Broadleaf Partners, LLC

Our Take on the Fed Minutes August 21, 2014

I hate to blow up everyone's inbox with a second Economic Update in just over a week, but I guess I just did. Usually, I don't have anything intelligent to say more than once every month or so and since I'm not a journalist, I'm never forced to make stuff up just to sell papers.

I do believe, however, that the release of the Fed Minutes was worth a few of my minutes and perhaps yours. Even if you're yawning right now, please know that putting my thoughts in writing helps me to better manage your investments. As a money manager, we pick your investments, not your money managers. The buck starts and stops with us.

Unless you're a policy wonk, the Fed Minutes aren't all that entertaining. But, as the past few years have shown and nearly all of modern financial history, the Fed's actions and words can clearly move markets.

I read the Fed Minutes. The Fed sees an economy that bounced back from weak first quarter levels in the second quarter, but remains more subdued than one would expect at this stage of the game, particularly with housing. Late last week, we took a new long position in a homebuilder and maintained our bullish position in Home Depot, anticipating an eventual improvement in the data.

The housing data releases and commentary from Home Depot's call this week both suggest that we made a good short term call, which we believe will prove positive over the longer haul as well. While housing isn't off to the races, like employment, it continues to improve at a slow and steady cadence. The Fed didn't see this in its June minutes but likely will in the coming minutes.

What is the Fed's dual mandate? To ensure price stability (inflation) and full employment, not necessarily a specific level of economic growth. We would argue that the employment data has continued to improve and is getting closer to levels that the Fed would deem both full and sustainable. In addition, it is our thesis that inflation will remain low for an extended period of time regardless of loose money policies around the globe.

The amount of slack in the global economy is tremendous, particularly with overseas weakness. The most hyped IPO's (Amazon, Lyft, Uber, AirBNB) are all those with a goal of increasing asset efficiency, i.e. identifying ways to exploit slack from an already existing asset base or natural resource. There are also brand new sources of energy, here at home. We believe the commodity complex, a huge determinant of inflation, is entering a structural long term downtrend based not only on weaker global environments, but also the disinflationary impact of these "slack" economic factors.

So, the Fed may very likely raise rates sooner than anticipated, but perhaps not to the degree that history would suggest if our thesis of lower structural inflation pans out. Long term interest rates, not subject to Fed intervention, may remain lower for longer given the flight to safety, our position as the default global currency, and weaker global economies.

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In our spring Economic Update, In The End Time Is Everything, we postulated that the trashing high growth and small cap stocks took was likely a response to anxieties over Fed rate hikes in addition to the completion of the tapering process. Historically, the stock market has been hit temporarily, roughly six months in advance of rate hikes.

We compared last spring's swoon in the stocks of high growth innovators – those where the bulk of earnings was far out in the future like a zero coupon bond – to what occurred during the 1994 rate hike cycle in which Greenspan aggressively raised Fed Funds six times in a very short period. What happened to stocks at that time? Pure growth and small cap names got hit particularly hard, much more than the stock market as a whole (I remember Cisco Systems, at the time a relative small cap, getting cut in half), but recovered within the year, ushering in a strong subsequent six year period for U.S. equities.

I would also add, however, that the driving force behind the rate increases in 1994, at least as I recollect them, was not a process of interest rate normalization, but because the Fed felt the growth at that time would become inflationary in quick order if they did not raise rates aggressively.

Nowhere in today's Fed minutes can I find an overwhelming emphasis on budding inflationary pressures as a reason to raise interest rates today. I think the Fed recognizes that the recent economic cycle has been different than most. It is my belief that that productivity gains across a whole host of areas is exploiting new asset efficiencies like never before, a constant headwind to any inflationary pressures that might have otherwise been.

If we're right, that eventual rate hikes by the Fed won't really be about containing inflationary fears, then I suspect a short term hit to the markets might be avoided this go around. Regardless, from a positioning point of view, high growth and small cap stocks already got hammered last spring, and while they have recovered, the key is that those who owned these areas on the basis of Fed policy and not earnings potential have likely already sold. Their ledgers have been cleared. Quarterly earnings were fantastic.

In conclusion, I don't know that the Fed's forecasting ability is any better than others, but it is more relevant to the markets than most. The Fed remains data dependent, just like the rest of us. They see an improving economy, improving employment, and low inflation. Given my view that inflation will stay structurally lower for far longer, I don't think we should be too concerned about the impact of any Fed move on stock prices. During past rate hike cycles, oil prices were increasing and the talk among Fed officials was much more focused on worries of potential runaway inflation, something I don't see today.

I really do believe we could be entering the best of all worlds for equities; low growth and low inflation, an ideal environment for business planning and expansion.

Giddy Up!

Kindest Regards,

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