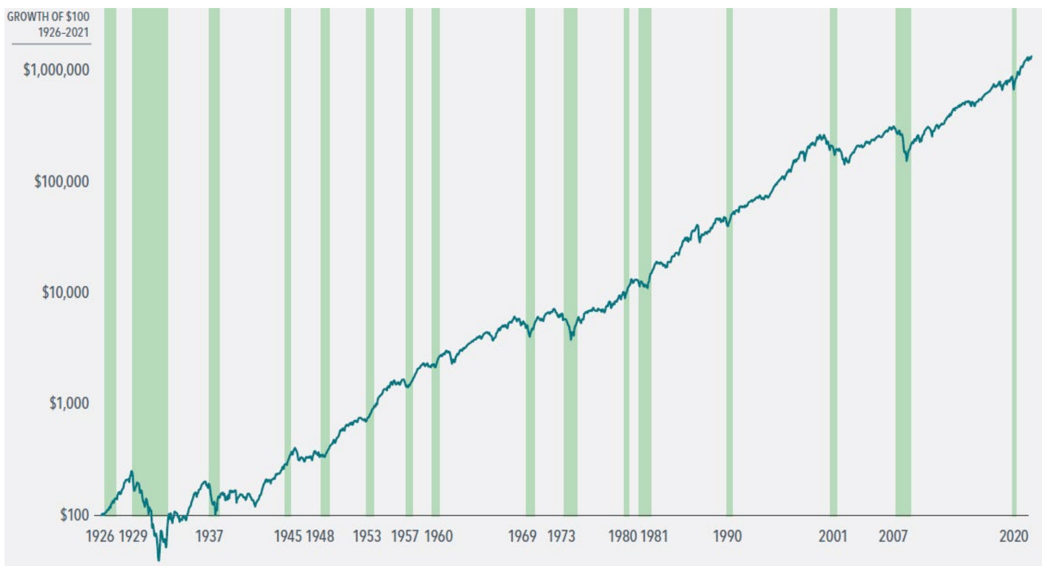
The Federal Reserve vs The Market

Which Came First, the Chicken or The Egg?

The question of which came first, the chicken or the egg, may never be solved. However, we do know that one produces the other in a perpetuating sense. In a similar manner, the Federal Reserve and the capital markets respond to each other in a perpetuating sense. In the case of the U.S. economy, the central bank, as we know it, was formed on Jekyll Island in response to the panic of 1907. Then, six men gathered on the island off the coast of Georgia to plan a reform of the banking system. The Federal Reserve Bank was the result of this meeting. Ever since, the Fed has been responsible for inciting several recessions.

Market Performance through a Century of Recessions



Past performance is no guarantee of future results.
Is US dollars. Recessions are shaded in green. Stock returns represented by Fama/French Total US Market Research Index, provided by Ken French and available at mba.tuck.darthmouth.edu/pages/facuty/ken.french/data_library.html.

The chart above shows that investing over the long-term has paid off for investors. The green shaded areas are recessionary periods of the economy. In some of these periods we realized a market bottom before the recession officially began i.e., prior to 1945 and 1953. However, in most scenarios the market bottoms, then a new growth cycle starts during the recession.

Do We Need More Chickens or Eggs?

Over the years the Fed has taken the responsibility of maintaining price stability and maximizing full employement. In response to the covid-19

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Warwick Shore Advisors LLC (WSA) is an independent investment advisor focusing on investment strategies designed to outperform the market and mitigate risk over the long-term. We employ a rules-based academic approach that incorporates top-down, macroeconomic analysis and quantitative research. Our rigorous research and portfolio construction process gives us opportunistic insight into the investment landscape.

Our rules-based top-down macroeconomic approach differentiates us from traditional bottom-up investment management firms. We believe a global perspective driven on macroeconomics is needed to fully synthesize the current market environment. This approach is also paramount in forecasting the road ahead and building risk-controlled, goal-oriented portfolios.

