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Registered Investment Advisor

FCM Weekly Market Notes

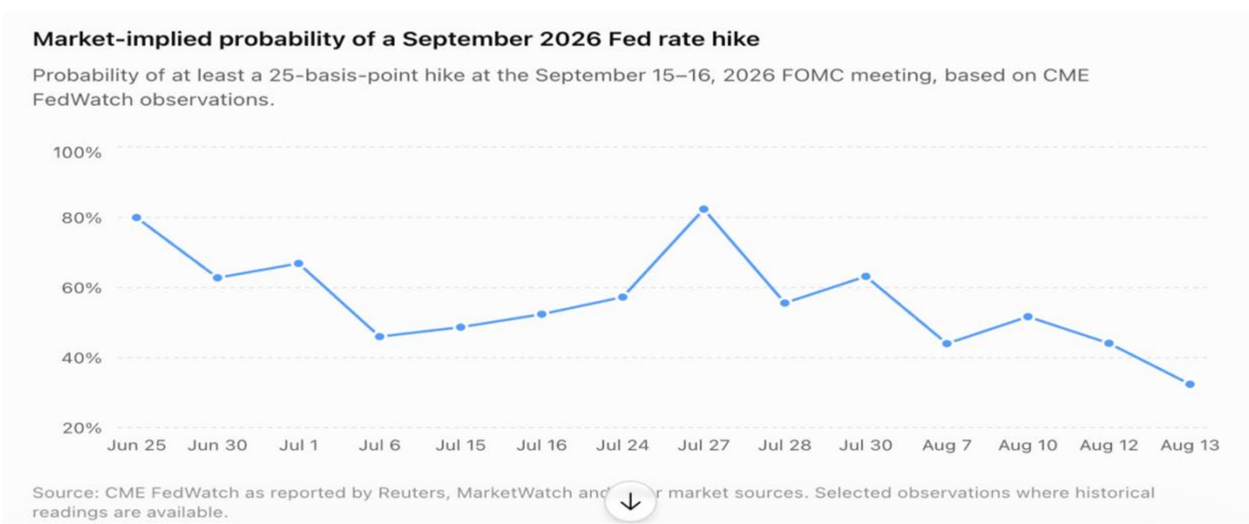
Always Choose Liquidity

Here is an investment quiz:

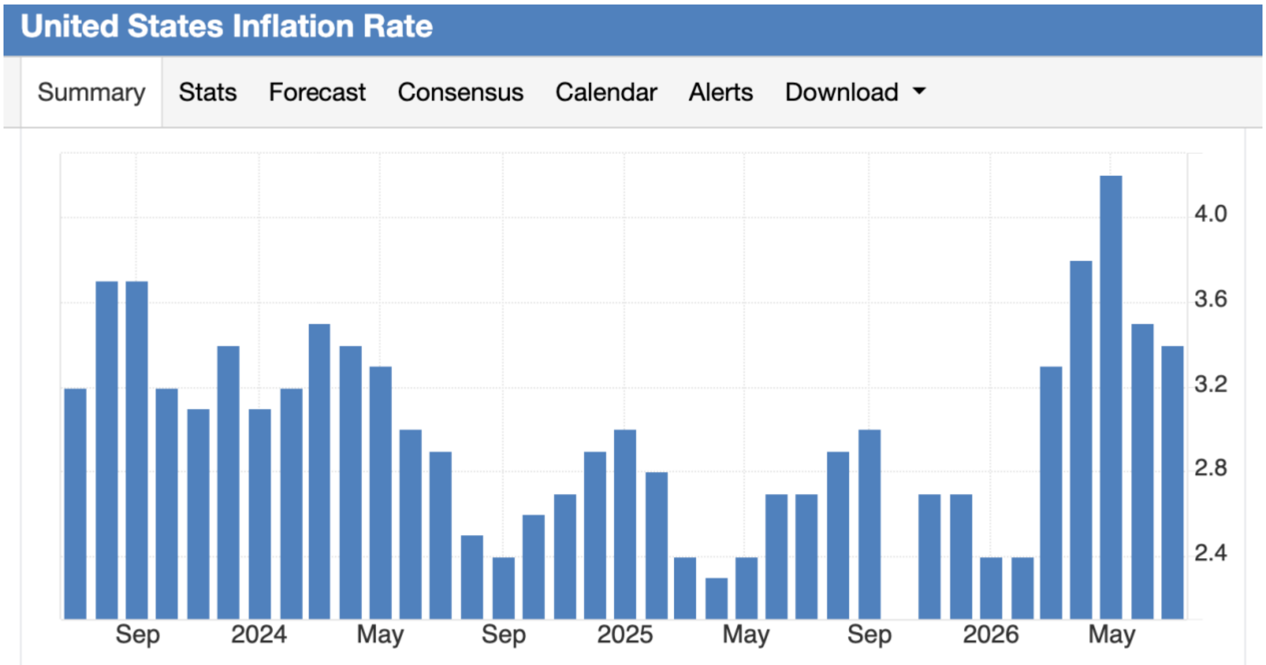
When growth is slowing, but inflation is persistently above target, what SHOULD the Fed focus on?

