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SPECIAL MARKET UPDATE – CENTRAL BANKERS, INTEREST RATES, AND INFLATION

Dear Investor,

Last month, following the July 31 Federal Open Markets Committee's (FOMC) decision to cut interest rates by 0.25%, we sent a Special Market Update describing the Fed's return to monetary stimulus, and described how this type of action was meant to protect the US economy from the risk of a recession.

Since that time, the European Central Bank followed suit, cutting its deposit rate (on Sept 12) to a record low of -0.5% (yes, negative 0.5%) and revived Quantitative Easing (the systematic repurchasing of 20 billion Euro of bonds per month, beginning in November). You may recognize Quantitative Easing as a tool from our own Federal Reserve's tool belt, meant to encourage lending and investment, especially in environments where the impact of reducing interest rates further is not particularly meaningful. Our own Federal Reserve implemented three rounds of this tactic on this side of the pond between 2008 and 2014, increasing our Balance Sheet from $700 Billion to a staggering $4.5 Trillion.

As expected, the FOMC again cut interest rates today by 0.25%, bringing the new target rate to 1.75%-2.00%. The market expects the Federal Reserve will continue these stimulative measures, with interest rates ultimately falling to 1.50%-1.75% by January of 2020. As we suggested last month, the Committee believes sustained economic growth, strong labor market conditions, and muted inflation will prevent recession in the near term, yet uncertainties remain, and lowering interest rates is a prudent step at this time.

INFALTION AND THE DUAL MANDATE

The Federal Reserve is tasked with a dual mandate – to maximize employment and to maintain price stability in our economy. While the former is quite intuitive, the latter is often interpreted to mean low and stable inflation. Specifically, the Federal Reserve has stated that it will target a 2% rate of inflation. But why 2%? And why does the Federal Reserve prefer to see prices rise, rather than fall or remain constant?

The answer is partly due to how we measure the rate of inflation - the annual change in the price a consumer pays for a wide range of goods and services such as cars, clothing, food, energy, healthcare and housing.

For one, it is very difficult to accurately measure inflation, as the measurements do not include all goods and services a consumer may actually purchase. Further, the measurement tools have a slightly upward bias, meaning that a 2% observed rate of inflation is probably closer to a 0%.

Second, higher inflation rates tend to be associated with higher interest rates. As a result, higher inflation gives the Fed more room to cut rates in the event of a recession, thus the Fed's preference for a positive rate of inflation.

Third, targeting positive inflation provides a buffer against deflation – a downward movement in prices – which many believe is more harmful (consider how a decline in the value of your home, stock portfolio, business, or wages would feel).

Ultimately, inflation expectations impact how consumers and businesses make economic decisions, and maintaining credibility with respect to a stable long term target rate helps achieve price stability in the economy.

OUTLOOK

We continue to believe the cumulative impact of global Central Bank easing, continued inflation, slower yet positive economic and profit growth, and reasonable global equity valuations, pushes out the prospect of an economic recession in the US past the 2020-2021 time horizon and is quite favorable for investors in the equities markets.

Despite this, headline risks, such as a "no-deal" Brexit, uncertainty in Hong Kong, upcoming US Presidential elections, US-China trade uncertainty, Iran-Saudi military escalation, and global central bank policies, will continue to lead to volatility in the equities markets.

As such, we continue to expect low to mid-single digit returns for globally diversified investment portfolios.

If you have any questions or concerns or would simply like to discuss this or any other issues further, please do not hesitate to call us anytime.

Looking forward to speaking soon,

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