JUNCTURE
WEALTH STRATEGIES

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The "Fumbling" Fed and the Brexit "Battle"
Market & Strategy Update

The U.S. Federal Reserve Bank decided to not only keep interest rates unchanged, but they essentially admitted defeat in that the economy and inflation has not responded in a manner consistent with their forecasts. While the postponement of rate hikes is generally viewed as "bullish", the Fed's capitulation (via its public embrace of the "new normal" mindset) has undermined the confidence of the few remaining who supported the Fed's policy decisions over the past few years. At the same time, the European Union (EU) is undergoing its own scrutiny with regards to its credibility. In this case, it is an actual referendum vote on whether Britain will remain within the EU. In both cases, reputations are at stake, but the ultimate real outcomes that will take place in the coming years are probably not as impacted by these emotional debates as one might think.

Data Dependent?

The U.S. Federal Reserve has consistently claimed that they are "data dependent", but the consistency of their "data" choosing doesn't appear to be particularly predictable or inspiring of confidence. Last fall the Fed decided to not raise interest rates due to "global events" despite evidence that the U.S. economy and labor market were continuing to improve. A couple of months later they admitted that the prior focus on "global events" was misguided and that the economy had improved sufficiently such that the initiation of interest rate normalization was warranted and they raised the Fed Funds rate by 0.25%. Earlier this year the Fed reverted back to their focus on "global events" and they decide to not raise interest rates. This past meeting they not only continued to focus on global events, but they admitted that the economy is not improving at the pace that they had expected and that their pace of anticipated rate hikes was being scaled back. This more subdued view of the economic environment was expressed despite the fact that both labor and inflation "data" are approaching their targeted levels. Increasingly, the Fed's "data dependency" is being interpreted as "we will only be *dependent* on *data* that supports our underlying inclination which is to *not raise interest rates*." It appears the Fed is not so much "***minding*** the data" as they are "data ***mining***".

"Is there sufficient data to support rate hikes?"

Yes, both labor market and inflation-related data support the normalization of interest rates, especially when you consider that it can take a year or longer for monetary policy to impact the real economy and therefore monetary policy needs to be *proactive*, not *reactive*. To do otherwise risks that inflation will significantly exceed preferred targets and that more severe/abrupt measures will be necessary which can cause undesired consequences in both the capital markets and real economy.

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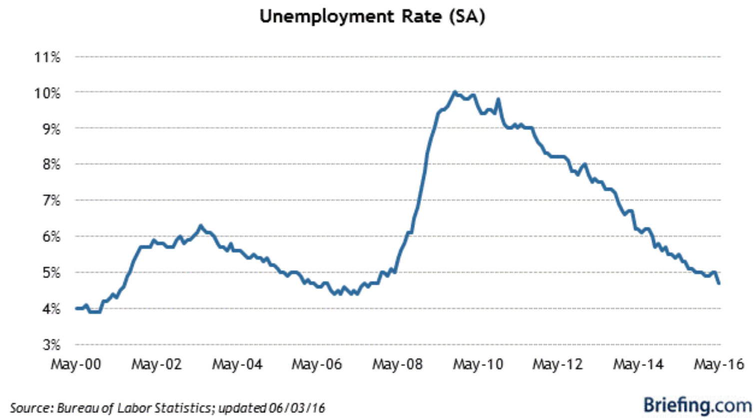
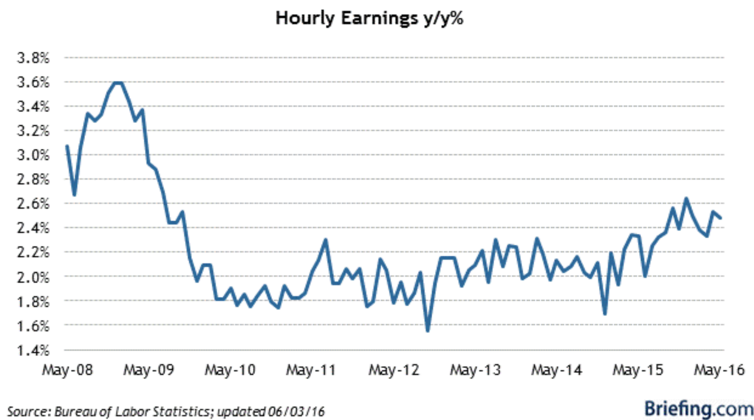
The unemployment rate is now below 5% and approaching what many economists consider “full employment”:



This growing shortage of available labor is starting to push labor costs higher (a major factor in a largely services-oriented economy such as the U.S.):



Higher labor costs do not necessarily translate into higher levels of overall inflation provided that productivity growth is robust. Unfortunately, U.S. productivity growth has been decelerating:

Some have tried to claim that the unemployment rate is understated due to low labor force participation rates, but the fall in labor force participation has been mostly a function of demographics not “discouraged” workers.

