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Quality Comes Into Favor as the Fed Pivots

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Recently, investor focus has been shifting and the result has been a broadening of participation among more sectors. With some emerging concerns about a softening economy, quality is being emphasized to a greater extent, and since this is the predominant characteristic of our portfolios, this has been reflected in the returns. All of this is welcome news.

The most important economic news may have occurred right at the end of August when Federal Reserve (Fed) Chairman Jerome Powell made his annual remarks at Jackson Hole. As expected, he confirmed that, "It is time for policy to adjust." While not being specific on the timing and magnitude of federal funds reductions, it is now widely assumed that the September meeting of the open market committee will bring the first cut in this extended cycle of monetary tightening. Importantly, Powell indicated that the Fed's focus is shifting to one of more balance between inflation and the labor market. This signals that the Fed is more confident that inflation is on a path toward the target of 2% and that unemployment needs more attention since it has been slowly rising over the last year. From a low of 3.4%, it now resides at 4.2%.

There have been several economic data points recently that indicate why the Fed is beginning to shift its focus. First, the Fed's favorite inflation measure, the Personal Consumption Expenditure index continues to decline and now stands not too far above 2%. We note that its decline is being impeded by housing costs, which are a lagging indicator. This was followed by two indications that the labor market is continuing to weaken. Also, the Fed's Beige Book showed signs that economic growth is softening with low inflation. Finally, we received an unemployment report that confirmed the slowing trend in job additions, although the unemployment rate dropped to 4.2%.

The net result of these economic releases is that inflation continues to improve while the labor market softens, and it confirms that the Fed is correct to begin shifting its focus more in the direction of supporting the labor market. Thus, the signal is that interest rate policy will be shifting. It is not clear whether the first cut will be 25 or 50 basis points. Either way, it will signal the next step in the Fed's long process of attempting to bring inflation, interest rates and employment back into neutral range.

The Fed will be making these moves in the interest of achieving a soft landing for the economy. This will not be an easy task. While we certainly hope they are successful, we recognize the difficulty in managing such a large and complex economy to a perfect state. And, in shifting its focus from inflation fighting to employment support, our concern is that the inflation fight not be weakened or abandoned. In our view it is imperative that the task be finished at a 2% level that is sustainable and with inflation expectations firmly grounded at a low level. Completion of the inflation task will give the other factors of growth and interest rates a better chance of also moving into neutral territory.

The Fed is obviously concerned that if they do not get started on an easing policy that unemployment may begin to rise rapidly and eventually cause a recession. How this unfolds will determine the pace at which the Fed will reduce interest rates. Most recently, the markets have been sharing the Fed's growing concern over the labor market. But amid this volatility there has been a further drift toward quality as a good place to be as all of this plays out. We will continue to manage our portfolios according to our long-held philosophy, with quality as the primary focus.