Connecting the Dots

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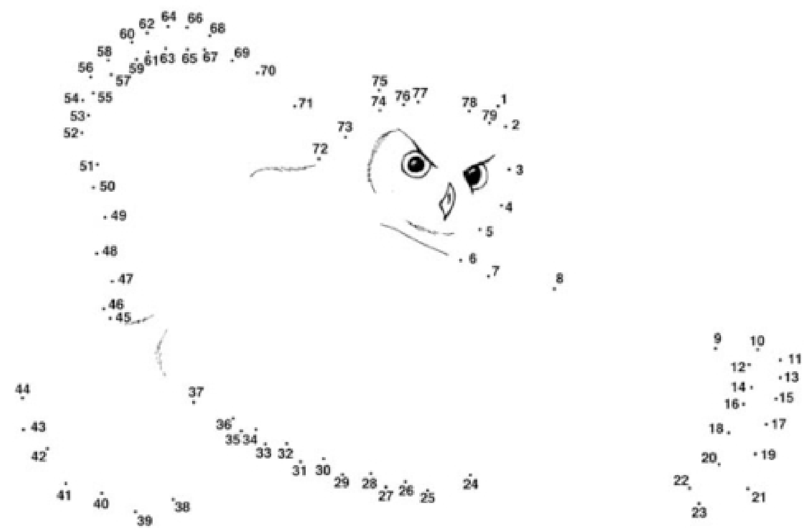


Source: SAIV.org

The Federal Reserve said on Wednesday that the US economy was slowing more than previously forecasted, and the economy in 2019 was well below economist estimates. At the end of the meeting, they left rates unchanged and signed through their "Dot Plot" with very little appetite for raising them again soon.

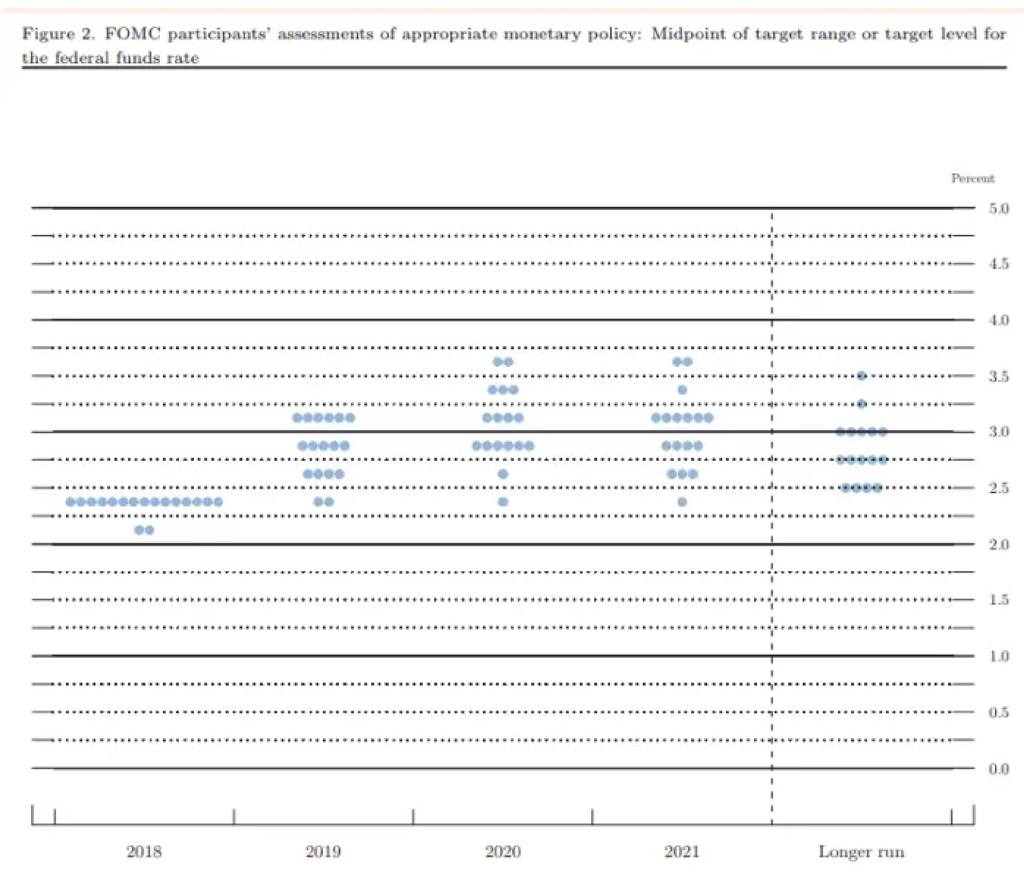
Going into the meeting, many investors (me included) thought the Fed might have at least one more 2019 rate hike in their pocket. But Wednesday's dovish announcement was a complete 180-degree turn from their language just a few months ago.

Wednesday, stocks initially went higher but then sold off toward the close of the day as traders started to realize that a potentially positive announcement could turn out to be a negative for the longer-term economic outlook. The Fed announced yesterday it was going to cut its estimate down to 2.10% in 2019 and trimmed its Personal Consumption Expenditures (PCE) inflation forecast to 1.8% (below their 2% inflation target).

Treasury yields moved lower in the wake of the decision and the dollar tumbled to a six-week low.

