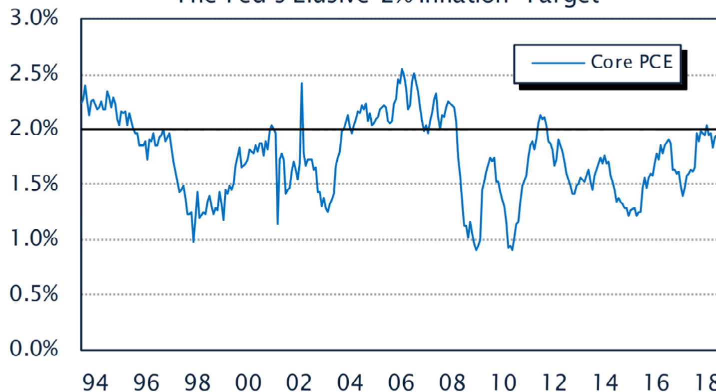
JUNE 2019

INVESTMENT UPDATE

There are those who believe that the Federal Reserve has so bungled monetary policy during recent months that the institution itself has become a major risk to the US economy. It's becoming more clear with every passing day that the December rate hike was unnecessary, if not outright destructive.

We can only imagine, dear reader, your disappointment in opening this envelope and seeing another page with the words "Federal Reserve" in the first sentence. We feel your pain. It's a sign that something isn't quite right when the regulator of the US' monetary system becomes the dominant feature on the investment landscape. Like a referee that changes the entire complexion of a game with a series of bad calls, attention gets directed to an entity that should really be in the background. Meanwhile, those of us who make important decisions on how to allocate our clients' money are reduced to playing guessing games with a group of people who don't appear to be very good at what they do.



If that sounds a bit harsh, we say it knowing full well that the members of the Fed's monetary policy committee (the FOMC) have a tough job. The Federal Reserve has enormous influence over the global economic system, and its dual mandate (to maintain price stability and full employment) is about as ambiguous (if not down-right schizophrenic) as any job description you will find. After all, if you want full employment, you must encourage economic growth, and if you follow policies that maximize growth, you run the risk of price inflation. What's a central banker to do?

Even this truism—that economic growth and inflation are joined at the hip—hasn't proven to be valid, and not just in this cycle. As we've pointed out in previous *Investment Updates*, the Fed operates under the belief that strong economies eventually absorb any slack in the labor market, which leads to workers demanding higher wages. Higher wages, in turn, increase the costs of doing business, and those costs get passed on to consumers. The linkage between growth and inflation is known as the 'Phillips Curve' among economists, and it's one of the Fed's primary guiding principles. The Fed increased the benchmark overnight rate, the Fed funds rate, nine times between December of 2015 and December 2018 in order to slow the economy to keep the US' tight labor market from pushing up inflation.

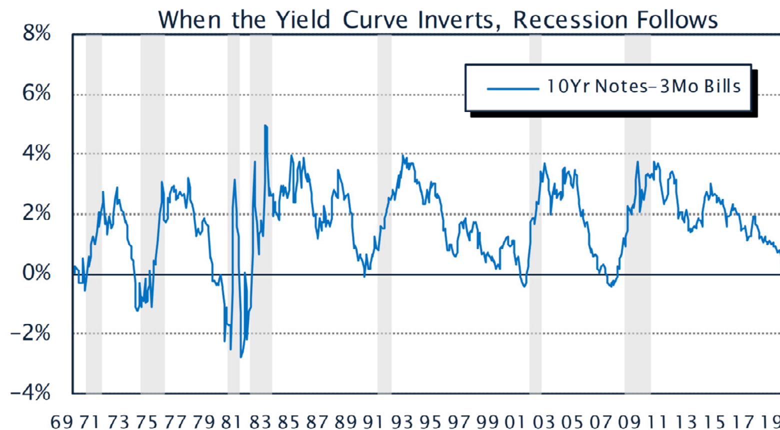
For a multitude of reasons—too many to enumerate here—there has been little upward pressure on wages and virtually no increase in core price inflation at the consumer level during this recovery. And yet, for years the Fed has blithely assured investors that inflation was being held down due to "transitory" factors. Never mind that over the past 25 years the core PCE, the Fed's preferred inflation gauge, hasn't risen more than 4/10ths of a percent above the magical 2% level except for four lonely months in the mid-2000s (see chart on this page). If the inflation target for the US economy is 2%, the Fed has consistently failed to hit that target over the last three business cycles. During the last decade, while the US unemployment rate fell to its lowest level since 1968, the core PCE has averaged 1.58%, including the most recent reading of 1.57%. Can we finally, once and for all, declare the Phillips Curve dead and buried?