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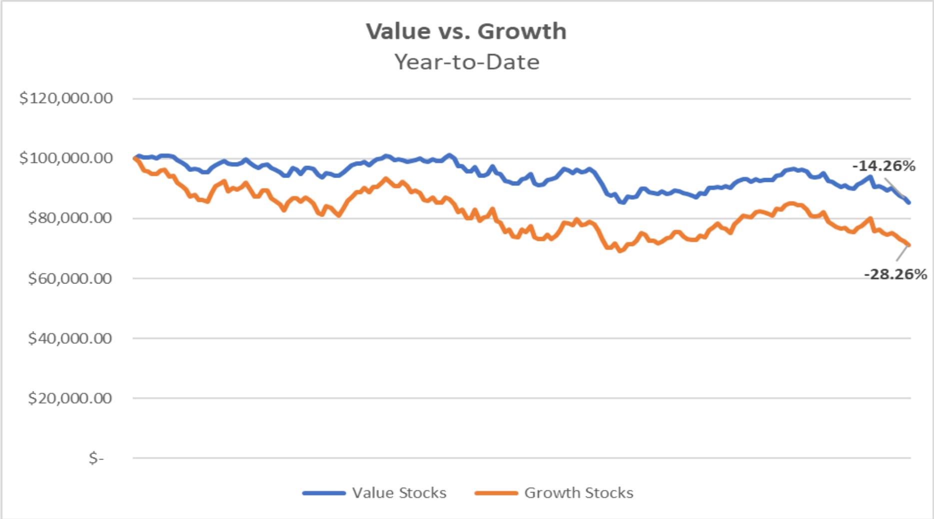
pandemic, the federal reserve provided “eggs” in the form of accomodative monetary policy which kept interest rates artificially depressed. Meanwhile, the fiscal policy stance from Washington provided “chickens” prepared for consumption in the form of stimilius checks. Both forms of policy response provided a perpetuating source of growth for our economy in response to a health-related crater. Of course, a response to the pandemic was needed however, does the economy still need eggs and chickens that will produce even more eggs and more chickens? **#Inflation!** Many economists argue that the fiscal policy stance lasted too long catapulting the economy into the inflationary stance that we have today. As a result, the Fed is carrying out the mandate that its was chartered to do, respond to financial crises.

FOMC Intervention

The federal open market committee has initiated a pathway to economic rate neutrality by raising the target funds rate. Currently, resting between 3% and 3.25%, this target funds rate will not combat inflation until it reaches ~4.6%. This is based on feedback from Fed chairman Jerome Powell. Historically, and I mean the very recent past, every textbook produced prior to 2022 recycled the theme that the neutral rate was 2%. This recent change on the part of the Fed has changed the narrative going forward and caused current textbooks in production to be invalid.

The pathway ahead, as told by the Fed, includes as least two more rate hikes of 0.75%. Chairman Powell is also forecasting a 1% increase in unemployment and a higher probability of a recession in 2023. What does all this mean for my portfolio and the investment landscape?



Source: Morningstar. Vanguard S&P 500 Growth index used as a proxy for “Growth”. Vanguard S&P 500 Value Index used as a proxy for “Value”.

Investment Implications

We've seen multiple rounds of volatility in the market since inception of the rate hiking regime. This is a normal response. As interest rates rise, investments in rate sensitive sectors face headwinds. We have seen growth (technology and cyclical stocks) underperform value (consumer staples and healthcare) year-to-date by 14% as seen in the chart above. Large cap stocks have also outperformed their small cap counterparts. Remember the original question of which came first the chicken or the egg? Well, we still do not have the answer to that question, but we do know that the Federal Reserve open market interventions will cause market fluctuations. So, is the market a result of monetary policy or is monetary policy a result of market?

In short, economically, we are strong! We are at full employment; however, spending has not slowed as expected which will continue to prompt monetary policy intervention. As this happens, we can expect more headwinds in the market. Maintaining a fully diversified portfolio that coincides your risk tolerance and your goals is imperative during times like these. As can be seen in the first chart, staying invested during market volatility leads to increased portfolio returns and the growth of wealth. Remember, the key to investing is not "timing" the market but "time in" the market. Never attempt to catch a falling knife but prepare a strategic asset allocation that will mitigate short-term risk and allow for long-term growth.

Index Descriptions

Treasury Yield Curve- Is a measure yields and maturities for current government fixed income securities. The yield curve is often used as a benchmark for lending rates. Investors inspect the shape of the yield curve for insight into the current state of the economy.

Housing Starts- Is an economic indicator that measures the amount of new housing units starting construction for a given month. These data are designed to measure living dwellings and not commercial property. The living dwellings are considered single-family units, townhomes, apartments, and apartment buildings that have less than 5 units.

Gross Domestic Product- A measure of the market value of all final goods and services produced within an economy. This is measured on an annual or quarterly basis and provides insight on the growth of an economy.

Term Structure of Interest Rates – A measure of the relationship between interest rates of different term or maturities along the yield curve. A normal yield curve is upward sloping with short-term rates (1-month, 3-month, 2-year) providing a lower yield than long-term rates (7-year, 10-year, 20-year)

Growth Investments – New or less mature companies in which the trajectory for increase is above-average rate of return. These investments typically do not pay a dividend as they use excess earnings to reinvest in the company.

Value Investments – Investments that trade below their intrinsic value. These securities typically pay a larger dividend and are companies that are less affected by volatility in the market

Disclosures