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The Fed is the new macro

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Stock markets have rallied significantly and consistently since 2009 when central banks cut interest rates to zero and increased the money supply through quantitative easing (QE) programs. Ten years later, these measures are largely still in place. Even though it is not their mandate, central banks have been supporting financial assets while promoting risk-taking without consequence. With no end in sight, economists have described this as the "new normal."

Every now and then, central banks may attempt to bring us back to the "old normal." In that world, lenders got paid a decent interest rate – ideally above inflation – and bad businesses got flushed out as they failed to adjust to competition and higher borrowing costs. It sounds fair, but it does not suit the objective of governments that want economic growth now, no matter the cost. So far, central banks have failed to achieve the old normal as individuals, businesses and governments are unwilling to accept higher borrowing costs and tighter credit conditions. We continue to see many companies with no earnings continue to survive because of low-cost loans. Instead of letting them fail, central banks have aided in their continued existence.

The underperformance of many stock pickers has coincided with the use of QE by central banks since the 2008-09 financial crisis. The markets have done well over this period, but those strong gains were not accompanied by strong gross domestic product. Instead, most markets' returns have been the result of an expansion of price-earnings ratios, not earnings growth or dividends. The rising tides have lifted many companies, making individual company selection less important, even when they're better "boats." In this environment, passive stock selection has benefited from the rising prices of weaker companies.

It's not hard to imagine that as the U.S. Federal Reserve (the Fed) and other central banks around the globe start to wind up their QE programs, this trend may reverse. Weak companies will fail and stock picking will matter again. However, it seems we will be waiting a while for this. After a significant stock market decline in the fourth quarter of 2018, the Fed turned dovish at its January 2019 meeting, a 180-degree change from its message just one month before. We see this as a bailout for weak hands and a punishment for strong hands. The S&P 500 Index has posted a strong performance with benign volatility. From the Fed meeting on January 30 to March 13, 2019, the S&P 500 Index returned 7% and did not have any day with a 1% loss.

As an investor, you may start to believe that investing is no longer about the quality of a company or its earnings. Is it just about what the Fed says and does? It was not true prior to 2008, but it now seems to be the case as the Fed has become the biggest lender with a balance sheet of almost US$4 trillion. The need to restore confidence and boost economic activity was why the Fed and other central banks became more active in financial markets. Ten years later, their actions are still the dominant force in those markets. There are a growing number of investors that pay more attention to Fed statements than company income statements or balance sheets.

At the macro level, we are respecting the possibility that the current economic cycle could last longer, and valuations and fundamentals are not the only factors to consider. While we are not in the business of guessing what the Fed's next move is, we are paying attention to its actions and the implications for capital markets. Ultimately, interest rates and the availability of credit do affect earnings and valuations. We welcome the time when central banks bring QE to an end, share prices reflect company fundamentals and the overall performance from stock pickers improves.

Thankfully, active management is about more than stock selection. There is also opportunity to generate incremental excess returns from active asset allocation. In the portfolio construction process, we also closely examine other factors that can impact returns, including industry, country and style exposures. We will continue to manage all the variables that can influence an investor's total return, with the goal of obtaining strong long-term results.

Combined top 15 equity holdings as of February 28, 2019 of a representative balanced Private Client Managed Portfolio with alpha-style equity exposure:*

1. Atco 2. Canadian Utilities 3. Loblaw Companies 4. Enbridge 5. AT&T	6. AltaGas 7. IA Financial 8. Power Financial 9. E-L Financial 10. CIBC	11. Canadian Natural Resources 12. Suncor Energy 13. Bank of Nova Scotia 14. Canadian National Railway 15. Microsoft

Combined top 15 equity holdings as of February 28, 2019 of a representative balanced Private Client Managed Portfolio with value-style equity exposure:*

1. Apple 2. Microsoft 3. Brookfield Asset Management 4. Royal Bank of Canada 5. Toronto-Dominion Bank	6. Dollarama 7. Bank of Nova Scotia 8. S&P Global 9. Magna International 10. Alimentation Couche-Tard	11. KLA-Tencor Corp 12. Parker Hannifin 13. DowDupont 14. Gilead Sciences 15. TMX Group

Combined top 15 equity holdings as of February 28, 2019 of a representative balanced Private Client Managed Portfolio with growth-style equity exposure:*

1. Middleby 2. Keyera 3. TFI International 4. Tourmaline Oil 5. Boyd Group Income Fund	6. Athene Holding 7. Premium Brands 8. Great Canadian Gaming 9. Sleep Country Canada 10. Amazon	11. CSX Corp 12. Microsoft 13. George Weston 14. Dollarama 15. Alphabet

*Approximately 33% fixed-income, 10% enhanced income, 49% equities, and 7% global real estate.

To see the top 15 holdings of the individual pools or the equity alpha mandates, please contact your Stonegate advisor.

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