CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 4, 2019

The Fed or the Economy...
...Which to Follow

Despite economic reports showing that the US economy is weakening, the stock market rallies, presumably because governors of Federal Reserve Board hint at loosing monetary policy.

After the quite intense selling in the stock market up to Christmas Eve day, things in the market have turned round completely and the market has made up a good deal of lost ground. Stocks declined by twenty percent from their highs in September to the Christmas Eve lows, whereupon they rallied by nineteen percent from those lows, and, as I write, stand just five percent below the September highs. What has happened?

The US economy has, by many important measures, been on a weakening path since September. (I summarize some of this below.) There has been no striking economic improvement in these first weeks of 2019 to account for the persistent buying. Instead the Fed has vigorously and persistently been telling the world that it intends to stop (or at least pause) the monetary tightening in which it had been engaged for the last couple of years. As far as we know, it has not changed anything yet, but says that it will. As discussed in previous letters, the Fed's last action, taken at the December 18th and 19th meeting of the Fed's Open Market Committee, was another increase by one-quarter percent in the Fed funds rate, the fourth in 2018. At his post-FOMC new conference in December, Fed chair Jerome Powell said more Fed funds increases were likely in 2019 and that the Fed's process of reducing the assets on its balance sheet, mostly US Treasury bonds, purchased during its rounds of so-called 'quantitative easing,' was on 'auto-pilot.'

The December FOMC meeting and Mr. Powell's comments came during a period of intense selling. After Mr. Powell's remarks, the intensity of selling increased. It appears that Mr. Powell and his colleagues were spooked by the market's reaction. What followed was a swift about face in the Fed's rhetoric. Mr. Powell and other Fed governors gave a series of speeches suggesting the upcoming 'pause' in monetary tightening. Recently released minutes of the January FOMC meeting confirm the Fed's change in attitude.

Against the new 'dovish' tone to Fed comments are the economic reports of various aspects of America's economy, showing significant weakening of many sectors. I set forth a few from a list compiled by David Rosenberg, an economist at the Canadian firm Gluskin Sheff. His list shows a set of indicators with their changes in recent reports expressed in annualized percentage terms: Existing home sales, -19.8%; auto sales, -17.6%; housing starts, -7.3%; non residential construction, -6.6%; core capital spending orders, -4.8%; real retail sales, -1.8%; manufacturing work week, -1.0%; employment of 25 to 54 year olds, -0.4%. Mr. Rosenberg's list goes on, but import is unambiguous: Key elements of the US economy are weakening.

By

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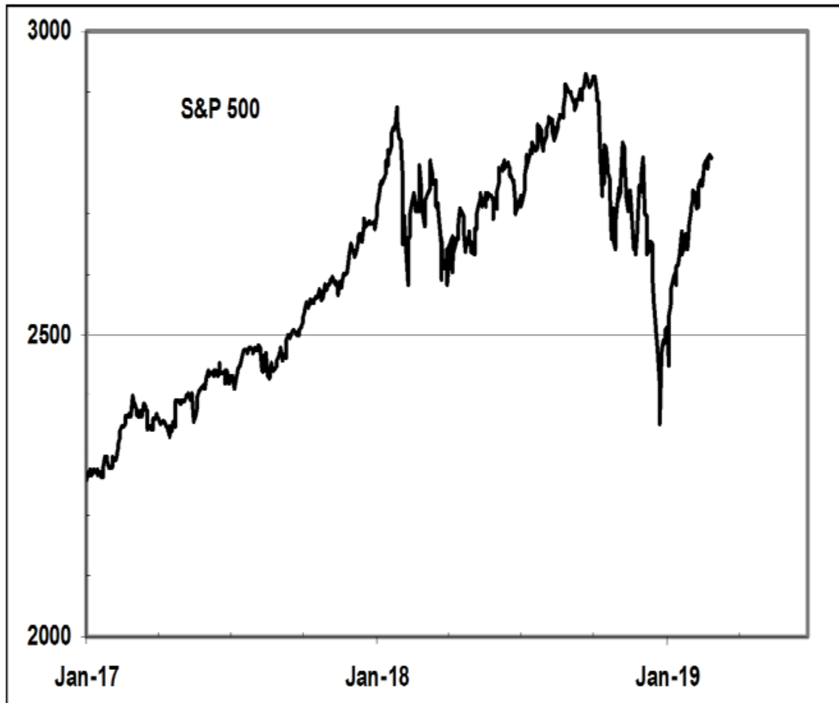
The chart below shows the movements of the US stock market in the last couple of years, featuring the sharp decline last autumn and the recovery so far this year.

Reading these and other economic reports, one realizes that an economic recession in the US this year is a strong possibility. If so, how then do we make sense of the nineteen percent rally in the S&P 500 since the December low? Admittedly, by Christmas Eve and a twenty percent decline in the S&P in only three months, the stock market was deeply 'oversold' and due for a bounce, particularly with the soothing words emanating from the Fed. Thus the first few weeks of buying at the end of December and early January made sense. But for the last month, against the steady drip of weak economic reports, the buying continued unabated.



The Fed appears to have more impact on the markets now than does economic reality. That this should be the case must arise from tremendous influence of the Fed on the stock and bond markets in the long aftermath of the deep recession of 2008 and 2009. In response to that really alarming period, the Fed cut interest rates essentially to zero and bought trillions of dollars of treasuries and other securities in order to stimulate the economy and to support the stock and the bond markets. The economic expansion since 2009 has been notably weak, but the Fed's actions certainly stimulated investors' interest in financial assets. Have we reached the point at which economic activity is less significant to investors than are comments by Fed officials about what may be its future monetary policy?

History tells us a few things germane to this: In each of the bear markets of the last many decades have been periods, like this one, when stocks have rallied substantially, only to turn back down again and head lower. In my judgment, this is what is now unfolding: A bear market began in September 2018 when the stock market turned lower after making an all-time high. The market action presages economic contraction. The weakening economic indicators in the last three months probably confirm the import of the stock market's sharp autumn decline. To position clients' portfolios in the likelihood of further stock market declines and a recession, Core has sold stock positions in all portfolios and purchased long-term treasury bonds and a small amount of gold. We have retained our other fixed income positions in short-term corporate bonds and in a diversified bond mutual fund and we hold money market funds. As the economy weakens bond yields will fall and bond prices will rise, so we expect our fixed income investments to flourish in the weakening economic environment that now unfolds.

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