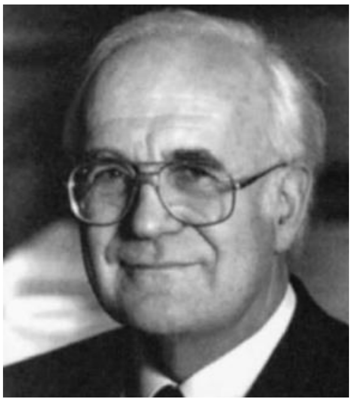
VIEWS FROM THE DESK (VFTD) February 2019

If the US sneezes, does the rest of the world catch a cold?

Two men have been at the forefront of our minds over the last few weeks. One is a keen cyclist and often seen riding his bike to work; the other was renowned for his sense of humour and enjoyed a game of cards. Both have committed some, or all, of their careers to the public sector and decisions made by each influence the lives of us all today. Perhaps more important, each man tried, or continues to try, stopping what most of us believe is inevitable. We are confident you will recognise one of these, but who is the other?



Of the men pictured, the less well known is on the right. He is David Tyrrell - the 'reluctant young virologist' – as he described himself when he became the head of the UK's Common Cold Research Unit (CCRU) in 1957. Why has he been on our minds? Well, in recent weeks numerous colleagues in the Affinity team have been fighting a cold – or man-'flu in the case of male members of staff. It is hard to think of another illness that inspires the same level of collective resignation. The common cold slinks through homes and offices, towns and cities, making people miserable for a few days, without warranting much afterthought once they recover. By way of contrast, Tyrrell dedicated almost every day of his working life to understanding the common cold. During his time at the CCRU, Tyrrell oversaw the first successful effort to culture the virus most commonly responsible for the cold – the *rhinovirus*. Additionally, he identified and investigated treatment options, undertook studies of influenza vaccines and examined the relationship between stress and the cold.

Alas, despite all this detailed research leading to an in depth knowledge of how a cold is caused, the mechanics of how it is caught and its variety of forms, Tyrrell and his team were unable to find a cure. When the group discovered there were over 100 different *rhinoviruses* and the human body saw each of these as a different virus, they realised there was no way they could develop a vaccine. As a consequence, despite the many billions of US dollars collectively spent around the world on over-the-counter remedies, adults typically suffer an average of between 2 and 4 colds a year, and children as many as 10. At this stage of the twenty first century, humankind has been forced to accept the regular pain and discomfort caused by the tiny rhinovirus as an inevitable part of life.

The man on the left, of course, is Jerome Powell, current Chairman of the Federal Reserve. He and his fellow Federal Open Market Committee (FOMC) members are tasked with fulfilling the dual mandate set for the Fed, by the US Congress; price stability and maximum employment across the economy. Like most investors, in recent weeks, we have debated the future direction of FOMC interest rate policy. The ability to adjust the 'cost of money' is the single most important tool available to central bankers, as they manage their domestic economies. It is doubly important to the Fed, as they dictate the cost of the world's reserve currency and thus impact the health of many other economies, not just that of their own.

We are now into month 115 of this current US expansion, which is about double the post WWII norm and just 5 months shy of matching the longest cycle on record. Price stability and maximum employment requires steady economic growth and the Fed has set about achieving this, whilst engineering the transfer from an environment of extraordinary Quantitative Easing to one of Quantitative Tightening. The latter has involved trying to increase interest rates just enough to dampen a fast growing economy, but not by too much to trigger a contraction. All good in theory, however, we see parallels with the team at the CCRU; in other words, is the Fed trying to prevent the inevitable?

Fed tightening cycles

First Hike	Last Hike	Result
October 1950	May 1953	Recession
October 1955	August 1957	Recession
September 1958	September 1959	Recession
December 1965	September 1966	Soft Landing
November 1967	June 1969	Recession
April 1972	September 1973	Recession
May 1977	March 1980	Recession
August 1980	December 1980	Recession
March 1983	August 1984	Soft Landing
January 1987	May 1989	Recession
February 1994	February 1995	Soft Landing
June 1999	May 2000	Recession
June 2004	June 2006	Recession
December 2015	???	???

Source: Gluskin Sheff

There have been 13 Fed tightening cycles post WWII and 10 have landed the economy in a recession. Sadly, the folks at the Fed do not have a good track record in preventing contractions and have commonly overtightened at just the wrong time. Having increased interest rates at the December 2018 FOMC meeting – in the teeth of a significant wobble across global financial markets – Jerome Powell has subsequently adopted an increasingly dovish tone, culminating in a much more supportive January 2019 FOMC statement.

Risks assets have rebounded strongly on this shifting stance. Time will tell whether they have tightened too far but, whilst it does not possess a 'cure all' vaccine, they do at least have some 'remedies' should the US economy go into reverse. This is not the case for other major central banks, particularly the ECB, especially at a time when Eurozone economic data is weakening.

Implications for portfolios

Despite this less than upbeat message, it is important for us to recognise that, much like the common cold, recessions are not the end of the world - they are merely part and parcel of life's cycle. There is no sense denying their existence or their inevitability. The reality is – using US economic history – recessions and bear markets have existed for c.15% of the time, over the last 70 years. The remaining 85% has been represented by expansions and bull markets. Moreover, late cycle/recessionary periods do not mean an end to money making opportunities from an investor perspective. A focus on strong balance sheets, minimal cyclicality and a step up in quality across the entire capital structure can still generate returns. At the other end of the scale, distressed assets will undoubtedly emerge creating openings for those investors able to sell short.

Despite increasing deglobalisation, the world remains very interconnected. Market volatility around trade talks, or the impact of dollar strength on emerging market assets are testament to this. Therefore, actions by the Fed will inevitably lead to repercussions domestically and abroad. Given their track record of overtightening, it is right to be watchful and cautious; if the US sneezes, the rest of the world may well catch a cold.

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