CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 23, 2019

Alea Iacta Est

The die is cast. Thus said Caesar* as he crossed the Rubicon, a small river north of Rome, with his army in 49 BC. Caesar had been campaigning successfully for years in Gaul and Britain and his army was very loyal to him. The Senate had ordered him not to lead his army toward Rome. He disobeyed. And so began the twenty-year civil war that would end the Roman Republic and usher in the Roman Empire under his adopted son, Octavian, who styled himself Augustus Caesar.

In this case today, it is the Federal Reserve Board that has cast the die. Its actions--raising the Fed Funds rate in September and again in December, all the while reducing relentlessly the vast sums of Treasury securities it holds--have set in motion conditions for an economic recession in America this year.

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In the post-Christmas recovery rally, Core sold its remaining equity positions for clients and bought positions in long-term treasury bonds and in gold.

With the government's partial shutdown, a number of economic reports are not being prepared and released. Thus, the full range of monthly reports is not at hand, making determination of the present state of the US economy cloudy and uncertain. But weakness in key sectors of the economy--including housing, capital spending, rather punk sales before Christmas at major department stores, and a warning by Federal Express of falling demand for delivery of goods--suggests that the "robust condition" of the US economy, of which many speak, better characterizes the past than the future. The very length of the economic recovery and expansion, now in its tenth year, is itself a warning. The sharp and sudden decline in the yield of the 10-year Treasury bond from October 5th, when it touched 3.25%, to January 3rd, when it reached 2.55%, indicates that a weakened economy is in prospect.

On Christmas Eve day, the stock market culminated a three-month period of intense selling and reached a level 20% below its all-time high set on September 21st. This decline itself suggests an almost certain slow down in the economy, if not an outright recession. In the four weeks after Christmas Eve, the stock market staged a recovery rally of more than 13%. This rally arose from the deeply, deeply oversold conditions that developed in the pre-Christmas selling, supported by soothing comments from Jerome Powell, chairman of the Federal Reserve Board, and other Fed governors indicating that the Fed might 'pause' in its cycle of short-term interest rate increases and might not continue at the same pace the reduction of the Treasuries it holds. A supposed prospective lessening in Mr. Trump's trade war with China also cheered investors.

By

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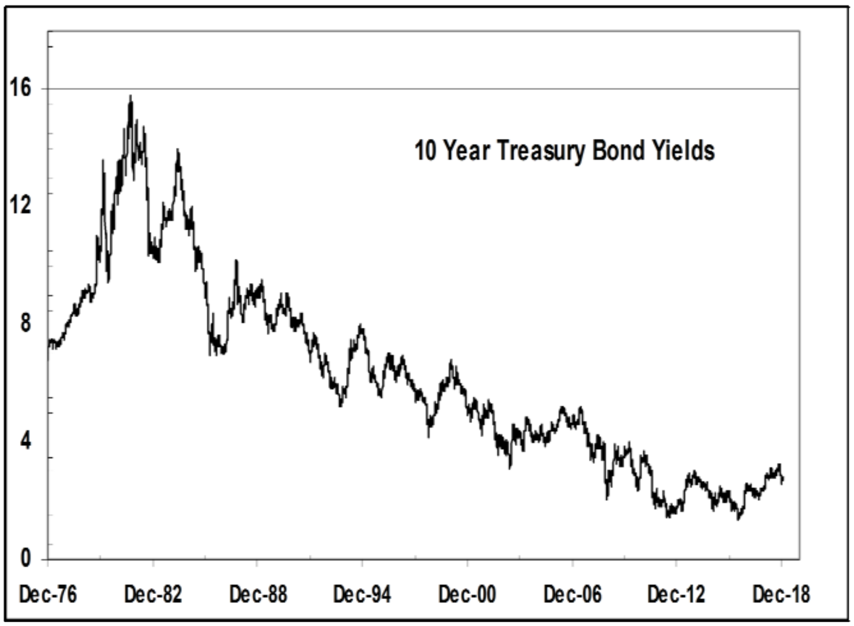
The chart below shows the decades-long decline in yields on Treasury bonds. If the US slides into recession this year, we can expect lower yields than the 2.75% on the ten-year that now prevails.

Depending upon the severity of the recession, we may see a new low in bond yields and a new high in bond prices.

The problem is that monetary policy actions--those actions by the Federal Reserve--operate with a lag in time. This has been demonstrated for decades. The last meeting of the Fed's Open Market Committee (that sets Fed funds rate and other monetary policies) was held on December 18th and 19th; the decisions taken then were announced on the 19th. The stock market had been engaged in serious selling for several sessions before the 19th, but as Mr. Powell spoke at his post-meeting press conference, the selling intensified and carried on without pause through Christmas Eve day.

Then, in the weeks after Christmas, came the speeches by various Fed governors, including Mr. Powell, with a 'dovish' tone, persuading the world that a 'pause' in interest rate increases was at hand. At his December 19th press conference, Mr. Powell had described the balance-sheet reductions as on 'auto-pilot.' Since then, Mr. Powell has amended his remarks to indicate that these sales may also be reduced.



Well and good. The prospective pause has cheered the markets and spurred buying. Unfortunately, because of the inherent lags by which monetary policy operates, we have not yet seen the economic consequences of the Fed's actions taken in the September and December meetings. These will reveal themselves in coming months. In my view, as 2019 unfolds, we will see that the Fed tightening in the latter half of 2018 will have constrained economic activity. We will also observe much more selling in stock markets.

The die has been cast.

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*According to the Roman historian Suetonius, Caesar said "*iacta alea est*" as he crossed the Rubicon in 49 BC. See *Suetonius, Divus Julius, Chapter 32, section 1*. For reasons unknown to me, the phrase is commonly remembered and widely used as *alea iacta est*. (For amateur Latinists and those without Latin, Tufts University has a wonderful website with an extraordinary and accessible range of Classical texts, at www.perseus.tufts.edu.)

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