Another Milestone on the Road to Policy Normalization

The twin tailwinds of strong earnings and easing financial conditions are unlikely to remain as favorable as they've been since early 2016.

Jurrien Timmer | Director of Global Macro | @TimmerFidelity

Key Takeaways

- The Federal Reserve (the Fed) held interest rates steady in September, but in a slightly hawkish tilt it indicated another hike in December and three more in 2018.
- The Fed also announced plans to trim its balance sheet, a major positive milestone since the financial crisis.
- With the Fed putting the market on notice that its rate tightening is far from done, the tailwind of easing liquidity conditions may moderate or even reverse in the coming quarters.
- This suggests that the stock market's near-record risk-adjusted returns since early 2016 could moderate as well.

The Federal Reserve Open Market Committee (FOMC) met on September 19-20 and, as expected, did not raise short-term interest rates, keeping them in a range of 1% to 1.25%. Also as expected, the Fed announced it will begin to trim its balance sheet starting in October. It plans to put a $10 billion cap on reinvestment per month ($6 billion for Treasuries and $4 billion for mortgages), and the cap will increase by the same amount every three months, until it gets to $50 billion per month in about a year.

While both the decision to leave rates unchanged and the balance-sheet reduction plan were widely expected by investors, what was not known was the status of the "dot plot," a graph that shows where each FOMC member expects the Fed funds rate to be at the end of a given year. The median dot is widely followed as an indication of where the Fed wants to take the policy rate for the cycle (see Exhibit 1). Ever since the dot plot was created, the market (as indicated in the chart by the fed funds spread[1]) has consistently priced in far fewer rate hikes than the Fed has signaled via its dots. As the chart shows, with the exception of late 2016 (following the election amid expectations of a fiscal boost), the dots have always converged toward the fed funds curve.

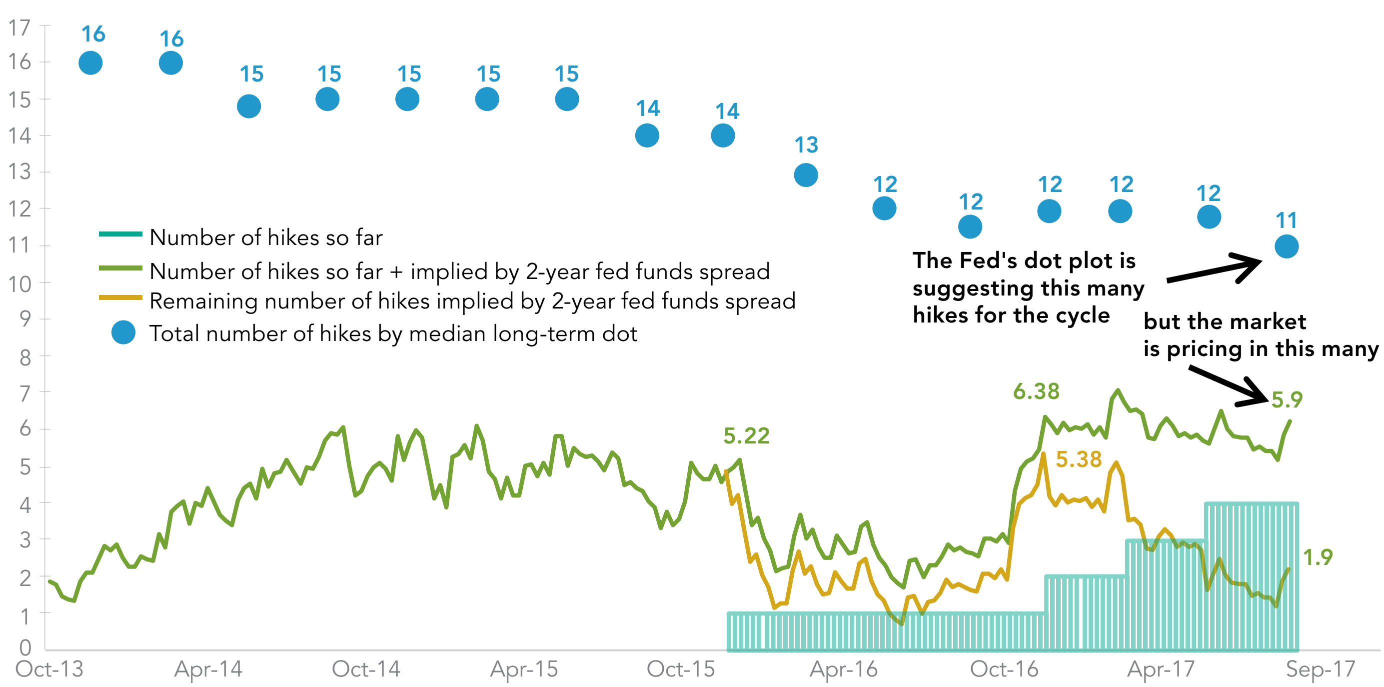
Prior to last week's FOMC meeting, the Fed was signaling seven more rate hikes through the end of 2019, but the market had only priced in between one and two more hikes. This persistent and large disconnect made the September FOMC meeting very interesting. With core inflation running well below the Fed's 2% target all year long (and confounding many economists in the process), would the Fed capitulate to the market and lower its dot plot, or would it hold its course and force the market to reprice? As it turns out, it did a little of both.

