The Krygier Report

An exclusive newsletter from Mark J. Krygier, Vice President & Portfolio Manager | September 2020 www.krygierwealthmanagement.ca

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Don’t Fight the Fed - again!

Once again, investors are cautioned to heed the changing mantra of U.S. Central Bank policy. In the last week in August, Jerome Powell, the Chairman of the “Fed” (the Federal Reserve – the U.S. Central Bank) made a complete about-face in changing Fed policy towards inflation. This is something which all investors would be cautioned not to ignore, but rather to consider the longer-term implications for their investments and for the broader economy. The expression “Don’t fight the Fed” implies that investors should align their investment policy with that of the Fed, so that investors should be cautious about investing when the Fed is raising or threatening to raise interest rates (which generally is done to slow down the economy) and to invest or stay fully invested when the Fed is keeping the stimulus “peddle to the metal” in lowering rates or keeping them low. In December 2018, in the midst of an already tumultuous market environment, Powell reiterated that the Fed fully intended to raise rates at least three times in the coming year as they strove to fend off inflationary pressures they believed were building – sending shockwaves around the investing world and markets crashing. A mere few weeks later, in early January 2019, Powell held a news conference and announced that not only would the Fed not raise rates at all in the coming year, but would likely lower rates – which in fact they did, three times in the ensuing 12 months, sending markets to a rapid recovery of the late 2018 “crash”. Investors who ignored this change and remained frozen like the proverbial deer in the headlights lost out on great investment returns during the market rebound.

Throughout these back-and-forth actions, Chairman Powell has been indicating that this move to lower rates in early 2019 was a temporary measure, as he remained ready to raise interest rates just as soon as inflation pushed above 2% on an annualized basis. Then came the dreaded Covid pandemic in early 2020 with the resultant forced closure of the U.S. and global economies, resulting in the most dramatic economic slowdown since the Great Depression of the ‘30s. As has been the case in recent economic crises, Central Banks globally stepped in and used “off-the-charts” amounts of debt to keep their economies afloat in doling out free money to those negatively impacted (Canada lost its coveted triple-A or AAA rating by at least one debt rating agency, based on the amount of debt Trudeau’s government added – and recent policy announcements indicate that is just the tip of the debt iceberg to be amassed). Yet, most viewed the underlying theme of Central Banks focus as having their figurative fingers ready to pull the interest rate trigger to prevent inflation, should it rear its ugly head. That brings us to the last week in August 2020.

When the new policy of the U.S. Fed was unveiled, it changed the underlying theme from one of being ready to combat inflation to one of allowing inflation to rise above and beyond that theoretical 2% level. In “Fed-speak” this was referred to as the Fed’s new, “flexible form of average inflation targeting,” (and you wonder why nobody pays attention to these news conferences). This shift in monetary policy implies that interest rates (already near zero) will remain low for years to come.

The other change that resulted from the shift in Fed policy has to do with employment. While unemployment figures rose to Depression-like levels in the immediate aftermath of Covid-economic closures, employment levels have improved since the reopening of economies, but remain significantly below pre-Covid levels. Powell indicated that "maximum employment is a broad-based and inclusive goal," of the Fed. So now the Fed has adopted yet another role for itself – one of "creator of jobs". This again is a dramatic about-face as, prior to this announcement, the Fed's policy was that if unemployment levels dropped too low it would create wage inflation which would filter through to raising prices throughout the economy. Now, with "maximum (i.e. full) employment" as the new goal, and no concern about inflation rising well-beyond the previous "concerning" levels, the stage is set for inflation to enter after literally decades of disinflationary pressures.

Will the Fed be successful in generating inflation? That, as we used to say, is the "$64,000 question." If the mantra of "Don't fight the Fed," remains true, inflation will creep into the economy and grow unabated for years to come. Further evidence that this trend will occur is the massive supply chain disruption that resulted, first from the U.S. trade tariffs on China, and then from the shut-down of Chinese manufacturing during Covid, both of which likely caused many a CEO to consider relocating the location of their key-component manufacturing from somewhere other than China – hence, higher costs that will eventually be passed onto the end consumer of goods. Investors are forewarned to consider the implications to their investment strategies and not to ignore these changes in policy, despite all the eye-glazing "Fed-speak".

Bottom line

Successful investing is mostly about being in the right spot at the right time. Recent statements from the U.S. Fed indicate the tides are indeed a changin'. Perhaps those investments which thrived in a deflationary environment (think technology!) may not have the same kind of success going forward – in particular in the face of outrageous valuation levels of many companies' stocks. On the other hand, areas which have long been ignored by investors may turn out to be a source of superior returns in the coming years. Consider that headline news often marks the "tops" in markets – and that while Powell was shifting policy, the committee that determines which stocks will be part of the "Dow Jones" benchmark index just added yet more technology exposure and further reduced commodity exposure…hmm…

Global benchmarks
As at August 31, 2020 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	-1.1%	3.8%	6.0%
S&P 500 TR - US$	9.7%	21.9%	14.5%
NASDAQ Composite - US$	31.2%	47.9%	22.4%
MSCI Europe Index Price Return	-6.6%	1.4%	0.5%
MSCI Emerging Markets	-0.3%	10.1%	2.0%
China S.E Shanghai A Price Return	14.2%	21.0%	0.7%
MSCI World Index Price Return	5.0%	13.0%	9.6%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - US$	23.6%	13.3%	12.0%
10-year U.S. T-Bond - US$	12.6%	8.9%	6.6%
Long GOC Bond (2048)	14.7%	7.5%	10.2%
10-year GOC Bond	11.0%	6.4%	5.6%
5-year GOC Bond	7.0%	5.1%	3.6%
3-month CDN T-bill	15.7%	16.4%	6.1%
US$/CDN$ (1.3097)	0.9%	-1.6%	1.6%

Source: RBC Capital Markets Quantitative Research

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