BLOG POST
The Ultimate CONfidence
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Who can forget the picture of Frank Abagnale walking arm and arm with 6 flight attendants dressed to the nines as an airline pilot? The only problem was that Frank, played brilliantly by Leonardo DiCaprio, was not a pilot and had no idea how to fly a 747. “Catch Me if you Can” is a hilarious movie about Frank Abagnale, the most famous con man in U.S. history. Abagnale was able to convince people he was doctor, an attorney, as well as a pilot in carrying out some of the boldest cons ever witnessed.

Frank Abagnale understood that to really fool someone you had to act the part, you had to gain their confidence to avoid suspicion. As the markets soar to new heights amid the pandemic, where a large part of the economy remains locked down, I question where the confidence to buy risk assets is coming from. Is it possible that the Fed is playing the role of Frank Abagnale to unsuspecting but trusting investors?

The disconnect between the economic disruption caused by COVID-19 and stock prices is as significant as anything I have seen in my nearly 30 years of managing portfolios. Investors are betting that the Fed has both the ability and conviction to keep the markets from collapsing. The reality is that there are things the Fed can do to support the markets and the economy, but there are many things they are powerless to change. The Fed is able to keep interest rates at historically low levels to support home buying and real estate, but what they cannot do is make people consume at higher levels. The problem with the economy is weak demand, and regardless of how low rates are, some people are going to put off making purchases in order to decrease debt and build savings. The Fed can also reduce bank reserve requirements in an attempt to drive higher loan volumes, but they cannot make banks make more loans and credit conditions have tightened noticeably since the coronavirus became an issue.

Let’s take a look at three specific risks the economy and markets face today that the Fed is incapable of addressing.

1. **Congressional oversight of Big Tech.** Not only are Apple, Amazon, Alphabet (Google), and Facebook among the largest companies in the world, they are also among the principal reasons why stocks are at an all time high. If you include Microsoft and Netflix in the equation, Big Tech is up around 45% this year and the S&P 500 would be down approximately 5% if you exclude those 6 stocks. The equal-weighted index is -4.5% for 2020 as of this writing. If Congress tries to move beyond hearings to actual sanctions, it could create a rush for the exits starting with the best performing stocks.

*FAANGM refers to Facebook, Apple, Amazon, Netflix, Google and Microsoft

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2. **Trade War with China.** Fed Chair Powell has referenced the risks to the economy of a prolonged trade war with the second largest economy in the world as reason to keep rates at historically low levels. The potential economic disruption caused by both sides assessing tariffs would result in a significant reduction in earnings and would likely cause a sell-off the Fed could do little about. China, being an authoritarian government, does not rely on election cycles or quarterly earnings — they are willing to be patient and endure short-term pain for long-term success.

3. **Supply Chain Interruptions.** This ties in with the potential of a trade war but is much bigger. Increasingly we see countries around the world adopting more protectionist policies intended to benefit their own citizens. The COVID-19 pandemic has led to different parts of manufacturing and supply chain capacity being negatively impacted. If a relatively inexpensive part made in Korea that is used to make a car cannot be sourced, auto production stops. There is also significant risk of inflation occurring from a supply chain interruption as companies spend to create new supply chains.

I believe the CONfidence in the Fed is irrational and may ultimately lead to catastrophic losses for investors who do not have any ability to hedge their equity market risk. Any of the three scenarios listed above, and dozens more that could be listed, could cause a rapid loss of confidence in the Fed and panic selling. However, never stray from the wisdom of Keynes who said, “The market can stay irrational longer than you can stay solvent.”