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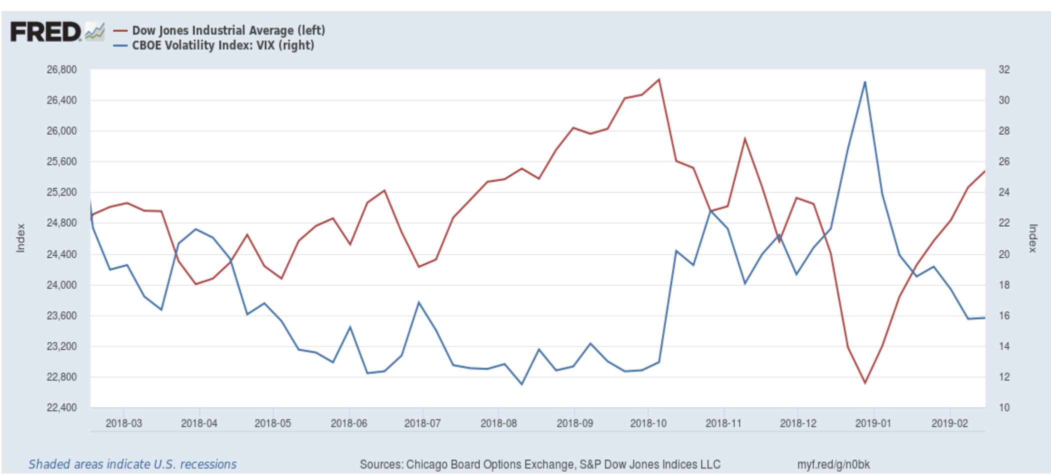
WTF: WHAT THE FED!

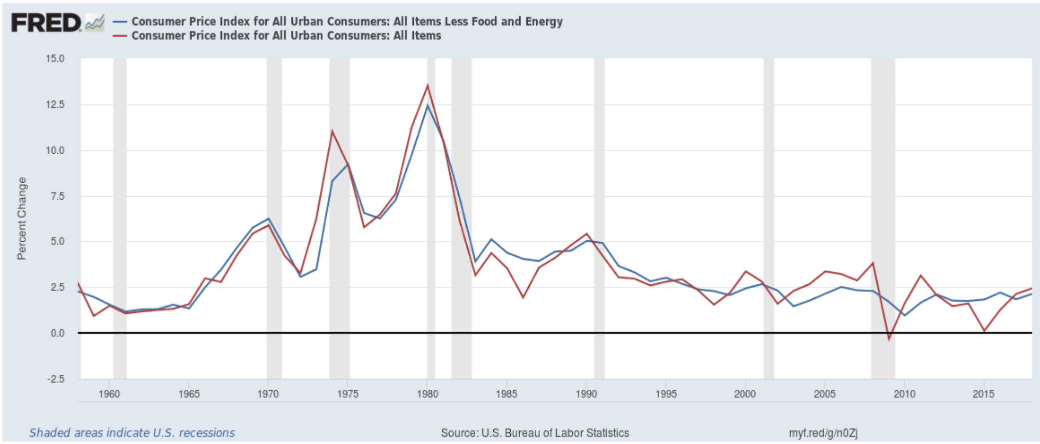
A more than 9000 points down-and-up swing in the Dow Jones Industrial Index (DOW) within five months is how the market responded to the Federal Reserve's initial *"we know better"* thinking and its subsequent *mea culpa*!

We typically avoid using "colorful" language in our commentary, but have taken the liberty to do so in this communique to unambiguously convey our total disdain for the actions of the Federal Reserve (FED) over the last few months. Not only have they caused incredible volatility in the financial markets but have also, we suspect, damaged the credibility of the institution itself.

Let's look at the sequence of events beginning with the comments on October 3, 2018 by FED chairman Jay Powell (whom we have praised previously, prematurely as it turns out) about interest rates being "long way from neutral." Almost instantly, markets started reacting negatively as can be seen in the chart on left with equities falling and volatility rising.