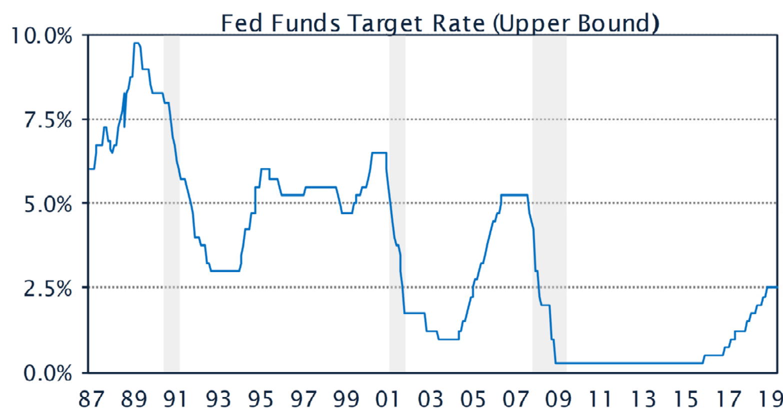
Certainly the rest of the world has—the most recent University of Michigan monthly household survey of 5- to 10-year inflation expectations hit its lowest level ever last month. Importantly, those low expectations for future inflation are reflected in investors' pricing of interest rates, by maturity. Low inflation means there's no compelling reason for investors to demand a high rate of interest when they consider buying long-term fixed income instruments. Inflation expectations have become so well-anchored that 30-year maturity Treasury bonds have barely been able to break above the 3% range during this cycle (and currently sit below 2.6%). As has been clear since at least the Fed's last rate hike in December, the Fed funds rate is detached from reality—at least the reality that is determined in the open market.

The disconnect between what the Fed is doing and what the market has priced in is at the very heart of our current inverted yield curve. Millions of investors, buying and selling billions—if not trillions—of dollars of bonds of all maturities and descriptions every hour of every day determine what prices and yields will clear the market. They define what the US economy's "speed limit" is when it comes to interest rates. And while the investing

public may not always get it right (especially in the short term), it's not merely a coincidence that in the seven recessions we've had in the past 50 years, every one of them has been preceded by an inverted Treasury yield curve (defined as 3-month Treasury bills trading with higher yields than 10-year Treasury notes, see top chart). Again, this is not a theoretical exercise cooked up by economic PhDs, it's pure common sense: the yield curve reflects the up-to-the-minute supply and demand for credit, and an inverted yield curve is a symptom of an out-of-touch Federal Reserve that's following misguided policies.

So where does that leave us? Are we headed into recession in the near future? Before we address that question, let's take another look at the chart. You can see that we have been in an unusually long period without a recession, having just this month reached the 10-year mark of the current recovery. This matches the expansion of 1991-2001 as the longest period of uninterrupted economic growth in US history. Some would point out that this expansion may go on longer since it's been relatively weak in terms of economic growth when compared to past cycles—and we would mostly agree. Part of that is attributable to just how deep the last recession was; it took more than six years for the US labor force to regain the 8.5 million jobs lost after the financial crisis. Today, the labor market, with an unemployment rate of less than 4%, has become one of the strongest elements of the US economy. But employment stats are "lagging indicators," and usually remain strong even after a recession has started. Nobody knows exactly when this cycle will end, but it's safe to say that this recovery is mature, and we know that one day—perhaps sooner than later—we will find ourselves in another economic downturn.





The next move for the Fed now has to be a rate cut. Not because stock investors will cause a sell-off if the FOMC doesn't lower the funds rate, and not because the President is chewing the Fed out for its anti-growth policies, but because its policy stance is out of whack with the current macro environment. There's not enough inflation or economic growth, and there's little confidence at this late point in the cycle that either of them are going to accelerate from here. Add in tightening credit standards, lagging economic growth outside the US, and the prospect for a full-out trade war, and you've got a late-stage economy that's stumbling over the finish line. There's no magic number, no perfect interest rate, that will place monetary policy perfectly in line with investors, but even a cursory glance at the yield curve tells you that the current Fed funds rate is too high.

Is there a precedent for the Fed to "fine tune" monetary policy and keep the expansion going? Yes, as a matter of fact, there is. As the bottom chart shows, in the mid-1990s (the previous longest-ever expansion), the Alan Greenspan-led Fed, after hiking the funds rate a number of times early in the cycle, lowered it three times in late 1995-early 1996, then hiked once before lowering the rate back below 5% in the wake of the Asian currency crisis of 1998. It's anyone's guess whether a stable (say, 5.25%) Fed funds rate over this period would have led to a different outcome, but a charitable observer could conclude that at least the Fed didn't keep hiking and end the expansion two or three years earlier.

Accordingly, current Chair Jay Powell recently dropped the Fed's previous operative word ("patience"), and is now using the phrase "sustain the expansion" to describe the Fed's evolving monetary posture. He and other Fed officials, while acknowledging the weakening economic backdrop, are sure to attribute the current slowdown to "external forces" (just as Greenspan did 20+ years ago) when discussing the reasons for a possible rate cut this year. There will be no talk of "overplaying our hand" or "relying on a debunked economic theory" when discussing the need for a rate cut. Although it would be helpful for the Fed to admit to its policy errors, and develop new methods for guiding policy in a low-growth, low-inflation world, that's not going to happen in 2019. The best we can hope for is a Fed that doesn't drag its feet too slowly in moving to a more accommodative stance, consistent with a weakening macro outlook.