QUARTERLY MARKET COMMENTARY

Phraseology or language can be a powerful tool in the world of economics and investments, especially when used in certain contexts and by certain people.

The legendary investor, Warren Buffett, is often quoted with his missives such as ‘be fearful when others are greedy and be greedy when others are fearful’ and evidence would suggest that many have acted upon his chosen words or perceived wisdom. Jim O’Neill, the retiring Chief Executive of Goldman Sachs Asset Management, famously coined the term ‘BRIC’, which led to significant exposure and investment by retail investors in Brazil, Russia, India and China.

The point here is that phraseology or language can not only just describe the current sentiment or feeling in the world by investors but sometimes can help shape the future direction of that world. Tone or language is often identified by traders as the single most important factor they look for when assessing the minutes of central bank meetings to gauge the path of future monetary and economic policy in a country.

Perhaps one of the most famous examples of this was made on 26th July 2012 when Mario Draghi, President of the European Central Bank ‘ECB’, gave a speech in London. At the time, the euro-zone was in the throes of crisis, with monetary bailouts of debt laden members pushing the currency union to the verge of collapse. But with a simple, seemingly off the cuff phrase, Draghi fundamentally changed the course of events.

“Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough”

Traders reacted immediately to Draghi’s forthright resolve, and a week after his speech, the ECB announced a programme to buy the bonds of its distressed countries, known as the ‘Outright Monetary Transactions’. Interestingly, the ECB never ended up using this programme but the promise alone was enough to calm investors and bring down bond yields (or borrowing rates) across the European region. Perhaps one of the most influential examples of the power of words!

However, why is any of this relevant in today’s world I hear you ask?

Well, it has become clear in the last few weeks that the tone or language has considerably shifted in direction from perhaps the most powerful man in the world. I am not talking about Donald Trump but instead Jerome Powell, the US Federal Reserve Chairman.

In this update, we consider the directional shift in language, the possible path of economic policy in the US and the impact this could have.

Jerome Powell was elected the 16th chairperson of the US Federal Reserve and took up his position in February last year. His appointment followed the outgoing Janet Yellen, who had steered the US economy seemingly well over her tenure, which included the final stages of central bank support in the form of US Quantitative Easing. At the point of Yellen’s departure, the US economy was in a strong position. US economic growth, as measured by their Gross Domestic Product or ‘GDP’ numbers was one of the highest in the developed world, the unemployment rate was at a multi decade low, the US housing market was buoyant and corporate earnings were exceeding analysts’ expectations. As a result, the US $ was strong and the US stockmarket, as illustrated by the US S&P 500, had been one of the best performers over the last 10 years.

Jerome Powell had taken over at a time of strong US economic and investment growth. However, many believed his remit was perhaps one of the hardest roles to play in central bank governing in that he was now responsible for steering the US economy during a period when central bank support needed to be reversed and rising US interest rates would be required. The economic data was simply too strong to ignore.

At first, Jerome Powell was steadfast in his belief that US economic reform and growth was sufficient for money supply to be extracted from the system, in the form of Quantitative Tightening 'QT' and a 'normal' trajectory of US interest rate rises would be delivered. As recent as only December last year, the US Federal Reserve increased interest rates in the US by 0.25% and the future spot price, which measures the number and frequency of US interest rate rises, was suggesting that 3 rate rises would be seen in 2019.

However, investors had already issued their view and concerns to a return of tightening monetary policy. The S&P 500 index lost over 10% between October and December last year, despite no clear economic issues surfacing over this period. Many commentators respected Jerome Powell for his firm beliefs in the action he felt he needed to take. Others were less enthusiastic, including Donald Trump, who publicly lambasted his US Federal Reserve chairperson, following the rate rise in December.

Then, in February, the language changed. Jerome Powell stated in the last US Federal Reserve meeting that the board would look to end QT later this year and they were open to keeping monetary policy fluid. Why does this matter? Because markets have spent the last ten years gradually getting used to the idea that whatever happens, the US Federal Reserve will put investors first. Jerome Powell's recent speech reinforced this. As a result, the 'Powell Put' was born as reference to the 'Greenspan Put', when Alan Greenspan was US Federal Reserve chairperson and was known to put economic policy second to Wall Street performance first. As a result of this speech, markets have been stronger on the belief that the economic landscape will be more supportive for risk assets.

This may well be the case. However, the growing concern among certain investors is that the longer economic policy remains accommodating, the more issues could be seen in the future when 'normal' economic policy resumes. Specifically, we are talking about ***inflation.***

Since 2008, the US Federal Reserve has created or printed more than US $2 trillion, which means that its balance sheet has increased to over US $3 trillion in just 10 years. The amount or extent of this additional money supply in the economy should normally result in a rise in inflation, which arguably most central banks want or wish to target, as this helps to offset the significant amount of personal debt in the system. However, the control of future inflation is virtually impossible, given the lagged effect from monetary policy but there is a growing concern that inflation levels may rise significantly if monetary policy is not tightened relatively soon. This could have wide and far reaching implications, certainly for future US interest rate rises, but at the moment, inflation is not a threat. Indeed, the US Federal Reserve is currently looking at making another policy adjustment in terms of adopting a 'price-level targeting' policy for inflation but this is for debate another time.

As always, it is impossible to predict the future - especially whether stocks and shares will fall or rise. Therefore, it is important that medium to long term investors maintain a diversified portfolio to benefit from stockmarket rises when they happen and to dilute volatility when there is a fall. Our strong belief is that a sensible investment strategy involves riding out stockmarket volatility.

March 2019