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Claro Market Insights
Super Fed to the Rescue

During the roughest part of the storm, as the economic survival seemed most dire, the Federal Reserve has once again stepped in to calm the seas and steer the ship away from danger. Faced with a mandated stoppage of the economy, mounting layoffs, and business defaults, the Federal Reserve has taken steps to be the superhero that the economy needs. They are more than willing to expand their super-sized balance sheet to not only include higher quality debt such as U.S. Treasury bonds, Municipal bonds, Investment Grade Corporate bonds, and Asset-Backed Securities, but now also… lower quality, higher yielding debt or the aptly named "junk bonds". Now every business is too big to fail.

As a human being, I get it. The virus wasn't anyone's fault. It came out of nowhere and surprised us so that we had to shut down the economy for a couple months. People shouldn't have to worry about getting sick and dying, so we all had to self-quarantine in an effort to slow the virus down. This is putting companies big and small in a difficult position where they might not be able to pay bills and survive. They just may have to close up and lay people off. The Federal Reserve is helping at-risk companies by taking away the burden of debt defaults. This will allow these businesses to survive and hopefully allow them to keep people employed. This is a good thing.

As an economist, I have reservations about whether their action is the right course. For one, they are interfering in free markets by not allowing the economy to follow its natural course and bailing out businesses that potentially should be allowed to fail. It also has moral hazard written all over it, meaning that parties are now willing to take on more risk knowing that they no longer bear the full cost of that risk (since the Federal Reserve will always bail them out).

All good intentions aren't always rewarded as things don't always go according to plan. What the Fed may be doing is delaying the inevitable by allowing these businesses to survive temporarily, only to fail eventually. A possible result of the Fed's action is that business owners and investors are the ones who will be bailed out, but employees are still at risk as businesses likely will be faced with cutting costs amid weak demand.

And, one of the biggest questions will be if the Federal Reserve can successfully unwind their balance sheet (which has ballooned to more than $6 Trillion) after the storm is over and we are in calmer seas. The statements by the Fed seem to suggest they have no doubt that they will be able to do so. These actions are unprecedented, so how could they know with such great certainty? Markets will have to be operating efficiently with a robust number of buyers and sellers for the Fed to exit their positions and sell them back to the marketplace. I hope that is the case.

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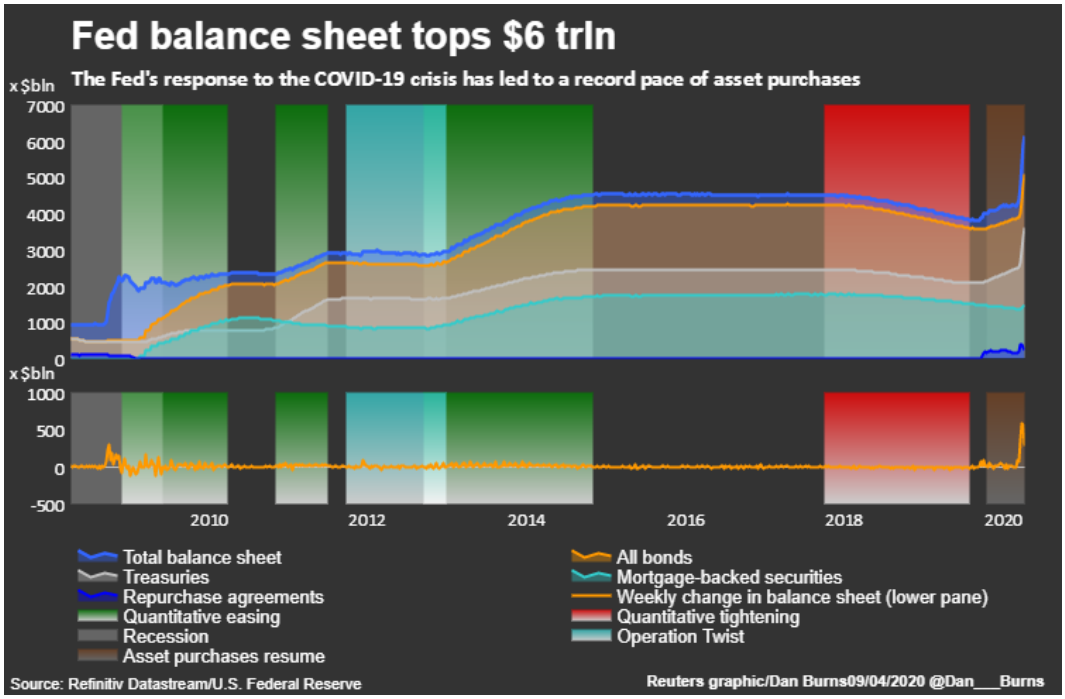

And then there is the question of what is waiting on the other side? If the money supply starts to accelerate too rapidly it can drive asset prices up quickly and create a situation that ends in hyperinflation. That seems a little far-fetched at the moment with low rates and muted inflation. Instead deflation might be the more immediate concern, but that can change in the long run. We will have to wait and see how the economy responds.

There seems to be too many unknowns to say with great certainty that everything will be completely fine for everyone involved. The road ahead over the coming quarters will be difficult as the economy tries to regain its footing. What we can have confidence in is that people/consumers will still need and demand goods and services over time. Businesses will continue to innovate, grow and find ways to meet that demand. And investors will be able to participate in the growth of those businesses. There will be challenges along the way, no doubt about it, whether it's another pandemic or some other external shock. Some companies will not last or be forced to adapt in unexpected ways. People will lose or change jobs periodically so there will still be fluctuations in demand and therefore bumps in the path of the business cycle. This has always been the case. At least we know for sure that the Fed has our back and will be there to support the economy during those rough periods.

Overall, investors should be able to move forward and have confidence that maintaining their asset allocation will allow them to achieve their investing goals over time. Market dislocations, like we just experienced, occur during periods of great uncertainty, but also provide opportunities for long-term investors. As we begin another earnings cycle, and companies provide more guidance on how their businesses have been affected, we should be able to better value securities. Whether that is to reward stocks of companies that are likely to outperform, or to shy away from those that will struggle. Or perhaps that means valuing bonds on a company's ability to meet their debt obligations. From an investors' perspective, these are the things that are most important and contribute to the "return on" and "return of" capital over time. And they once again will drive investor returns going forward. The Federal Reserve simply removed much of the uncertainty by saving the economy in its time of need. Super Fed to the rescue yet again.

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April 14, 2020