Changes at the Fed: A Focus on Monetary Policy

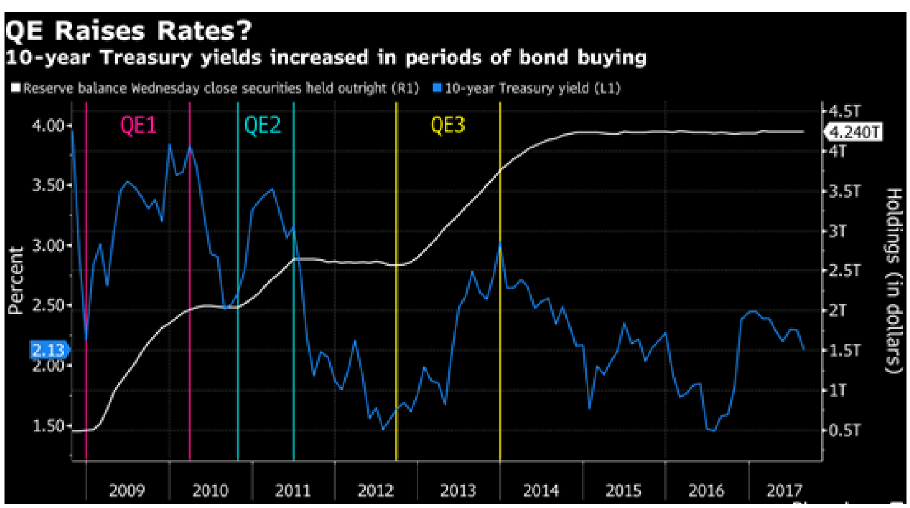
Have you heard that the Federal Reserve (the Fed) is tapering its balance sheet by slowing reinvestments of incoming cash flows? I ask that in jest; I hope you have heard, as it has been one of the most widely discussed and telegraphed decisions to hit the bond market in years (more on that a little later). Our intention here is not to recap the situation and pontificate about the size of the balance sheet, what the terminal size is, at what point the economy will "grow" into the balance sheet etc., but rather to highlight a couple of points that might be of interest.

Interest Rate Direction?

Not quite so well publicized, but equally exciting, was a recent article on Bloomberg (link below) containing some perspective from our very own Ken Harris, Portfolio Manager and Director of Fixed Income Portfolio Management at Denver Investments.

https://www.bloombergquint.com/markets/2017/09/18/wall-street-s-bond-gurus-have-it-all-wrong-as-qe-unwind-looms.

To borrow a snippet from the piece, the idea is that in the aftermath of the various quantitative easing (QE) episodes instituted by the Federal Reserve since 2009, the near- to intermediate-term reaction has been unequivocally that longer-term interest rates have increased. That's right, not decreased with increased purchases, but increased with perceived optimism around the economy as a result. Interest rates have then subsequently fallen at or around the cessation of each program.



Source: Bloomberg, Federal Reserve. Past performance is no guarantee of future results.

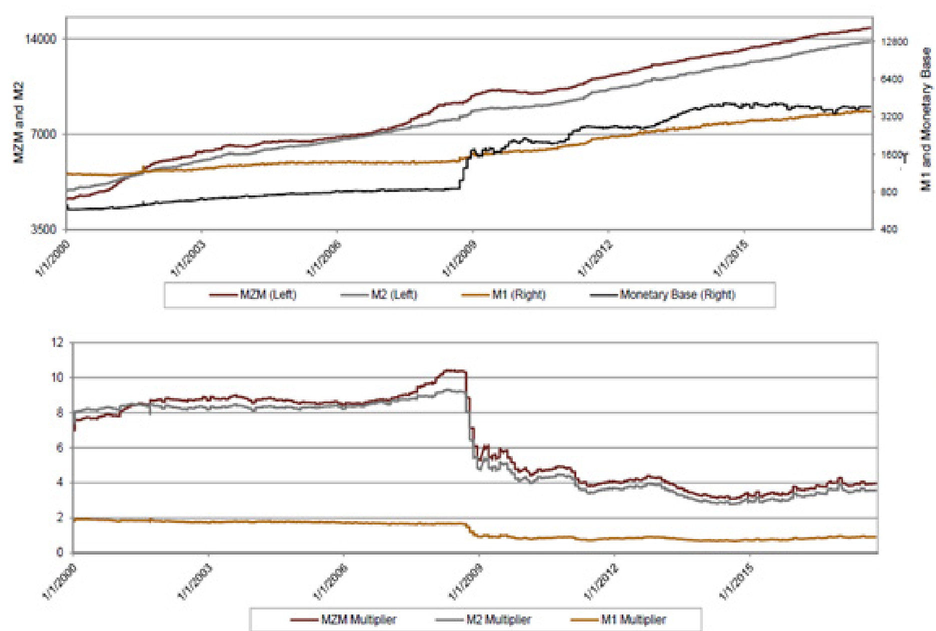
What then would you expect to happen when the Fed stops buying? If the previous relationship were to hold, you might expect long-term rates to fall when the Fed reduces asset purchases. We don't believe the relationship is that obvious of course, but the key, as outlined in the article, is:

"The lesson, investors say, is that what really matters to the bond market isn't so much what the Fed is doing, but what the policy changes mean for the U.S. economy in the months and years ahead."

We feel investors shouldn't make a rash reaction based on the immediate trend in Fed policy, but should focus on the longer-term outlook for economic growth and inflation, and let this outlook inform educated decisions.

Inflation and the Money Multiplier

For several years, one thing we have been paying attention to, which has confounded a plethora of market participants, is the fact that the liquidity that has been injected into our financial system has failed to permeate through the economy. As we know, loans drive purchases, that in turn drive profitability, which facilitates further loans or purchases…this is the virtuous cycle of the money multiplier. Below is a chart that shows, on top, various measures of U.S. money supply, and on the bottom, the multiplier. Note the contemporaneous spikes in the upper (log scale – trust us, it's a big move), and precipitous drop in the lower. Money was not put to "productive" use, and it sat on balance sheets (not all a bad thing, as capital cushions at financial institutions are far more robust than prior decades).



Source: Bloomberg. Data points are weekly. The Y-axis in the upper chart is in $billions, the Y-axis in the bottom chart is a muliplier ratio.

The point I want to make here is simple. It doesn't refute the above, but perhaps dulls the effect, and it may be pre-emptive, but I imagine somewhere in the next 6-12 months you will hear this argument made. The very definition of the velocity of money is a measure of economic output (i.e., GDP) divided by the money supply. If you increase the denominator instantly, and massively, what will happen? The velocity will fall. The above bank lending/capital story is real, this is not purely mathematical. Bear in mind, however, that it may not be as simple as it seems.

When someone says to you in coming quarters that inflation is set to skyrocket because the velocity of money or the money multiplier is ticking up, remember that it is ticking up as the denominator in the equation is being reduced. Fed tapering doesn't mean we're going to have runaway inflation as the money supply contracts on the margin. In fact, less accommodative policies are disinflationary, which brings us in a roundabout way to our last point.

Focus on the second (or third?) derivative

OK, the Fed is going to taper its asset purchases, thus tightening monetary conditions. We know how much is planned, we know when it is planned, we know how it is planned. This brings me back to my earlier point - this has been one of the most anticipated, hinted, guided, telegraphed moves in terms of asset purchases that we have ever seen. The U.S. Treasury and mortgage-backed securities are two of the largest, most transparent, most liquid markets in the world. I'd suggest that all available information as it pertains to the Fed's tapering of purchases has been priced in a long time ago. You won't profit from that alone.

What you should be trying to think about are the "knock-on" effects, and the Fed's reaction function. For example, a second derivative would be something like volatility. That may be priced in also, but do the Fed's actions result in an increase in volatility that could affect other asset classes? (Side note, I heard a great quote recently that volatility is like cholesterol – there are both good and bad kinds. You can use that at your next bond-themed dinner party.) A spike in volatility could impact credit spreads, it could impact equities, and/or it could have a further impact on rates. The third derivate then would be this - how does the Fed then react to that perhaps unintended consequence? Does the Fed ease policy at any sign of market unrest or another undesired result? While the Fed's dual mandate is inflation and employment, a severe market reaction would likely warrant further action.