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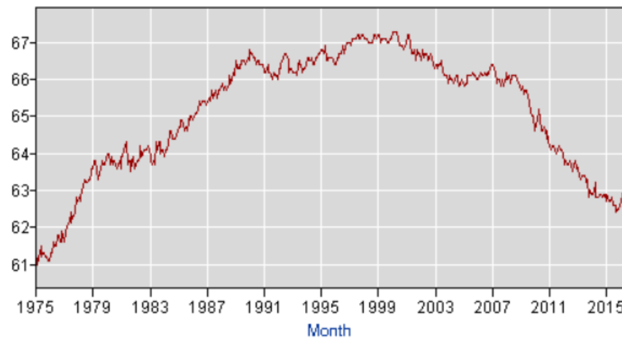
As the following chart illustrates, labor force participation has been falling for over 15 years, closely tracking the aging Baby Boomer generation. The current 4.7% unemployment rate occurred despite a sharp uptick in labor force participation thus far in 2016. Much was made about the lower rate in May, but the average rate for the first 5 months of 2016 has been higher than what prevailed at the end of last year:

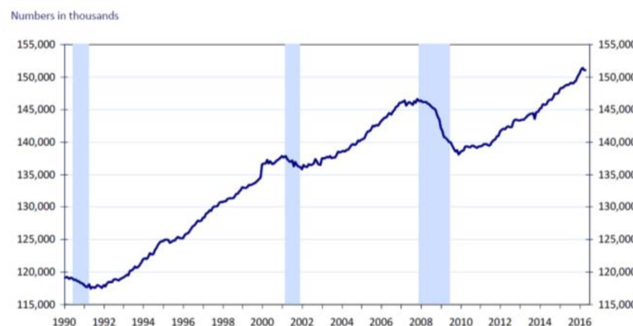
U.S. Labor Force Participation Rate Since 1975



Source: U.S. Bureau of Labor Statistics

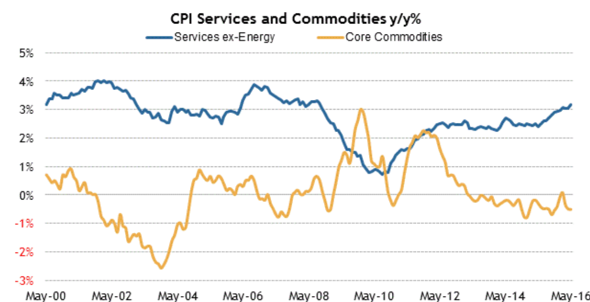
Despite the decline in labor force participation, the absolute number of employed persons in the U.S. is near an all-time high:

Civilian Employment Since 1990



Source: U.S. Bureau of Labor Statistics

Since the U.S. economy is overwhelmingly a services-oriented economy, the rate of inflation related to services is far more important than the rise in commodity prices with regards to the overall rate of inflation. As the below chart shows, the rate of price increases in services has broken above 3% (well above the Fed's 2% inflation rate target). While not as impactful, the decline in commodity prices appears to have ended and a noticeable uptrend appears to be establishing itself. The impact of rising services costs was somewhat masked by the precipitous and historic decline in commodity prices, but that era appears to be coming to a close:



"If unemployment is approaching targeted levels, and some inflationary indicators are above the Fed's targets, what is the Fed waiting for?"

The problem with the above question is not that we outside of the Fed don't know the answer. The problem is that many outside the Fed are starting to think the Fed does not know either. As you review the broader labor data, you can see that there is still room for improvement in terms of employment of the longer-term unemployed, minorities, teenagers and those without a high school diploma. To the extent that the public and/or the government want to address these issues, there are a wide variety of methodologies proposed by many at either end of the political spectrum (i.e. job training, improved placement services, relocation cost support, tax incentives to increase investment by businesses, increased educational financing, sponsored intern/apprenticeship programs, etc.). Unfortunately, the tools available to the Federal Reserve are not precise or targeted enough to address these challenges in an efficient and effective manner. Consequently, as the Fed tries to "fine tune" the economy, it may in fact be undermining its longer-term health by allowing either inflation to establish itself in a pronounced and undesirable way, or by encouraging a misallocation of capital via "cheap debt" as individuals and businesses either assume too much leverage and/or invest in higher risk assets in the pursuit of yield.

"How might the outcome of the Fed's monetary policy and the Brexit interplay?"

The implications of a flawed Fed policy have the potential to impact the global economy in a significantly negative fashion and the manifestation of those effects could come within a matter of quarters if inflationary pressures build in a sudden manner. On the other hand, a "Brexit" (a majority vote by Britain to leave the European Union) will have a more mixed and longer-term impact.

-Not much will change for at least two years if there is a "leave vote" majority. During that 2-year period, Britain will attempt to negotiate with either the EU as a group, and/or its individual members, to reestablish trade and travel agreements. One of the arguments for a "stay" vote is that these agreements may not substantially differ from current arrangements. While in theory, Britain may have significantly more autonomy with regards to trade agreements, immigration policy and fiscal support of EU initiatives, the political reality may be much less dramatic.

