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JULY 8TH 2019

HALF TIME

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It was a great first half of the year for both the stock and bond markets. While there is always a myriad of factors that drive returns in various asset classes, the strong market has been driven largely by macro[1] factors, and specifically, interest rates.

Let's dive in by revisiting exactly how interest rates impact the economy:

When an economy is weak, the Federal Reserve will often "push a button," lowering interest rates to "wake up" the economy and get it going again. I always find it interesting when someone accuses the Fed of manipulating the economy. In fact, that's its purpose for existence.[2]

When interest rates are low, business owners are more likely to borrow to purchase equipment and hire employees. Consumers are more likely to buy cars, remodel or buy homes, and make other major purchases. Lowering rates basically drives demand. Think of it as if the Fed was simply flying a plane over a city and dumping money on it. Of course, soon the money will be spent and prices will eventually rise. This leads to the biggest concern, which is that eventually there will be "hell to pay" for the nearly-free money. Many worry about runaway inflation or the consequences of another business, market and/or housing bust when rates rise and return to more normal levels.

AN INVESTOR SHOULD NEVER BE AT THE MERCY OF INTEREST RATES, TARIFF TALKS, ELECTIONS OR ANY OTHER ISSUES...

[1] Fancy economic term for 'big picture'
[2] If you ask a kid what she wants to be when she grows up, and she says the "the guy behind the curtain from the Wizard of Oz", then tell her to start working on her economics major, and target a future role with the Federal Reserve.

This brings us to why the Fed cannot leave rates low forever. The goal of the Fed is to lower rates long enough to get the economy going, but to raise them back to normal levels before bubbles form or high inflation occurs. This is easier said than done. Nearly every time the Fed even hints at raising interest rates, the markets gently – and sometimes violently - pull back. This is one of the consequences of very low interest rates. They are like drugs, and weaning the markets off of them is not easy. Low interest rates have driven many investor decisions.[3] For example, if the 10-year Treasury note pays only 2%, an investor is more likely to invest in riskier assets like real estate or stocks to get a better return. When rates rise, some investors will pull money from riskier assets and use the proceeds to purchase new bonds issued at higher yields.

Consumer behavior also impacts the markets. When interest rates rise, consumers are less likely to pay top dollar for a new home. Many home purchasers buy all the home they can afford with a monthly payment. With rates higher, that same monthly payment buys a lower-priced home. This ripples through the economy and the markets because a home purchase triggers spending on appliances, furnishings and more. When housing spending declines, the economy and markets often do so as well.

The Fed's top goals are to keep unemployment low and inflation under control. Its preference is to have interest rates far higher than they sit today, if only so they can lower rates to stimulate the economy in the event of a recession. With rates very low, the Fed is "out of bullets" so to speak and finds it harder to ignite a recovery.[4] We are now in month #121 of economic expansion – the longest in history - and much of this has been attributed to the Fed keeping rates lower than average since the expansion began in 2009. Yes, the Fed has raised rates over and over, but has always done so with baby steps, a quarter-percent at a time, and has always paused to make sure the economy and markets were not adversely impacted.

[3] This is the economic equivalent of kicking the can down the road, which politicians are awesome at doing, and is why Presidents always want lower rates.
[4] Speaking of being "out of bullets", most of western Europe now has negative rates. If you loan your money to a country like Germany or Italy, you have to pay them to hold your money for 10 years! This is not a joke.

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And that brings us to today. [5]

The Fed has given guidance that it expects to lower rates in the coming months. So, why in the world would they do that with the market strong, unemployment at record lows and 121 months into an economic expansion? Well, there is only one reason: they see a potential economic slowdown on the horizon and are trying to avert it.

The markets loved that guidance. The impact has been felt in both the stock and bond markets. The stock market loves when the cost of money falls. Businesses will pay lower interest rates, home buyers will pay lower mortgage rates, and on and on, resulting in higher stock and real estate prices, both of which we have seen over the last month. Bond holders that purchased bonds with higher yields over the last few years saw their bonds become more valuable, as new bonds are being issued at lower rates.

Of course the party – always – eventually ends.[6] If the Fed can reinvigorate the economy, investors will win two ways: first with today's inflated prices and, second, with a prolonged economic expansion. If the Fed is unable to avert a pullback (or worse, a recession), then we will be left with a market pullback and less room for the Fed to stimulate the economy. The stock and bond markets tend to "price in" the expectation of what will happen. Right now, investors believe the Fed is playing this right, and that we will see the economic expansion continue its record run.

Our take? The markets are simply too dynamic and variable to be predictable. An errant missile by North Korea, a counter cyber-attack by Iran, or any unexpected economic event, can instantly change anything. That is why every investor should have enough money in safer investments to meet short-term needs, and long-term money should be invested in stocks, real estate and other volatile investments. We know the markets are unpredictable over the short run. Over the long run, the markets overcome shorter-term obstacles, and return expectations tend to be far more predictable. *Investors should never be at the mercy of interest rates, tariff talks, elections or any other issues.* Instead, they should have a portfolio best suited to meet their needs, regardless of market outlook.

[5] I know, I know, get to the point already, Peter!

[6] Though recently I took our tax team out and they did their best to challenge this notion.

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