HIGHLAND

MARKET BRIEF
MARCH 2018

POWELL ENTERS THE RING

ROUND ONE
The Federal Reserve (Fed) raised rates for the sixth time since monetary policy normalization began in December 2015. The target Fed Funds rate now lies between 1.5%-1.75% based on a unanimous vote by the Board of Governors.

According to the dot plot (the chart plotting Federal Open Market Committee (FOMC) participants' target level for the Fed Funds rate), FOMC participants are split on whether the Fed will raise rates three or four times in 2018. In fact, it would have only taken one more voter moving their estimate higher to shift the median to four hikes this year. The median long run Fed Funds rate is 2.9% but is estimated to move as high as 3.4% in 2020. This would indicate that the FOMC is planning for growth and inflation to overshoot their targets before settling at the long run neutral rate. There is potential for an additional two rate hikes in 2019 and 2020.

The vote to raise the target was not a surprise, as the market priced in a 94% probability of a rate hike prior to the meeting. Given strong job gains over the past quarter and a 17-year low in the unemployment rate, the Fed seems to be pleased with the first half of its mandate—to foster maximum employment. With regards to the Fed's other mandate, Powell noted that at this point he is not too worried about inflation. This could be misguided as the fiscal stimulus that was passed late last year has not entered the economy as of yet. The impact will no doubt cause economic growth and prices to rise. Further, the three-month annualized rate for core inflation is above 3%, the highest in a decade. Nevertheless, Powell did state that although rate hikes will remain "gradual," the pace could pick up if inflation exceeds their 2% target. Importantly, Powell reiterated that the Fed will "always…be seeking 2% inflation" to combat those who speculate the Fed might let the economy "run hot."

POWELL'S DANCE
Powell has a difficult balancing act as he enters an environment unlike any Fed Chair before him. While he is not the first Fed Chair to enter a rate hiking cycle as he takes the helm (Miller, Greenspan, and Bernanke were all faced with similar circumstances), he is the first to enter a rate hiking cycle with real rates still in negative territory. He is also the first to take over the reins for the inaugural unwind of "unconventional monetary policy" known as Quantitative Easing, which has distorted risk markets and quadrupled the size of the Federal Reserve's balance sheet. Central banks globally have been price-insensitive buyers of bonds, pushing yields to historic lows. These purchases have driven the "term premium" (the compensation investors receive for bearing the uncertainty of future interest rates and inflation) negative for the longest persistent time frame in history.

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HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 OR (205) 933-8664
F. (205) 933-7688

Meanwhile, credit spreads on high yield bonds (a harbinger of future risk) are the tightest they have been for any entering Fed chair at below 400 basis points. History shows when the Fed tightens monetary policy by raising interest rates, ultimately credit conditions tighten.

No other Fed governor has entered a rate hiking cycle to persistently low inflation while unemployment is below the Fed's long-run projection. Yet the Fed's own projections show the unemployment rate going as low as 3.6% in 2019, well below the Fed's long run projection of 4.5%. Since World War II, every time the unemployment rate has risen 0.3% above its three-month moving average, there has been a recession. This is an indicator we will closely watch that could lead us toward a risk-off stance.

The environment most similar to the one Powell is entering as new Fed Chairman was when Greenspan took office in August of 1987. He arrived in the midst of a rate hiking cycle that started in March of that year. Within two months, Greenspan saw the largest one-day decline in the history of the stock market on what has been dubbed "Black Monday." On the economic front, unemployment fell below the Fed's long-run projections later that year, but unlike today, inflation was already on the rise. Powell has an unusually tight rope to walk as he attempts to prod inflation without stifling growth and employment.

Powell was adamant about steering market watchers away from the Fed's dot plot and to focus more on the Fed's current policy. His stance has inserted a high level of doubt in long run economic projections. Chairman Powell continues to downplay the dot plot by saying that it reflects a "diversity of views" and that the group made just one decision—to raise rates. The shift in attention from Fed Chair to FOMC participants is a notable change, as Powell is resistant to sharing his own opinion over the group's. Recall he is the first non-economist Fed Chair since Miller in 1978, which is why who fills the four vacant FOMC seats can be an important indicator to the path of the Fed. While Powell is poised to continue Yellen's policy of gradual rate hikes, there is more to be seen as to how this evolving FOMC Board and Chair will handle the future.

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