Sterling Advisors

THE MARKET MATTERS

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

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Take a Hike

We all knew this was coming. Weeks ahead of the Sept. 26 decision, the Fed used its standard playbook to prepare us for a 25-basis- point increase in the Fed funds rate. The Federal Open Market Committee (FOMC) left the door wide open for a September hike back at the June meeting. Then, throughout the month of August, Fed officials unleashed a flurry of public testimonies, speeches, and Q&A sessions. The vast majority conveyed an eagerness to tighten. Since Aug. 2, Bloomberg's estimate of the implied probability of a September rate hike (based on Fed funds futures trading) never fell below 90%. By Sept. 19, the measure was stuck on 100% for good (Bloomberg). Agree with the decision or not, that amount of certainty is a testament to the clarity in the Fed's forward guidance and the credibility they have restored following communication missteps in the Bernanke and Yellen eras. More recently, the Fed has done an admirable job executing tighter monetary policy sans tantrum. Remember the Taper Tantrum in May 2013? An announcement by then-Fed Chair Ben Bernanke that the central bank would start reducing its asset purchases caused a violent reaction in yields. That year, 2-Year U.S. Treasury yields more than doubled from May to September while 10-Year U.S. Treasury yields climbed roughly 140 basis points (from 1.62% to 2.99%) over the same span (Bloomberg). Traders were caught off-guard by hawkish intentions from a regime that, up to that point, had been ultra-dovish. Today, the messaging and execution are significantly better aligned.

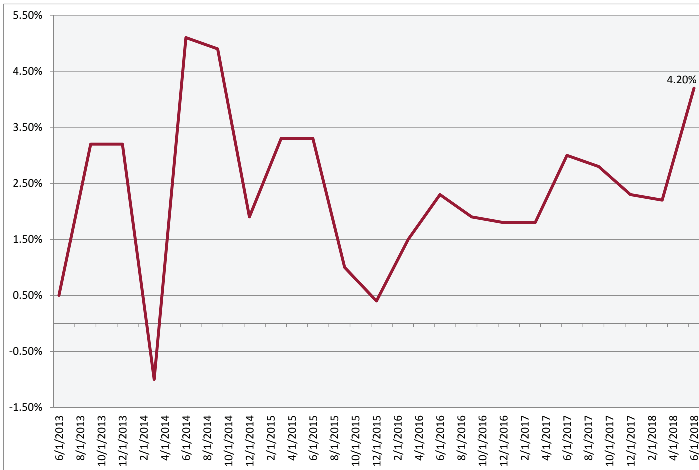
In raising the Fed funds rate to a range of 2.00-2.25%, the Fed clearly remains encouraged by the ongoing strength in the U.S. economy. It is the eighth rate increase since December 2015 and the third this year. The central bank is trying to strike a balance between raising rates further away from zero (to create breathing room to loosen policy in the next downturn) while staying true to its definition of 'gradual' hikes. The Fed recognizes there is a time limit upon any expansionary period – and it wants to take full advantage of what's left on the clock. But, there are concerns that the Fed needs to acknowledge. Below we walk through the positives that are validating the Fed's recent maneuvers and the red flags policymakers need to monitor very closely.

The Positives

Q2 U.S. GDP – Without question, domestic growth in the second quarter was exceptional. At 4.2%, it was GDP's best performance since Q3 2014. Personal Consumption Expenditures (PCE), business spending and federal defense spending all contributed. Last year's tax cuts are showing up in the numbers. American families are spending more disposable income, and companies are deploying their newfound cash flow to buy equipment, vehicles, land, and bring in new talent. Q2 GDP did benefit from a one-time boost in U.S. soybean exports, which spiked ahead of Chinese tariffs going into effect. Still, the positives far outweighed the negatives. Q2 growth combined with healthy employment should beget accelerated inflation. Though that has not fully emerged, the strong quarter permitted the Fed to move forward normalizing policy.

YTD U.S. Inflation – Since August 2017, Core PCE (the Fed's favorite inflation gauge) has risen from 1.4% to 2.0% (Bloomberg). The Fed follows an unofficial objective to hold core inflation near 2.0%, which has proven itself in previous cycles as the 'sweet spot' for price growth. The Fed anticipated Core PCE's rise and has hiked rates four times over the past 12 months. In the first half of 2017, the Fed was raising rates routinely while inflation was steeply declining, an uncomfortable combo. Core PCE and the Fed's rate decisions are cooperating at the moment and is allowing the FOMC to operate more freely.

Wage Growth – September's move to higher U.S. Treasury yields was due in part to a surprise increase in hourly wages. Wages grew at the fastest pace since 2009. A textbook will tell you that achieving inflation has three steps: 1) strong labor markets 2) wage growth as companies chase a diminishing talent pool; 3) accelerating inflation as a result of more disposable income in the system. We have achieved the first step but have been stuck on the second step for some time. Inflation is picking up, but far more slowly than one would expect given our current labor conditions. The "pep" we saw in August's hourly earnings data supports higher inflation expectations – of which the Fed wants to stay ahead.



Graph 1. Quarterly U.S. GDP for past five years Source: Bloomberg

The Concerns

U.S. Yield Curve – As of this writing, just 23 basis points separate 2-Year (UST 2) and 10-Year U.S. Treasury (UST 10) yields. The last nine inverted yield curves – when the UST 10 yields less than the UST 2 – have correctly predicted a recession in the subsequent two years. The Fed is downplaying the razor-thin margin, blaming the curve's flatness on atypical factors like loose global monetary policy and foreign demand for U.S. debt. We are not willing to dismiss the significance of the yield curve's current slope. The curve is telling the Fed to slow down. The Fed says it must continue raising rates so it can have more room to cut rates (i.e., support the U.S. economy) in the next slowdown. But the Fed may be dangerously close to creating the downturn that it fears so by its own hand.

Long-term U.S. Inflation – Although hourly earnings have improved, they are yet to fully emerge in U.S. inflation data. Core PCE's ascension over the past year appears to be decelerating. August Core PCE actually fell month-over-month. The Fed has the ability to pause and gather more insight to inflation's next move – but Fed officials don't seem to think so. It has already set the table for a December hike and several more next year. The Fed claims to be: 1) data-dependent, and 2) comfortable with an inflation overshoot (i.e., a slightly 'hot' economy). Its current plans for short-term rates contradict both claims.

Q3 U.S. GDP – It appears we should not expect a repeat performance of Q2 U.S. GDP in Q3. Several headwinds are mounting that could pull Q3 growth sub-3.0%. The primary challenge is on the trade front. The U.S. and China's trade dispute could start to drag on GDP as soon as this quarter, based on August's trade deficit. It reached it widest point in six months after U.S. exports of food and autos declined sharply. Simultaneously, companies are paring back capital investments partially due to the uncertainty around the U.S.-China standoff. President Trump is dangling tariffs on another $267 billion worth of Chinese goods if China retaliates to the U.S.'s most recent escalation. If enacted, U.S. tariffs would cover the equivalent of all the goods imported from China in 2017. Economists' estimates suggest U.S. GDP could lose 1.0-1.5% if that happens. This is a major complication for the Federal Reserve, who must formulate near-term policy amidst a hazy, volatile global trade environment. If the U.S.-China stalemate turns ugly, the economic fallout could force the Fed rethink its 2019 plans.

Conclusion – We believe the U.S. expansion still has room to run – but there are indications the Fed's intended policy path will create hurdles the economy will eventually have trouble clearing.