Cornerstone Report

Special Report | **October 1, 2019** | **By: Jerry E. Tuma, MS, CFP®**

Topics:

- The Federal Reserve and interest rates
- Liquidity in the system
- Yield curve and other economic indicators

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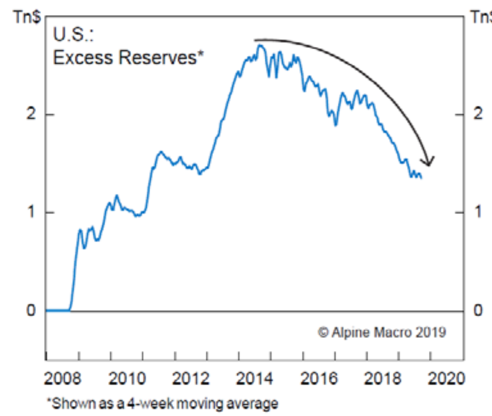
Don't Fight The Fed

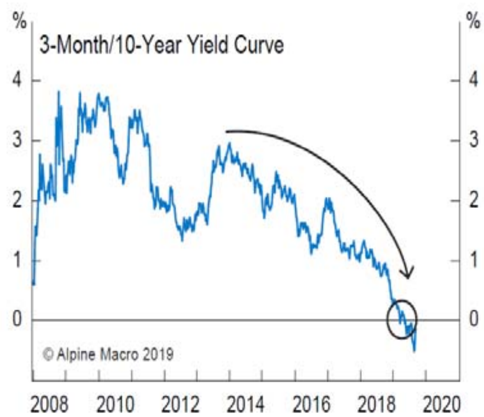
To quote late investment luminary Marty Zweig, when investing in the stock market, it is vitally important that we ***"Don't Fight the Fed."*** The Federal Reserve has (finally) acknowledged that they need to lower interest rates in the attempt to offset global economic weakness and threats to the U.S. economy from the ongoing trade war with China. However, from everything I'm seeing, the Federal Reserve is behind the curve, ***perhaps way behind the curve***, thus it is possible that their rate cuts may end up being too little, too late.



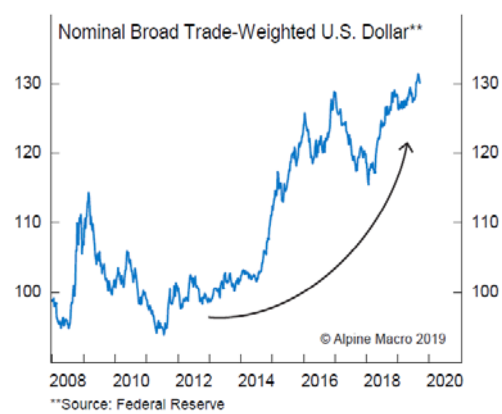
To the right you see a chart showing the liquidity drained by the Fed's recent actions. All last year, both on radio shows and seminars, I hammered the fact that**,** at the end of the day, ***liquidity trumps economic momentum*****,** and this is now showing up in the system.

In a recent report **Alpine Macro** *(September 2019)* stated:

> *The Fed is much too sanguine. A broad range of indicators are warning that policy is too restrictive. With typical lag times, this will result in weaker growth.*
>
> *Start with this week's spike in overnight lending rates. This is widely attributed to technical factors such as corporate tax payments and the settlement of Treasury auctions. But this misses the forest for the trees. The fundamental reason for the liquidity crunch is the Fed's tight policy stance. The Fed has drained too much reserves from the banking system.*



(Ed. Note: Over the past several weeks The Fed has injected some $100 billion into the banking system to stabilize things, proof positive that they have excessively tightened. In some ways this is eerily similar to the liquidity crunch which started in 2007, just before the Crash in 2008. *Source: WSJ 2019*).



For several years the Fed has been removing liquidity from the system, which, in turn, ultimately caused short-term interest rates to rise too high when compared with longer-term rates, spawning the vaunted *inverted yield curve*.

