Southern Capital Perspective

VOL 28, NUMBER 1

January 2020

Southern Capital Services, Inc.

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"Don't Fight the Fed"

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> The late Marty Zweig is credited with the saying 'Don't Fight the Fed.'
>
> In his book Winning on Wall Street, which was published in 1970, he writes "indeed, the monetary climate—primarily the trend in interest rates and Federal Reserve policy—is the dominant factor in determining the stock market's major direction. *Quote from realmoney.thestreet.com/investing*

The two previous years, 2018 and 2019, are classic examples of the validity of this old adage that dates back to 1970.

2018 was a year that saw a very active Fed raising interest rates four times along with a steady reduction (draining liquidity from the system) in the Fed balance sheet. The economy was very strong with the Gross Domestic Product growth coming in as 2.9% (GDP has only reached that level twice before in the last ten years since hitting 3.5% in 2005).

What is GDP?

"Gross Domestic Product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of the country's economic health." *Source: Investopedia*

2018 showcased the power of the Fed and monetary policy over the economy itself. Corporate profitability grew at a 22.6% rate fueled by strong employment growth, corporate tax cuts and the rollback in regulation. The stock market responded through the first three quarters to the strong economic news with a positive performance. But, in the fourth quarter the cumulative effects of four .25% interest rate increases along with the Fed shrinking its balance sheet eventually dragged the market down in the fourth quarter causing 2018 to end up with a negative return.

What is the Fed's Balance Sheet?

The Federal Reserve's balance sheet, like any other consists of assets and liabilities. But, "Unlike any other business enterprise, the Fed can expand its balance sheet by printing as many dollar bills as it wants.

Astronomical Expansion

Theoretically, there is no limit up to which the Fed can expand its balance sheet. The balance sheet of the Fed automatically expands when the Fed buys assets. Likewise, the Fed's balance sheet automatically contracts when it sells them. However, contraction of a balance sheet differs from expansion in the sense that there is a limit beyond which the Fed can't contract its balance sheet. That limit is determined by the value of assets. Unlike dollar bills, which can be used for buying assets, the Fed can't create the government securities out of thin air. It can't sell more government securities that it owns.

Apart from this, while expanding or contracting its own balance sheet, the Fed has to also take into account its effect on the economy. Generally, the Fed buys assets as a part of its monetary policy action whenever it intends to increase the money supply for keeping the interest rates closer to the target the Fed funds rate and sells assets when it intends to decrease the money supply."

Source: Investopedia

The Fed reduced its balance sheet by about $400 billion in 2018. Some pundits have indicated that that was equivalent to a dramatic increase in interest rates in addition to the actual four .25% rate increases that were implemented. The conclusion is that Fed policy took a strong year for the economy and turned it into a losing year for the stock market and dramatically weakened the economic outlook.

2019 was the year that witnessed a dramatic reversal of the Fed policy of 2018. It reminds me of the role of the President

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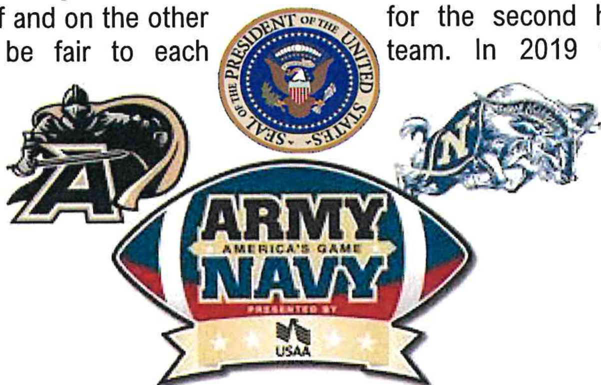
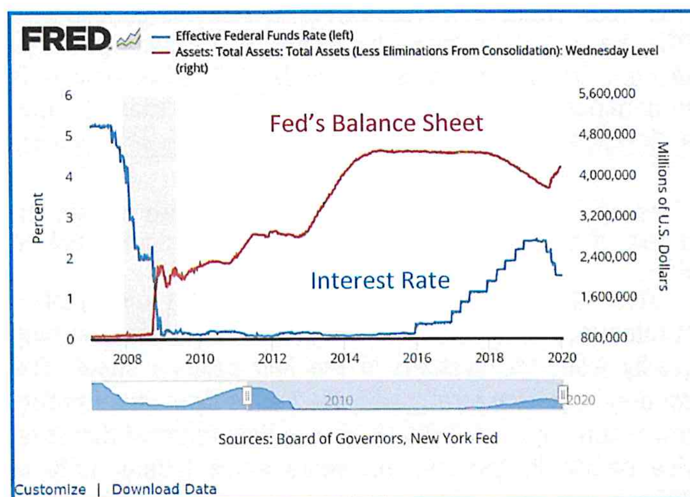
of the United States attending the annual Army-Navy football game. The President sits on one side for the first half and on the other for the second half to be fair to each team. In 2019 the



