October 3, 2018

Dear Clients and Friends:

I rather like the new chair of the Federal Reserve. He is not an economist and, therefore, does not suffer from the pretense that he is a scientist - or that economics is a science as one would traditionally understand that term. This was not the case with most of his predecessors. The notorious maestro, Alan Greenspan, being the most egregious example of these practitioners of the dismal science, actively fostered a cult of personality centered on his unique ability to see the future and massage economic outcomes. His powers were so robust that he did not limit himself to economic matters. He was asked to expound on things such as the future of humanity in space as well as the bleak future of a world warmed by the unchecked growth of carbon emissions. He was only too happy to oblige. His successors to the throne/chair were somewhat more restrained in their forecasts, limiting them largely to economic issues. This did not spare them from a similar outcome, that of being incorrect far too often to be useful. This brings me to the current chair, Jerome Powell. In his most recent press conference, he cast doubt on the forecasts of the Federal Reserve, positing they just weren't very good at it. We thank him for stating the obvious. But if they aren't good at economic forecasting, what good are they at all? To answer this, we must journey into the past and the reason for the creation of the Fed in the first place.

The history of our country, like the world, is filled with financial panics, including those of 1819, 1837, 1873, 1901, and 1907. All shared common characteristics - a significant increase in debt, which fueled a rise in speculation in the asset of the day, be it land, railroads, stocks, commodities, or a combination thereof. The inevitable collapse destabilized the banking system and economy. Recovery varied but usually involved significant pain, with deflation in asset prices and debt. The Federal Reserve, in its current form, was created in 1913 to stabilize the banking system and, as a result, prevent panics from occurring so often and with such severity. Did it work? Well, that depends on whom you ask and how you interpret the data.

We have continued to experience economic cycles with varying degrees of severity, as well as the occasional panic. Common in all severe downturns is the level of debt allowed to accumulate combined with lax lending standards, which foster speculation. This is where we take issue with the recent leadership of the Federal Reserve. Rather than monitoring and controlling those variables we know to be responsible for negative economic outcomes, such as levels of debt and lax lending standards, they navel gaze and opine endlessly about such things as R*, which is unknowable and likely only moderately relevant. R* is the neutral level for the Federal Funds rate, one which is neither restrictive nor accommodative for the economy. The current debate about this level is fierce among the chattering classes and the staff of the Fed but perhaps not so much with Chairman Powell. And for that, we may end up being grateful.

You see, those variables we view as highly correlated with adverse economic outcomes are looking especially worrisome and have looked that way for some time. Aggregate debt levels are at all-time highs, and lending standards are, without question, lax. Asset prices are incontrovertibly stretched, and financial conditions are getting tighter. It is likely too late to prevent the next phase of the cycle, and based upon a variety of factors, we believe it could be severe. Our hope is that perhaps under the leadership of the current chair, the Fed will begin doing its job and will stabilize the system, rather than cheerleading policies that result in the accumulation of debt, fiscal profligacy, and rampant asset price speculation.

At Reams, we are maintaining our aggressively cautious portfolio positioning. The level of real rates has risen, and while this is in no way attractive on an outright basis, it does provide a certain level of protection from the storm we foresee. Risk assets have been muddling along, and although there has been some improvement recently, we are maintaining our significant underweight. Volatility has been subdued, and the price of protection is low. Our portfolios are positioned with what we believe to be a high level of protection. We have had this position for some time and are acutely aware we have been early. We are also aware of the adage that being too early is the same as being wrong. To those, we say that we are charged with investing for a cycle, and unlike the Fed, we do not believe in our ability to forecast the short term, or any term. Rather we believe in the tenets of principled investing, and our belief in that will never be shaken.

Sincerely,

Mark M. Egan, CFA
Managing Director