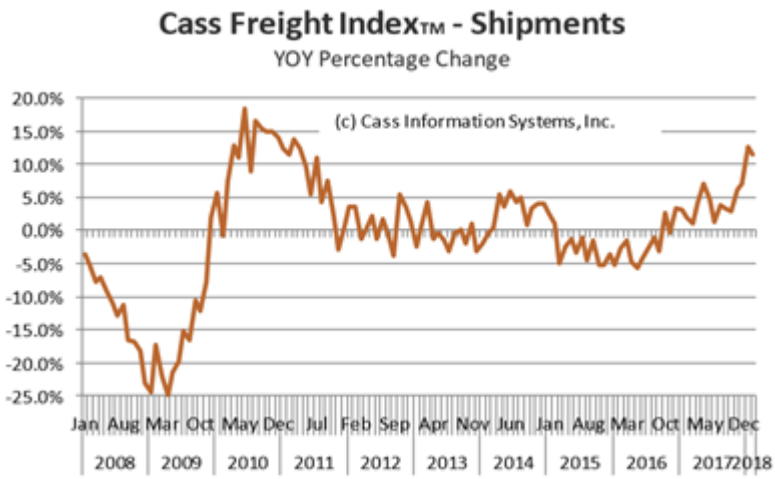
RIA Advice

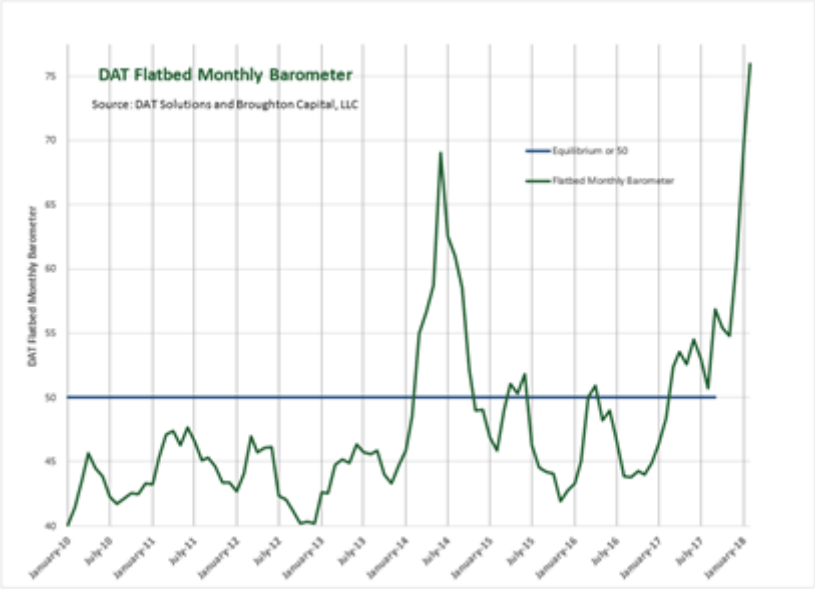
*?Peter Cook is the author of the **?Is That True??**•series of articles, which help explain the many statements and theories circulating in the mainstream financial media often presented as ?truths.? The motives and psychology of market participants, which drives the difference between truth and partial-truth, are explored.?*

Someone has it wrong.• Is it the bond market or the stock market?• Or the Fed? As bond yields push up against multi-month highs and long-term levels of technical resistance, stocks have been in decline since peaking on January 26, almost two months ago.• In fact, as shown below, the differenc g sharply s market-b