Investors had already been apprehensive about the FED's prior policy of "gradual" increases in interest rates given the stagnation in key economic sectors of housing and automobiles as well as the noticeable softening in many international markets. So, the introduction of "long way from neutral" took the markets by complete surprise. The implication of those comments was unmistakable: *markets were underestimating future rate hikes*. But why would the FED think many more rate hikes were needed when inflation measures have been around the FED's target of 2% for years now as seen in the chart below. In our view, the only justification for raising interest rates is when inflation begins to threaten price stability, which is not the case currently. So, the eagerness to raise rates seemed almost nonsensical. We heard arguments that the FED was trying to preempt inflation from taking hold or that it was trying to create room for cutting rates in the next economic downturn by raising rates now. The first argument is flawed because the fear of inflation could be used to justify policy tightness at every level which means policy should never be loose, regardless of the economic circumstances. We think preemption is not indispensable when conducting monetary policy. The second argument is actually quite bizarre because it seems to justify raising rates even at the risk of recession in order to use a policy tool. It's like making a person deliberately sick so that some already produced medicine can be used. WTF!



Some participants may have hoped that this was just a single off-the-cuff comment that would surely be "clarified." No such luck. In fact, on December 19, 2018 chair Powell, speaking at the press conference after a FED meeting not only defended the 0.25% rate hike that the FED had just passed but also seem to endorse the possibility of three future rate hikes in 2019 that many FED voting members anticipated. No prizes for guessing the equity market's reaction…the DOW lost nearly 2000 points over the next four sessions to record the worst Christmas eve in its history.

After having caused and witnessed the carnage in financial markets, the geniuses at FED then changed their tune and began talking about "patience" and "flexibility" with future rate hikes. Markets started to recover and on January 16, 2019 Chairman Powell in an interview with David Rubenstein of Bloomberg, *emphatically* stated that the FED would do whatever it took to support the economy including halting the balance sheet run-off that had been in place for well over a year. Now that's real foresight, isn't it? (if you sense we a little ticked off, you would be correct.)

Risk markets haven't looked back since with the DOW now having almost recovered all of the 5000 points lost during the 4Q18. This entire episode though lays bare the utter amateurish and below average thinking of our "highly educated" FED officials. So, the next time someone mentions the sophisticated and complex nature of the work done at the FED, you might hear us say - WTF!!

Performance Review

It would be meaningless to talk about performance numbers for 2H18 without mentioning the dramatic moves markets have made in the first two months of 2019. Hence, we will be sharing year-to-date numbers as well. Similarly, given the broad-based nature of the sell-off in the latter part of 2H18, the drivers of performance for both periods will, to some extent, be the mirror image of each other and, therefore, we will focus our discussion on the actions that we took in the half, particularly in 4Q18. Our intent is to highlight the factors we control.

Core strategy

OppoQuest's Core strategy (CORE) posted a gross return of -12.57% for the 2nd half of 2018 versus -4.98% for the benchmark, S&P Target Risk Growth Index (SGI). However, year-to-date (through 02/25/2019) CORE has generated a gross return of + 17.61% versus +7.23% for SGI. As of the week ending 02/22, most equity market indices have had the longest stretch of uninterrupted weekly gains since 1964! About the only positive thing we can say about this volatility is that it did create opportunities for those participants who had been at least somewhat defensive coming into the 4Q18. We were one of them. Nevertheless, having the ability to take advantage is only half the equation. The other half is willingness to take advantage. We were in the group of the willing too.

Looking at the changes made in 2H18, the most important one was to increase CORE's Technology exposure by almost 6% points. Cash exposure went down from close to 11% at the end of June 2018 to less than 2% and we reduced REITs, Utilities, and Healthcare exposures as well. The rationale, obviously, was to sell positions that had held up very well in the sell-off and buy ideas that were hit hard but retained their investable thesis. Within Technology, we have initiated two new positions; one in global ecommerce platforms and other in U.S. cloud-based software companies. Additions to existing positions included names in Industrials, Energy, Biotech and Financial sectors. The cumulative effect of these actions resulted in almost 11% points of reduction in the strategy's defensive positions while increasing the strategy's offensive positioning by the same magnitude. It was one of the largest reallocations we have conducted within such as short period and, therefore, very gratifying to see our year-to-date (2019) performance across all strategies strongly validate those actions.

Conservative Strategy

OppoQuest's Conservative strategy (CONS) also underperformed its tracked benchmark, the S&P Target Risk Moderate Index (SMI) with 2H18 gross returns of -8.96% against -3.01% for SMI. However, year-to-date (through 02/25/2019) CONS has generated a gross return of +13.47% versus +5.27% for SMI. Repositioning actions in this strategy during the 2H18 were similar to CORE and were also weighted heavily towards 4Q18. New positions and additions in the Technology sector were around 7% while another 5% was reallocated to Industrial, Energy, and Financial sectors. On the other hand, exposures to Utilities, REITs, and Healthcare sectors were reduced significantly and Cash position of 5% at the end of June 2018 went to less than 1% on December 31, 2018.

