PALOS

Weekly Commentary

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*By Charles Marleau CIM® and William Mitchell CIM®*

# The Fed Obsession

Throughout most of 2022 investors have been laser focused on the U.S. Federal Open Markets Committee (a.k.a. FOMC or the "Fed") and the federal funds rate which the Fed uses as its primary tool to manage the direction of monetary policy and interest rates in the United States. As dictated by U.S. Congress, the Fed is assigned their dual mandate: keep inflation under wraps and maintain maximum employment.

In a nutshell, the Fed meets eight times a year and mandates a rate that's designed to do the following: manage the direction of the economy by boosting interest rates to slow consumer spending and manage capital investment and borrowing when the economy is deemed to be overheated. It also has the ability to lower interest rates when economic stimulus is in order, as was the case during the early days of the pandemic. The impact of the fed funds rate is felt throughout the global economy as well as in financial markets. Typically, although not always, rising rates are bearish for growth companies due to higher borrowing costs. Central banks around the world have been aggressively battling inflation by tightening monetary policy. This has been achieved through interest rate increases and the easing of stimulative asset purchases (bonds).

On August 26, at the annual Jackson Hole, WY economic symposium, Fed Chairman Jerome Powell reiterated prior comments that the Fed would continue to raise interest rates until inflation is under control. Powell further commented that should excessive inflation persist the associated economic consequences would get worse. Powell was crystal clear, acknowledging that higher borrowing costs would cause some "short-term pain for long-term gain" but was necessary to conquer the highest inflation since the eighties.

Central banks continue to be aggressive. The Fed increased the funds rate by 75 basis points (0.75%) at its June and July meetings and markets are anticipating an additional 50 to 75 basis points at the upcoming meeting on September 15. Last Wednesday, the Bank of Canada (BOC) increased its target for the overnight rate to 3.25% as the Canadian economy continues to operate with excess demand and tight labour markets. Higher rates are impacting Canada's mortgage rates which in turn has the housing market softening. On September 8, the European Central Bank (ECB) also announced a 75-basis point hike. The next BOC meeting is scheduled for October 26.

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Market prognosticators continue to offer a variety of projections on when and where the Fed will halt its aggressive stance. We are inundated daily with borderline comical comments from supposed “experts” claiming that either the bear market is certain to continue, culminating in new lows, or conversely that the “bottom is in” and markets are sure to head higher. Investors and money managers have become fixated to the point where speculation on when central bankers will stop their aggressive measures has become an obsession. The truth is nobody knows for sure, yet novice investors seemingly react to every inflation data point or comment from the fed with excessive optimism or fear. In our view, this is irrational behaviour based on nothing more than guesswork.

In our opinion, speculating on future interest rates is a fool’s game. Years of experience has taught us that maintaining a long-term perspective, portfolio diversification, sector rebalancing and capitalizing on seeking opportunities when they present themselves offers the best approach to achieving long-term success. Given time to filter into the economy, we are confident that coordinated central bank maneuvering will achieve the goal of taming excessive inflationary pressures and returning the economy to an equilibrium between supply and demand and normalized interest rate policy.

We have been busy over the summer months, and we’re already seen some interesting opportunities in markets, particularly in the energy and staples sectors which have significantly outperformed their peers in 2022. Recently, we have seen some strength returning to beaten down technology stocks, materials and financials. Geopolitics continues to create uncertainty with continued covid shutdowns in China and disruptions from the conflict in Europe however, we believe much of the bad news has already been accounted for in market prices. Eventually, optimism will return and the markets, which are forward looking mechanisms, will have “turned” well before the headlines inform us that the worst is behind us.

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| Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1] | FundServ | NAVPS | YTD Returns |
|---|---|---|---|
| Palos Income Fund L.P. | PAL100 | $8.66 | -7.99% |
| Palos Equity Income Fund - RRSP | PAL101 | $6.61 | -8.09% |
| Palos Merchant Fund L.P. (Dec 31, 2021) [2] | PAL500 | $1.16 | 24.67% |
| Palos WP Growth Fund - RRSP | PAL213 | $13.88 | -26.53% |
| Palos-Mitchell Alpha Fund [3] | PAL300 | $8.43 | -17.97% |
| S&P TSX Composite (Total Return with dividends reinvested) | | | -4.91% |
| S&P 500 (Total Return with dividends reinvested) | | | -13.72% |
| S&P TSX Venture (Total Return with dividends reinvested) | | | -31.22% |
| **Chart 2: Market Data [1]** | | | **Value** |
| US Government 10-Year | | | 3.31% |
| Canadian Government 10-Year | | | 3.13% |
| Crude Oil Spot | | | US $86.79 |
| Gold Spot | | | US $1,718.80 |
| US Gov't10-Year/Moody BAA Corp. Spread | | | 222 bps |
| USD/CAD Exchange Rate Spot | | | US $0.7674 |

[1] *Period ending September 9th, 2022. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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