Trick question—it doesn't matter what the Fed <u>should</u> focus on, for investors it matters what the market thinks the Fed WILL focus on. And the answer to that is the Fed will choose to interpret lower growth as a reason to address the inflation part of their mandate—later.

Here is what has happened to market implied odds for a rate hike in the September meeting as softer economic data has rolled in:

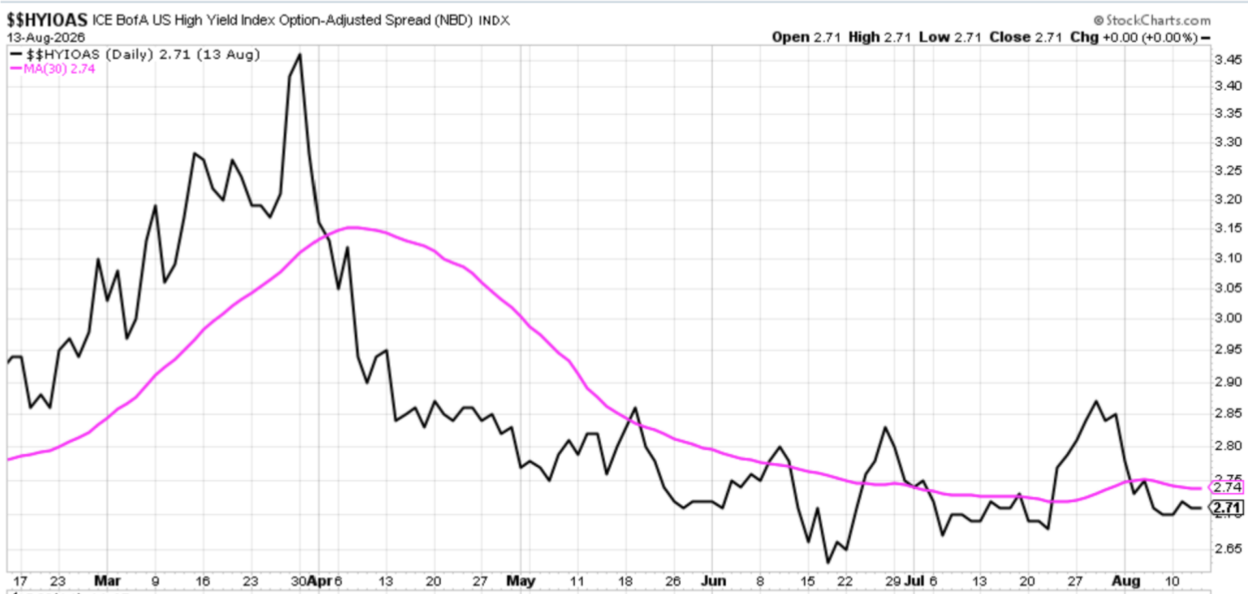


The market understands that the Fed will always choose liquidity. And five straight months of headline inflation over 3% is an issue for later.



Investment Implications

The market's perception of lower odds for any type of restrictive policy loosens already loose financial conditions. High yield bond spreads have retreated near historical lows:



And the dollar has softened further, another expansionary factor.