Given that CONS's mandate include lower volatility and income generation, the technology positions added were mostly large-cap, dividend paying ideas although the primary reason they were added was their upside potential. As a reminder, we never look at ideas simply because they have been beaten down or the yield attached. Only if we are convinced that a beaten down idea possesses the ability to rebound, then it would be considered. All these changes led to a slight increase in the yield of the strategy to 4.53% from 4.13%.

Outlook

The FED's idiotic blunder (sorry, we just can't hold back) and its subsequent *mea culpa* has significantly improved the future prospects for risk assets. Other headwinds like political and trade uncertainties are yet to clear but we don't think their resolution is essential for a sustained uptrend. It actually scares us now to acknowledge that the FED is a bigger factor than trade and wields more power than most agencies of our government…yikes!

One last comment on the FED - if you thought that its members may have learnt their lesson after the 4Q18 debacle and would stay away from challenging market expectations, we hate to burst your bubble. Loretta Mester, the Federal Reserve Bank of Cleveland President, was at it again as recently as February 19, 2019 saying "if the economy performs along the lines that I've outlined as most likely, the fed funds rate may need to move a bit higher than current levels." While she did temper her remarks with some "on the other hand" comments, we are struggling to understand the utility of mentioning rate hike possibilities when the markets just went through a tumultuous episode for exactly the same issue. We fear it has to do with the human tendency to not acknowledge mistakes, the trait that we all observe in our teen aged kids. In all fairness to our kids though, they do listen once in a while and own up to their mistakes. We are not going to hold our breath for the same behavior from Ms. Mester. Luckily, she is not a voting member this year and no other FED official has raised the issue of higher rates since 4Q18. So, our baseline case is that the FED will stay put, although we must admit we are a bit wary of making that assumption.

The focus now is entirely on the trade negotiations with China and the USMCA (NAFTA 2.0) vote in the new Congress. Reports coming out of the administrations in the U.S. and China indicate progress. USMCA, meanwhile, seems to be in some sort of blackout period. We can only hope there is movement in the background that will bring the agreement to a vote and follow-on actions. However, even in the event that both these agreements fail to see the light of the day, we don't think the markets will react too negatively because the current U.S. economic strength is not based on the expectations of these agreements being passed. A lot, of course, will depend on what actions the Trump administration takes then, specifically in terms of tariffs. Status quo will likely be cheered by the markets.

Business Investment Takes Over
Percent change in real GDP and related measures from preceding period

	2016	2017	2018
Overall Gross Domestic Product	1.6%	2.2%	2.9%
Personal consumption	2.7	2.5	2.6
Gross private domestic investment	-1.3	4.8	6.0
Nonresidential	0.5	5.3	7.0
Residential	6.5	3.3	-0.2
Government consumption expenditures and gross investment	1.4	-0.1	1.5

Source: Bureau of Economic Analysis THE WALL STREET JOURNAL

There was certainly a lot to cheer about in the 4th quarter GDP report that was released recently by the Bureau of Economic Analysis. The excellent chart on the left shows the contributions made by major sectors of the economy over the last three years. What caught our attention was not only the trajectory of the overall growth which has almost doubled going from 1.6% to 2.9%, but also the Private Nonresidential investments (a proxy for business investments) which grew by another 7% in 2018 after a very strong 2017. Significant cuts in regulatory burden most likely pushed businesses in 2017 and tax cuts seemed to have incentivized them in 2018. While we may see a drop off in that category in 2019, hopefully the anemic performance of the Residential sector in 2018 will turn around in 2019. The FED being on hold is critical here to facilitate lower mortgage rates and increase affordability.

Overall, the FED's *mea culpa* has increased our confidence in the sustainability of the current uptrend in risk assets. The actions we took in 4Q18 have put all our strategies in a position to stay ahead of the curve. Given our expectations of continued volatility, the game plan for all our strategies remain unchanged – we will sell incrementally into strength and buy incrementally into weakness. It's nothing new actually; this has been one of our foundational tools to manage risk and add value. We think risk assets will likely have a great ride in 2019 and we are positioned well to capitalize on the bull!

For OPPOQUEST
PARESH JAIN
Founder & Portfolio Manager