The Fed lowered its longer-term dots (bringing the terminal median dot down from 3% to 2.75%), thus implying one fewer rate hike for the remainder of the cycle than before. But the 2017 and 2018 dots remained unchanged, putting the market on notice that another hike may be coming this December, followed by three more next year.

This was a slightly hawkish surprise, which forced the bond market to do a bit of repricing. As a result, the yield on the 10-year Treasury rose following the FOMC announcement and is now about 25 basis points higher than just two weeks ago. The number of additional rate hikes priced in by the fed funds futures curve (for the coming two years) has increased from 1.1 to 2.3 over that same time span. Also, until a week ago, the market had priced in only a 25% probability of a December hike, but now those odds are up to about 70%.

EXHIBIT 1: The Fed's dot plot suggests nearly twice as many interest-rate hikes than the market expects.

Federal Reserve Dot Plot



Source: Bloomberg Finance L.P., as of Sep. 25, 2017.

Essentially, the Fed has put the market on notice that it expects this year's surprising weakness in core inflation to be only temporary and that the market should not expect the Fed to call it a day yet in terms of the tightening cycle.

Even with the bond market's re-pricing, the gap between the Fed's dot plot and the fed funds curve remains notable (1.9 vs. 7). Time will tell how this plays out, but my guess is that the bond market is still a touch too complacent about how far the Fed will go.

Having said that, the Fed is likely equally complacent about how far it thinks it can move rates higher without negatively affecting asset prices. My guess is that the two will continue to converge and that the cycle of interest rates will end with a policy rate in the neighborhood of 2% (compared with today's 1% to 1.25% range).

What happens next?

As always, ultimately the question is what this all means for investors.

Since the first quarter of 2016, six quarters ago, the global stock market has had an amazing run, rallying more than 30% (for the S&P 500) against record low volatility and without even a single 10% correction.[2] That's historically very unusual and, therefore, statistically unlikely to be sustainable. That's not to say we'll have a correction tomorrow, since those things are inherently unpredictable, but the current risk/return dynamic is about as favorable as it ever gets. Only 1996 produced higher risk-adjusted returns (based on the Sharpe ratio[3]) than the current regime.

The market's gains have been driven by two tailwinds: Earnings have been growing about 9% to 10% year-over-year, while financial conditions have actually eased (as measured by the Goldman Sachs Financial Conditions Index). Strong earnings growth and accommodative liquidity conditions have actually driven stocks higher than normal. Typically, the equity market has produced a 10% return against a volatility (standard deviation of return[4]) of 15. Since Q1 of 2016, the S&P 500 has produced a 32% return against a volatility of six.[5]

The rise in liquidity is somewhat counterintuitive. When the Fed is tightening monetary policy—and it has raised interest rates four times now in the past couple of years—it is called "tightening" for a reason. Yet financial conditions have been easing. My guess is that over the next year or so this combination of increasing earnings growth and easing financial conditions, while not reversing, could become less favorable as the Fed pushes further into its rate-tightening cycle.

