OTHER SIDE ASSET MANAGEMENT

The Fed:
Data Dependent or Defending their Position?

You can't be Serious?!

Today we're going to talk to you a little about the Fed. We'll keep it high-level as we intend to go into much greater detail in our upcoming quarterly; but for now, please find our thoughts below…

I have to say that it was nice taking a breather from discussing the "Fed" the last month or so. Though, given the FOMC's decision on interest rates having been released last week, and the absurdities being discussed thereafter, I couldn't help but weigh in on this subject.

Many of you could have guessed my knee jerk reaction to the most recent "Fed Speak" was something along the lines of, "you've got to be *$%*ing kidding me"? (Add a headshake with simultaneous forehead slap for a more realistic mental picture).

If forced to describe the FOMC in a single word, *predictable* would be first to mind; if allowed a few more adjectives; dangerous, irresponsible, inept and cowards would be suitable as well.

As many of you know, we do our best to not get caught up in what we would consider to be "noise"; headlines such as Russia-gate, the Mueller report, all noise. We wrote about this in our 1Q2017 quarterly. In that note, we described the difference between "noise" vs. larger market forces, i.e. "coordinated Global Central Bank intervention" however; at this point it bears repeating and further scrutiny.

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Today's headlines are a little different than traditional noise.

> - The global growth story has now been replaced with concerns over crosscurrents…
> - The US is blaming Iran for the bombing of a Japanese oil tanker (while the Japanese and Iranians happened to be meeting with each other)
> - The Iranian Revolutionary Guard shot down a U.S. Drone

Immediately followed by:

> - Donald Trump apparently had a retaliation attack ready to go until he got word there would be nearly 150 casualties; he stood down (for the moment)…

While much of this still looks like "noise", geo-political headlines are a little different - they give the FOMC cover; they can easily mask the larger driving forces behind highly questionable policy changes due to their ability to invoke emotion.

For years we've provided references showing how the Fed's monetary and fiscal policies, coordinated with the likes of the ECB, Bank of Japan, The People's Bank of China, Banks of Switzerland, et. al., have directly correlated with the rise in global equity prices over the last decade. We've cited numerous resources, most recently in our last quarterly, Nomi Prins, Collu$ion as she cited work done by the Central Bank of Brazil.

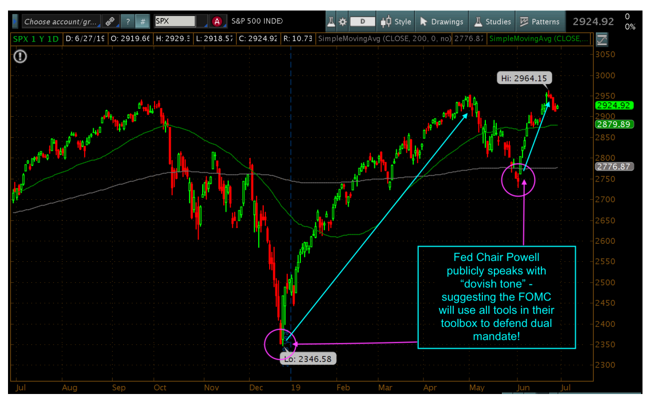
Last week alone, the 3 largest contributors to easy global monetary policy made it a trifecta, with the ECB (European Central Bank) and Fed (Federal Reserve of the United States) and BOJ (Bank of Japan) overly "hinting" that further market stimulus is at the ready.

Does anyone else feel like Bill Murray's character in the movie Groundhog Day, constantly re-living the same day as if his life was caught in a repeating loop?

Our most recent chapter:

On May 1, 2019 the S&P 500 reached a new all-time high of 2,954.13, immediately retreating to 2,728.81 through June 3rd, a (-7.63%) decline. At that time the Fed's stance was, shall we say, "unclear". The Fed has been "unsure" as to whether they needed to increase or decrease rates since their February 2019 meeting. Historically, equity markets do not like uncertainty.

