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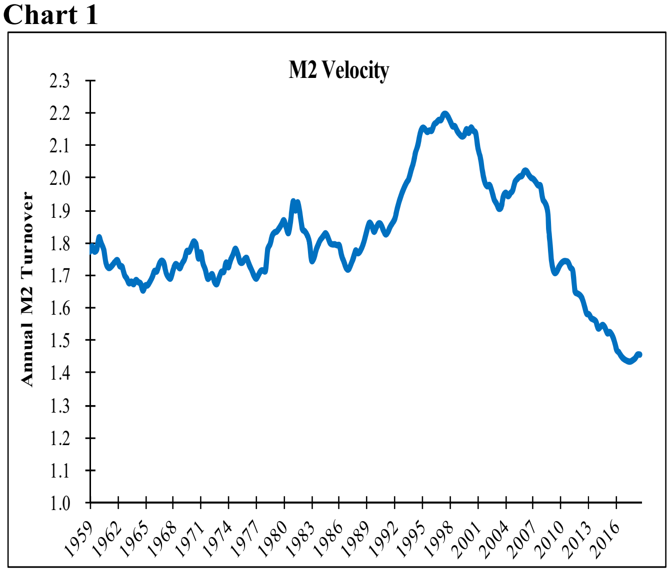
Fed Decision Disappoints: Increased Recession Risk

The Federal Reserve announced that it will increase the Fed Funds target rate another 0.25%, and signaled plans to continue to raise rates in 2019. The new target for the overnight bank lending rate is between 2.25% and 2.5%. There was some softening in the Fed's tough stance. It was reported that 11 of 17 Fed members expect rates to be increased no more than two more times in 2019. Six members thought rates would need to rise at least three times, but that is down from nine members at the last meeting in September.

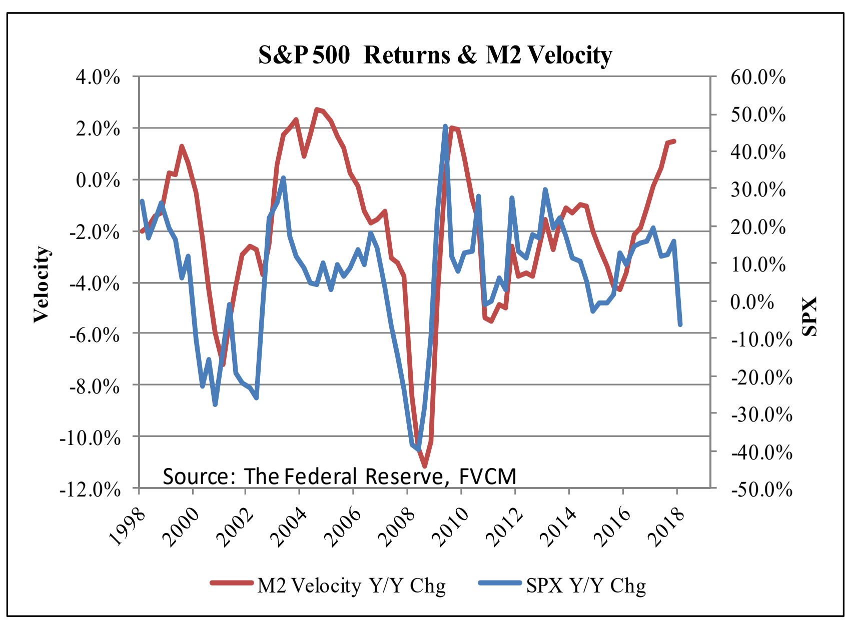
As we have written in previous reports, most business indicators do not show any signs of recession on the horizon. However, it is possible for the Fed to induce recession. This risk is now apparent. In recent decades business conditions have become much more sensitive to the level of liquidity. Since the late 1990s, the demand for cash balances has steadily risen and thus caused the turnover of money (M2 Velocity shown in Chart 1) to continuously decline. Even more interestingly, since that time 20 years ago, the year-over-year growth in M2 velocity has closely tracked the year-over-year change in the S&P 500 (correlation coefficient = 56%). Why? Because when stock prices rise people feel more secure and are willing to spend cash. When stock prices fall, people get nervous and start hoarding cash. The blue line in Chart 2 reflects the stock market as of today. If the red line (year-to-year change in velocity) follows stock prices downward in a similar path, the effect on spending would be of the magnitude of negative 4%-to-6%.

Chart 1



Source: The Federal Reserve, FVCM

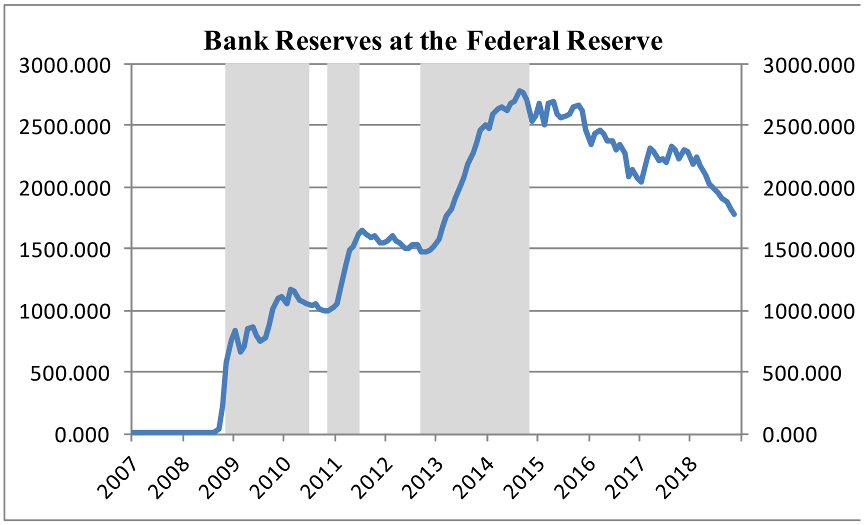
Chart 2



Source: The Federal Reserve, FVCM

In addition to raising interest rates, the Fed has been shrinking its balance sheet. Bank reserves have been contracting and money supply growth is slowing. As shown in Chart 3 below, bank reserves rose sharply during QE1,2 &3 (the shaded areas). From the end of 2014 through the end of last month, the Fed's balance sheet contracted some $374 billion. At the same time, bank reserves at the Fed have contracted $804 billion. The M2 money supply, which had been growing at a 6% clip, was up only 3.9%, year-over year, as of November. The combination of slowing growth in the money supply, along with increased hoarding of money and falling velocity, suggest that total spending could turn negative.

Chart 3



Source: Federal Reserve, FVCM

At this stage, we suggest that most investors neither add to nor reduce equity exposure. It was our hope that the Fed would weigh the evidence of slowing growth in the emerging markets, China and Europe, consider the recent decline in U.S. stock prices, and decide to temporarily postpone further monetary tightening while more data is gathered. This has not happened. The next meeting of the Fed's Open Market Committee (FOMC) is January 29-30, 2019. With stock prices already down 15% from September 2018 peak, sellers have the risk of getting whipsawed. Volatility will likely remain high during the next month, but we remain hopeful that the Fed will come to its senses and stop tightening. With the valuations of many stocks now very attractive, there could be a sharp rally on any change in Fed policy next month. Fingers crossed.