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Circling the Wagons

Current Federal Reserve Chair Jerome Powell shares the stage with former Fed Chairs Janet Yellen and Ben Bernanke at a recent economics conference in Atlanta.

In a time filled with drama and intrigue for investors, we were struck by the current Federal Reserve (Fed) Chairman joining a panel discussion with his two predecessors in early January. We can find no precedent.

Powell wasn't there to gather advice. Yellen and Bernanke didn't offer it. Instead, they were there to discuss the role of the Federal Reserve and to defend its independence. President Trump is irritated that recent Fed rate hikes may be dulling the impact of the stimulus from the recently enacted Tax Cuts and Jobs Act and has reportedly considered firing Powell. Powell took the opportunity in Atlanta to say he would not resign if asked.

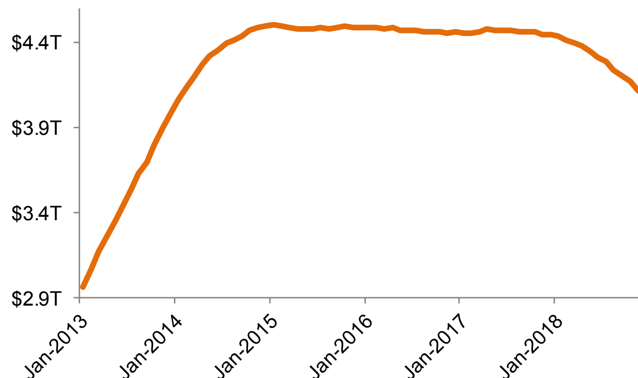
Powell also clarified his stance on interest rates. Since October, by our count, he has changed his public view four times – each time with market impact. In early October, he said rates were 'a long way from neutral'[a] which signaled the Fed would continue hiking rates despite signs of a weakening global economy. Markets sold off. Then, in late November, Powell pivoted and said rates were in fact close to a neutral level. Markets rallied.

The Fed then raised rates at its December meeting. Initially the bond and equity market hardly moved as the hike was expected. But at the news conference following the Fed announcement, when asked about the Fed's program of reducing the size of its bond holdings, Powell casually commented the program was 'on autopilot' and was having minimal market impact. The market swiftly reacted, sensing Powell and the Fed were out of touch.

A brief look back. In the aftermath of the Great Recession of 2008, the Federal Reserve embarked on an unprecedented effort to, among other things, reduce the cost of borrowing by buying bonds. This was known as Quantitative Easing (QE).

The Federal Reserve can be thought of as the bank for the bankers and has always had its own bond holdings. QE inflated the Fed's holdings from about $870 billion to over $4.5 Trillion[b]. In October 2017, the Fed started to reduce the size of its holdings. Slowly at first and then more quickly. At its current pace, $50 billion per month[c], many feel this unwinding magnifies the impact of the four interest rate hikes during 2018. It also speaks to two experiments the Fed is conducting at the same time — there is data and experience associated with rate hikes but not with hikes coupled with balance sheet reduction.

U.S. Federal Reserve Balance Sheet
(2013-2018)



Data Source: U.S. Federal Reserve

Now, back in Atlanta in early January, Powell took the opportunity to once again moderate his stance by signaling an openness and flexibility to adjusting both the pace of interest rate increases and balance sheet reduction. Markets, again, rallied.

Powell became Fed Chair this past February and this flip-flopping feels like a series of rookie mistakes. The Fed's job of balancing economic growth with inflation containment is tricky. The market is looking for Powell not only to get the right policy mix but also to more deftly communicate the Fed's views.

Elsewhere in the World

China and the U.S. also seem to be circling each other, like two wary boxers in the ring. Leaders of both countries appear to be bracketed by advisors that a) want a deal and b) are looking for capitulation by the other side. Our sense is the two sides will, in time, agree to be "frenemies" where the bulk of the trading relationship is maintained while there is recognition of areas that cannot be bridged.

