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THE DANA VIEWPOINT

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*June 29, 2018*

*Dow: 24,271*

## **Who's In Charge Here?**

No, we don't mean Congress or the President, we don't mean the U.S. or China in the trade war, and we don't mean the market bulls or the market bears. We are referring to the yield curve and expectations for rates going forward. The bond market has kept long rates consistently in a range around 3% even as the Fed has continued to raise the Fed funds rate in a measured fashion, and the two-year Treasury has doubled from 1.30% in September to almost 2.60% in May. The yield curve has continued to flatten by increased yields on the shorter end, driven by Fed rate increases and rather stubborn stationary rates on the long end. We believe it is always important to listen to what the market is saying, and currently it is saying that there is no danger of significantly higher inflation.

It makes sense to step back and take stock of where we have been over the last 30 years, with an eye to inversions of the yield curve (situations where the ten-year Treasury yield remains below the Fed funds rate for a significant period of time). This happened in 1990, 2001, and 2009, all periods now defined as recessions. What is interesting is that the inversions were caused largely by the ten-year yield moving down, not the Fed funds rate moving up. Many would say this was the market sending a message to the Fed that it wanted lower rates and a more stimulative monetary policy. So does the market know more than the seers and soothsayers at the Fed? The Fed has continually told us that inflation is moving towards their target, and largely it hasn't. We have seen some moves up, usually driven by oil prices, but we haven't seen a sustained move towards 3%. In fact, the annual consumer price index has not touched 3% in six years, even as the unemployment rate has moved from 8% to below 4% over the same period. The Phillips curve (low unemployment=increased inflation) is dead.

So will the Fed go too far? We hope that past experiences with yield curve inversions will give them pause. We would like to see them stop increasing rates when the Fed funds rate gets within 50-60 basis points of the ten-year Treasury. That would mean two more rate increases before a longer pause. The stock market is flat this year, even with extremely strong earnings

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growth, and first quarter GDP was only 2%. Is the stock market trying to tell the Fed to back off as well?

Our fixed income strategies are largely positioned to have a combination of shorter maturities, a faster return of funds invested, and higher yields than their respective indices. (We currently are buying high quality, short duration bonds with yields over 3%) Many use securities with adjustable coupons or periodic calls to further reduce risk. This positioning has served our clients well through this period of uncertainty.

How the once mighty fall. General Electric was founded 126 years ago by Thomas Edison and J. P. Morgan, among others. It was a member of the original Dow Jones Industrial Average in 1896. As of June, it was the last original member to be removed from the index. Since its high in 2000, it has fallen 60% with dividends reinvested! Ours is a dynamic economy, and the future is guaranteed for no one.

As we celebrate our nation's birth, for this month's random thought, we looked to a group of documents from our founding: the Federalist Papers. These were a set of articles published periodically in 1787 and 1788 to promote the ratification of the Constitution. They provide an insight into the thinking of our founders as they established our government, one that has served us in substantially the same form for over 240 years. There is truly an insight for everyone in these papers, so we chose two, one for each end of the political spectrum, and both by James Madison.

*“The powers delegated by the proposed Constitution to the federal government are few and defined. Those that are to remain in the State governments are numerous and indefinite.”*

*Madison Federalist #45*

*“Enlightened statesman will not always be at the helm.” Madison Federalist #10*

***Happy 4th of July to all.***

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