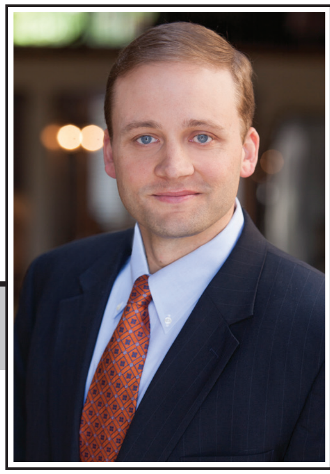
Sterling Advisors

THE MARKET MATTERS



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Chip Hughey, CFA®
Head of Retail Fixed Income Strategy and Services
BB&T Scott & Stringfellow

The Power of Words

Since 2008, writing any economic commentary without mentioning – or completely focusing on – the U.S. Federal Reserve and its policies has proven a virtually impossible task. On Wednesday, November 28, we were all reminded why that's the case. The Fed's primary job is to formulate policies that support stable prices and full employment. The central bank's degree of influence over financial conditions, economic outlooks, and investor sentiment cannot be overstated. Manipulating the Fed funds rate, and buying and selling U.S. debt securities are often cited as their most powerful tools. But that claim shortchanges its most powerful weapon of all: words.

Market participants hang on to every word written and spoken by the inhabitants of D.C.'s Eccles Building. In recent history, even slightly off-target messaging from Fed chairs has erased billions of dollars' worth of wealth from global markets in a matter of minutes. Some of the more famous examples: the Bernanke Taper Tantrum in 2013, Yellen's first post-FOMC (Federal Open Market Committee) decision press conference in 2014, or Powell's comments two months ago claiming the Fed still had a "long way" to go in its rate hike program. Each of these events jarred equity markets based on a common concern: the Fed was actively looking to reduce its support of the U.S. economy.

Beginning in late 2016, the FOMC, the Fed's monetary policy-setting committee, essentially put rate hikes on auto-pilot mode. We have endured seven 0.25% rate hikes since then, and the Fed is signaling yet another will occur at the December 19 meeting. Rate hikes and the ongoing unwind of the Fed's asset purchasing program (i.e., quantitative easing) are tools used to modulate the pace of the economy's expansion. The Fed raises interest rates to prevent asset prices from overheating (i.e., high inflation). Policymakers are also eager to create some distance between zero interest rate policy (ZIRP) and their stance today. That would help restock the Fed's toolbox ahead of the next downturn. Currently, Fed voters believe the U.S. expansion (already the second longest in U.S. history, and still going) is on sufficiently solid footing to withstand tighter policy. We believe while U.S. data may have warranted tighter policy in 2015 and 2016, the Fed is not providing sufficient time for data to reveal the impact of its decision-making. The recent pace of removing accommodation – and the roadmap it is currently laying out – are misaligned with U.S. fundamentals. That remains especially true with inflation. In recent months, inflation measures have plateaued – or even fallen – depending on the measure used. That doesn't sync well with several more rate hikes and further balance sheet reductions over the next 12 months. Yes, one would have expected inflation to gain more steam in this environment of improving employment and wages conditions – but that has not happened. The next four to five rate hikes the Fed is contemplating appear harsher than ever.

The Fed's policy narrative has grown even more complicated in the past eight weeks, largely thanks to a 34% decline in crude oil prices in October and November (Bloomberg). Inflation data was already a concern. Oil's recent challenges provide a powerful deflationary force that will likely emerge in early 2019. That should put downward pressure on intermediate and long U.S. yields, increasing the threat of a yield curve inversion – a reliable recession indicator. Falling inflation expectations puts the Fed in an uncomfortable position. Decelerating global growth and significant sources of economic uncertainty with Brexit, Italy's budget crisis and the U.S.-China trade standoff only add to their angst. U.S. and global markets have grown fearful of the Fed's plans. On November 28, the Fed finally acknowledged the stress.