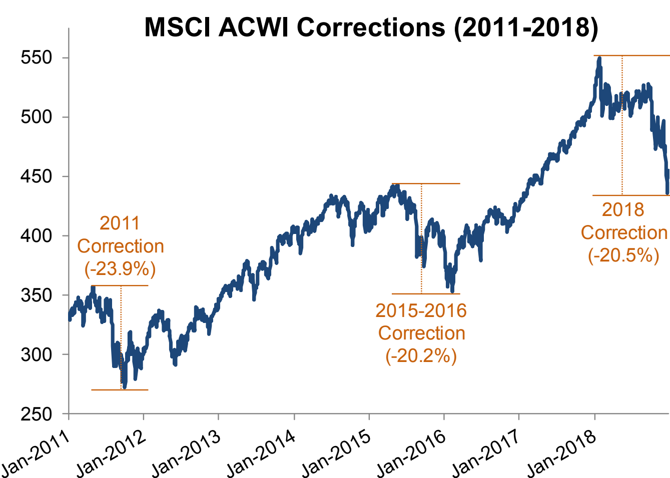
a. CNBC, "Powell says we're 'a long way' from neutral on interest rate hikes, indicating more hikes are coming", Jeff Cox, 10/3/18, https://cnb.cx/2OwJLvP
b. Source: U.S. Federal Reserve. Total Fed assets increased from $870B on 8/8/07 to $4.5T on 1/14/15. https://bit.ly/2eHfmrv
c. CNBC, "The Fed is still tweaking its balance sheet unwind, Jeff Cox, 11/29/18, https://cnb.cx/2RJv9uy

The uncertainty had economic consequences during 2018 as companies hurried orders to ship before the tariffs were set to go into effect[d]. This pulled economic activity forward this past summer which made growth look stronger. As these orders naturally subsided, growth this fall looked anemic and spooked investors. The trade tensions have also caused companies to put off investment plans until they get a sense of what the rules of trade might look like longer term.

The impact of shifting Fed messaging and trade tensions led to a volatile fourth quarter for investors. A combination of higher interest rates, slowing global economic activity and reversal of positive investor outlook led to a nearly 14% sell-off in the fourth quarter for the S&P 500; December's 9% plunge was the worst December return since 1931[e].

If this downdraft felt uncomfortable, you were not alone. On the year, almost all equity markets were down with the S&P 500 posting a 4.4% loss while international developed stocks declined nearly 14% and U.S. Small Cap stocks declined 11%. Bonds were generally flat to modestly down on the year. Cash was the best performing major asset class, posting a gain of almost 2%.

While 2017 was a favorable year for almost every asset class, 2018 turned out to be a frustrating year for growing wealth as no major asset class climbed even 5%.



Data Source: Bloomberg. MSCI ACWI Price Return.

Valuations now seem reasonable to us, especially in light of current interest rates. As you can see in the chart, we've had three 20% corrections for the global equity market in the last seven years. Each time was in reaction to a global economic slowdown. The first two did not result in a recession and equity markets recovered. Our suspicion is that this correction may have a similar outcome but we are wary that continued policy errors could exacerbate recent weakness. We have been neutrally positioned in our Global Asset Allocation strategies and our inclination is to use weakness to rebalance (i.e., sell bonds to buy equities) and tilt the strategies to own more equities at attractive valuations.

Our Dividend Growth strategies now sport dividend yields above 3% with the dividend hikes in 2018 averaging more than 13% for the stocks currently in the strategy. While the stock prices declined during the fourth quarter, we were generally pleased with the operational progress and dividend increases of our holdings.

We wish you and yours a healthy and prosperous 2019.

Performance of Notable Indices	Q4 2018	1-Year (1/1/18 – 12/31/18)
S&P 500 Index	-13.5%	-4.4%
U.S. Midcap Equities	-17.3%	-11.1%
U.S. Small Cap Equities	-20.2%	-11.0%
International Developed Market Equities	-12.5%	-13.8%
Emerging Market Equities	-7.5%	-14.6%
U.S. Core Bonds	1.6%	0.0%
Global Bonds	1.4%	-1.0%
Gold, $/troy oz	7.5%	-1.6%

Data Source: Bloomberg. Total return indices unless otherwise stated.

d. Wall Street Journal, "Ocean Carriers Brace for Orders Surge Ahead of Potential New Tariffs", Erica E. Phillips, 10/30/18, https://on.wsj.com/2CSobLM
e. Business Insider, "Stocks book their worst year since the financial crisis and worst December since the Great Depression", Jonathan Garber, 12/31/2018, https://read.bi/2SScIRR

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9. This report is for the quarter ending December 31, 2018.