CONWAY• JARVIS LLC
Investment Outlook

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Update

Is the Fed Inflating the Economy or a Market Bubble?

That's what investors are asking this week following a statement from the Fed that threw new light on how it would implement monetary policy in pursuit of its mandate. You know, the mandate that characterizes stable prices as a rate of 2% inflation? That rate, in the past, has sounded the starting gun for the Fed board of governors to beginning normalizing interest rates. In the parlance of investing, that means removing the punchbowl and calling an end to the party being thrown in the stock market.

The Fed statement, delivered by Chairman Powell, referenced the 2% inflation rate but as an *average* rather than a nominal rate. This marks a shift in policy that hints of close to zero interest rates as far as the eye can see. Targeting a 2% *average* might require seeing 2.5%-3% inflation for several years. Do the math and it might be *five years* before the gun goes off and we see the normalizing of rates begin. That gives comfort to those at the party and signals to investors that they can continue banking on the punchbowl.

So, why the shift in methodology and what does the Fed see that prompts them to tweak their mandate? Maybe it's fear of a historic recession devolving into something worse if the virus persists in altering human and government behavior. They've continuously emphasized the uncertainty surrounding the virus as it affects the economy. It prompted them to "get ahead" of the problem with unprecedented abandon in deploying all the tools available to them. The result? The quickest bear…and bull markets in history. It could be that the Fed is taking no chances that the financial markets add to the problem and that fueling the fires of inflation is far preferable to seeing confidence erode and deflationary pressures come to bear.

Currently, this economy is *recovering.* It is by no means fully *recovered*. Investors, addicted to low interest rates, have chased *selected* stocks and *selected* real estate markets higher, paying any price for *quality*. That's not surprising given the lack of investment alternatives. What is surprising is the trajectory the market has taken. We're enjoying the ride but have expected to see a period of consolidation that would afford us an opportunity to rebalance portfolios and deploy capital into companies that we see as winners in a *recovered,* post-COVID economy.

The Fed's actions this week could defer that consolidation into the future but could also inspire investors to look beyond the "Few" large-caps propelling the averages higher to more rationally valued issues that would benefit from a long-run zero interest rate environment. Next week could provide a clue to when that happens. Stay tuned!

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