THE DANA VIEWPOINT

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Does the Fed Have Our Back?

The Fed has a dual mandate: pursue full employment while keeping inflation low. As the years have passed, they seem to have added even more to their plate. They have shown concern for instability in both domestic and overseas markets, a weakening or strengthening dollar, the fiscal deficit and debt, climate change, and income inequality. Some say they have one arrow and multiple targets. Actually, they have created more arrows for themselves by becoming a key purchaser of both Treasuries and mortgage-backed securities. Once again, the markets are leaning on the Fed for continued support and fearing when that support might begin to be curtailed.

The last rate increase cycle that took place in 2017-18 is instructive. From December, 2016 through December, 2018, the Fed implemented eight quarter-point increases, moving the Fed funds rate from 0.375% to 2.375%. At that time, we did not believe there was any compelling reason for the Fed to start a tightening cycle; CPI vacillated between 1.5% and 3% even as unemployment continued to drop below 4%. The S&P 500 gained over 20% in 2017, but fell 5% in 2018, with a 15% correction in the fourth quarter of 2018. We always believed that the markets would have to force the Fed to stop the increases, and the first cut came in July of 2019 as inflation and GDP drifted lower and the stock market was close to flat for nine months prior to the cut. At no point in the last decade did consumer inflation move over 2.5% per year on a sustained basis, even as unemployment moved below 4%.

In addition to what was learned in that rate cycle, the Fed now has the added uncertainty of the pending COVID-19 recovery. Will businesses be willing to rehire anywhere near as quickly as they laid off employees? The Federal debt has ballooned, and the Fed certainly worries about the ability to finance that debt at low rates. They also know that those on the lower end of the income scale suffered disproportionately from the economic effects of COVID-19. They know that easy money doesn't significantly help that portion of the population until the unemployment rate again moves towards past lows. Those with non-specialized skillsets are the first to be laid off and the last to be rehired. The Fed has already told us that they will allow inflation to run above 2% for a period of time. Will they let it run at 3% or more if they believe that there is still work to do on the employment recovery? That certainly is more likely now than it was a few years ago.

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Recent economic numbers have come in below expectations due to winter storm Uri. Almost ten million people lost power, the greatest number since the New England storm of 2003. This resulted in a downtick in home sales and first quarter GDP, which is now expected to be in the 6% range rather than 8%. Don't be fooled; the economy continues to move toward a broader reopening as the U.S. vaccinates millions of people per day, and the caseload for the virus continues to drop even as people increase their activity, travel, and interactions. We will see a move up in the CPI, potentially above a 4% annualized rate, in the coming months. Supply chain bottlenecks will exist as the economy rebuilds inventory. Some of those supply line constraints already exist in the semiconductor space, and the shortages have been so severe as to lead to temporary shutdowns in major automotive plants. We would expect inflation to settle back after the spike over the next few months.

The uptrend in the stock market should continue broadly in line with the reopening and increased vaccinations. The market leaders of the past year have corrected, with the NASDAQ Composite Index down over 10% through March 8th. Value stocks have outperformed growth stocks this year in anticipation of the economic reopening.

Longer term interest rates have also risen over the last two months, resulting in negative returns in most longer fixed income portfolios. This move off last year's lows was also expected, but impossible to time. It is also another sign of the forthcoming economic recovery and can be managed through proper portfolio positioning and allocation. With higher portfolio yields currently available, portfolios should be less price sensitive to similar rate moves going forward.

The Fed does have investors' backs this time. They want to see the economy heal, and they want to do all they can to help those who were hurt most by COVID-19. Expect them to continue to resist a push for tightening, regardless of the inflation numbers, until the unemployment rate has moved below 4% for a significant period of time.

Random thought: "Our greatest responsibility is to be good ancestors."

- Jonas Salk, inventor of the polio vaccine

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