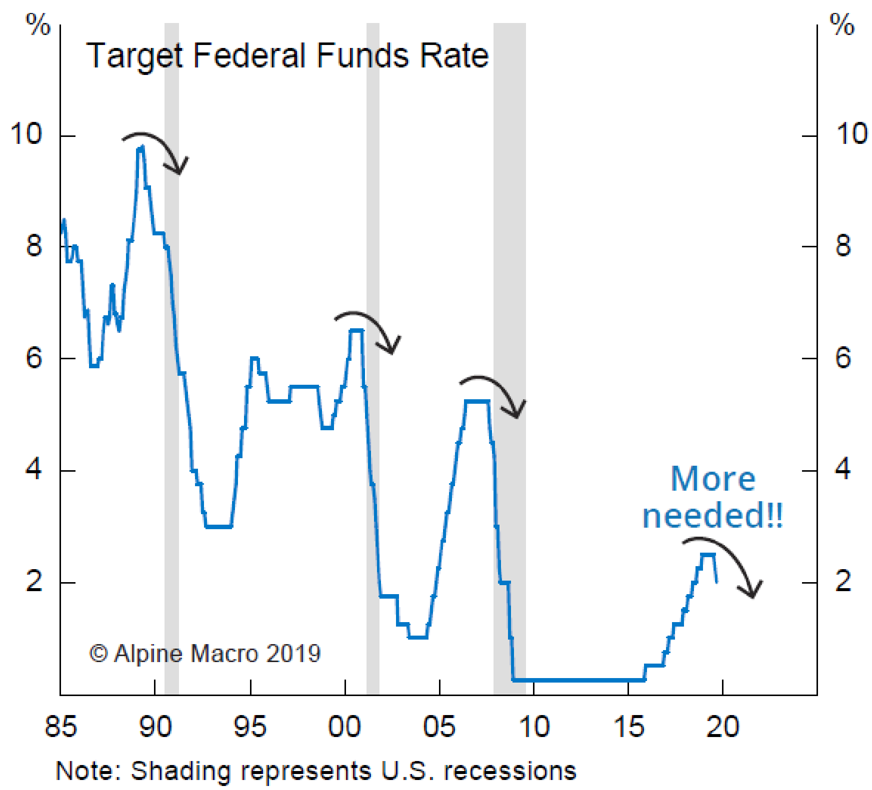
On the previous page you can see the significant depletion of excess reserves in the banking system over the previous several years. While some of this is due to technical factors, a lot of it is due to the Federal Reserve taking liquidity out of the system after the Global Financial Crisis. The Fed "printed" (electronically) some $4.5 trillion or so in the attempt to re-liquefy the financial and banking systems after the Crash, in order to prevent a repeat of the 1930's Great Depression deflationary spiral.

Much of this $4.5 trillion found its way into the banking system, showing up as excess reserves, as banks kept more in reserve for their lending than previously required by law, producing excess liquidity in the system.

But as you can see when you compare the charts, as the Fed began bleeding money out of the system in what is known as Quantitative Tightening, it began to greatly reduce liquidity, likely contributing to a rise in the dollar, plus at least partially causing the inverted yield curve as shown.

According to ***Bank Credit Analyst***, seven out of the last eight recessions were preceded by an inverted yield curve. When short-term rates rise above long-term rates, it reflects a lack of liquidity in the system. The Fed has inadvertently "kinked the liquidity hose" so to speak, which over time results in reduced lending activity, which, in turn, slows the economy.

This reduced liquidity also shows up in a stronger U.S. dollar (as shown on previous page) versus other currencies, such as the Euro or China's yuan. A stronger dollar makes it more difficult for U.S. multinational corporations to make profits both in the U.S. and overseas due to foreign competition.



Plus a stronger dollar slows economic demand in ***emerging*** economies like China and India, since oil and other products are typically priced in U.S. dollars. So for example, when the dollar rises in value, the price of gasoline in emerging market economies rises as well, thus reducing their demand for oil, ie: less driving.