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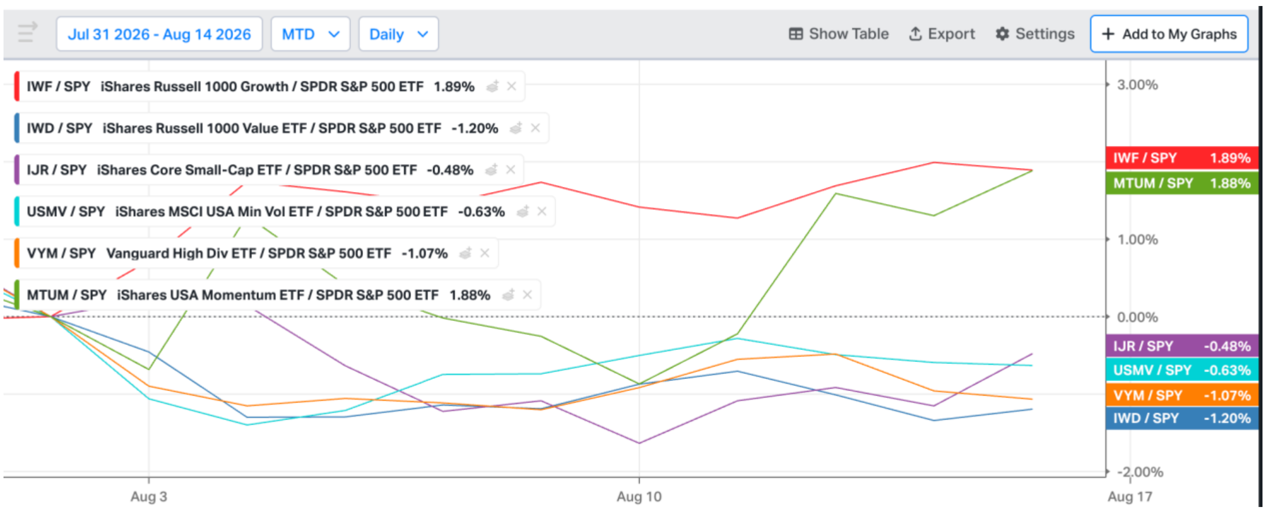
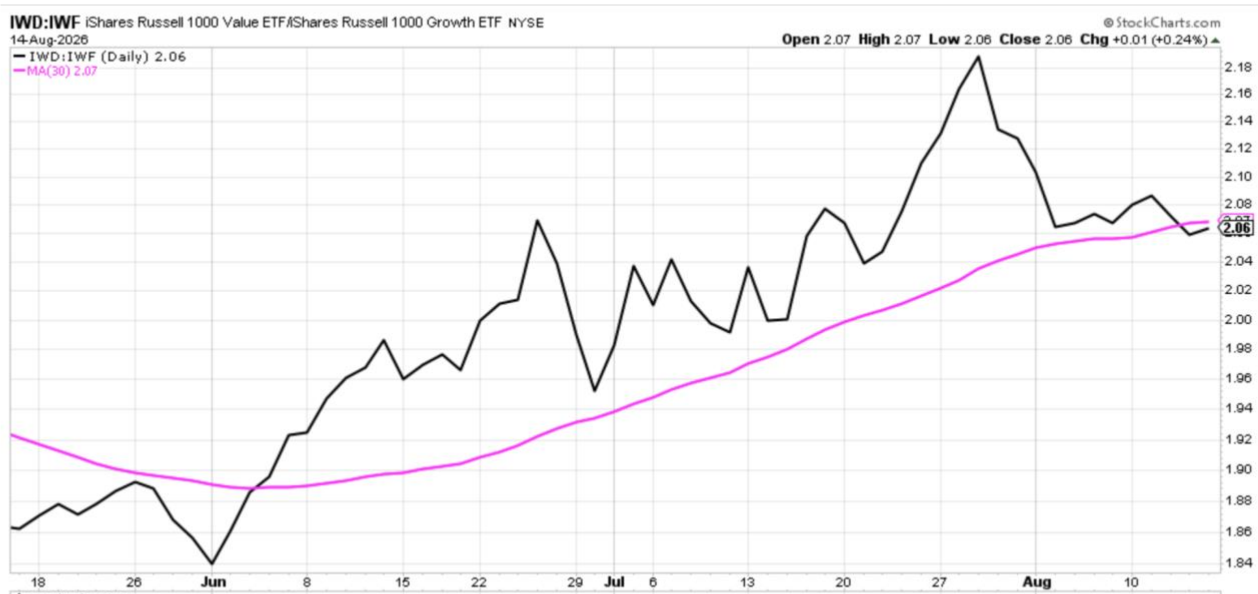
And it at least contributed to a change in the composition of equity returns. We flipped from AI-bubble worries in June and July to "growth stocks are all right" so far in August. Growth and momentum stocks led the market since April, faltered in July, but are back on top in August.



Value stocks steadily outperformed growth beginning in June, but they have under-performed this month. Clearly, investors are more comfortable with risk as they perceive the Fed reluctant to take away the punchbowl in a softening growth environment.



What might put a damper on a market re-asserting an already robust risk appetite? Fed chair Warsh, of course could do so with what now would be a surprise rate hike in September. It's quite possible however that Warsh could continue to argue rising bond yields will do the Fed's job for it:

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While it's true that rates have risen and they will act as a headwind to growth, it is far less clear that such a headwind will by itself bring inflation lower. And so far, it is quite clear that higher yields will not dampen risk appetite.

An event that pops the AI bubble is always a candidate, but funding for the endless AI spending needed to fill a perceived endless need is clearly flush. The Iran conflict seems destined to run in the background unless oil prices truly spike.

Forecasting what might happen to derail risk appetite as markets rise is an impossible task as is timing when that might happen. We monitor objective price measures to decide when to lower portfolio risk. This helps not only to limit downside, but also to stay invested. For all investors risk is a two-sided coin: the risk of loss, which is what pundits and the media (and we) obsess over, but there is the equally valid risk of missing out when the market offers abundant returns over your investing lifetime.

And right now is one of those times.

When the market reinforces a belief that the Fed will always choose liquidity, asset prices respond accordingly.

James Barrineau, Chief Investment Officer

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