Summer 2017

As a young man, Mark Twain (then Samuel Clemens) saw in the Mississippi all its majesty. "There were graceful curves, reflected images, woody heights, soft distances," he wrote, in his famed essay, "Two Ways of Seeing a River," "and over the whole scene, far and near, the dissolving lights drifted steadily, enriching it, every passing moment, with new marvels of coloring." Once he became a seasoned riverboat pilot, and absorbed the language of the water, however, he saw the mighty river differently: "All the value any feature of it had for me now was the amount of usefulness it could furnish toward compassing the safe piloting of a steamboat."

What happened? In order to become a master of the nuance of steamboating, he had to make a trade-off. Expertise came at the cost of appreciation. The sun now meant there would be wind the next day. The floating log, once lovely, meant the river was rising. The slanting mark on the water signaled "a bluff reef which is going to kill somebody's steamboat one of these nights."

The team at OCM has navigated many a river over the years. To our minds, however, we still view the financial world with the same awe and passion as the younger Twain viewed the Mississippi. But, like the seasoned Twain, we're always scrutinizing the floating log and slanting marks, piloting the boat away from potential hazards.

And we may have spotted one. A few weeks back, the Federal Reserve released a statement announcing they will be raising interest rates. Nothing to fret there. A normal occurrence. Still, for background, let's take a look at the ramifications of that before getting to that slanting mark on the water, off in the distance.

A primer: the Federal Funds Rate is the interest at which a depository institution lends funds, maintained at the Federal Reserve, to another depository institution overnight. It hugely affects monetary and financial conditions, which have a bearing on key aspects of the broad economy, including employment, growth and inflation. While this rate applies only to US financial institutions, it is an indicator of the world economy (since the US is the largest single economy).

Since December of 2015, the Fed Fund rates have risen four times, taking the target rate from 0.25% up to, just weeks ago, 1.25%. And likely we'll see additional rate bumps into 2018.

Again, this is not reason to be alarmed. Here's why. In September of 2007, the target rate for fed funds was 5.25%. Then came the financial crisis. In order to salvage the economy, the US (and many other countries), dramatically lowered rates, all the way to 0.25% by January of 2009. The European Central Bank followed suit, dropping rates (the ECB Deposit Facility Rate) from 3.25% to 0.00% by mid-2014, then proceeded to push into negative interest rates. It still hasn't raised them. In fact, its current rate is negative (0.40%).

While the US economy has been much stronger post-crisis, Europe's, which emerged from recession in 2014, has steadily grown at a slower pace. Canada was able to move through the crisis relatively unscathed. Still, the sharp drop in oil prices caused the need to stimulate their economy and the Bank of Canada lowered rates from 4.25% in September of 2007 to the current rate of 0.5% for their Overnight Lending Rate. This prompts the real possibility the European Central Bank and the Bank of Canada will also begin raising rates this year or early next.

While we've highlighted the US, Europe and Canada, the same scenario is taking place across the globe.

Historically, lowering interest rates has been one of the best ways to kick start economies. Lower interest rates allows businesses, both large and small, to grow by borrowing money cheaply, allowing the adding of employees, expanding of operations, and purchasing of new equipment. Lower interest rates also allow governments to spend more, with a lower tax burden.

So, when central banks start to raise interest rates, businesses and investors take notice. It generally means economies are *healthier* and can tolerate higher borrowing costs without slowing expansion.

This is where we-the US and other countries-find ourselves now. Paddling down the river, a wide familiar bend in front of us. We've been here before. Things are going smoothly. But every good riverboat pilot looks forward, scans what's to come.

A close read of the Fed's seemingly innocuous announcement reveals what may be a slanting mark in the water: "The Committee currently expects to begin implementing a balance sheet normalization program this year, provided the economy evolves broadly as anticipated."

This means the institution is planning to unwind a significant portion of their large holdings of US Treasury notes, mortgage-backed bonds, and asset-backed bonds. Though it doesn't necessarily indicate a dangerous bluff reef, it's noteworthy. And merits close analysis.

Prior to the financial crisis, the US Federal Reserve had assets on their balance sheet of around $900 billion, accumulated over the normal course of activities. When the crisis hit and banks were teetering (or, in some cases, collapsing), the US Fed and central banks around the globe pumped a lot of money into financial institutions to add liquidity to the system. Chiefly, this was done by buying debt from banks, which added cash to their balance sheets. In the US, this took the Fed's balance sheet up to $2.2 trillion. Subsequent efforts to stimulate the economy, in the form of quantitative easing, raised that number to almost $4.5 trillion. Once again, the US wasn't alone in this strategy. The total assets of the major central banks around the world total close to $14 trillion.

The Fed's statement on reducing their balance sheet doesn't give a specific start (or end) date, but will likely begin before the end of this year. Reducing the balance sheet $1 trillion or $2 trillion by selling bonds on the open market might have a huge impact on prices and future interest rates. Currently, the Fed reinvests all the bonds as they mature, keeping the money in mortgages and Treasury notes.

So as not to roil the markets, the Fed will start slow, reducing, monthly, their repurchases of Treasuries by $6 billion and mortgages by $4 billion. Every three months thereafter, they will reduce their reinvestments again, by the same respective amounts. If all goes without a hitch, the balance sheet would be normalized-between $2.5 trillion and $3.5 trillion-by the end of 2020.

(It's worth noting that the plan is flexible. We predict those reductions will be smaller, and the overall process will take longer. Also worth noting, other central banks are also likely to reduce their holdings.)

What's the potential impact of these actions, and why are we, as pilots of our clients' portfolios, keeping a watchful eye?

First, it is a major reversal of policy, changing the accommodative stance to a more restrictive money supply (the amount of capital floating around the globe for use in loans, investments, and employment). Second, it reduces a steady source of demand (buyer) in the markets. Others will have to absorb the additional supply. And, because the US government still spends more than it takes in, the Treasury will need to increase the amount of bonds sold to fund government operations. All this puts additional pressure on interest rates, meaning they'll rise.

But other factors could offset those hikes. The economy could strengthen enough to cause more demand. Lower taxes could help. So could less regulation. Rising inflation, especially wage inflation, would be a huge boon.

Nobody knows for certain if these things are coming. So we need to steer the boat in a direction that keeps her safe and on course. We're doing that. While early, we've built our fixed income portfolios, whether through individual bonds or with ETFs (exchange traded funds), with a rising interest rate environment in mind, holding higher credit quality and shorter duration bonds. This will enable us to protect more principal and take advantage of higher rates when they arrive.

Twain's essay ends on a somber tone. Reflecting on his experience, the author pities doctors, who can't help but see the "flush in a beauty's cheek" as a sign of some deadly disease. We're not nearly so grim. Still, an ounce of prevention...

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