With markets spiraling in the "Red" as trade negotiations with China looked grimmer by the *tweet*, Wall Street once again called upon their "white knight"… Fed Chairman Jerome Powell:



On June 4th, 2019 Fed Chair Powell began his speech at the "Conference on Monetary Policy Strategy, Tools, and Communications Practices" sponsored by the Federal Reserve Bank of Chicago, by saying:

> *"I'd like first to say a word about recent developments involving trade negotiations and other matters. We do not know how or when these issues will be resolved. We are closely monitoring the implications of these*

> *developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective." Fed Chair Jerome Powell 6/4/2019*

This is the same Jerome Powell that went on 60 minutes in early March and said:

> *"We see the economy as in a good place. We think that the outlook is a favorable one. Inflation is muted and our policy rate we think is in an appropriate place. So what we've said is that we would be patient." Jerome Powell: The 60 minutes interview*

Aaannnd the same Jerome Powell who, on June 19th 2019, once again stood at his pulpit and preached out of both sides of his mouth, first, as to how strong the American consumer is, then as to how tight labor markets are:

> *"The baseline outlook has been a good one and that has basically been consumer spending coming back up in the second quarter; that is coming true and consumer spending is at a healthy level and that makes sense. You've got a tight labor market; you've got companies in surveys saying that labor is scarce you've got workers in surveys saying that jobs are plentiful, you've got wages going up – you've got high levels of household confidence. So all of that underlying fundamental(s) for the consumer spending part of the economy, which is 70% of the economy is quite solid. Job creation, if you take a 3-month average is still well above, ah (you know) the level of entry into the workforce so that part of the economy is solid. FOMC press conference minute 24:05 Powell's answer 24:30*

He did follow with a very muted caution:

> *"We have been mindful of some ongoing crosscurrents, including trade developments and concerns about global growth.*

He continued:

> *In the weeks since our last meeting, the crosscurrents have reemerged. Growth indicators from around the world have disappointed on net, raising concerns about the strength of the global economy. Apparent progress on trade turned to greater uncertainty, and our contacts in business and agriculture report heightened concerns over trade developments. These concerns may have contributed to the drop in business confidence in some recent surveys and may be starting to show through to incoming data. Risk sentiment in financial markets has deteriorated as well. Against this backdrop, inflation remains muted."*

If you're asking what a crosscurrent is, it would be "Fed-speak" for conflicting data… But I'd kindly ask you to really think about his concluding words:

> ***"It is important, however, that monetary policy not overreact to any individual data point or short-term swing in sentiment. Doing so would risk adding even more uncertainty to the outlook. Thus, my colleagues and I will be looking to see whether these uncertainties will continue to weigh on the outlook. And, we will use our tools as appropriate to sustain the expansion."***

Leaving many experts to ponder… If he FOMC Chair is openly admitting that the consumer, who accounts for 70+% of what drives the economy is strong and the labor market tight, noting *some of these developments being so recent*, then closes with the importance of not "overreacting" – his words, not mine; why remove "patient" from the FOMC's language and how on earth can the Fed be talking rate cuts, even in the name of "crosscurrents"?

Puzzled? You're Not Alone...

The Fed's flip-flopping and communication has been as clear as mud lately, leaving many Wall Street portfolio managers making short-term investment decisions fed meeting to fed meeting. Some of the most well respected academics in the industry have been left *puzzled*.

David Kotok of Cumberland Advisors was recently scratching his head on both Yahoo Finance TV and Bloomberg TV. I've never seen the man like this. He looked confused; almost dumbfounded in both interviews (I urge you to watch by clicking here or the below link) his emotion/concern is very real.

Cumberland Advisors was once a wholly owned subsidiary of Ryan, Beck & Company; the firm I began my career at more than 23 years ago. While I do not always agree with Mr. Kotok, I do respect him. I believe Mr. Kotok to be a highly intelligent, wicked smart man, a well-respected academic and cerebral thinker.

From his Bloomberg TV interview:

> *"You know today is the 46th anniversary of the founding of my company... and 50 years in this business. And never in 50 years did I think $12-trillion would be negative interest rates and we would be talking about cutting rates at a time there is a shooting war in the middle-east and oil is not going up....* ***Could you have ever forecasted any of this? And if you can't forecast anything, how can you guess about what will happen tomorrow? It's impossible!"*** *David Kotok, Cumberland Advisors, Bloomberg TV 6/18/2019*

Well-respected economists like Mr. Kotok are finding frustration in typical market "norms" as traditional correlations are quickly disappearing. This has left many suggesting they could never have foreseen the current environment in equity and debt markets right now; and this thinking is arguably the prevailing thought amongst academics in the industry!

