Global Investment Letter

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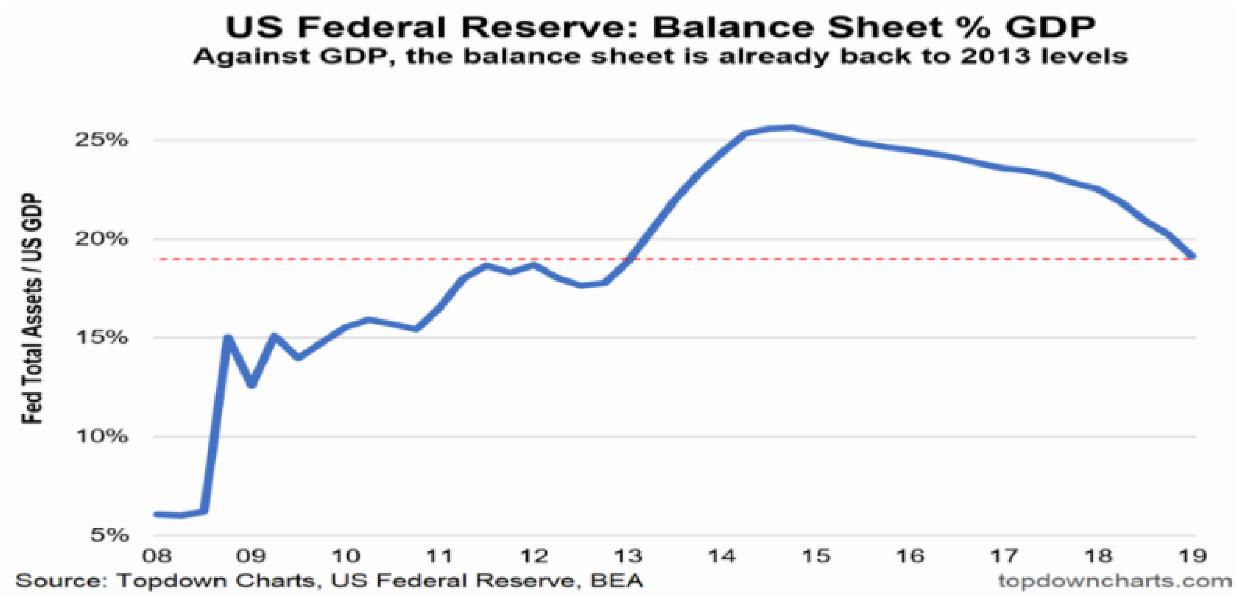
**IS THIS THE NEW NORMAL?**

It is human nature to adapt to changes and quickly consider them the new normal. An obvious example is behaviour from our politicians that is now generally accepted but would have ended careers 15 or 20 years ago. The chart below provides another example that is particularly relevant for investors. It illustrates what has happened to the Fed balance sheet as a percentage of U.S. GDP since the financial crisis of 2008.




The first observation from the chart is that the Fed has reined in Quantitative Easing (QE), shrinking the Fed balance sheet by some 20% since its peak in 2014. It is currently at levels generally seen in the 2011-2013 period. As noted in the first paragraph, there is a tendency to think of recent events as representative of normal conditions. So it is with the Fed balance sheet, with many market observers noting the Fed's recent efforts at Quantitative Tightening (QT).

Those of us who choose to take a longer perspective will note that after the recent QT, the Fed's balance sheet as a percentage of GDP remains almost 400% higher than it was before the financial crisis of 2008! To my mind, this is the most pertinent message of this chart, that current economic conditions in the United States, and the developed world, remain far from normal compared to historic norms.

Most telling of the fragile nature of the global economy is that despite the unprecedented intervention by the Fed, European Central Bank (ECB), Bank of Japan et al., these efforts have produced a weaker than average economic expansion. It should be said that the central bank intervention was warranted both from an economic and social standpoint, but the mediocre economic response to such a massive stimulus effort portends future problems for the global economy.

Despite the actions of the Fed to raise interest rates and shrink its balance sheet, global central bank policy remains very accommodative. Interest rates in the United States remain low in historic terms, while interest rates in the EU and Japan remain negative! Mounting evidence of a slowing world economy suggests that central bank policies may begin to ease again soon, even from the traditionally highly-stimulative levels of today.

The Fed deserves credit for its attempt to raise interest rates to more normal levels in order to develop a tool to combat the next recession. Their colleagues in Europe and Japan didn't even try. Unfortunately, they appear to have run out of time. The next recession will push U.S. rates lower and interest rates in the EU and Japan even further into negative territory. The effect of such an unprecedented economic environment remains to be seen, but the law of unintended consequences will surely assert itself. It is likely that both economies and markets will behave in unanticipated ways.

It has long been our contention at the Global Investment Letter that the factors that produced the financial crisis of 2008 have never been properly addressed, and are now even more severe. We continue to believe the years ahead will be volatile, full of threats and opportunities. Our combination of practical experience and use of historical context has been effective so far and will be especially appropriate over the next 5-10 years. The upcoming April issue of the Global Investment Letter will include a discussion of how U.S. equities may behave in unexpected ways over the next several years.

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