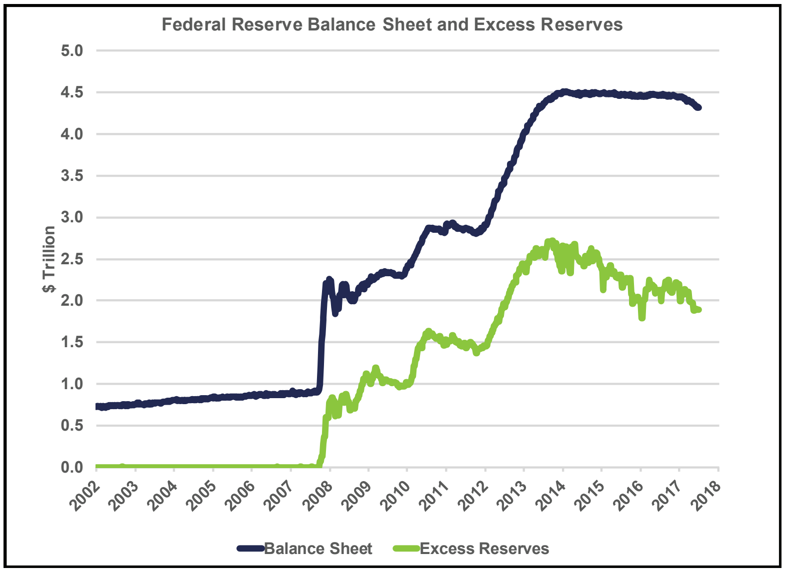
Disappearing Dollars

Well reported for over a year, the Federal Reserve plan to "normalize" or reduce its balance sheet has been under way since last October. As a refresher, the central bank's balance sheet currently stands at $4.3 Trillion - down from $4.5 Trillion last fall. Recall also that the balance sheet was about $850 Billion in 2007. As the Fed grew its balance sheet, it purchased Treasury bonds or mortgage securities in the open market. These became assets on the books and a corresponding liability was created in the form of a bank deposit with the Fed (money owed to the selling bank). The creation of the liability is the point that many refer to as the "printing of money". It was simply a computer entry to credit the proceeds of the bond purchase to the seller's bank account. The bond-buying-balance-sheet expansion created so many deposits that commercial banks were flush with more than $2.8 Trillion of cash in excess of the minimum required by regulations to support a stable banking system. Because the Fed was concerned this safety blanket might filter into the economy they paid interest to the banks on the excess reserves, thus incentivizing the banks to leave it on deposit at the Fed. Think of it as a huge cushion of safety for the banking system that was largely not employed in traditional lending until the last couple of years. Since 2015, excess reserves have declined by $900 Billion while the Fed's balance sheet is only $200 Billion slimmer. Now that the economy appears to be on solid footing and some $700 Billion of excess reserves have left the Fed's corral, the Fed feels it appropriate to reduce the size of the cushion. Should the remaining $1.9 Trillion of excess reserves be lured away by profitable incentives in traditional lending markets, inflation could easily accelerate ahead of Fed targets.

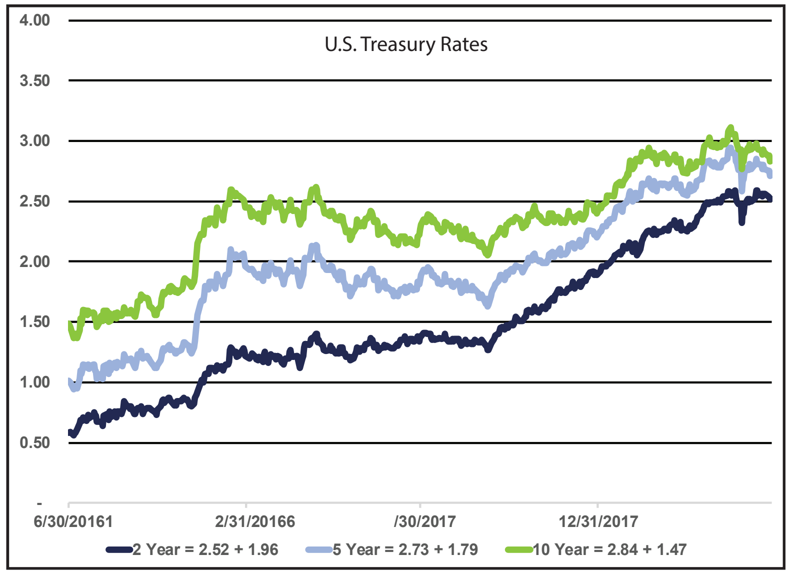


The process of balance sheet normalization reduces the bonds held by the Fed and deletes the dollar balances that had been created during the expansion phase. Dollars are disappearing.

The process has been well reported but is dwarfed by the debate regarding the impact of normalization. In reality, nobody knows what the true impact will be. Not even the Federal Reserve knows what the final size of the balance sheet will be when this process is completed. Any prognostication is pure speculation. The only thing we know for sure is that the Fed is selling $30 Billion of bonds each month and $30 Billion dollars are disappearing each month. According to the planned schedule this amount will reach $50 Billion per month in the fall. Supply and demand in the bond market has and will be affected on the margin.

