

The Fed Is Raising A Spoiled Teenager

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Thirteen years ago last month (June 2007), the Fed Funds interest rate peaked at 5.25% and since then has been steadily declining. Apart from one short rate hike cycle in 2018, The Federal Reserve Bank ([The Fed](#)), has consistently reduced interest rates and implemented what is known as accommodative monetary policy. This accommodative policy has led stock investors to become dependent on lower rates to help them justify investing in stocks. In the absence of lower interest rates and Central Bank accommodation, as we saw in 2018 and in February/March of this year, stock prices struggled.



During this 13-year period, the one time (in the fourth quarter of 2018) that The Fed raised rates and showed ‘tough love,’ stocks, as measured by the S&P 500, dropped almost 20%. This decline almost ended what was then the longest running bull market in U.S. history. What is concerning is that this stock market reaction occurred when the The Fed raised the Fed Funds rate to only 2.5%! Despite this relatively low rate, the stock market threw a sharp and sudden hissy fit. This underscores the difficulty The Fed will have when it eventually decides to raise interest rates or use other available tools to tighten money supply.

It is often said that the child you have at age 3 will be the child you have at age 13—and that is proving true with our stock market. Investors are showing no signs of being able to wean themselves off of Central Bank dependency. To be sure, few are suggesting that The Fed should

tighten policy with Covid-19 still prevalent and much of the economy shut down; but long-term investors should begin to consider what may happen when The Fed unwinds this extremely accommodative policy. We had a glimpse of this in 2013 when the stock market went into what is affectionately known as the the ‘taper tantrum’. This refers to the reactionary panic that occurred when investors thought that The Fed was ending its market friendly quantitative easing (QE) program. However, investors quickly realized The Fed was not tightening, and stock prices rebounded.

During these past 13 years, there have been other times when Central Bank intervention (here in the U.S. or abroad – think ECB and the Greek Banking crisis), rescued investors from the debacle du jour. When this Central Bank accommodation stops, will investors throw another tantrum and drive stocks lower?

For now, Central Bank tightening is not a risk, and in the near term, it may make sense to ride The Fed Train. TINA (There Is No Alternative) is alive and well, thanks to low interest rates making cash and bonds uncomfortable for those seeking income or retirement cash flow. If rates stay low—or go even lower—look for more income investors to eschew low bond yields in favor of higher-dividend yielding stocks.

Complicating matters is that, in the most recent market crash, growth stocks performed so well on a relative and absolute basis that some pundits are now considering them to be ‘safe havens.’ And while there are no safe stocks, in a post Covid-19 ‘work from home’ world, it is hard to bet against big tech and growth stocks despite their lofty valuations.

One area that doesn’t benefit from a low interest-rate policy is banks. When rates are low, and when the yield curve is relatively flat as it is now, it reduces bank’s gross profit margins. When you combine lower gross profit margins on performing loans, with loan losses from non-performing loans to industries most affected by quarantine (e.g., travel, retail, real estate, restaurants, hospitality), it becomes easy to see that banks will be challenged to report sustained and meaningful profit growth.

Economic weakness as a result of Covid-19 is not ending anytime soon. But neither is the candy The Fed is doling out to investors. As long as The Fed continues to accommodate its petulant and needy child, the child will behave. This may allow investors to look only at the positive side of Fed policy and ignore the long-term problems that may inevitably develop down the road.

Contributor’s Bio

Mark Avallone is the author of Countdown To Financial Freedom, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the Wall Street Journal as well as in Forbes where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in USA Today, U.S. News & World Report, The Washington Post, and other leading publications.

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