the expansion. If strong retail sales over the holiday season are any indication, the consumer is worth watching. We remain focused on the Fed as well as a wide variety of other economic data. Most of all, we enjoy serving our client's interest by seeking and analyzing one investment at a time. Our target is good, solid investments with very attractive risk profiles: industry leadership, durably clean balance sheets, attractive valuation, and out of favor in the popular press.

Wishing you a warm and productive start to the new year.

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