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Market Commentary

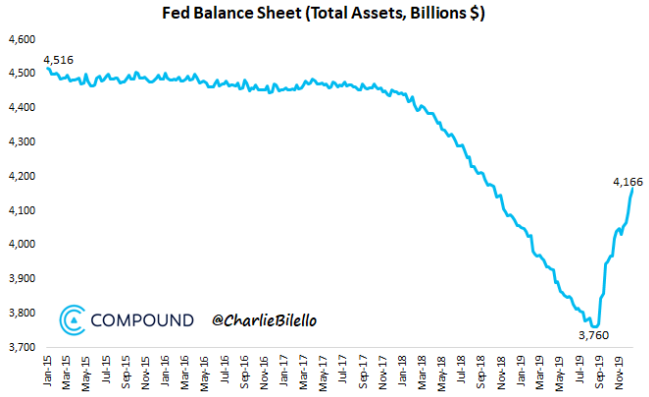
Tuesday, January 14th, 2020

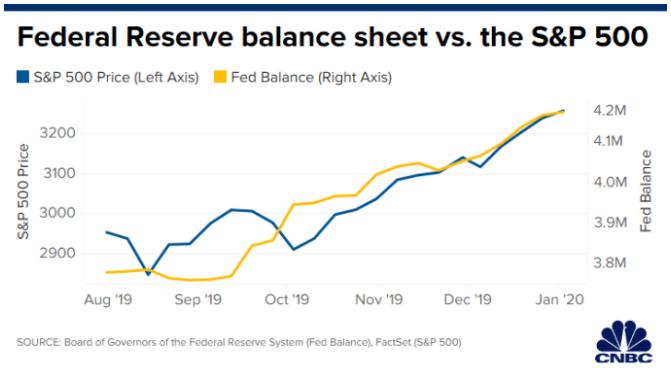
"Fed quietly easing as inflation stays muted. Stocks continue to benefit"

The stock market continues to make new highs after breaking out of its trading range in the fourth quarter of 2019. Going back to the Christmas Eve lows of 2018, the S&P 500 is up over 40% including dividends. A span of less than 13 months. This abrupt shift in momentum following the worst December since 1931 coincided with the also abrupt reversal in Fed policy from tight to neutral to what has now become accommodative once again.

After raising rates for the last time in December 2018, the Fed cut rates three times in 2019. While the rate cuts are likely on hold for the time being, the Fed also has other ways to stimulate markets, principally by expanding its balance sheet through its purchases of treasury and agency bonds.

Through the three major quantitative easing programs (QE1, QE2 & QE3), the Fed's balance sheet expanded to hit a peak of ~$4.5 trillion, holding steady around those levels until late 2017. Along with the rate hikes that started in December 2015 and ended in December of 2018, the Fed also started rolling bonds off its balance sheet at the end of 2017. This continued until September 2019 with the balance sheet reduced to just under $3.8 trillion, itself a fairly significant "tightening" of monetary policy.





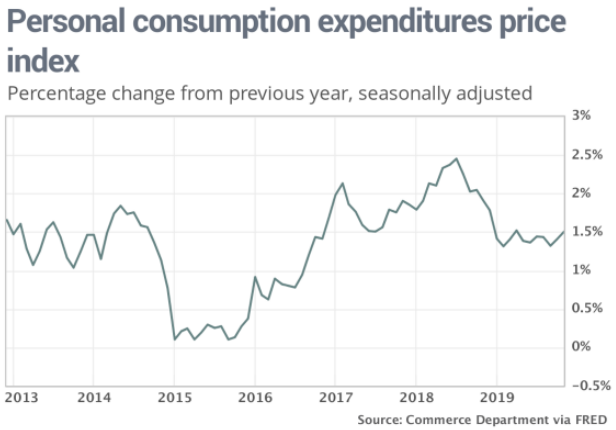
What might be surprising to those who haven't paid attention is that the Fed has since started expanding the balance sheet once again. This most recent balance sheet expansion coincides with the Fed's intervention in the overnight borrowing system (aka "repo market") that serves as the plumbing for the banking industry. The amount of Treasuries purchased by the Fed to support this market has varied by week, but if the trend continues, the Fed balance sheet could be back to its peak levels by around April of 2020.

Whether it is a coincidence or not, the Fed's most recent actions have corresponded with the latest surge in stocks in the fourth quarter and first couple weeks of 2020. The S&P 500 is up over 12% since the beginning of September 2019 when the Fed started purchasing Treasuries in the repo market, along with the three interest rate cuts in July, September & October of last year.

What has also changed from the end of 2018 to now is the Fed's stance on expectations for future tightening. There was undoubtedly some uneasiness from the market as the Fed appeared to be on auto-pilot with its tightening policy in the fourth quarter of 2018 heading into 2019. Then in January of last year, the Fed abruptly responded by reverting its policy to neutral to what has now become accommodative.

In October of last year, Fed Chair Jerome Powell fueled the rally when he stated that "we would need to see a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns." That was further support for the market knowing that conditions were going to stay loose for the foreseeable future. In other words, the party was still on.

There are some metrics of inflation that have picked up over the past few years, but the Fed's preferred metric, the Personal Consumption Expenditures (PCE) index has remained well below 2%. It is likely that this would need to jump well above 2% for the Fed to start re-considering its stance on accommodation.



The employment report from December actually showed some moderation in wage inflation, which hit its lowest year-over-year gain since June 2018 despite the tight labor market. So although inflation is likely a matter of if, not when, we have yet to see anything surface that would make the Fed reconsider its stance.

So the economy is growing just enough to provide a tailwind but not too much that would dictate higher inflation and tighter policy from the Fed. As we have learned, they will now error on the side of accommodation given that it is very hard to take away the punch bowl from the party once it has started.

There is an old investing mantra that states "don't fight the Fed". That would certainly hold true on both sides of policy action over the past few years.

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