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"By The Way"

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"I curse the guy who said, 'may you live in interesting times'"

The Fed has killed the bear, and the "Fed Put" has been re-established. I mistakenly believed that Chairman Powell was a different breed than his predecessors and would stick to doing what he thought was the correct policy for the economy and not be dissuaded by the machinations of financial markets. As recently as his October 3rd press conference he declared rate increases would steadily continue for the foreseeable future, and he saw no reason to be worried about markets. Even as late as December 19th he used the term "autopilot" to describe how Fed policy would remain unchanged. Whether the cause was pressure from the President or the major banks, the near 20% decline in the S&P 500; or a concern about the economy, Powell folded and in a January 4th speech announced rate increases would be put on pause for the time being. From that point on the S&P has been on wheels. I don't want to suggest Fed language is the only factor impacting markets, but the correlation, especially recently, has been very strong.

Almost all of the concerns and caveats I wrote about in the last letter have been nullified by the strength of the market since the December 24th low. The resistance levels between 2600 and 2650 have been exceeded; momentum is extremely strong, and participation is broad across the board, especially in the "risk-on" sectors like small cap stocks. The notion that buying dips is the appropriate strategy is again fashionable. The boss suggested that with so much volatility, I might need to write twice a month. I assumed he was kidding, but even if he wasn't that would just double my chances to be mistaken. I have always believed one should listen to the message the market sends us, and right now the message is a positive one. Having said that, I am convinced economic and corporate earnings growth while still positive is slowing, and geopolitical risks remain plentiful. Therefore, while remaining invested, I would still counsel a continuing program of lowering the risk level of one's portfolio. The study of behavioral finance would say I'm proof of what is called "prospect theory", that the human desire to avoid loss exceeds the desire for gain. I plead guilty, and I am prepared to give up some profits to avoid potential losses.

In China, 4th quarter GDP came in at 6.4%, which while not a bad number was the lowest quarter since 1992. The January PMI was below 50, predicting a possible contraction in the economy. In addition, December exports were reported down 4.4% and imports down 7.6%. The central planners continue to walk a tight rope trying to slow growth, while still achieving a soft landing.

Europe's 4th quarter, on the other hand, grew at miserable 0.2%, and only 1.2% for the year. The Chinese slowdown has been one factor in the weakness as has Brexit, recession in Italy and protests in France. Germany has long been the main driver of growth in the region but the January ZEW survey of analysts and economists came in at 5.3%, down shockingly from 56.4% a year ago.

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Japan's manufacturing PMI for January was 50, also close to contracting, and industrial production in 2018 only grew at 1%. Stimulus will be needed to offset the new VAT tax set for October.

The economy in the U.S. is expected to return to a level around 2% in 2019, down from a high of 4.2% in the 2nd quarter of 2018. That rate is still respectable, but there are scores of geopolitical ticking time bombs that could well affect the economy and financial markets if something goes wrong.

To that point, the inflexibility and inability to compromise by the two parties in Washington provides uncertainty and the potential for negative outcomes. The government shutdown only serves to demonstrate how wide the abyss and how intransigent the two sides are. There will be many more issues such as tariffs, the debt ceiling, spending and tax cuts, and even the new NAFTA which could lead to adverse outcomes for the economy and markets if not resolved in a timely manner. There are 10 new Senators and 101 new members of the House, and many were elected on the basis of staking out a hard-line position and arrive prepared to press their own agendas. Compromise will not come easily. Two of the new members are of particular interest, Alexandria Ocasio-Cortez of New York, known as AOC, and Rashida Tlaib of Michigan, both belong to an organization called the Democratic Socialists of America; (and 40 other members were elected at the state and local level). The association has only about 50,000 members today, but that is up from 6,000 when Trump was elected. Interestingly it is attracting younger voters, such that the average age is now 33 as opposed to 68 in 2013. While not necessarily Marxian in policy, there is one thing for certain, the group is anti-capitalism. Not much of a worry today, but it is well to remember few people thought there were enough outsiders to elect Donald Trump. The number of people dissatisfied with the current system continues to grow, and they are prepared to listen to any and all new ideas.

Finally, I have recently been made more aware of a new economic theory that if implemented could well have a major impact post the 2020 election. It is known as Modern Monetary Theory or MMT, and its chief proponent is Professor Stephanie Kelton of Stony Brook University who was economic advisor to Bernie Sanders during his run for President. I don't have the knowledge or inclination to go too deep into the theory at this time, but simply put the theory states that government deficits don't matter as long as inflation is held in check. Current economic policy asserts that revenue plus borrowing provides the budget available to the Government. MMT, on the other hand, suggests that with a simple key stroke at the Fed dollars can be created for any project. If a bridge collapses or even more seriously kids are going hungry, the Government has the power to print more money and pay for the remedy. While this is anathema to all I've learned, and I am confused as to how such a system would actually work. It does strike me that if the Fed after the 2008 crisis had built infrastructure to shore up the economy instead of buying bonds (which served to inflate financial markets and widen the gap between the haves and have-nots) we might well be better off. I am not enough of an economist to figure out where this may lead us, but it will be a different world and cannot be ignored.

In the midst of all the confusion and volatility I agree with a recent comment by Jared Dillian; "I curse the guy who said, 'may you live in interesting times'".

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