Moving from markets to the



at shipments began spiking in Q4 2017. A measure of



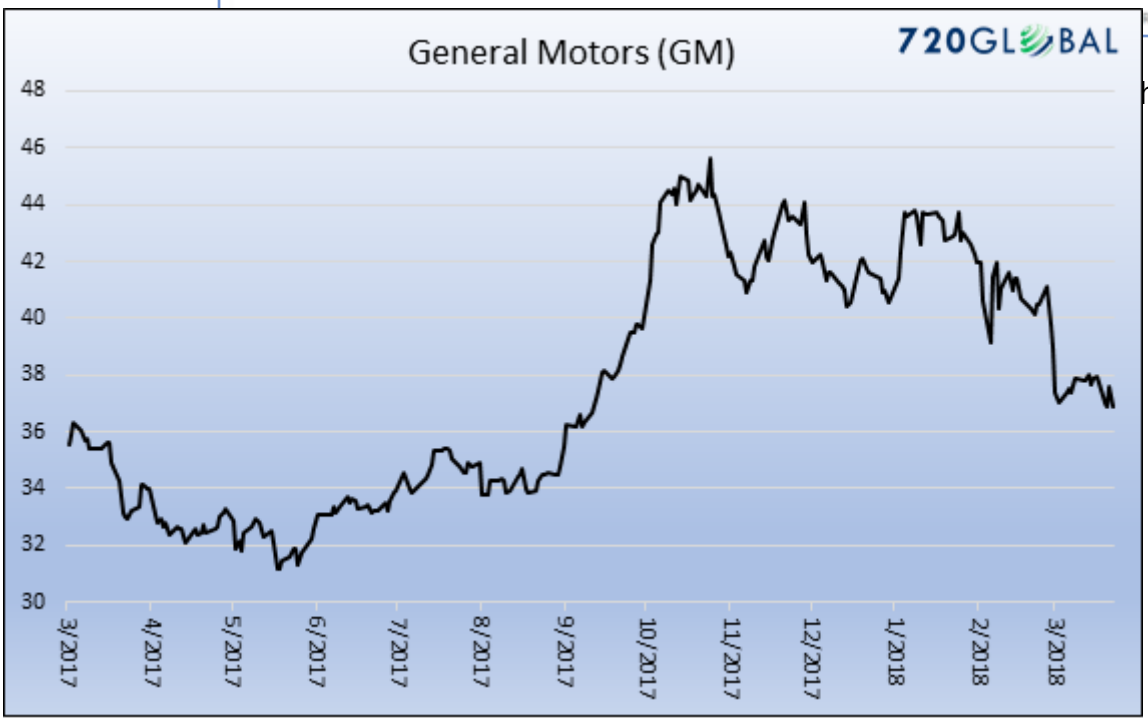
en more drastic acceleration.

The Fed agrees with the bond market

ement in the most recent FOMC press release and growth in 2018 and 2019. ?*The economic outlook* tatement, March 21, 2018

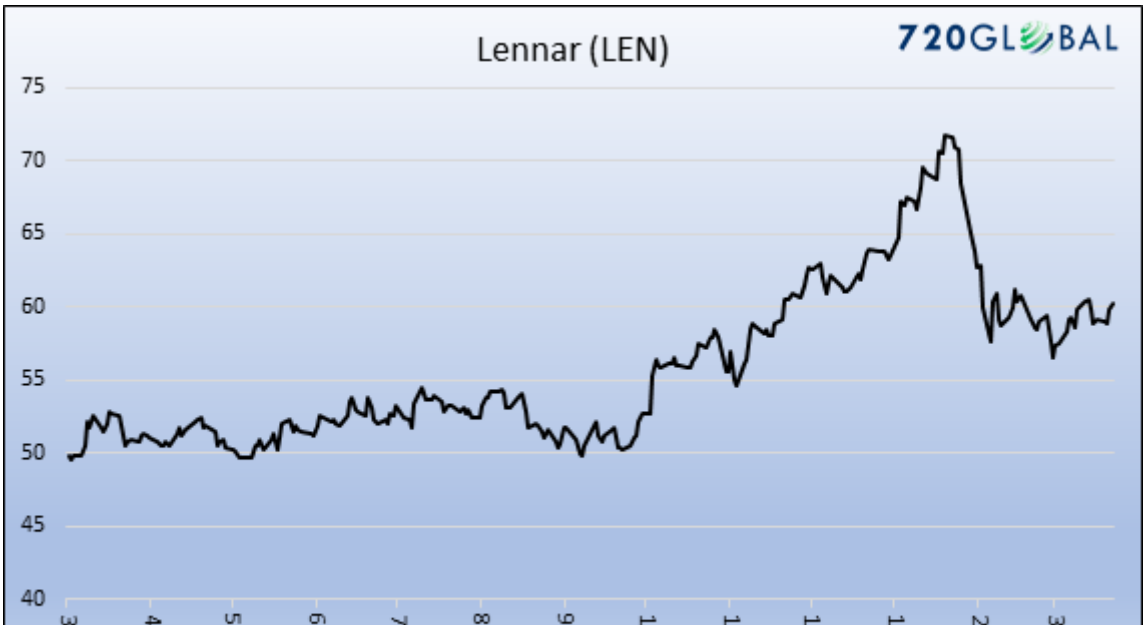
The graph above further confirms this. The Fed now expects GDP growth of 2.7% in 2018 and 2.4% in 2019, up from previous forecasts of 2.5% and 2.1% as of December 2017.• The Fed?s forecast of long-run GDP growth (blue line) remained at 1.8%, meaning that the Fed believes the short-term economic performance will be greater than

its long-term projection. In summary, the Fed and the bond market believe that economic growth is accelerating, justifying a series of interest rate hikes that will stop the economy and inflation from growing too quickly. However, an alternative explanation for the recent growth spurt is also possible.• The hurricanes that struck Florida, Texas and Puerto Rico in September 2017, and the subsequent rebuilding activity, may have been responsible for a one-time spike in economic activity.• Monthly data from the auto sector confirms the alternative explanation, showing a spectacular rise in auto sales in the wake of the hurricane.• But the most recent statistics show auto sales settling back into the range of the last 18 months.



hurricane, GM?s

The stock price of



ently
ed since at

If indeed the hurricanes produced a spike in rebuilding and general economic activity and inflation in some sectors of the economy, the Fed seems to agree, given its most recent forecasts, shown below.• The Fed sees decelerating GDP growth and stable inflation over the next three years.

