THE DANA VIEWPOINT

June 27, 2019
Dow:26,527

Behind the Curve

This phrase is used to describe a Federal Reserve and Federal Open Market Committee that is out of sync with the markets. They are always using many measures of rates, economic activity, employment, and inflation in an attempt to set an interest rate that neither encourages irresponsible risk-taking nor hinders growth. As part of our investment management process, we do the same thing in an attempt to better gauge where the economy and the markets are going, and use that information to position portfolios properly to benefit under the most likely outcome. In life, business, and sports, preparedness and anticipation usually lead to greater success. By being “behind the curve,” the Fed is being reactive, and since monetary policy operates with somewhat of a lag, this approach can compound errors and swings in the economy.

So what economic indicators should the Fed be heeding? There are a number of them that we would suggest and that we also use to try and gauge which way the economic winds are blowing. Oil and other commodity prices give a simple price signal. Oil spiked and then fell last year, but now is back to its longer term average of between $50 and $60 per barrel. A broader index of commodities has stayed near its fifteen year low for the last few years, signifying a troubling lack of inflation. The dollar has been strong versus other global currencies, and it would be weaker if market participants thought there was a danger of inflation. Wage growth has been moderate, and wage growth would certainly be higher if individuals thought there was any danger of higher future inflation. The Fed seems totally confused by the combination of low inflation and low unemployment. Housing price growth has also slowed nationwide to the low single digits, so no inflation concern there.

There has been much talk and consternation about the inverted yield curve. We believe an inverted curve, where long rates are lower than short rates, is a market indicator that the Fed should respect. The shape of the yield curve, and longer rates, comprise the sum total of the market’s collective knowledge about where rates are headed. It also gives information on whether market participants think the Fed is ahead or behind the curve. When the Fed increases short rates and long rates do not move up along with them, it is a sign that the Fed is too tight and is hindering potential economic growth. Low inflation can actually discourage investment and risk taking, as businesses are discouraged from investing due to a feared lack of demand. Japan is the most extreme example, but low growth plagues

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most areas of the world right now. The market now expects three rate cuts this year, and one more in the first half of 2020. The Fed should listen to the market.

As we have said before, our investment approach in our different strategies must reflect the risks and realities in the market. In our equity strategies, we hold companies that have meaningful advantages in their business areas, with proven management. We also look to hold companies that can grow revenues, although these become rarer and more expensive in this environment. In our fixed income strategies, we also maintain a balance of credit exposure, duration, and yield. We try to diversify risks as much as possible in our bond holdings, but inevitably all bonds are slightly riskier as yields move lower. Our goal is to anticipate market conditions, and avoid being surprised by unseen events. Our goal is to remain 'ahead of the curve' in the markets.

Random Thought for June 2019: The only thing that is constant is change - Heraclitus

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