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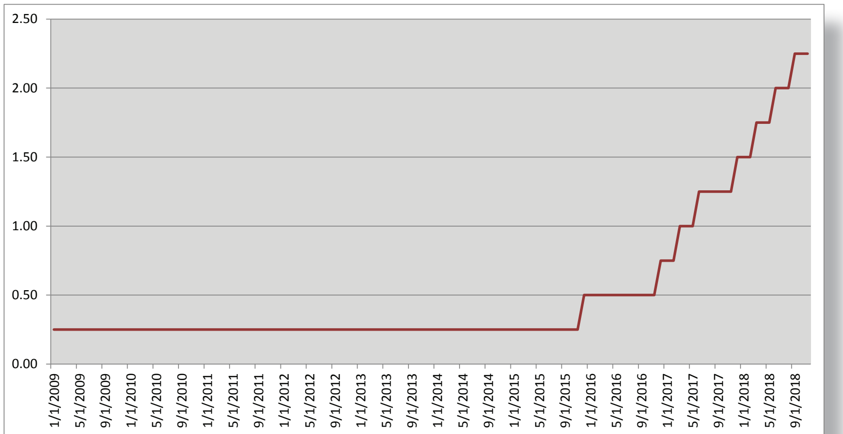

Figure 1: The Fed funds rate (upper range) since 2009 Source: Bloomberg

Fed Chair Jerome Powell took the stage at the Economic Club of New York (ECNY) and mercifully toned down the hawkish rhetoric. Only two months ago, Powell claimed the Fed had a "long way" to go before reaching a neutral level of interest rates – the level that neither helps nor hurts the U.S. economy. This time, Powell claimed the Fed was now "just below" that same neutral level, suggesting the Fed was closer to pressing the pause button. Given the Fed's prior hawkishness, Powell's ECNY speech jumped out to those who have been listening. U.S. and global stocks soared at the Fed allowing it may need to reassess. The Dow advanced more than 600 points and U.S. yields fell to their lowest levels in more than two months. The reaction made clear: global markets view the Fed's policy plans as a threat. Therefore, the Fed potentially sheathing its sword – even temporarily – resulted in a collective sigh of relief. We would expect near-term strength in risk assets – U.S. equities, emerging markets, and high-yield debt – as a result.

Still, it's important we don't get ahead of ourselves. While Powell sounded a dovish bell for the first time since taking office, his words are a relatively minor tweak. The rest of his speech sounded similar to previous ones. The more significant test will come December 19 when the Fed releases its rate hike projections for 2019. As it stands today, the Fed believes roughly four hikes are appropriate next year. If that total falls when its new projections are released on December 19, it will signal a more meaningful change in tone. Unfortunately, some damage may already be done. The effect of the Fed's tightening won't show up in data for some time. Thus far, its impact has largely been investors reacting adversely to the Fed's stance relative to incoming economic data. The true dampening effect as a result of 2018's policy changes will eventually emerge.

It's not the Fed's job to fuel equity market rallies. However, the equity and bond markets are a discerning evaluator of whether or not the Fed's plans align with our economic health. An extremely flat yield curve and a tough, volatile two months for U.S. equities suggest investors had endured all the hawkishness they could take. The Fed's urgency has caught up with it. The Fed would be wise to forgo its intended December hike, though the market still assigns a 79% chance that it will do so (Bloomberg). Inflation is not providing the requisite pressure needed to justify this pace. Understandably, the Fed is anxious to re-build a buffer from 0% interest rates. But, going slower would permit the economy to build more momentum and allow the Fed to operate more freely again. There are no signals the economy is on the verge of overheating. On the contrary, auto and home sales seem to have peaked and inflation is slowing. Foreign central banks remain far more accommodative than the Fed. There is room for patience.

Current conditions support a marathon approach from the central bank – not a sprint. Fed officials could take this opportunity to catch their breath, align their actions with their words and allow hard data to dictate the next phase. Let's hope November 28 signals the arrival of a more realistic and cautious Fed.

And that it's not too little, too late.