Year-End• •••••• GDP%••••••••••••• PCE%••••• •••• Fed Funds

- **2018 • • • • • • • •• 2.7••••••••••••••••• 1.9••••••••••••••••• 2.25**
- **2019• ••••••••••••••• 2.4 • • • • • • • •• 2.1••••••••••••••••• • 2.90**
- **2020 ••••••••••••••• 2.0••••••••••••••••• 2.1••••••••••••••••• •• 3.40**

Chairman Powell?s quote from the most recent FOMC press conference validates the Fed?s inflation forecast: *?There is no sense in the data that we are on the cusp of an acceleration of inflation,? Powell told reporters on Wednesday in Washington. ?We have seen moderate increases in wages and price inflation, and we seem to be seeing more of that.?* Interestingly, the column on the right in the table above shows that the Fed expects to continue its program of interest rate hikes through the end of 2020.• That is, the Fed expects to tighten monetary policy at a time that GDP growth is slowing and inflation isn?t a threat to rise. •What could explain the Fed?s reaction?• Let?s quote Chairman Powell again: *?This decision marks another step in the ongoing process of gradually scaling back monetary policy accommodation -- a process that has been under way for several years now,? Powell said.* With this quote, we are getting closer to the primary explanation of the Fed?s motives.• Maybe the Fed isn?t hiking rates to counteract a rise in GDP growth and inflation.• Instead, the Fed is probably focused on preserving its reputation as a powerful economic actor. Consider the following scenarios.• Fed interest rate hikes today provide more room to cut them if a recession were to occur at some point in the future.• In that scenario, the Fed rides to the rescue with rate cuts, and could cut rates as an intermediate step before another bout of QE.• That?s important because QE is increasingly being perceived as a primary determinant of income inequality. It is also possible that recession occurs just after the series of rate hikes.• In that scenario, the Fed?s rate hikes would be perceived as causing a recession. That may not be the ideal scenario because the Fed would take the blame for a ?policy mistake.? However, the third scenario is the worst one.• In that scenario, a recession occurs while the Fed?s interest rate policy is still ?accommodative.? That?s a problem for the Fed for two reasons.• First, recessions aren?t supposed to happen when Fed policy is accommodative because it would undermine the main theoretical justification for the Fed?s manipulation of interest rates.• Second, a recession during an era of accommodative Fed policy would leave the Fed very little ammunition to fight it. It is difficult to reduce rates dramatically if they are already on the floor.• Another round of QE, and the political

baggage that comes with it would be the likely response. To be sure, the Fed cares about its executing on its mandates of controlling GDP growth and inflation, however, in conflict, those mandates may be.• But it cares even more about making sure it keeps those mandates, which can only be accomplished if Congress perceives the Fed?s actions actually have a positive impact. •Without the mandates, it can?t execute on them. Therefore, the worst-case scenario for the Fed is for a recession to occur while its interest policy is accommodative.

Conclusions••

The conventional wisdom is focused on an upcoming economic boom which will inevitably drive inflation higher, forcing the Fed to respond with higher interest rates in coming years.• In this view, stocks can continue to rise because the boom will produce an upswing in corporate earnings.• It is possible that rising rates could halt a stock market rally, but if the bond market doesn?t have a tantrum, conniption, or some other emotional reaction to the rise in expected growth, then stocks will be good investments.• For bonds, disaster will be averted because modest capital losses in the bond market will be offset by annual coupon interest. An alternative explanation is that economic growth is already slowing from a one-time spike that occurred in the wake of the hurricanes.• Transportation costs have spiked higher as goods needed to be physically transported to the affected areas.• But it is likely that transportation costs will retreat soon if it hasn?t already begun. Similarly, the stocks of auto and homebuilding stocks have retraced most of the gains they made shortly after the hurricane. •A recession is not necessarily in the cards for 2018 or 2019, but expecting a sustained boom in coming years based on hurricane-related activity is to extrapolate a one-time event.• In the alternative explanation, stocks and junk bonds are expensive while Treasury bonds are oversold and due for a trading bounce, and maybe even more. As to the Fed, its behavior is better explained by concern for its institutional reputation than by a change in economic outlook. •The Fed plans on hiking rates in 2018, 2019, and 2020, even though it forecasts that GDP growth will decelerate and inflation will remain stable. In those conditions, the Fed would be expected to cut rates, not hike them.