SIERRA RIDGE WEALTH MANAGEMENT

1435 River Park Drive, Suite 504
Sacramento, CA 95815
Office: 916-891-2557
Fax: 916-891-5907
sierraridgewealth.com

Capital Market Outlook

9/20/2019

MARKET NEWS

QUICK VIEW

- Stocks closed slightly lower last week, following three straight weeks of gains
- Attack at largest Saudi refinement plant resulted in steep oil supply shock across global market. Quick return to prior production standards expected
- U.S. Fed lowered fed funds rate by 25 bps on 9/18; market briefly declined but rebounded nicely by week's end
- SRWM qualified model portfolios have been rolled out, tax-advantaged and income-focused models currently in development

Oil: (9/14/19) A bombing attack on key oil infrastructure at a major Saudi Arabia refinement plant resulted in the worst oil supply shock in history, as 6% of the world's production was impacted. Oil prices briefly jumped 15% but retreated on news that production is expected to be returned to normal by the end of the month, sooner than some had expected.

Monetary Policy: (9/18/19) The Federal Reserve lowered its federal funds rate by a quarter point to insure against risks from slower global growth and trade uncertainties. This accommodative Fed activity may help extend the U.S. expansion, but expectations for continued rate cuts could prompt short-term volatility.

U.S. REPO MARKET

Just prior to the Fed's monthly meeting and economic outlook commentary this past Wednesday, the public was made aware of, what many pundits have called, an inefficiency in the U.S. Repo market. Here, we explain what a repo instrument is, the issue that arose in the system and how the problem was addressed.

The U.S. repo market is a widely-used mechanism intended to satisfy the short-term liquidity needs of banks and large corporations throughout the country. Securities dealers sell high-quality financial products to these institutions with the promise that they will repurchase (Repo) them for a higher price at a later date (typically the following day). Essentially, you can think of these as trades of cash for some kind of collateral. The interest rate on the loans, the Secured Overnight Financing Rate (SOFR), is determined daily by the supply and demand for financing through the repo market.

Last week, an exceptionally large upswing in demand for cash from U.S. companies sucked a major portion of available funds out of the financial markets, driving the SOFR up ~7.25% within one day and forcing asset owners to pay the increased rate or face potential insolvency.

So what happened to the usual abundance of cash that drives the trillion-dollar repo market?

It's actually been slowly evaporating for several years, since the Fed ended their policy of quantitative easing (QE), its maneuver to increase monetary supply through the purchase of highly liquid bank securities. The idea was meant to encourage banks to increase lending to spur economic growth. Since this accommodation had ended, total bank reserves have steadily been decreasing due to increased government debt issuances over the same time frame.

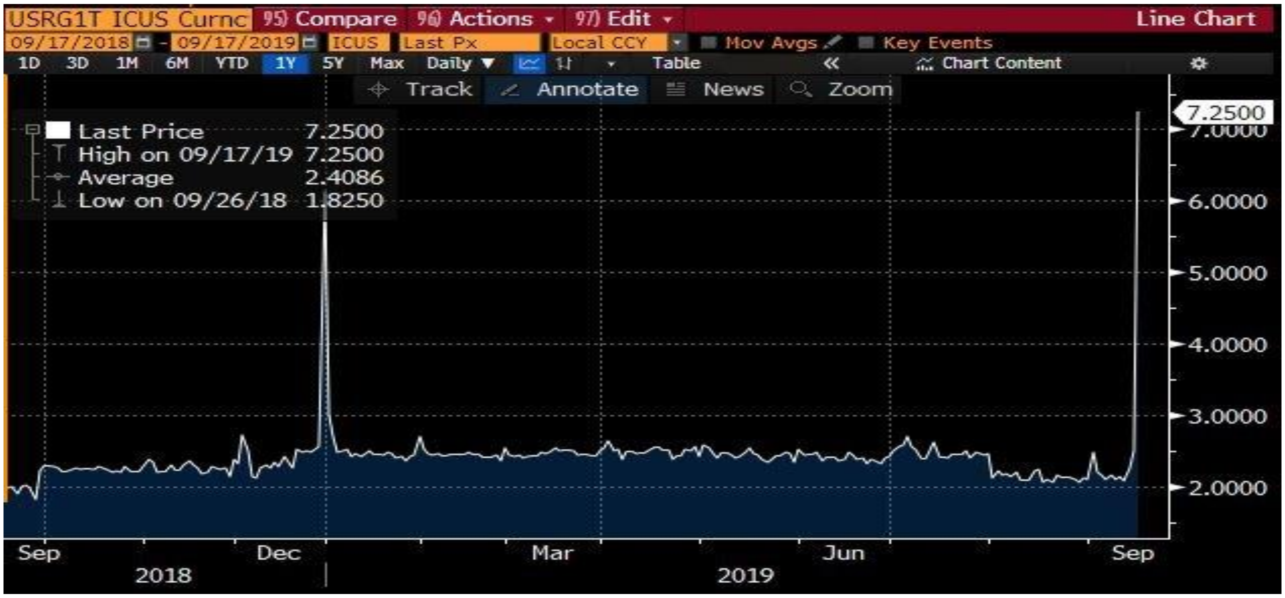

Exhibit 1 – Overnight Repo Rates; September 17, 2019

Put simply – the supplies of cash and collateral were dwarfed by the demand for overnight financing, adding upward pressure to the cost of the borrowing. Balance sheets of securities dealers were highly overweight in U.S. Treasuries, which needed to be financed daily with available cash in the market. When the cash essentially dried up, its market price skyrocketed.

To address this issue, Economists at the Fed quickly responded with a plan to inject capital into the financial markets through a series of large-scale Treasury purchases. This is expected to increase the supply of money in the economy while decreasing companies' needed level of debt financing. Rates returned to their steady state after this plan was announced, and the Fed has since increased their focus on its ongoing management.

You may be asking, "how does this issue pertain to me and my clients?" While the Sierra Ridge Wealth portfolio models do utilize the money market to invest excess cash in client accounts, the SOFR expands well beyond its use in the overnight funding market. Much like LIBOR, the SOFR is considered a benchmark rate used to determine the value of many variable rate loans, home mortgages and interest-rate sensitive derivative products. As we learned from the 2007 recession, these products are major factors in the overall health of the U.S. economy. For now, this anomaly looks to be under control and will be closely monitored going forward.

MARKET INDEX PERFORMANCE

As of 9/20/2019

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	26,935	-1.0%	15.5%
S&P 500 Index	2,992	-0.5%	19.4%
NASDAQ	8,118	-0.7%	22.3%
MSCI EAFE*	1,913	-0.4%	11.2%
10-yr Treasury Yield	1.72%	-0.18%	-0.96%
Oil ($/bbl)	$58.09	5.9%	27.9%
Bonds	$112.92	1.0%	8.1%

INDEX DEFINITIONS

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

GLOSSARY

Benchmark Rates are globally-accepted reference rates used to determine the values of various classes of financial instruments traded worldwide. A famous example is LIBOR (the London InterBank Offered Rate) which is the agreed cost at which major global banks can borrow funds from one another.

Monetary policy consists of management of money supply and interest rates, aimed at achieving macroeconomic objectives such as controlling inflation, consumption, growth, and liquidity.

Money Market is the market for securities with short-term maturities. Times to maturity range from overnight to a maximum of one year. Anything with a longer time to maturity is considered part of the capital markets.

Sources:

1. https://www.marketwatch.com/story/strategist-uses-the-simpsons-to-explain-what-this-repo-stuff-is-all-about-2019-09-18?mod=mw_theo_homepage&mod=mw_theo_homepage