

Q&A ON THE FEDERAL RESERVE AND FUTURE RISKS



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- Trade and tariffs remain a risk, with inflation having the potential to force the Federal Reserve off its path of interest rate normalisation
- But the Fed is vigilant and its projections represent its best current thinking
- Either way, investments should be focused on long-term secular trends rather than the overall direction of the market

DO YOU THINK THE FEDERAL RESERVE IS ON THE RIGHT PATH AS IT RAISES INTEREST RATES?

It's a major debate as to whether normalising interest rates (ie, removing extraordinary policy intervention) is different from tightening interest rates (ie, raising interest rates from already normal levels). Think about it in terms of driving a car: braking to avoid a dangerous object in the road is different than simply taking your foot off the accelerator. You slow down in both cases, but one is more aggressive than the other. I think the Fed is taking its foot off the accelerator by injecting less money into the financial system, rather than braking hard.

I remain convinced that the projections the Fed gives us for interest rate increases (through its so-called dot plots) represent its best current thinking, and if things change it will slow down the rate of increases. I'm confident the Fed is vigilant, and I don't think it will raise rates just for the sake of doing it. I believe it is on the right path.

THE FED MAY BE WATCHING FOR THE YIELD CURVE TO INVERT AS A SIGN OF AN UPCOMING RECESSION. WHAT DO YOU THINK?

An inverted yield curve occurs when yields on short-term debt are higher than on long-term debt. I've read Fed reports on this topic dating back to 1996. The consensus is that six–18 months after an inverted yield curve, a recession will follow – regardless of what causes it. I have no reason to doubt that the Fed's consensus will hold true again, other than the fact that we've never had the experience of coming out of an extraordinary period of Fed policy intervention. But if you go back and review the recessions preceded by an inverted yield curve, they weren't terribly bad for the stock market because they were reasonably short-lived, the drop in the equity market was reasonably mild and the economy recovered fairly quickly thereafter. So to take dramatic action around an inverted yield curve seems unwarranted to me.

WHAT ARE THE BIGGEST RISKS RIGHT NOW?

I am concerned about trade and tariff issues. There are inflationary aspects to tariffs that could force the Fed to move off its path of interest rate normalisation, but I'm hoping it sees it as a one-off price adjustment rather than ongoing inflationary pressure. We are starting to see some slowdown of world trade activity, which will at least raise levels of uncertainty – and when you have uncertainty in the market, the amount of return investors expect for taking on risk also rises. I think investors' levels of concern on trade and tariff discussions depend on what community they live in and what industry they're associated with. If you count on soybeans to make your living, you may be feeling concerned. We know the tech industry is worried. How the automotive industry will be affected is up in the air.

There has been a lot of divergence between US and international equity market performance this year. I believe it's too early to tell the extent this divergence reflects potential winners and losers from trade conflict.

I would also be a little cautious about straight equity beta, which tracks the overall direction of equity markets. We believe investments should be focused on long-term secular trends rather than the overall direction of the market. The past decade has been pretty good for investors, and although we still expect positive future returns, they may be more modest than they've been over the past decade. We also expect higher volatility, especially given the uncertainty over the longer-term consequences of normalising interest rates and trade disputes.

HAVING RECENTLY GAINED A DEEPER UNDERSTANDING OF BLOCKCHAIN, CAN YOU TELL US MORE ABOUT THIS TECHNOLOGY?

The transformational power of distributed ledger technology – the most commonly known is blockchain – has been too heavily associated with Bitcoin and cryptocurrency, but it has much broader applications. Our research analyst who covers the consumer discretionary sector recently gave us an update on Home Depot as an example of a company testing the use of a distributed ledger (blockchain) to improve the data quality between its supply chain and finance departments. It could even have an effect on emerging markets. Workers in the US who transfer money back to their families in other countries are currently charged upward of a 10% fee on the transaction, but with blockchain technology charges may fall to a few cents on the dollar and the transactions will occur faster.

I can even see applications for blockchain in my own responsibilities managing our investment and research processes. We could run a crowd-sourced research project by making small payments to large numbers of people as a way of extending how we research major thematic topics.

It could also give financial advisors the ability to offer increased client identity security, which may ultimately make clients more comfortable sharing their information. The medical field has found that patients are more willing to participate in medical studies if they are confident that only part of their files will be shared as opposed to the whole thing.

There are still some issues though. The number of transactions you can process per second using blockchain is still low (less than 10), and if you compare that to something like Visa, which processes tens of thousands of transactions per second, there's a long way to go.

But there are many large firms and a consortium of banks examining these issues, and I believe as more people and companies adopt the technology the flaws will eventually be resolved.

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