HIGHLAND

MARKET BRIEF
SEPTEMBER 2017

FED POLICY: ACT II, SCENE II – COMMENCE NORMALIZATION AND TRANSITION

The Federal Open Market Committee (FOMC) entered Scene II of policy normalization as it followed through on its assurance to let the balance sheet wind down in a "gradual and predictable way." As noted in our previous Market Brief ("Fed Policy: Act II, Scene I"), the Federal Reserve (Fed) will follow its prescriptions outlined in its June 2017 Addendum to let agency debt, mortgage-backed securities, and treasuries maturing in October roll off the balance sheet without reinvestment up to a specified cap. The starting monthly reduction caps are $4 billion for agency debt and mortgage-backed securities and $6 billion for treasuries. However, Chairperson Janet Yellen did not provide any clue as to what a "normalized" balance sheet would look like, but that the tapering process will not be stopped unless economic growth falters and the Fed funds rate has been reduced back to zero.

As Yellen reminded us in her comments, the primary monetary policy tool remains the target federal funds rate. The target remained unchanged from June's meeting and will be held at the 1-1.25% range. The Fed's Dot Plot—reflective of FOMC participants' expectations—shows consensus around one more rate hike for 2017 at the December meeting. The market is expressing a similar sentiment—pricing in a little more than a 70% probability of a final rate hike this year. The most interesting piece of new data was the Fed reducing its median long-term policy rate to 2.75%. This rate has fallen 0.75% since the Fed's initial rate hike in 2015.

Other notable remarks give us a sense that the Fed will maintain its dovish (i.e., accommodative) posture and will only alter this in response to stronger economic data. Inflation has been somewhat elusive even for the Fed, as their "understanding of the forces driving inflation isn't perfect." To put this into context, the Fed's favored inflation metric, Personal Consumption Expenditure (PCE), has only been above the Fed's 2% target less than 20% of the time since 2009. Yellen left the door open to monetary policy adjustments as needed to achieve the stated inflation and employment objectives. While there is no indication as to the specific pace at which rates will move, Chairperson Yellen reiterated that it will be gradual over the next few years to sustain the economic expansion.

While the Fed's meeting results outlined above were fully anticipated and well projected, the course of the Fed remains uncertain for one notable reason—leadership transition within the Fed Board of Governors. Vice Chairperson Stanley Fischer's recent, unexpected resignation perplexed investors as to why he would resign when there is so much in flux with the Fed's interest rate shaping board. His resignation leaves three of the seven board seats occupied. While the Fed eagerly watches and waits on their inflation target, investors are scouring the headlines for signs of the next Fed nomination. Why is this so important? The makeup of the Fed, especially the Fed chair, sets the tone for monetary policy-making.

TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of June 30, 2017, we serve as investment consultant on approximately $22 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

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

Fed governors usually fall into one of two camps. Dovish governors are characterized by their tendency to favor more simulative policies or more accommodative monetary policy and lower interest rates for longer. Chairperson Yellen falls into the dovish category. Hawkish governors favor monetary policies that are aimed at keeping inflation in check and are less concerned about economic growth. The most famous hawkish governor was Paul Volcker.

Currently, the Federal Open Market Committee participants lean more dovish. The four open seats are rumored to be filled by those who are all hawkish in nature. The Senate Banking Committee recently voted to advance the confirmation vote for Richard Quarles as vice chairperson for supervision on the Fed board of governors. Quarles' past comments have advocated for a more rigid formula for setting monetary policy and been broadly critical of government for "unpredictable policy-making." Similarly, Marvin Goodfriend, former Fed economist and Carnegie Mellon professor, has been mentioned as a potential nominee. Goodfriend has been similarly critical of the Fed and has called for use of a policy decision rule like the Taylor Rule, a formula that models what the level of the Fed Funds Rate should be with consideration paid to differences in current GDP growth from trend growth and current inflation from target inflation. Currently, the many versions of the Taylor Rule infer a range of target Fed Funds Rates anywhere from 0.37% on the low end to 2.5% on the high end, versus today's target at 1-1.25%[1]. It is worth noting that even implementing a more rules-based approach to policy can lead to wide-ranging outcomes.

There is a great deal of uncertainty surrounding Trump's candidates for the next leader of the Fed, and some believe that Yellen could possibly be reaffirmed. While Chairperson Yellen may not be Trump's most likely pick to lead the Fed for another term, she is still eligible to serve the remainder of her 14-year term through 2024. This would be highly unusual and a first for a Fed chairperson to remain on the board after being relieved of his or her responsibility as chairperson. She did not comment today on her future at the Fed, but this also bears watching.

As we head into the 4th quarter of 2017 and into 2018, there still has not been any clarity that would change our lower-yield stance. Based on Highland's outlook for yields and the continued uncertainty with the Fed, we remain underweight fixed income. We believe that the addition of new decision makers into the mix could be the move that sets the stage for a pivotal Act III in Fed Policy.

[1]https://www.federalreserve.gov/monetarypolicy/2017-07-mpr-part2.htm