It leads us to wonder why the teas leaves have left so many seasoned veterans befuddled?

Before moving forward I want to say that we don't disagree with much of what Mr. Kotok has cited as what we would refer to as lunacy in today's markets (*we will examine both, our agreement and disagreements in greater detail in our upcoming quarterly note*), for now we'll offer thought on what has got so many highly intelligent academic/money managers in disbelief.

Let's see if we can't quickly tackle this subject with an analogy a little personal in nature... I have two highly intelligent siblings, first, my older brother; an Aeronautical Engineer – West Point Graduate, war veteran, and Chinook pilot, a true hero of mine. I believe he's also got his MBA; his *academic* accolades are extensive and impressive.

Growing up, my younger sister was a bookworm, she never left her room – she was constantly reading. She has her master's degree in Chemical Engineering. Upon handing in her master's thesis, she was basically offered her PhD; all she had to do was stay in school on additional year (which the school would have paid for) and simply turn in and defend her 180+ page Master's thesis as her Doctoral. That's how good her advisor believed her thesis to believe. (I couldn't make it out of her table of contents – way over my head) She respectfully passed on the offer, but that's irrelevant, the offer was there – she's brilliant.

While I don't want to give my folks the role of referee, I'm fairly certain we'd agree that my bother and sister are both highly "book smart".

Then there was me, simply stated, I learned differently. I was a more visual learner. By no means a "dummy" but the intelligence and learning process was quite different. I'll take something apart; break it, simply to learn how it works. Anyone who has read these notes for any length of time knows I preach reading the fine print. Detail interests me… I want to know the why to the "why"!

In my early 20's, I took a 600-sqare foot, nearly condemned "cape" that smelled like death and converted it to a 3,000-sq ft, beautifully custom home, doing much of the framing, electrical, plumbing and heating work on my own. While I consulted with friends, even having some complete high detail furnace and trim work, I built myself a beautiful home (while working a full time job). Until that point in my lifetime, I had barely picked up a hammer.

My mother would always say I had "street smarts", "common sense", and intuition. I want to make this clear - I'm not judging what's better or worse, who am I to judge? I'm merely pointing out there is a significant difference in the way the same information can be interpreted by those who look at things differently.

I view the world much differently than most – from quite a different perspective. I'm also a loner – I don't need approvals from a group to remain firm in my beliefs and convictions. I don't take anyone's "word for it" and don't mind standing alone if it means doing what I believe is right over popular opinion. I'm open to conversation and healthy debate, but you better

bring your supporting documents to back up your position.

So long as I believe my research to be extremely well documented and sound, I take comfort and pride in my work.

Sociologist, Mark Granovetter wrote a brilliant paper on "Thresholds" discussing different personality types – fascinating paper which I'll be referring to in the very near future – I happen to have a low Thresholds.

Visual learners or those with "street smarts" may not always be able to tear through "geeky" mathematical models, though, more frequently than not, we are able to adapt and sift through B*lls**t very quickly, while the highly intelligent "book smart" individual, at times, find difficulty in pivoting; they often outsmart themselves.

We believe the Fed's manipulation of interest rates and QE has created enormous distortions in the data traditionally measured by the historic economic models used by Mr. Kotok and his ilk. The highly complex models simply don't account for the FOMC's absurdities and hubris (some would call it stupidity, I won't argue).

These exceptionally "book smart" individuals are having trouble forecasting because what *should be* rational is not. Academics know how damaging $13-trillion of negative yielding bond instruments around the world will be for the growth outlook, especially for financial institutions. Some of these guys are too smart for their own good; they often fail to take a step back and look at things in their most simple forms.

Data Driven or Defending their Position?

