April 10, 2019

THE FED PAUSES

Dear Investor:

The huge change in policy by the Fed has totally dominated the latest quarter. It's interesting how fast things can change. If you just consider my recent letters, last fall we talked about the "Economy Booming", in December it was a "Wild Ride", and now we are talking about "The Fed Pauses". That gives you a bird's eye view of what's going on. Things have slowed down. The question on everyone's mind is how much?

As you may remember, last December, the Fed hiked rates for the ninth time since the bottom of the Great Recession. At that time, they were projecting two more hikes in 2019 and one more hike in 2020. They also stated that the reduction of their balance sheet, commonly called quantitative tightening (QT), would basically keep running in the background on auto pilot. This led to the huge sell off that bottomed out on Christmas Eve. As soon as the holidays were over, a very different message started to come out of the Fed. Chair Powell began to respond to the tremendous angst in the market over rates, and also, many were expressing serious concerns over the balance sheet reduction, fearing that it was adding too much additional tightening to the economy. He started to emphasize the word patience, and also stated that they would be willing to adjust the balance sheet runoff if it was determined to be a problem.

At the end of the January FOMC meeting, Chair Powell moved forward with the new direction. He backed off "further gradual increases", stating that the case for higher rates had weakened and patience was the order of the day. This is very significant as the outlook has been for gradually increasing rates since the process began in December 2015 under Janet Yellen. He also made it official that the quantitative tightening (QT) program was under review. The balance sheet reduction had been carefully planned several years ago, and honestly, no one at the Fed viewed it as an issue, so this was another major concession.

The reasons commonly given for this change in direction are a slowing world economy, softness in inflation, and a decrease in both consumer confidence and business sentiment. China and Europe have both slowed down which is a substantial headwind. The softness in inflation primarily came from lower energy prices, which have just picked up again. It's my opinion that the government shutdown played a large role in the deterioration of confidence. The negative effects went far beyond the people who were actually out of work for a time. I think it was a big mistake, and the data shows there was also a monetary loss to the economy as a whole. We are just getting it fully behind us and out of people's minds. On top of that, winter seemed to be nasty everywhere.

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com

You could hardly watch the evening news without seeing storms and massive vehicle pileups on the highways. Doesn't exactly make you feel like going out and spending money. It's also very likely that the maximum effects of the tax cuts are behind us. These issues have all contributed to the sense that things have indeed slowed down.

The final step in the "Pause" came out of the March FOMC meeting. They went "all in" at that point and indicated they expect no more rate hikes this year and that they would remain patient. They also announced that the bond roll off program (QT) would likely conclude at the end of September, much sooner than most of us were expecting. These two announcements completed a very dramatic change of direction. Obviously, the Fed does believe things have slowed and they cannot remain on their previously announced path.

So, what is the outlook going forward from here? The first thing you see is that the market had a very good first quarter, being up over 13%. This is almost entirely due to the actions taken by the Fed. The market is now convinced the Fed is not going to drive us into a recession, in the near future at least, with tight monetary policy. This has brought us very close to the old highs from last September, but we are not there yet. Estimates of 2019 GDP growth are in the range of 2.1% to 2.3% for the year. The labor market is still very strong, with layoffs and unemployment near a fifty-year low. Although job openings have dropped from their recent high, they are still over 7 million, which is a big number. The rise in housing prices has been slowing down noticeably. Along with lower mortgage rates, this is leading to some increases in sales and large increases in refinance activity. According to the University of Michigan survey, consumer sentiment is rising again. Retail sales, consumer credit, personal income, and consumer savings rates are all doing alright. Inflation is modest, and some measures are a bit below Fed targets. If you put it all together, there's no compelling reason right now to think 2019 will not be a decent year.

We see new calls out there by the administration to lower interest rates and even restart quantitative easing. There have also been some new names put forward for possible positions at the Fed. This has naturally led to discussions of Fed independence, which is a very important part of our current system. If the Fed is seen as becoming a partisan organization, there will be a distinct loss of their credibility. I'm totally against the idea of restarting quantitative easing (QE). A recent CNBC survey showed that virtually no one in the financial community was in favor of restarting QE, and only a very small percentage were supportive of cutting rates at this time. The economy may not be running hot, but most of the stats look pretty good. To conclude, we have seen a dramatic change in Fed policy in just three months. I don't know of anyone who predicted it, although eventually someone will claim they did. We think the outlook is good right now, but no one knows where we will be a year from now. Long term, people have made money by owning successful companies and keeping their portfolios in line with a level of risk they can manage. I believe if we continue to do that, things will work out well.

Please contact me anytime to discuss your portfolio.

Best Regards,

David E. Keim

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com