



# Southern Capital Perspective

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*Registered Investment Advisor Since 1982*

## How is the Federal Reserve (Fed) Influencing the Markets?

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It is widely known that the actions of the FED have a big impact on the US economy and the stock markets. Traditionally, the FED lowers interest rates and/or adds liquidity when the economy is going into recession or is under stress from various financial problems as in 2008. This time, however it seems to be different. Chairman Powell and his fellow Board members are acting in a pre-emptive manner to avoid a recession. The global economy has slowed significantly and the US economy is slowing from its robust pace but is not presently in danger of slipping into recession. Therefore, the FED's actions are clearly not designed to fix a problem but instead to keep the economy strong. This is not necessarily wrong, but it is a different approach.

One of the FED's chief roles is to control inflation, and recent data from the US Bureau of Labor Statistics shows that inflation is running at 1.7% which is well below the FED's target rate of 2%. Therefore, there is clearly no need to raise rates to combat inflation and it gives the Federal Reserve the leeway to actually lower interest rates.

The other FED mandate is to accommodate full employment. The unemployment rate is near an all-time low; consequently, they are not required to do anymore, but Powell seems committed to make sure that there is no reversal. There have been two interest rate cuts in 2019. Speculation is that there will be at least one more, maybe two.

Another factor influencing the FED is the extremely low level of interest rates around the world.

Reportedly there are about 16 to 17 trillion dollars of negative interest rate bonds this means that the borrower (usually a government) is paid interest by the lender for the privilege of loaning money. These bonds have been issued mostly by Japan and European nations. Because of this fact there is a great demand for US bonds which drives down our interest rates and greatly increases the value of the dollar. Powell does not want the dollar to appreciate too much because then US exporters cannot export and recessionary forces

increase.

Finally, the FED is injecting money into the system. No, Powell says it is not QE (quantitative easing – the US central bank which is the FED injecting money into the system to stimulate the economy), but it is essentially the same thing. Over the past two months, the FED has been supplying short-term money into the system as needed. It has been reported that this money will remain in the system and will total about 400 to 450 billion dollars. So, even though it is not labeled QE, it is effectively QE.

The answer to the question 'HOW IS THE FED INFLUENCING THE MARKETS?' is this: They are cutting interest rates and adding liquidity. Even though a recession is not immanent, they are taking steps to protect the economy from a recession. We are not criticizing them or saying that they are wrong. We are merely pointing out what is going on.

### Preparing to Play Defense

We are not saying that it is now time to be defensive, but it is prudent to be prepared. Playing defense entails assembling a portfolio that protects in a down market. However, it is also essential that there is an ability to profit in an up market even if it is at a diminished level. Because the all-important question "WHAT IF WE ARE WRONG?" must be answered.

Why would we even consider going defensive? In order to answer this question, it is essential to put aside all of the emotion involved with our polar-

ized political environment and try to focus solely on economics and finance. Since January of 2017, US policy has been tax reduction, regulation reduction, and a business-friendly

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environment which has produced a strong stock market, a robust economy, and record-breaking levels of employment. Now, we are faced with potential candidates that are proposing to take the opposite approach. Logic would indicate that this would produce the opposite results, that is: a declining stock market, a contracting economy, and rising levels of unemployment.

Once again, it is vital not to focus on politics, but to consider the possibility of facing a very challenging financial environment and being prepared to deal with it. It may not be the likely outcome, but it could happen. Now it is very important to understand that we are not talking about timing the market; we are talking about a major strategic shift.

There have been many academic and industry studies on market timing. None of them have ever been able to find a system that worked consistently over time. This makes sense because a perfect timing system would destroy the markets. If all investors were either bullish or bearish, then we would either have all buyers or all sellers and no trading. An active market depends upon people believing that a particular security represents value and other people believing that that same security is fully valued and should be sold. The concept of market timing is alluring and even "sexy" -- that is being positioned correctly at all times, but in reality it seems to be unattainable.

A strategic shift, on the other hand, is a change in investment position based upon economic conditions brought about by substantive change in the economic environment. This could be triggered by a large and abrupt alteration of governmental policy. Markets allowed to function on their own will find equilibrium between buyers and sellers. This is called price discovery which is

how free markets operate. However, all governments impose some level of taxation and regulation which affects how markets function. Markets adapt to subtle policy changes by gradual adjustment through securities pricing and the volume of shares actually trading. However, radical changes can bring about large scale and rapid adjustment which can be very unsettling to investors if it is on the downside.

To assemble a portfolio capable of a breakeven performance in a year like 2008 along with being able to capture about 50% of the upside in 2009 requires blending assets that benefit from declining markets along with those that gain on the upside. In order to determine the potential viability of a blend of these types of assets requires back-testing those two opposite and tumultuous years. One interesting thing that this exercise revealed is that maintaining this asset mix over the long-term is not a good strategy and will produce only a low single digit compounded rate of return. Therefore, it is not a strategy to put on auto-pilot and forget about, but also does not depend upon short-term timing to avoid negative performance.

Deploying this strategy is not without risk. First, if it is deployed and the strategic shift does not occur then there would be opportunity cost meaning that you would miss out on some gains. Second, deploying it after the market discounted the coming strategic shift would subject you to a substantial portion of the market losses. Third, for taxable accounts, selling existing positions would trigger the realization of the accumulated capital gains in the existing positions. Therefore, careful deliberation must go into the consideration to employ this strategy. If executed at the appropriate time, it could have a meaningful financial impact.

## OUTLOOK

The third quarter was very volatile and ended up being pretty much flat for conservative objectives and slightly down for moderate and more aggressive objectives. During this quarter investors had to endure the ever changing outlook for a China trade deal, Brexit, 24 potential presidential candidates vying for the Democratic party nomination and the possible impeachment of the President. The July-Sept period is often the most volatile each year and the month of September is frequently the most problematic.

The outlook is mixed primarily due to the wild political environment that we are experiencing. Politics aside, the outlook is pretty hopeful because:

- 1) it appears that at least a partial China deal is in the works,
- 2) there are some optimistic signs coming out of the Brexit negotiators,
- 3) the FED is accommodative and indicates that there will be at least one more rate cut,
- 4) the consumer is in good shape which is likely to result in a good economic Christmas season,
- 5) there is a reasonably good chance that the US-Mexico-Canada trade agreement will be approved. and 6) the tax and regulatory environment remain favorable for business.

The political environment is where the danger lies. If the impeachment effort is successful or if the election results in a radical change in economic policy, then it might trigger the necessity to "Play Defense." Otherwise, the outlook is favorable, but continuing to be volatile. If you would like to review your portfolio objective, please call and schedule a time to discuss it.