Fed reversed both of its policies: starting at the end of July the Fed did the first of three .25% rate cuts. They halted the balance sheet reduction in September when the balance sheet had been reduced by almost $700 billion from the beginning of 2018. They started expanding the balance sheet (claiming that there were short-term liquidity needs that dictated their course of action). By the end of 2019 they had restored $400 billion of the $700 billion reduction.

From the standpoint of the economy, 2019 was a very different year than 2018. In 2019 GDP rose an estimated 2.3% (final numbers are not in at this time) and corporate profits only rose by an estimated 1-2%. These numbers are far weaker than the very strong 2018, however, the stock market had a spectacular 20+% year. Remember, the government policy backdrop remained the same, namely: the employment numbers were strong, the tax cuts were still in place and regulation rollback was still happening. The dramatic differences were the Fed policies that produced a strong market with a mediocre economy and in the previous year produced a down market in a year with a much stronger economy. The bottom line is that if you fought the Fed then you lost: in 2018, if an investor bought on the basis of a strong economy, s/he lost money; and if the investor didn't participate in the market in 2019 because of weak corporate profitability, then s/he missed out on a great opportunity.

Historical perspective is important, however the Fed's intended actions are not always clear; therefore, it is important to pay attention to all of the various factors that impact the economy and the markets. The Fed's stated position for 2020 is to be neutral regarding raising or lowering interest rates. Chairman Powell said that the Board will be data dependent and act accordingly. The expectation for balance sheet expansion is to continue adding short-term liquidity in the early part of the year and then take a neutral stance. If they follow these anticipated courses of action, we will have to get our clues for market direction elsewhere.



OUTLOOK

2019 was a great year for the stock market. The last quarter of 2018 with its sharp sell-off helped to set the stage for the market advance the following year. The Fed certainly did its part and the two big trade deals that seem to be coming together were significant contributors. The year ended with the market being fully valued on a Price/Earnings (P/E) basis although not necessarily overvalued because of the low level of interest rates which affects the relative values of stocks.

2020 has begun on a positive note through the first week and one-half. We are faced with a market that is on the brink of benefitting from the trade deal with China (expected to be signed on January 15) and the USMCA trade deal with Canada and Mexico. The first employment report of 2020 shows 145,000 jobs created and the unemployment rate holding at a very low 3.5%. Also, we are still benefitting from the tax cuts and the rollback of unnecessary regulations. The American consumer is in good shape and consumption is about 70% of the US economy.

Fundamentally, the outlook for 2020 is solid and corporate profitability is expected to rebound up to the mid-single-digit range. And as discussed above the Fed balance sheet activity is expected to remain supportive in the early part of the year and then become neutral.

In this election year, the main challenges are the political uncertainties of possible impeachment and the unknown policies of a potential change in the administration. Also, the ever-present geo-political risks (like Iran or North Korea) could disrupt markets. Additionally, the fully valued status of the stock market could add to volatility.

Our best prognosis is that the underlying fundamentals of the economy and a neutral Fed will be the biggest influences. If there is status quo on the political front, that should give us a positive year although not nearly as good as 2019 and with volatility. As always, there are no guarantees and unforeseen events could dramatically change the outlook.

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