-Since the United Kingdom does not use the Euro, and because of the perceived strength of the British pound sterling, the uncertainties that surrounded scenarios of Greece, Italy, Spain or Cyprus reintroducing their native currencies are not an issue. Contracts with British entities stated in pound sterling will continue as in the past. This certainty is not present in the case of a country that currently uses the Euro, especially one that is considered to be fiscally vulnerable. This is the primary argument against a Brexit being a "roadmap" for other countries to also leave the EU. Britain is already viewed as being a robust and viable country. Their exit will certainly introduce uncertainty, but their stature will not necessarily be permanently reduced if they seek more autonomy. On the other hand, many of the weaker southern European countries need the EU umbrella to maintain their economic stature.

-Britain enjoys a special advantage as it is considered the business and financial center of the EU. This "prize" is a primary reason why a Brexit is unlikely and why, even if a Brexit did occur, little change is expected as Britain will have to give back large portions of their newly acquired autonomy to prevent this advantage from moving to the EU's political hub in Belgium or elsewhere.

-If Britain does not leave the EU, the Euro will likely strengthen due to the removal of the uncertainty, but also due to the reluctance of the U.S. Federal Reserve to normalize interest rates. Europe has recently seen a number of its key interest rates turn negative. This is highly unusual, and unsettling to many, but as the Brexit vote has approached, the European economy has continued to improve nonetheless. This economic improvement, combined with a British "stay" vote, may further strengthen the Euro against the U.S. dollar and also aid in the rise in European rates back into positive territory.

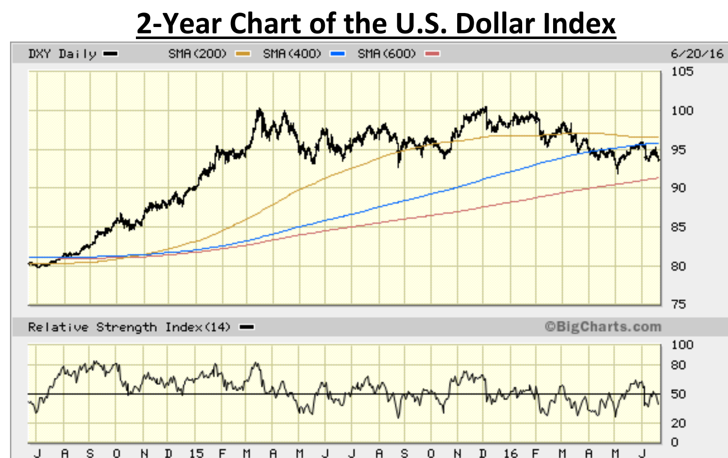
-If Britain does exit the EU, there will certainly be near-term market volatility, but much like the "Y2K" scare at the turn of the century, the speculation about the implications of a certain date passing is likely to be scarier than the reality.

Strategy Implications

Whether it is U.S. Fed fueled inflation, or post-Brexit vote anxiety, precious metals-related investments are likely to be attractive investments in the coming year. If Britain decides to stay in the EU, there could easily be some short-term weakness as "safe harbor" trades are unwound, but if labor markets continue to tighten, and commodities continue to stabilize, building inflationary pressures will eventually draw attention, even from the Fed. Also, if Britain remains in the EU, non-U.S. equities, both developed and emerging, and commodity-related securities will likely begin to perform much better than they have during the past few years as the removal of the Brexit anxiety permits investment plans to be taken off of "hold". Further supporting non-U.S. investments and commodities would be the migration of funds placed into U.S. dollar-based assets back out into the global economy. A weaker U.S. dollar would also help U.S. corporate earnings and assist the S&P 500 in breaking out of the sideways pattern that has plagued it for more than a year.

If the supporters of the "leave" vote prevail, we will need to closely watch the U.S. dollar to see if it attempts to break higher to a new cyclical peak or if, despite a Brexit, it demonstrates an inability to fight what currently appears to be a "rolling-over" process before committing additional funds to non-U.S. dollar investments and/or commodity-related assets.

2-Year Chart of the U.S. Dollar Index



While politics can be entertaining for many, and an obsession for some, ultimately, reality prevails. Political "will" manifests itself as the inevitable is accepted and political "action" rises above the hurdle of the prior political stalemate. The Fed can choose to be "measured" in its approach towards the normalization of interest rates, but the decision is really not theirs in the end. In the final analysis, they are subordinate to market forces.

The same is true for Britain. The "leavers" seem to think that they can have their "crumpets, and eat them too", but the reality of trying to negotiate a better deal with people/entities that you have just "shunned" will likely prove to be more formidable than the pre-vote rhetoric would indicate.

"Look to the Future, be Optimistic…but Hedge."

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