Can Your Portfolio Withstand Divided Government?

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In the United States, monetary policy is primarily administered by the Federal Reserve and fiscal policy is administered by elected officials both at the federal and state level. Currently, these two largest levers of economic influence are working in opposite directions. While the current circumstances are not ideal, Crawford Investment Counsel invests in high-quality companies in an effort to persevere in a variety of market environments.

First, a brief background. Monetary policy is a set of interest rate-related actions that control the overall money supply in order to achieve stated goals. In the United States, the Federal Reserve's stated goals are "maximum employment, stable prices, and moderate long-term interest rates." The Federal Reserve was created in 1913 following a series of financial panics (i.e., bank runs). The original purpose of the Federal Reserve was to prevent bank panics, but it was expanded greatly during both the Great Depression and Great Recession.

Fiscal policy utilizes government spending and taxation in order to influence the economy's trajectory. Typically, fiscal policy has been used for initiatives to promote sustainable growth, reduce poverty, help stimulate spending in recession, and redistribute wealth. Prior to the Great Depression, most governments took a laissez-faire attitude toward fiscal policy, but have since become more active.

Sometimes monetary and fiscal policy work together. A good example occurred in early 2020 in response to the COVID pandemic. In a matter of months, the Federal Reserve (monetary policy) cut the overnight bank lending rate (Federal Funds Rate) to zero and created over $1 trillion, about the same amount of monetary stimulus provided during the Great Recession. Simultaneously through legislative efforts, the Federal Government (fiscal policy) granted almost $2 trillion of aid through the American Recovery and Reinvestment Act, along with other stimulus efforts and expanded tax credits. The combined effort resulted in the shortest recession in U.S. history, with only two months of severe economic downturn followed immediately by strong economic growth.

But now, monetary and fiscal policy are working against each other.

Currently, in efforts to slow down the economy and lower inflation, the Federal Reserve is aggressively tightening policy by increasing interest rates and, in the process, reducing the amount of money in the financial system. Many view the Federal Reserve's primary mandate as maintaining stable prices, often translated in popular terms as a rate of inflation of 2% annually. With the Consumer Price Index at 8.2% and the Core Personal Consumption Expenditures Price Index at 4.6%, the Federal Reserve is expected to continue tightening. So far this year, the Federal Funds Rate has moved from 0.8% in February to 3.1%, and it almost certainly will go higher.*

Divided Government

While the Federal Reserve is trying to slow spending and curb inflation, some fiscal policy actions are doing the opposite. Here are a few examples:

1. According to the Congressional Budget Office (CBO), the recently passed Inflation Reduction Act of 2022 is expansionary. The CBO estimates this law will increase government spending by $200 billion in 2022 and will have an expansionary impact on the budget each year through 2026.
2. The President has proposed to forgive $300 billion or more in student debt, which could serve as a stimulus to the economy. While this has not been passed into law, even the small part that defers payments for the rest of 2022 could be expansionary.
3. Two states have recently provided stimulus to their citizens through tax rebates. Economists have cited the actions of both California ($18 billion) and Georgia ($1.2 billion) as being inflationary. Fiscal stimulus at the state level is typically not as large or durable as Federal action.

So where does this leave investors? There is no definitive answer; the future is uncertain. Despite the fact that government spending will be lower this year than last (fiscal drag), as long as policy makers continue to stimulate the economy through fiscal means, it is a counter-influence to the actions of the Federal Reserve to slow the economy. Continued expansionary fiscal policies could keep inflation higher for longer, potentially forcing the Federal Reserve to raise short-term interest rates past the neutral rate of interest, thereby increasing the chance of a recession. This divided government, along with other factors, could lead to companies reporting lower margins and lower growth rates. In an environment of potentially lower earnings growth, we especially favor high-quality, dividend-paying equity securities.

We select dividend-paying securities for a combination of growth, income, growth of income, and ultimately, capital appreciation. We have found these companies have the best chance to continue to grow profits and increase dividends in good times and in more challenged environments. In a period where fiscal policy and monetary policy seem to be at odds, we believe investors should still look to participate in the market through higher-quality companies. We feel it is best to own companies that can prosper and meet investment objectives during an uncertain time.

*Most recent available data is represented. Consumer Price Index figure as of 8/31/2022, Core Personal Consumption Expenditures Price Index figure as of 7/31/2022, and Federal Funds figure as of 9/22/2022.

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