HIGHLAND

MARKET BRIEF
MARCH 2017

BEWARE THE IDES OF MARCH

On March 15, 2017, the Federal Open Market Committee ("Fed") voted to increase interest rates a quarter of one percent to a range of 0.75% - 1%. The market had already fully priced in the interest rate hike, as the Fed funds futures were pointing toward 100% certainty of an interest rate rise. The Fed's Dot Plot, which is its favored means of informing investors of its expectations for future rate hikes, illustrated no real changes from its last release in December. The Fed still expects two more rate hikes in 2017, with a gradual path up to 3% in the long run. In addition, there were no substantial changes to the Fed's expectations for economic growth, unemployment, or inflation. All in all, this was a rather uneventful meeting.

Even during Chairperson Yellen's conference, there was no new news around the Fed's expectations for its balance sheet, except to say the decline in the balance sheet would be "gradual and predictable." If rate hikes continue, however, the cost to the Fed of maintaining its asset purchases will also rise, since it must pay interest to commercial banks on their reserves. These reserves currently amount to $2 trillion. Any interest paid on the reserves reduces the Fed's payments to the Department of Treasury, thereby increasing the federal government's fiscal deficit. If the interest paid on excess reserves increases to 2%, then taxpayers would effectively be paying banks $40 billion/year not to lend to the private sector. It's difficult to see how this would align with what the Trump administration and GOP would like to see happen.

Many market participants were expecting the Fed's Dot Plot to show a quicker pace of rate hikes, so when it remained stable, bond prices rallied. The market cheered Yellen's remarks as U.S. equities rose, the U.S. dollar had its largest decline in two months, and gold prices increased. There is an adage on Wall Street termed "3 Steps and a Stumble," which describes the tendency of stocks to sell off after the third Fed rate hike in the cycle. However, these types of maxims are guides and not hard, fast rules grounded in economic rationale. For one thing, typically when the Fed is raising interest rates, it is because economic growth is booming and they want to slow down the threat of higher inflation. This is not the case in the U.S., where economic growth has remained in the 2% range since the financial crisis. Furthermore, core inflation exhibited a 2.2% year-over-year rise, thereby implying real (or inflation-adjusted) Fed funds rates are firmly still negative. The latest move by the Fed, as well as subsequent moves, is driven by the committee's desire to normalize policy, not slow down economic growth.

The "Trump bump" expectations for higher economic growth as well as the latest employment numbers continue to show strength.

- Nonfarm payrolls increased 235,000 in February, with construction jobs experiencing the largest increase in a decade.
- Labor force participation rate for the 25 to 54-year-old prime working age cohort rose to its highest level since June 2011.

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- Wage gains increased 2.8% on a year-over-year basis.
- Duke University CFO Confidence Index rose to its highest level since the 2nd Quarter 2004.
  - Notably, full-time hiring plans were the highest in 13 years.
- CEO Economic Confidence Outlook index experienced its biggest gains since the 4th Quarter 2009.

Even with economic growth trending higher, Chairperson Yellen downplayed the latest strength and noted that the Fed has not seen any hard data to substantiate that the latest optimism has made its way into spending by businesses or consumers. There still remains uncertainty as to what President Trump would like to see with monetary policy. During the pre-election, Trump admonished the Fed for keeping interest rates so low. However, since his election, he has not provided any more color regarding monetary policy. It is important to note that there are two open seats at the Fed, so Trump could influence it immediately. Additionally, Yellen and her Vice Chair, Stanley Fischer, will see their terms end in the first half of 2018. If Trump wants to see rates higher, then look for him to appoint members that favor a more methodical, rules-based method for monetary policy. Although Yellen is continuing to take a more gradual approach, this could change depending on whom Trump appoints and how much influence Trump holds. For now, the path of gradual rate hikes is supportive of equities. However, as William Shakespeare famously wrote, beware the Ides of March, as there are still a lot of questions with U.S. monetary policy.