



“[A] NONECONOMIC EXAMPLE WOULD BE YOU’RE WALKING THROUGH A ROOM FULL OF FURNITURE AND THE LIGHTS GO OFF. WHAT DO YOU DO? YOU SLOW DOWN. YOU STOP, PROBABLY, AND FEEL YOUR WAY.”

– Federal Reserve Chairperson Jerome Powell, Appearance at Dallas Federal Reserve on November 14, 2018

Assessing the Darkness

A dark period of monetary policy is upon us. Powell is in a difficult position since taking over as Fed Chairperson. The economy is exhibiting strength while the capital markets are showing weakness. Even so, the Federal Reserve (Fed) raised rates for the ninth time since monetary policy normalization began in December 2015. This brings the target fed funds rate to 2.25%–2.50%. The move was widely anticipated, with the market pricing in a probability of around 70% that the Fed would hike rates in December. The path forward, however, is less certain. Given increasing market risk and uncertainty, the Fed chose the middle ground by raising rates in December and indicating a slower path for monetary policy going forward.

The new dot plot (the chart plotting Federal Open Market Committee [FOMC] participants’ target level for the fed funds rate) projects two rate hikes in 2019, which is down from three in previous dot plots. No FOMC participants think the rate will now exceed 3.25% in 2019. The median projection for the longer run federal funds rate moved lower to 2.8% from 3.0% last meeting. The range of expectations also moved down slightly to 2.5%–3.0% (from 2.8%–3.0%). This puts the current federal funds rate at the lower end of the range of longer-run expectations, leading Powell to declare that policy has moved from “far from neutral” to “the bottom-end of neutral.” However, Powell cautioned market participants from placing too much focus on the dot plot, just as he did in September.

Certainly Uncertain

Powell has not shied away from the growing uncertainty surrounding monetary policy decisions. In his December press conference, he reiterated that



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

ST LOUIS:
7733 FORSYTH BLVD.; SUITE 1103
CLAYTON, MO 63105
P. 314-296-6171

there is a “fairly high degree of uncertainty of the path and ultimate destination of rates.” He has chosen to handle this conundrum with increased communication, starting in 2019 with a press conference after every FOMC meeting. As the Fed Funds Rate moves into neutral territory, Powell again emphasized data dependency, pointing to the pause in rate increases in 2016 as market volatility picked up after the first rate increase in 2015. Could this be Powell’s way of telling the markets, “We hear you, and we will be slowing?”

The FOMC statement certainly laid the foundation for a rate pause with dovish changes to its policy statement. The language changed from “the Committee expects that further gradual increases” are needed to meet its mandate to “the Committee judges that some further gradual increases” will be needed. Furthermore, as economic growth and inflation expectation forecasts were downgraded for 2019, there is certainly a solid foundation for a monetary policy pause. Financial market risks are more of a concern now than before, as indicated by the addition of the following statement: “The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook.” Powell went on to comment, “The economy may not be as kind to our forecasts [in 2019].”

Firm on Policy

While the path and ultimate destination of the federal funds rate is uncertain, Powell was clear in stating the FOMC’s certainty that interest rate policy is the active monetary policy tool for the Fed. Coming out of the Global Financial Crisis, the Fed chose to use another lever—it’s balance sheet—by buying financial assets to inject liquidity into the market. This policy is known as “Quantitative Easing.” The Fed is now conducting the reverse of that policy—“Quantitative Tightening.” Many in the investment industry estimate that the balance sheet tightening is the equivalent of 1–3 rate hikes and has certainly resulted in the tighter financial conditions that Powell acknowledged in his December press conference comments. Yet, the balance sheet runoff remains on autopilot. The continuation of balance sheet shrinkage is an un-

dercurrent likely concerning the markets. While the projection of a slower path for rate hikes was a welcome dovish remark, the Fed likely did not go far enough in appeasing financial market concerns over tightening monetary policy.

Fed Faces Off with the Markets

In the wake of the Fed announcement, the S&P 500 declined 1.5% and yields on the 10-year Treasury decreased 5 basis points to 2.77%. The S&P 500 has posted a loss each day the Fed has announced an interest rate decision under Powell’s watch—a record seven times now. During Yellen’s last year in office, negative market reactions occurred just three times. Why the market temper tantrum?

The market did not think the latest Fed announcement was dovish enough. The forecasts for growth and inflation, while downgraded, are still strong relative to what the market thinks. The market says the economy is moderating, and the Fed is saying, “Not so fast! Economic fundamentals are still strong.” The market sees risks to the downside, and the Fed sees risks to the upside as indicated by the latest rate hike. Curiously, signs of financial excesses are not present, leaving us to wonder, why the continuation of policy tightening? The S&P 500 is down close to 8% and the 10-year Treasury yield has declined 13 basis points since Powell’s first Fed meeting in office. Time will tell who is right, but historically, the Fed has raised more than the market can handle. The Fed would do well to heed the market’s warning—slow down or we all stub our toes in the darkness.

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