Our belief is and has been for quite sometime that interest rates will at some point in the future be significantly higher; our best guess was and still is 4Q2019 - 4Q2022; this is based upon the sheer volume of corporate debt that needs to be re-priced between now and then. However, so long as debts are financed, they can be increased as well as extended. Additionally, we have written for years that we were much more likely to see lower interest rates first; and there are a few reasons for this. As we wrote over 2 years ago:

> *"History suggests the late stages of most bull markets are where the greatest of gains are typically made. Euphoric buying pushes stocks up to unrealistic valuations and levels and in our current environment, central banks will more than likely attempt to "defend" their positions should markets attempt to take them lower. It's either defend your position or deal with a currency issue because of the value of your equity positions?!"* *Other Side Asset Management 2Q2017 Note*

What we are witnessing right now is the Fed "***defending***" their position.

Sadly, I believe you can sum up 44 minutes of the Fed press conference up in a few short sentences, first:

> *"Risk sentiment in financial markets has deteriorated as well" - Minute 2:35*

Looking back on May 1, 2019 Bloomberg reporter Michael Mckee asked Fed Chair Powell about asset prices and cutting rates:

> *"I'm just curious as to whether the level of asset prices is a reason why you might not be interested in cutting rates"*

Chair Powell's response at that point was as follows:

> *"We say in our longer-run statement of goals and monetary policy strategy that risks to the financial system that could prevent us from achieving our goals are something that we do take into consideration."*

Then again on June 19th, Mr. Mckee asked about cutting rates and "Asset Prices"; Powell's response is as telling as it gets…

> *"So, we take the—you know we take the cross-currents as a given and we have our tools. You know, we don't—**we react to anything in principle that could undermine our achievement of our dual mandate goals, maximum employment, stable prices, is worthy of our attention, and can call forth a policy response**." ~Minute 28:36 response to Michael McKee's follow up question*

I'm going to cordially ask that you dissect Mr. Powell's statements as quoted above… He flat out says the Fed takes the "crosscurrents", "**as a given**". The FOMC states in their "**longer-run statement of goals and monetary policy strategy that risks to the financial system that could prevent (them) from achieving their goals is something that they do take into consideration**" AND ***the Fed "react(s) to ANYTHING in principle that could undermine their achievement of our dual mandate goals***." Anything (falling asset prices) could possibly undermine this dual mandate ***"is worthy of our (their) attention and can call forth a policy response!"*** (Lower rates/QE)

These guys can and will make the data say whatever they want it to in an effort to keep the house of match sticks from setting ablaze… As the saying goes there are "lies, damned lies and statistics…" (Often attributed to Mark Twain; though others suggest earlier origins)

The Fed's "data" is akin to a war on "terror"; not the actual fighting, but it's chasing a "mythical creature". Both the Fed's "data" and a war on "terror" chase a constantly moving, ambiguous, never ending target, which is up for interpretation; thus allowing unelected officials to create whatever narrative they choose to support (at the moment it's asset prices), in the name of their dual mandate; "data" is simply their excuse.

Recessions happen, unemployment rises, bad companies should die… The bankruptcy process exists. The Fed is stifling growth by allowing unproductive companies remain solvent via copious amounts of debt. This will not end well.

There is not a question in my mind that we are in a late stage bull market. I can't tell you exactly where we are in the cycle, but to use a baseball analogy, I would say with certainty that we're in extra innings… I just don't know if we're in the top of the 10th or bottom of the 16th with 2 outs, bases loaded and a full count at the plate?

I do believe we've reached the point where the FOMC can't allow confidence to wane for as we've pointed out in the past, CONFIDENCE is what Reinhart and Rogoff point to as the determining factor leading to every major *financial folly* throughout history.

So if the Fed's so predictable and rates are moving lower, why aren't we currently more aggressive? Stay tuned for our Q2 note where we'll take a deeper dive into answering this question, provide more detail on our models, more on the Fed and Mr. Kotok and how we prepared for this moment in the 4th quarter of 2018. We'll show you how a simple shift tipped our hand… We'll also discuss why this weekend's G-20 announcement still leaves room for plenty of turbulence ahead.

As always, we're happy to discuss our market thoughts along with these strategies and more, never hesitate to reach out with any questions or concerns.

Thank you for your continued trust and support!

Sincerely,

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Disclosures

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