HIGHLAND

MARKET BRIEF
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YELLEN'S LAST STAND

In Janet Yellen's last meeting as Chairwoman of the Federal Open Market Committee (FOMC), the Committee raised the target level of short-term interest rates by 0.25% to a range of 1.25-1.5%. Janet Yellen's term will end with her raising interest rates five times and cutting interest rates zero times. She is the first Chairperson to end her term without cutting interest rates once.

The outcome of the FOMC meeting had been well broadcast by Fed officials prior to the meeting and therefore broadly anticipated by markets. The balance sheet normalization that commenced in October has proceeded in line with the Fed's guidance surrounding the gradual decrease to reinvestment of maturing securities. As of this week the balance sheet has shrunk about 1%, so we are still very early in this process.

Looking forward, the FOMC expectations, as noted by the favored "Dot Plot," indicate three additional rate increases in 2018 and two in 2019 to eventually land at a longer run target federal funds rate of 2.75%. This is consistent with projections from last meeting. Interestingly, the FOMC increased its expectations for higher GDP growth in 2018 and a lower unemployment rate, yet felt this would not warrant any change in the expected interest rate path. During the press conference, Yellen noted these projections are based on the increasing likelihood of fiscal stimulus from tax reform and continued strength in employment.

Perhaps the most anticipated metric—inflation expectations—remained unchanged despite the GDP and unemployment revisions. Transitory factors such as cellphone subscriptions and prescription drug pricing continue to be cited as lingering impacts; however, the Fed insists that minimal slack in the labor force and a continuation in strong employment should put upward pressure on wage growth. So far elusive, inflation will remain an important indicator to watch.

Why is this indicator so important? The Fed has a dual mandate to promote maximum employment and stable pricing. Stable pricing is achieved by not over- or undershooting the Fed's inflation target too much. This is exceptionally difficult for many reasons. For one, inflation is a lagging indicator measured a month and a half prior to the FOMC meeting. Meanwhile, employment metrics are also difficult to measure in real time and are often done by surveys that can be manipulated by emotions. While it may be taking longer than the Fed anticipated for inflation to pick up, we are now seeing pockets of wage inflation in several measures, such as U.S. hourly earnings, median weekly earnings, and private industry compensation. Furthermore, inflation typically lags economic growth by 12 to 18 months. With growth on the upswing, this suggests that we could be in for some accelerating inflation in the future.

While the rate hike and Fed outlook were largely "knowns" leading up to the meeting, Highland continues to focus on developments in the "unknowns"—namely, leadership transition at the Fed and how the Fed will react if inflation does move higher.

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We believe that new decision-makers could have important influences on the tone of monetary policy going forward. Since last update, Jerome Powell was nominated and confirmed as the next Fed chairman. Powell has been a member of the Federal Reserve Board of Governors (the Board) since 2012 and worked as a lawyer and investment banker in his prior career. He is the first non-PhD to chair the Fed since Volcker and is the first non-economist to chair since Miller in 1978. We anticipate that due to the uncertainty surrounding inflation outlined above and based on his market-practitioner background, Powell will continue Yellen's monetary policy of gradual rate hikes.

Another lawyer by training, Randal Quarles, joined the Board in October as the Vice Chair for Supervision and is largely anticipated to loosen banking regulation. Finally, Marvin Goodfriend was formally nominated by President Trump and is awaiting confirmation by Congress. Goodfriend is a former Fed economist and Carnegie Mellon professor who has been critical of asset purchases by the Fed and prefers a rules-based approach to monetary policy. He will likely be a vocal advocate for change in the way the Fed sets monetary policy. We eagerly await clarity on the direction of the Powell-led Fed as four seats will need to be filled in 2018. However, it is important to note that more than 21 years of experience on the Federal Reserve Board of Governors is exiting (Yellen, Fischer, Tarullo), while Powell has 5 years of experience. This heightens the risk of a policy misstep. With changes to the Board's composition, a change in policy direction could mean tightening monetary policy too soon. Conversely, an inflation shock could catch the Fed off guard. Either scenario would threaten economic growth.

In the meantime, our outlook remains positive for the economy in 2018, which will be broadly supportive for equity markets. We remain underweight fixed income due to our low yield outlook. We do not have reason to believe that longer-term yields will increase as the yield curve continues to flatten due to structural forces holding down the long-end of the curve. There will always be "unknowns" that present risks to our outlook, but a disciplined process will ensure we remain long-term patient investors.

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