Interest Rates

As noted above, the supply of bonds is increasing from the Fed balance sheet changes. As we noted a couple of months ago, federal budget deficit financing is also providing significant supply. Both have been factors in pushing 10 year rates to 2.85% over the last 18 months. Demand is likely to continue from other parts of the world as we have the highest rates among developed countries. Which force will win over the near term is difficult to predict. Short-term rates appear to be on schedule to increase to the 2.5% level over the next 9 months. And, given inflation of 2% it is very reasonable to expect a 4% yield on 10 year Treasury bonds. With continued risk of higher rates (and lower bond prices) we are maintaining short-term maturities in our bond portfolios. This scenario could be upset with a negative surprise. A default on dollar denominated debt by an emerging economy, further deterioration of European banks or an orchestrated devaluation of the Chinese Yuan have the potential to offer such a "surprise". However, it is not prudent to 'bet' on surprises.



Credit quality is a growing issue as well. Credit spreads (the amount of interest gained from owning low quality bonds) are historically low. And with interest rates rising, marginal borrowers will face increasing difficulty refinancing maturing debts. High quality corporate and government bonds offer better risk-adjusted returns.

The Economy

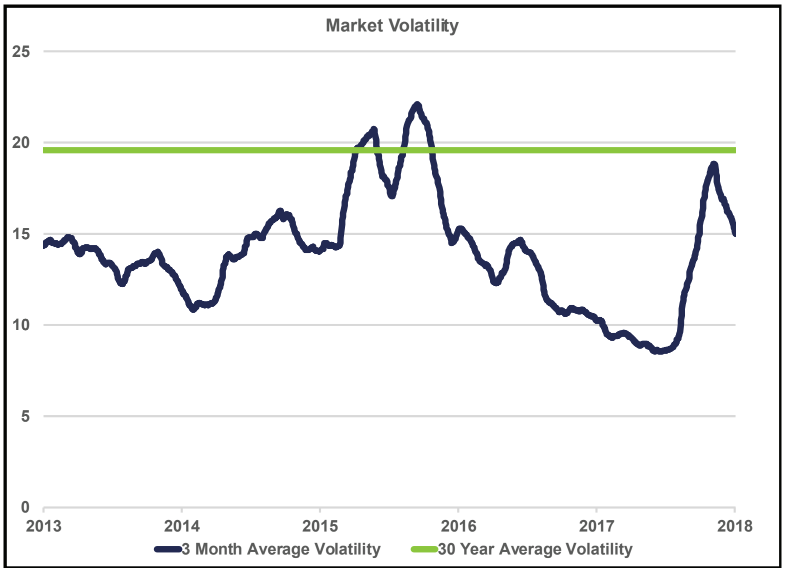
The final report for real first quarter GDP was just released with a disappointing 2.0% number (inflation was 2.7%). Second quarter GDP is projected by some models to be as high as 3.8%. The markets would likely celebrate anything between 3.5 and 4.0%, but anything below 3.0% would clearly be a disappointment.

Tariffs

The potential of a trade war is topping search lists and clearly dominating headlines, and we would be remiss to not address the topic. It is impossible to predict how we arrive at the end status, let alone the road we take to arrive there. For now, let's forget who paid what in the past and who will pay what in the future, and forget about the motivation for tariffs. What we do know for sure is China and the United States have the two largest export economies in the world, and each is the other's largest trading partner. Generally speaking, much of what the United States exports are raw materials like wood, metals, and agricultural products; whereas the largest imports are finished goods like electronics, furniture, and shoes. Simply put, any new tariffs will raise prices for consumers in both countries and reduce economic output in the short run. The total affect on the U.S. economy would be difficult to predict, but trade between the two countries is over $600 billion per year. Higher domestic prices and fewer exports would tilt the economy towards stagflation…slower growth and higher inflation.

The Stock Market

The stock market has stabilized after the February decline, yet broad indices of U.S. equities have not exceeded their January highs. However, indices of small company stocks did reach new highs in the second quarter. Small company leadership may be an indication that tariffs and reduced global trade will be an issue. Small companies tend to have a much larger portion of their sales and earnings derived domestically and are less susceptible to disruption from changing tariffs. Small companies also tend to have more pricing power and can more easily adjust revenues in an inflationary environment.



Stock prices in general continue to be relatively expensive compared to earnings, although less so as the benefit of corporate tax reductions filter into net earnings numbers. The S&P 500 is valued at a level that is higher than 66% of our historical observations. This is down from the pre-tax-cut reading of 82%. The bout of increased average volatility (as measured by the VIX® index) the market has experienced beginning in late January is likely to continue. However, three-month volatility is still below the long term average of 19.

Current stock values are supported by the prospect for improving economic growth, continued earnings growth and the low absolute level of interest rates. Challenges to valuations include accelerating inflation, changing tariff policies, and the Fed's monetary tightening plans. The last ten years of monetary ease and rising stock market valuations are behind us. Looking ahead, the market will need to adjust to gradually normalizing interest rates. We expect higher volatility during the transition.

Thank you for your confidence in our firm as we continue to apply our disciplines to the markets, looking for opportunities to add value.

Your AAMA Team