Current Market News

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Fed hopes fade, but all is not lost

"Think it over, think it under." - Winnie the Pooh

On Wednesday, December 19, the Federal Reserve ("Fed") raised short-term interest rates to a range of 2.25% to 2.5% – as expected. The Fed also lowered 2019 growth forecasts and inflation forecasts – as expected. They even modestly lowered interest rate forecasts for 2019 and beyond ***(Exhibit #1)***. The market, however, was hoping for a greater degree of rate path moderation, but directionally speaking the results were – as expected. What was not expected was a press conference performance by Chairman Powell that seemed to cast the Fed as out of touch with recent economic and market developments. An onslaught of skeptical questions came from reporters about the need to raise rates, particularly in light of low and falling inflation estimates. One after another, the crowd turned on him:

"If you haven't achieved 2% inflation, and you don't see an overshoot which would be implied by a symmetrical target, what's the point in raising rates again at all?"

"You're about to undershoot your inflation target for the seventh straight year . . . can you help us to understand why you would be advocating restrictive monetary policy at a time of persistent inflation undershoots?"

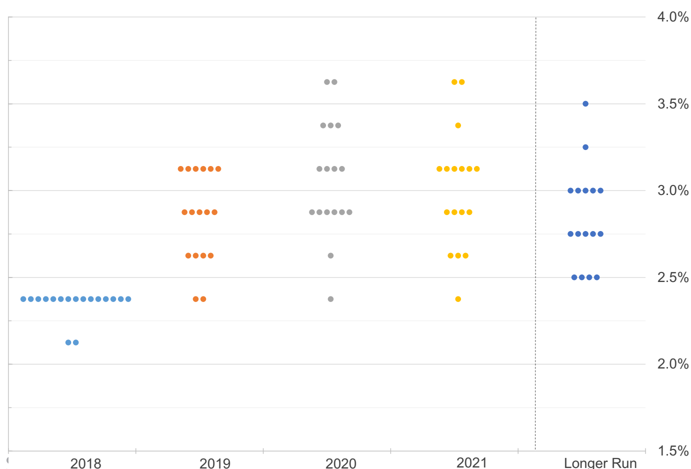
"What data are you specifically looking at for you that shows when the Federal Reserve starts to become that headwind in the economy with the rates?"

"Are markets on to something that hasn't yet showed up in the data?"

"What are the markets telling you?"

"The 10-year note yield has gone down pretty steeply . . . is it a worrisome sign for you?"

Exhibit 1: FOMC Participant Assessments of Appropriate Monetary Policy (Fed Dot Plot)



Chairman Powell's initial responses emphasized the health of the economy, but as the barrage continued, his answers devolved into statements that included, *"Some volatility probably doesn't leave a mark on the economy," "we'll just have to see," "people have disparate views,"* and, *"[falling rates on the 10-year T-Note] could be thought of as a signal of expectations of lower growth, but, you know, we don't know that that will happen."*. At the beginning of the press conference, the equity market was still holding on to half of its earlier gains. By the end, a fatigued Chairman Powell seemed unable to convince himself with his responses, much less the market, and equities closed down about one and a half percent on the day.

