Chart of the Month

July 2020

The Federal Open Market Committee (FOMC) met yesterday and "decided to maintain the target range for the federal funds rate at 0 to 1/4 percent."

The Fed promised to keep the rate near zero "until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." The central bank will increase its holdings of Treasury and mortgage-backed securities "at least at the current pace" for the foreseeable future.

During the press conference, Federal Reserve Chairman Jerome Powell, when asked about the outlook for interest rates, said, "We're not even thinking about thinking about thinking about raising rates." In so doing, Powell one-upped his statement at the June meeting when he specified, "We're not even thinking about thinking about raising rates."

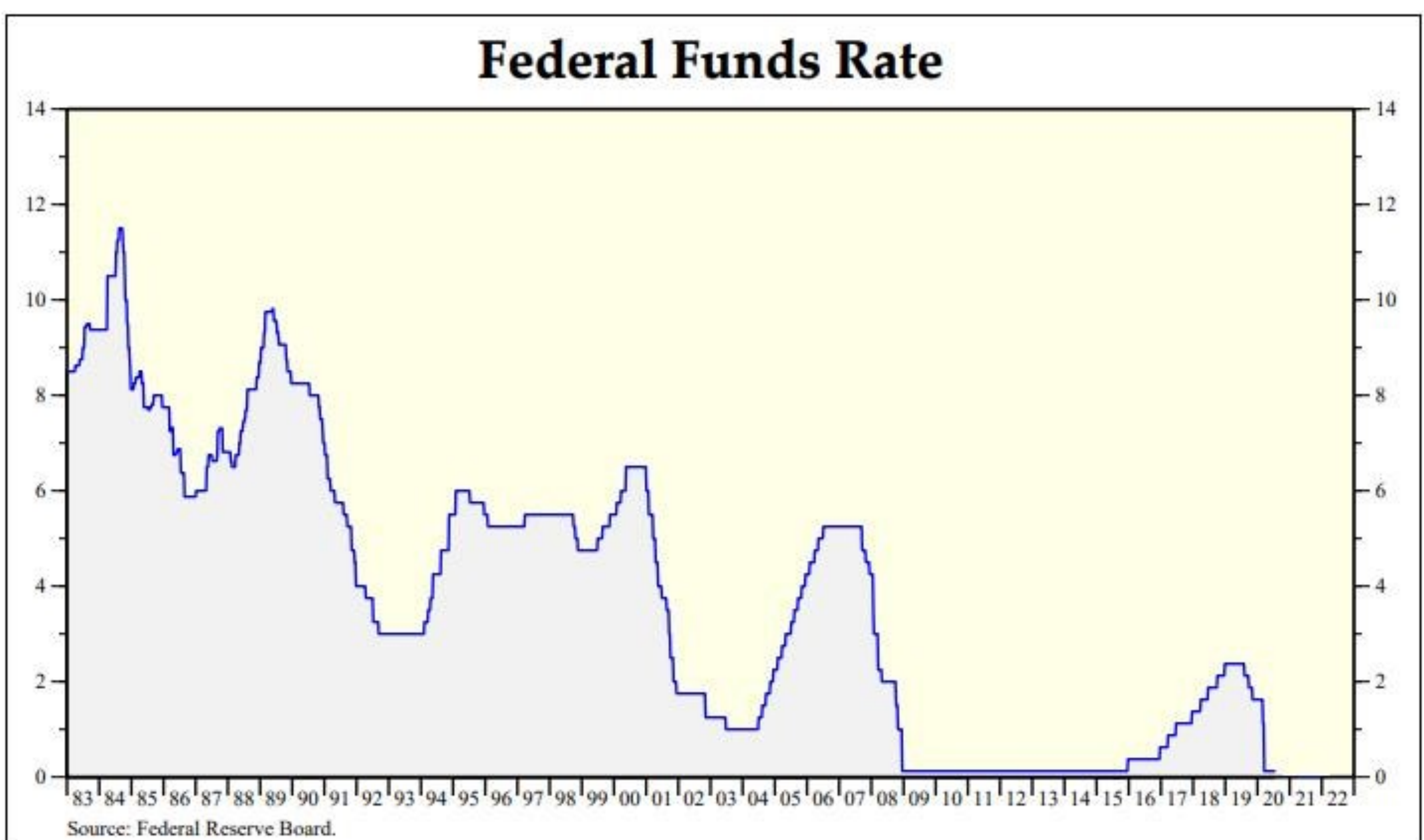
For those of you not keeping score, Powell added another "thinking about" to his previous statement. It was not a slip of the tongue nor a case of him stuttering. Instead, it was the most important reveal of his presser. The bottom line is that the Fed is unlikely to raise its key rate through 2022 and perhaps for years to come.

As shown in the chart below, the last time the federal funds rate was lowered to zero (in December 2008), it remained at that level for seven years (until December 2015). The low interest rates fostered the longest economic expansion and bull market on record, both of which were broken in March when the global pandemic turned a health crisis into an economic crisis.

While the economy has rebounded from the spring lows, it is still well below the pre-pandemic level earlier this year as evidenced by the 32.9% decline in Q2 GDP, the largest contraction ever. Consumer spending, which comprises about two-thirds of the U.S. economy, fell 34.6% during the quarter.

Aggressive monetary and fiscal policies have pumped trillions of dollars of liquidity into the system, greatly assisting a moribund economy while lifting the S&P 500 toward — and the Nasdaq above — the all-time highs in February. However, without the continuation of the stimulus measures, including the supplemental unemployment benefits set to expire tomorrow, the V-shaped recovery runs the risk of looking like a "W" in the second half of the year.

Although the amount of government aid is clearly unsustainable longer term, the excess liquidity has been finding its way into financial assets, driving stock and bond prices higher than perhaps imaginable just four months ago. With Treasuries ranging from approximately 0.10% inside one year to slightly more than 0.50% in ten years and investment-grade corporate bonds mostly offering only an additional one-half to two percentage points, the low yields on fixed-income securities are such that equities have become, almost by default, the vehicle of choice, either for their dividend income or prospects for capital appreciation. That said, the latter will become more challenging from today's elevated levels, particularly when coupled with the uncertainties surrounding the virus, economy, and election in the months ahead.



Lederer & Associates
Investment Counsel
5305 East 2nd Street, Suite 201, Long Beach, California 90803
Tel: (562) 434-5305 ▲ Fax: (562) 434-5306
www.lederer-associates.com