The Pivot

Its been called the "Powell Pivot," but the Fed Chairman doesn't work in a vacuum. As you can see by the chart below, Fed officials were on a rate-tightening course. Last December six (6) officials expected 3 hikes in 2019, five (5) officials expected 2 hikes, four (4) officials expected one hike and only two (2) officials expected the Fed to hold steady through the course of 2019.

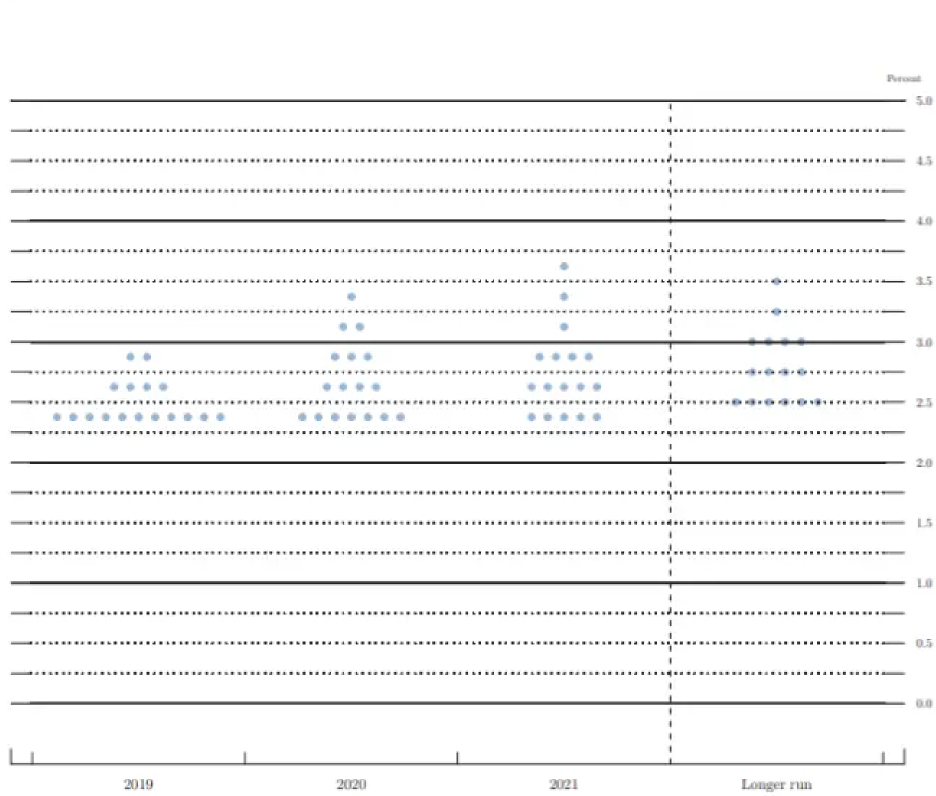


Source: Financial Times

So, did the economy slow that much between December and now or is the Fed just guessing like the rest of us? I would argue it's the latter. As you can see from the current dot plot posted on Wednesday, 11 Fed officials no longer predict any rate hikes for the remainder of the year and only six officials call for 1 or 2 hikes.

Our central bank is just guessing.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source: Financial Times

So, what now?

Rates:

I would anticipate the Treasury markets are going to continue to trade in a trading range for the near future. The current market is inverted from 0 – 5 years. As of 3/21/2019 – the 3-month US Treasury is trading at 2.46% while the 5-year is trading at a 2.32% (rates are subject to change). On the longer end of the curve, the 10-year is currently trading at 2.52% while the 30-year is trading at 2.97%. So beyond 5 years, the curve is shallow, and the markets are now positioning for a potential Fed cut before a Fed hike.

I continue to like the shorter end of the curve while the Fed continues to its “patient” approach.

Investors who are invested in high yield bonds may continue to see a rally in those assets because low rates and QE are (ultimately) deflationary, sustaining zombie-firms or lower credit institutions from failure. As interest rates stay low, those firms continue to get lower cost of capital than historical norms. So general risk of default may continue to stay low. However, like equities, I would advise constant rebalancing on any rally (aka: take profits off the table).

Equities

This asset class is a little harder to figure out.

Most indexes are up double digits year-to-date and investors will be well advised to again, take house money off the table. But what does the future hold?

Part of me thinks that markets have rallied in anticipation that the Fed would shift their position on rates. That’s done. So, what propels the market higher from here?

If the Fed is correct and we are living in a world where growth is declining, then it’s logical to believe that slowing growth will have a drag on the S&P 500 corporate earnings. According to FactSet, aggregate earnings guidance in Q1 2019 declined by 2.7% on an aggregate basis. In fact, the current forecasted earnings growth rate for Q2 2019 is a paltry 0.7%. So if that turns out to high, earnings could potentially slip into negative territory in which case earnings would be in a recession.

Nevertheless, the market is driven by the beat of its own drum. Inflows into mutual funds and ETFs currently still favor the sector, however, if the rally continues, fundamentals would be stretched (and that’s an understatement) and the risk to major pullbacks would increase.

Wisdom

It is said that an Owl is wise, and that may be true. However, I am not sure the Fed has quite as much as wisdom, as they continue to show signs (or Dot Plots) that they have no real handle on the economy and are guessing when comes to forward guidance.

As investors and advisors, we need to connect the dots. Asset allocation (or Risk Factor Allocation) only works if investors and advisors regularly tilt style or rebalance portfolios. I believe that index funds (and those who pile into them) could see underperformance versus active managers/advisors in this market. Slowing growth, Brexit, trade wars, valuations, etc. make this market too dynamic to not be active.

Be wise and invest well.