April 6, 2019

"*You wouldn't have won if we'd beaten you.*" - Yogi Berra

The Pivot and an inversion:

In last quarter's investment update we discussed how the Fed's tightening of their interest rate policy was negatively impacting the markets. At the time, it seemed like tightening was inevitable. In fact, Fed-head Jerome Powell said himself that the runoff of the balance sheet (a form of tightening) was on "autopilot." Further, on interest rate policy, most Fed officials projected in their December meeting the need to raise interest rates in 2019 between one and three times. Wow! What a different story today. In just three short months the Fed has made a significant pivot in their policy. Indeed, it was announced on March 20th that 11 of the 17 voting members of the market setting committee indicated there was no reason to raise rates AT ALL, for the whole 2019 year.

Going from a consensus projection of three hikes in one year to now a projection of no hikes is quite a different stance in monetary policy. The difference between the two positions is .75 per cent on the Fed funds rate. When that additional interest is added to the amount of the 2017 to 2018 year over year increase, to what the St. Louis Fed calls "Households and Nonprofit Organizations; Loans; Liability", the additional amount paid in one year would be over $3T. This is not an insignificant amount. The U.S. economy is about $20T. Personal consumption makes up roughly 70% of the $20T. If households are spending an additional $3T in interest, that is a big hit to their pocketbooks, and therefore stifles their ability to spend and support the economy.

The market refers to the Fed's significant change in policy as the "pivot". How does the Fed's pivot affect market conditions? On the one hand, the stock market cheered the new Fed policy of "wait and see", i.e. no further interest rate increases or tightening of the balance sheet until further data necessitates. On the other, there is an underlying market concern that with such a drastic policy change, the Fed must foresee slow economic times ahead.

Inflation isn't the reason for the about-face. It is well known that inflation is, and has been, including during the past three months, stable and in the Fed's target range of 2 per cent. (The Fed has a dual mandate from Congress to maintain stable prices and keep unemployment low. If inflation is too low or unemployment is too high, they will react with a lower Fed funds rate.) Therefore, Powell and company must be concerned about potential headwinds to the macroeconomic picture. There is no shortage of concerns held by the market, and it seems like the Fed is sharing in those concerns. To name the most alarming, there is the synchronized slowdown of the global economy, most notably in China and the Eurozone; the global slowdown can negatively feedback into the U.S. economy, especially considering it is already slowing; and global trade concerns - all of which add downside risk to stocks.

Also at the same time, the yield curve behaved in an alarming way. The yield curve is the graph plotting the difference between long and short-dated Treasury yields. The graph in "normal" economic times will slope upwards, as you go from left to right. This indicates that longer dated Treasurys have higher yields than shorter dated Treasurys. Only two days after the Fed announced its pivot in monetary policy, the yield curve did something unusual. Instead of sloping upwards, it made a so called "inversion". An inversion occurs when short-dated Treasurys yield more than longer dated Treasurys. Intuitively this is odd. Why would an investor buy a bond with a lower yield, and wait longer to get paid back than if you bought a short-dated bond with a higher yield?

Stocks generally get spooked by yield curve inversions. Indeed, there has been no recession since 1975 that hasn't been succeeded by an inversion. But, don't be fooled by Yogi's logic (Yogi's logic is sound, albeit a bit head scratching). Just because an inversion has succeeded every recession since 1975 that doesn't mean if you have an inversion, then you will necessarily have a recession. If A then B doesn't imply If B then A.

Just like the Fed, the market is in a "wait and see" period. As long as we don't see a recession and the Fed doesn't raise rates too much, stocks will continue right along.

For Q1 the S&P 500 had its best performance in over two decades, gaining over 13%. I am more pleased to announce *The Jensen Opportunity Fund* outperformed the benchmark with a 19.59% return.

Until next time,

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