So lastly, what does the recently announced election of Jerome (Jay) Powell mean for Fed policy and the markets?

Jerome Powell

In short, likely more of the same - at least in the near term. Powell and Janet Yellen have worked together on the Fed Board of Governors, which translates to some level of policy experience, unlike some other proposed candidates. Powell is viewed as a consensus builder, and shares similar views to Janet Yellen it appears. Under the leadership of Mr. Powell, you should likely expect a similar trajectory as anticipated and outlined above, along with perhaps a softening of stance on regulation. We don't currently view his nomination as a large risk event for the markets or for interest rates.

Positioning

Distilling this all down, our view is that the risk of runaway inflation remains low and we don't believe the Fed's schedule will result in the huge bear market many have feared. Our portfolios are positioned with modestly reduced interest rate exposure, mostly in acknowledgment of a slowly growing economy, solid corporate profitability, and the hope of some reform out of Washington. We have a modest allocation to Treasury Inflation Protected Securities (TIPs), as we believe at times the protection offered by the market has been attractively valued, but we are far from capacity if we saw inflation as a huge risk. We have modestly reduced agency mortgage-backed securities, which perform best in times of range-bound volatility, in favor of some assets with less cash flow variability should volatility increase, but there is still value to be had in that sector.

It's a long game and we view portfolios through that lens, and we'd encourage a similar approach.

As always, we would welcome the opportunity to discuss, so please contact Westcore Sales at 800.734.WEST (9378).

Past performance does not guarantee future results.

The views expressed herein are those of the Fixed Income team and do not pertain to all investment strategies offered by Denver Investments or Westcore Funds. The views expressed are general in nature and actual events may cause adjustments in portfolio management strategies from those currently expected to be employed.

RISK: Investing in the Funds involves risk, including loss of principal.

DEFINITION OF TERMS

Credit Spreads: A credit spread is the difference in yield between two bonds of similar maturity but different credit quality. For example, if the 10-year Treasury note is trading at a yield of 6% and a 10-year corporate bond is trading at a yield of 8%, the corporate bond is said to offer a 200-basis-point spread over the Treasury.

Federal Reserve (The Fed): The central banking system of the United States.

Gross Domestic Product (GDP): The market value of all officially recognized goods and services produced within a country in a given period of time.

Quantitative Easing: Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Money Multiplier: The money multiplier is the amount of money that banks generate with each dollar of reserves.

M1: M1 is a metric for the money supply of a country and includes physical money — both paper and coin — as well as checking accounts, demand deposits and negotiable order of withdrawal (NOW) accounts.

M2: M2 is a measure of the money supply that includes all elements of M1 as well as "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds and other time deposits. These assets are less liquid than M1 and not as suitable as exchange mediums, but they can be quickly converted into cash or checking deposits.

MZM: Money of zero maturity (MZM) is a measurement of the total amount of money in the economy that is immediately accessible at par value to individuals and companies.

Tapering: Tapering is the gradual winding down of central bank activities that begin when officials believe that the economy no longer warrants excess stimulus. Tapering activities are primarily aimed at interest rates and at the management of investor expectations regarding what those rates will be in the future.

TIPs: Treasury inflation protected securities (TIPs) refer to a treasury security that is indexed to inflation in order to protect investors from the negative effects of inflation.

Volatility: Volatility is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index.

An investor should consider investment objectives, risks, charges and expenses of the Fund(s) carefully before investing. To request a prospectus, which contains this and other important information about the Fund(s), please call 800.392.CORE (2673) or visit us online at www.westcore.com. Please read the prospectus carefully before investing.

Westcore Funds are distributed by ALPS Distributors, Inc.

The mountain logo together with "Westcore Funds Denver Investments" is a registered service mark of Denver

FOR MORE INFORMATION ABOUT WESTCORE FUNDS, PLEASE CONTACT:

Westcore Funds | 1290 Broadway, Suite 1100 | Denver, Colorado 80203

Individual Investors: 800.392.CORE (2673) | Financial Advisors: 800.734.WEST (9378) | www.westcore.com