BLOG POST
Rogue Fed
05/04/2021

According to the Cambridge English Dictionary, a rogue organization is one that no longer behaves in the usual or acceptable manner. Some of the Federal Reserve's recent actions arguably fall within this definition. The Federal Reserve, as the most powerful financial institution on the planet, has a responsibility to act in a manner that is both rational and predictable if the financial markets are to maintain a level of stability and confidence. A growing number of the Fed's actions are neither, which raises the possibility of a crisis of confidence that would impact the world's financial markets.

The Fed was created by Congress in 1913 to establish economic stability in the U.S. by introducing a Central Bank to oversee monetary policy for the country. The policy was to be carried out by the 12 Federal Reserve Banks and a Board of Governors. For decades it has been understood that the Fed has a dual mandate: maintain price stability and maximum sustainable employment. These goals of monetary policy are transparent and allow the markets to intuitively know what the Fed is likely to do based on economic data. Today's Fed, in sharp contrast, is pursuing monetary policy that is opaque at best, forcing market participants to guess what their next step might be.

In an attempt to be more transparent following the actions taken in response to the 2008 financial crisis, the Fed implemented a 'dot plot' matrix in 2012 to communicate where voting members of the Fed expected interest rates to be in the future. We were told by the Fed that they would be 'data dependent' in making changes to policy accommodation and interest rates. Fed Chair Powell's most recent press conferences suggest the role of data in his decisions may have diminished.

As 10-year Treasury yields moved sharply higher in March to 1.75%, up from just 0.9% in January and more than three times higher than the .53% in July 2020, Powell was asked if the Fed was going to cap how high long duration yields would move higher. While refusing to answer the question, he stated ". . . accommodation would continue until 3 criteria were met: non-transitory inflation was above 2%, forecasted future inflation was at or above 2%, and the economy was experiencing full employment."

Nice sentiment for sure, but the problem is that the Fed has done trillions in quantitative easing since the financial crisis and those criteria have still never been met. The Fed's ability to track inflation somehow misses the fact that esoteric items like 2X4's have risen around 300% or the Bloomberg Ag Index is up 76% this year. The Fed is searching for a 2% inflation print while anyone who actually goes to a store recognizes prices are 10% higher, if not more.

The markets intuitively understand we are on an unsustainable path as yields rise. Interest rate policy likely has a greater bearing on the direction of the stock market than earnings do in today's environment. You see this particularly in the technology sector, which tends to be very interest rate sensitive due to the long time frame between investment and earnings for many tech companies. Higher yields mean a greater opportunity cost, causing many investors to move out of the tech sector. Value stocks, that trade at modest valuations, are seen as less risky in a rising rate environment as are energy stocks which also provide a hedge against inflation.

Financial repression, the Fed's intentional actions to artificially suppress interest rates, is creating greater and greater distortions in the markets. I wonder if Cathie Wood's popular ARK Fund would even exist without the Fed-created distortion? When Fed policy can no longer be attributed to its dual mandate what do we tether it to? We are forced to invest in a world where the search for yield and returns has led to unprecedented leverage in the financial markets. If Fed credibility was to be seriously questioned you could see bubbles in housing, stocks, junk bonds, collateralized loan obligations, and many others simultaneously bursting, creating chaos.

A recent E-Trade survey of brokerage accounts with over $1 million had interesting results. Over 90% of respondents stated they believe the market is "fully in a bubble," "somewhat of a bubble," or "approaching a bubble." Housing prices in many areas are rising so fast there is almost no inventory for buyers. People are receiving astronomical offers for their home which is not even on the market.

This current market environment is likely to end badly for most investors. Fortunately, there are early warning signals we are able to track to help us maneuver and reduce risk before the fan spreads foul air.