viewpoint

MARSHALL & SULLIVAN

Marshall & Sullivan, Inc. / Registered Investment Advisor

Fall 2016 newsletter

Normalization

Despite a wall of worry for many investors, the US stock market has expanded steadily for nearly eight years. For sure, investors have had plenty to be concerned about, but the economy has remained strong and market participation has been well-rewarded. The next hurdle for investors to absorb is the Federal Reserve's return of both the Federal Funds rate and the debt on its balance sheet to more normal levels.

Recall that as the 2008-2009 economic crisis unfolded, a number of financial firms took massive losses on mortgage bonds, leveraged loans and other assets. In response, the Federal Reserve aggressively implemented programs intended to reduce market volatility and support the resulting liquidity issues.

The Federal Reserve's primary tactics involved the standard two-prong approach: reduce the Federal Funds rate to encourage lower short-term interest rates; and, expand open-market bond purchases to help keep long-term rates in check. While these programs did address the immediate concerns, it also resulted in significant changes to the Federal Reserve's balance sheet.

When the crisis began, the Federal Funds rate was at 5.25%. Over the following 16 months, the Federal Reserve lowered the Federal Funds rate all of the way to 0% where it remained until December 2015. Since then, The Federal Reserve has slowly raised the rate to 1.125% and is likely to continue raising the rate as long as the economy and unemployment remain healthy. We wrote about this in our 2016 newsletter.

After reducing short-term rates to zero, the Federal Reserve also began a program of purchasing government bonds and mortgage-backed securities in the open-market. Purchasing this debt achieved two important objectives for the Federal Reserve: first, it helped keep longer-term interest rates low; and, second, it added significant liquidity to the domestic money supply, thereby encouraging foreign trade and investment.

At the onset of the 2008 crisis, the Federal Reserve held about $1 trillion in debt. However, their holding swelled as they aggressively purchased bonds over the next 5 years. Today, the Federal Reserve holds over 4 times as many bonds as it did a decade ago – over $4.5 trillion in Treasury bonds and mortgage back securities.

When the Federal Reserve started buying this debt, several noted financial professionals voiced concerns about the possibility of runaway inflation resulting from all of the money being added into the economy. So far, however, their worries have been unfounded as the economy has continued to grow in a slow and steady manner with little or no visible inflation.

The Federal Reserve's open-market committee has clearly intimated that it is time to return their balance sheet to more normalized levels and have begun the process. They announced that they will not be replacing bonds in their portfolio as they mature.

To be sure, unwinding a $3 trillion bond portfolio is no small task. However, with over $1.5 trillion in treasuries maturing in less than 5 years, the Federal Reserve can easily be half-way towards their normalization goal by simply not reinvesting when treasury bonds mature. We are hopeful the Federal Reserve will accomplish the lowering of their debt level in the same methodical manner they have applied to raising the Federal Funds rate.

Believing the Federal Reserve's normalization efforts will progress slowly, we think it will not adversely affect either the stock market or the overall economy. As a result, we will continue our current asset allocation for equities. That said, we do anticipate a rise in interest rates over time so we will be maintaining our bond focus on shorter term securities so we can reinvest maturing proceeds into higher rates over time.

Greg Robinson, President
greg@msinvest.com

Davis Miracle, Vice President
davis@msinvest.com