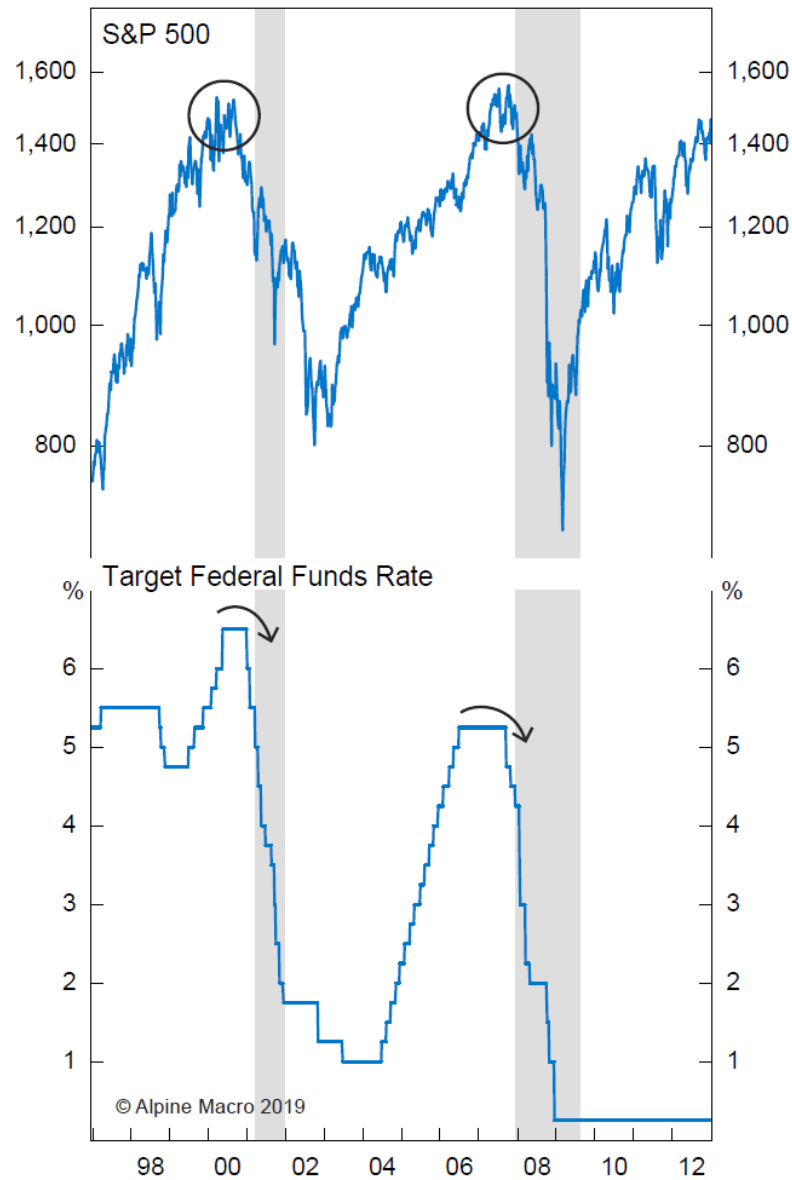
As you can see from the chart, the Federal Reserve historically has raised interest rates too high just prior to almost every recession. According to InvesTech, interest rate tightening cycles have occurred 11 times since 1955, resulting in 9 recessions with only 2 "soft landings."

By the way, the Fed missing it is nothing new. Every economic downturn that we have seen since 1960 was preceded by rising interest rates. Raising short-term interest rates too high and/or tightening the money supply too much has historically always precipitated economic slowdowns and recessions.

The charts you see to the right show the Fed's policy just prior to the 2000 and 2007 bear markets for stocks. As you can see, after raising interest rates too high, the Fed then cut rates 13 times starting in 2001 and 10 times starting in 2007, yet failed to prevent both of the 50%+/- "Daddy" bear markets in both cases (see CFS special report ***Goldilocks and the Three Bears,*** www.cornerstonereport.com, February 2019).

So the fact that the current stock market is just a few percent below the all-time highs should in no way shape or form breed complacency at this point in the cycle.

While it is too early to predict a U.S. and global recession, and/or a major bear market for stocks, from my perspective the Federal Reserve is on thin ice. The trade wars are unlikely to be successfully resolved near term despite seemingly positive talks. The trade war has taken a huge bite out of world economic growth this year, plus oil prices may be poised to move back up, which is also a true threat to the economic recovery should things continue to get hotter in the Middle East between Iran and Saudi Arabia.



Note: Shading represents U.S. recessions

The Fed and investors should not take too much comfort in that the stock market is still holding near the highs. While equities lead the economy, the lead is not long enough for policymakers to prevent recessions. The S&P 500 was a mere 1.5% below its record high in September 2000 before the recession started in March 2001. In the following cycle, the S&P 500 made an all-time high in October 2007, just ahead of the recession that began in January 2008. *Alpine Macro (September 2019)*

With stocks near record highs plus the largest percentage of margin debt compared to GDP in history, my view is that risk is extremely high and potential reward minimal for the next six-nine months or so. *(Source: Inves-Tech August 2019)*

Margin debt creates built in selling pressure during bear markets as falling stock prices cause accelerated losses when investing with borrowed money. This in turn tends to produce extreme drops both in terms of the magnitude of the drop percentage wise, plus the speed of the decline, as most recently witnessed in 2008-2009.

I am not predicting a repeat of 2008-2009 as the ***Global Financial Crisis*** appeared to have many "once in a lifetime" qualities to it, such as an historic real estate bubble, horrific lending standards and bad judgement by the rating agencies. Yet just because we are not likely to see a repeat of 2008-2009 does not mean that risk is not presently very high.

Every business cycle tends to pass through windows of danger when the risk of recession grows very high. This cycle is no different and it appears that we are in that window of danger right now.

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