Investment Perspective

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PREVAILING WINDS

October, 2018

Autumn has spawned severe hurricanes that have battered the eastern part of the country. As the weather has become more tumultuous, so too have the gyrations in the financial markets. Trading screens switched sharply from green to red this month as a remark by Fed Chairman Jerome Powell roiled equity and bond markets like a storm surge.

October surprise

Early this month, Powell sat down for an interview with Judy Woodruff at the Atlantic Festival in Washington, D.C. Queried about his outlook for more interest rate hikes, the chairman let slip his view that "We may go past neutral, but *we're a long way from neutral at this point,* probably." [Emphasis added.]

The reaction to that statement was pronounced. Over two days, the 10-year Treasury yield surged from 3.05% to 3.23%; the S&P 500 and NASDAQ dropped 1.8% and 3.3%, respectively, from their intra-day highs. And while bond yields held steady, stocks continued to be pummeled during the second week of the month.

Why the angst? Simply put, Powell implied that the Fed would allow short-term rates to rise considerably farther than many investors had been anticipating. Financial markets interpreted these comments as hawkish for both stocks and bonds.

Not loco

Fed policymaking often requires a balancing act, akin to walking on a tightrope; at certain times, without the benefit of a net. The central bank's "dual" (actually *triple*) mandate is to foster 1) maximum employment; 2) stable prices; and 3) moderate long-term interest rates.

Following the housing bust, the Fed dropped short-term rates effectively to zero in December 2008. By late 2009, at the depths of the recession, the national unemployment rate reached 10%. And more than one in six workers was either unemployed or underemployed. The bank ended up holding the policy rate near zero for seven years to help households and businesses survive, and then recover, from the *Great Financial Crisis.* During that period, the threat to employment clearly outweighed the risk of inflation.

Fast forward to the end of 2015. The U.S. economy was growing closer to potential and the unemployment rate had dropped back to 5%. The Federal Reserve tacked in a new direction, beginning the first in a series of small, gradual rate increases. This new interest rate regime also coincided with the wind down of the Fed's massive bond-buying program. Through such *quantitative easing,* the central bank had sought to hold down long-term rates as well.

Today, monetary policy can still be viewed as accommodative even three years into a tightening cycle. The current target range for the federal funds rate stands at 2% to 2.25%, a very low level from an historical standpoint. And in real (inflation-adjusted) terms, the rate still sits close to zero. Meanwhile, the U.S. economy seems to be surging, turbo-charged by extremely stimulative fiscal policy. The labor market remains very tight and wage growth is accelerating. Although relatively benign, the rate of inflation has picked up. At this stage of the business cycle, it should represent the greater risk.

Zero the old normal

So the bond market must now bow to the likelihood that interest rates will be heading higher for longer. Short-term rates are essentially set by Federal Reserve policy. Longer-term rates take their cue from the Fed but are also heavily influenced by inflation expectations. Assuming the economy maintains its traction, price pressures should naturally increase. Additionally, ballooning federal deficits over the coming decade will boost the Treasury's borrowing needs. Even higher yields may be required to entice bond buyers.

The recent bond market selloff is understandable: After years of near-zero, bondholders had become complacent to the risk of rising yields. That risk needed to be repriced. However, the stock market appears to have overreacted as it is wont to do. Like the short end of the curve, long-term yields are relatively low; they are not at levels consistent with our current economic momentum. Therefore, rates have room to rise before threatening the economy or hitting corporate profits.

Indeed, rising stock prices often move in tandem with rising rates, *up to a point.* And that leads to the question stock market participants will be asking: How high is too high? Will a 4% yield on the 10-year be the tipping point; a 5% yield? Whatever the ultimate level, we should not be there now.

Buyer's remorse

Investors could also be misreading the potential impact of the upcoming elections. There may be no ironclad rules in American politics but one can reliably expect a president's party to cede some House seats in a midterm election. In 23 of 26 midterms since 1911 (when the House was set at 435 members), the president's party has lost ground. The average swing to the other party has been 30

seats. This fall, the Democrats must gain 23 to capture control of the lower chamber of the 116th Congress.

Given voters' typical midterm pushback, along with Trump's low approval ratings, many pundits expect Republicans to lose control of the House. In the Senate, 35 of 100 seats are up for election but the math is more challenging for the Democrats who must defend 26 of those races. Nevertheless, the party need only win a net of two new seats to prevail. The race for the Senate appears to be a tossup with most polls giving Republicans an edge.

Just a distraction

The midterm races have galvanized much of the electorate and created a stir in the media. The investment community has also been laser focused on the potential outcomes. But the elections are likely to be far less relevant to investments than many presume — for whatever the outcome on November 6th, the economic agenda is not likely to significantly change.

Over the last two years, stocks have been buoyed by a strong corporate earnings picture driven in part by tax cuts, as well as a more favorable regulatory climate. Even if the Democrats capture both chambers of Congress, they will be hard pressed to really stop or reverse the administration's pro-business thrusts.

Tax cuts will not be reversed because the Democrats will fail to achieve a 60-seat, filibuster proof, majority in the Senate. And regulatory affairs fall under the purview of the executive branch. Moreover, the party will not be able to garner a veto-proof, two-thirds majority in each chamber. So their own policy initiatives will fall flat. Instead, we will experience gridlock — but fortunately, the stock market does not usually mind that outcome.

Trade winds

Of course, not all of the administration's policies have been pro-growth or friendly to financial markets. Trump's pursuit of an anti-immigrant, anti-free trade "America First" regime resonates with his base. But much of the electorate and many in the business community think he has gone too far.

The battle over tariffs and trade poses a threat to the global economic expansion. The International Monetary Fund just tweaked down growth forecasts for that reason. Because trade accounts for a small share of U.S. GDP, the direct impact on our shores may well be limited. But the potential hit to consumer and business confidence could prove meaningful, dampening the *animal spirits* that had finally emerged. For instance, a recent survey by the Business Roundtable found that

nearly two-thirds of CEOs expected the trade war to have a negative effect on their capital investment plans over the next six months.

Earnings still key

Over the past several years, the dominant theme has been that of surging corporate profits against a backdrop of low interest rates. How long will this environment prevail? Yields have moved up, but again, from a very low base. And in that same October interview, Chairman Powell went on to say that "We need interest rates to be *gradually, very gradually,* moving back to normal." [Emphasis added.]

At the moment, the profit picture appears solid. S&P 500 companies should achieve 20%+ earnings growth in 2018. This outcome is just about in the bag, absent some shock. Wall Street expects profits to increase at a still-buoyant 10% rate in 2019. However, it is much too early to rely on that outcome.

So earnings should remain the key driver of stock prices although investor sentiment could certainly shift with the winds. As has often been the case over this long bull market, there are many cross currents that could arise. Among them today: trade conflicts, geopolitical concerns, and political uncertainty.

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