How sensitive the markets will be to ongoing Fed tightening may come down to the track of the central bank's normalization path. There is little question in my mind that the Fed's zero-interest-rate-policy (ZIRP) and quantitative easing (QE) have affected the valuation of all financial assets via a suppression of the term premium.[6] Therefore, as this era of unconventional monetary policy slowly reverses course, it is only logical to assume that the term premium will start to rise over time, bringing with it an upward adjustment to the risk-free rate[7] and, therefore, a downward adjustment to the valuation of those asset classes that are priced off the risk-free rate (which is pretty much all asset classes).

Therefore, the slower and more gradual the path to normalization, the easier it will likely be on the markets. This is especially true if one assumes that the Fed and other central banks will only be willing and able to normalize policy if economic fundamentals justify it. A higher risk-free rate is far easier for the stock market to digest if earnings growth is robust than if it's declining.

The good news is that as long as inflation continues to run well below the Fed's target, the central bank has the luxury of going slow and gradual. If core inflation were to suddenly accelerate above 2% and force the Fed to raise rates faster, the markets might have a harder time with the rate cycle than what they've experienced since global reflation resumed in early 2016.

A milestone worth acknowledging

Ultimately, while not a market-moving event in the near term, I do think the Fed's plan to start rolling down its balance sheet signifies a major milestone of the QE era. It underscores the central bank's commitment (and more importantly the ability) to unwind its near decade-long easy-money policy.

From my perspective, the Fed's ability to both raise rates and pare its balance sheet is something to celebrate, even if it could lead to a downward adjustment in valuations down the road. After all, not many people would have predicted six or seven years ago that the Fed would ever be able to raise rates again, let alone reduce its balance sheet, all while the stock market is reaching record highs and bond yields remain near historic lows. So, I think the Fed deserves credit for getting at least this far along the path to policy normalization.

Author

Jurrien Timmer | Director of Global Macro, Fidelity Global Asset Allocation Division

Jurrien Timmer is the director of Global Macro for the Global Asset Allocation Division of Fidelity Investments, specializing in global macro strategy and tactical asset allocation. He joined Fidelity in 1995 as a technical research analyst.

Endnotes

[1] Fed funds rate is the interest rate at which banks and credit unions lend reserve balances to other depository institutions overnight.

[2] Source: FactSet, as of Sep. 25, 2017.

[3] A risk-adjusted measure calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe ratio, the better an investment's historical risk-adjusted performance.

[4] A statistical measurement of dispersion that depicts how widely an investment's return varied over a certain period of time.

[5] Source: FactSet, as of Sep. 25, 2017.

[6] The amount by which the yield-to-maturity of a long-term bond exceeds that of a short-term bond.

[7] The theoretical rate of return of an investment with no risk of financial loss.

Unless otherwise disclosed to you, any investment or management recommendation in this document is not meant to be impartial investment advice or advice in a fiduciary capacity, is intended to be educational and is not tailored to the investment needs of any specific individual. Fidelity and its representatives have a financial interest in any investment alternatives or transactions described in this document. Fidelity receives compensation from Fidelity funds and products, certain third-party funds and products, and certain investment services. The compensation that is received, either directly or indirectly, by Fidelity may vary based on such funds, products and services, which can create a conflict of interest for Fidelity and its representatives. Fiduciaries are solely responsible for exercising independent judgment in evaluating any transaction(s) and are assumed to be capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities.

Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the author and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision.

Stock markets, especially non-U.S. markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

Index definitions

Standard & Poor's 500 (S&P 500®) Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

Goldman Sachs Financial Conditions Index tracks changes in interest rates, credit spreads, equity prices, and the value of the U.S. dollar. A decrease in the index indicates an easing of financial conditions, while an increase indicates tightening.

If receiving this piece through your relationship with Fidelity Institutional Asset Management® (FIAM), this publication may be provided by Fidelity Investments Institutional Services Company, Inc., Fidelity Institutional Asset Management Trust Company, or FIAM LLC, depending on your relationship.

If receiving this piece through your relationship with Fidelity Personal & Workplace Investing (PWI) or Fidelity Family Office Services (FFOS), this publication is provided through Fidelity Brokerage Services LLC, Members NYSE, SIPC.

If receiving this piece through your relationship with Fidelity Clearing and Custody Solutions℠ or Fidelity Capital Markets, this publication is for institutional investor or investment professional use only. Clearing, custody or other brokerage services are provided through National Financial Services LLC or Fidelity Brokerage Services LLC, Members NYSE, SIPC.

813964.1.0