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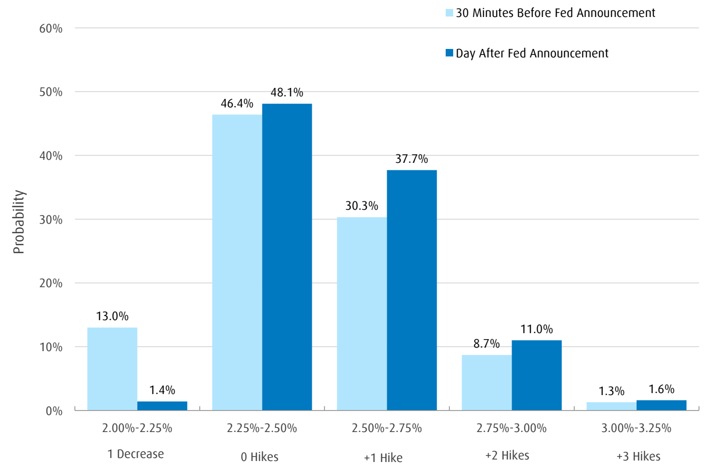
We have believed for some time that the Fed would ease back from its earlier projections for the path of interest rates in 2019. The reasoning behind our expectation is simply that the economic realities would prove to the Fed that its projections are untenable. Indeed, based on the new estimates released at this December meeting, the median forecast of FOMC members is now for 2 hikes in 2019 rather than the previous projection of 3 hikes. That's a start, but even after this December Fed announcement, the market is still placing the highest probability on zero rate hikes in 2019, and that expectation barely budged even after this December announcement ***(Exhibit #2)***.

In the near term, the hopes of the Fed communicating a position more supportive to equities have been pushed back to Q1 2019 at the earliest. We do expect the Fed's tone and outlook to shift gradually and lend support to equities over the next few months and quarters. The relentless line of questioning may have also had a sufficiently visceral effect on Chairman Powell that the he will focus more on the forest rather than the trees. In the meantime, the market will have to look elsewhere for positive news that will help regain economic momentum, or at least staunch the slowdown.

With the Fed seen as the primary hope to spark a meaningful year-end rally, it is now likely that 2018 will end with losses across most major equity asset classes. Sentiment also remains excessively bleak as investors consider the U.S.-China trade war, an earnings growth slowdown, BREXIT deadlines and recession fears. Contrast this to the start of this year, where overly enthusiastic expectations reigned supreme, and it is no wonder that volatility has increased markedly these past few months. So where do we go from here? As our 2019 outlook suggests, we believe 2019 will be a slower growth year, but do not see signs of a severe contraction in business activity or excessive systemic risks. Assuming the Fed continues to walk back its projections for higher rates and there is not a material escalation in the U.S.-China trade war, perhaps the end of 2018 may be the hour "darkest before the dawn". Indeed, global leading indicators have stabilized recently, and over 75% of manufacturing PMIs remain above 50 (indicating economic growth). The path from here will not be straight, but with valuations in-line to slightly below historical medians ***(Exhibit #3)***, corporate earnings still growing (though at levels below those seen in 2018), and interest rate pressures easing, our work suggests equities remain an attractive asset class for 2019.

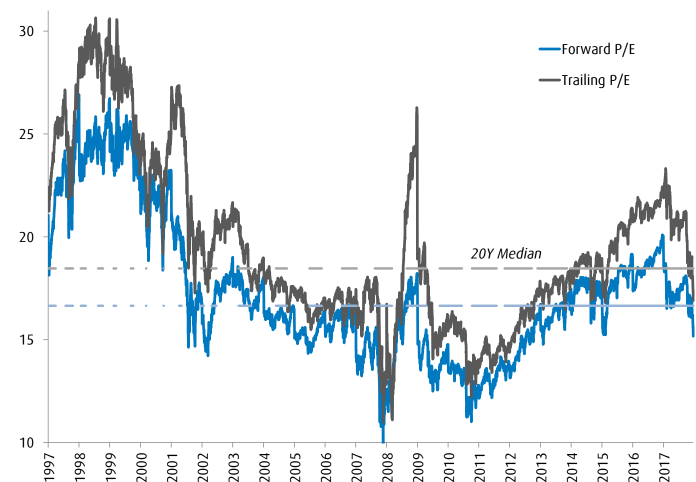
Exhibit 2: Target Rate Probabilities for December 2019 Federal Reserve Meeting



Source: CME, BMO Wealth Management

Exhibit 3: S&P 500 Price/Earnings History

Trailing 20-year daily data as of December 19, 2018



Source: Bloomberg Financial, BMO Wealth Management

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