Fourth Quarter 2017 Outlook and Commentary

The auspicious formula powering stock markets around the world remains intact. Economic growth remains strong in Europe, the U.S., Japan, as well as in China and most other emerging markets. Not surprisingly, a strong global economy is boosting corporate profits. Perhaps most importantly, interest rates remain remarkably low. We've made this point countless times but when investment grade corporate bonds are paying less than four percent and there are plenty of blue-chip stocks with a dividend yield of three percent or more and the possibility of significant price appreciation, stocks look reasonably attractive. And that's true even if many valuation metrics make it appear that stock prices are at high levels.

Interest rates have been low for so long that it's easy to forget just how depressed they are by historical standards. The yield on the benchmark 10-year U.S. Treasury is currently below 2.50% (2.28% at this writing), as it has been most of the last seven years. From 1790 until 2008, a period of 218 years, the only time the 10-year Treasury yield was under that threshold was a 12-year stretch following the Great Depression. Interestingly, that stretch of super-low rates didn't begin until 1938. Somewhat akin to the aftermath of the Great Recession, interest rates continued to decline even as the economy began to rebound and remained low for an extended period.

One of the reasons extremely low rates prevailed in the late 1930s and throughout the 1940s was the Federal Reserve, which kept the Fed discount rate at or below 1.50% from 1934 to 1950. Fed chair Janet Yellen and her predecessor Ben Bernanke have likewise provided an extended period of monetary stimulus, with the Fed funds rate[1] at or below 1.50% for nine years and counting.

The Federal Reserve Open Market Committee meets eight times a year to consider altering the target Fed Funds rate. Following each meeting--regardless of whether it hikes, eases or leaves rates alone--the FOMC publishes members' expectations for the future, the so called "dot plot." September's dot plot suggests the target Fed funds rate will climb from the current 1.13% to 2.13% by the end of 2018 and 2.63% by the end of 2019. While those increases would be considered measured by the standards of past rate hike cycles, they would constitute a clear break from the aggressive monetary stimulus that has prevailed for nearly a decade and could have significant implications across all sectors of the capital markets.

There are several reasons a discussion of the pace of future rate hikes is especially timely. First, President Trump is expected to name a new Fed Chair this fall. While he is considering renominating Fed Chair Yellen, he is also reported to be considering his chief economic advisor Gary Cohn, current Fed governor Jerome Powell, or former Fed governor

[1] The Fed funds rate and the discount rate are slightly different. The Fed, and therefore the financial press, tends to focus more on the Fed funds rate. Historically, the discount rate was more prominent, and if you go back far enough it's a lot easier to find discount rate data. The difference between the two rates tends to be pretty modest.

Kevin Warsh. None of the four are known as rigid hawks (i.e., biased toward higher rates), although Warsh comes close. Assuming Trump does replace Yellen, capital markets will be scouring everything her successor has ever written or said on the subject of monetary policy. There will also be a tremendous amount of speculation as to what may have been discussed during the presidential interview. Prior to taking office, Trump had been very critical of the Fed's aggressive monetary stimulus. Perhaps not surprisingly, since taking office he has sounded much more amenable to keeping rates low.

At the same time as a new Fed Chair is selected, the Fed is facing a difficult conundrum. The economy is doing pretty well. While it may not be booming, economic data over the last several months has gotten increasingly better, capped off by very strong numbers for the ISM manufacturing and non-manufacturing indexes. Meanwhile the unemployment rate continues to be very low[2]. Traditional economic theory says that significant inflation pressures should be building. Mysteriously though, the inflation data shows nothing of the sort. Central banks around the world began setting inflation targets over 20 years ago. The U.S. Federal Reserve was late to the game but adopted a target of 2.0% in January, 2012. Despite the Fed's best efforts, inflation seems to be stuck at around 1.5%[3]. Although 0.5 percentage points may not seem like a lot, in the world of central banking, that's a very big miss. Yellen and her colleagues have been arguing for much of the year that the Fed is making progress in achieving its 2.0% target and that only "temporary factors" are holding the numbers back. That argument is getting increasingly difficult to make, and the next Fed Chair will quickly have to decide what is going on.

There are competing theories to explain the inability of the Fed to create more inflation. One explanation, notably propounded by former Treasury Secretary Larry Summers, goes by the name of secular stagnation. Summers argues that in the wake of the financial crisis the economy has for many years been running below capacity and requires more aggressive monetary and fiscal stimulus. On this view, the unemployment rate of 4.2% is very deceptive, and there are millions of workers who are either working part time when they would like to be working full time or too discouraged to look for work and therefore not counted as part of the labor force.

An alternative view is that inflation expectations, once anchored at a certain level, can be very difficult to change. While the Fed may have set a target of 2.0%, there is nothing magical about that number and businesses and consumers don't have much interest in making Janet Yellen happy. On this view there is nothing inherently unhealthy about a 1.5% inflation rate--it's just where inflation expectations happen to have settled down[4].

The overriding point is that inflation is not behaving in the way central bankers and economists would expect. As Yellen admitted in a recent moment of candor, "Our framework for understanding inflation dynamics could be mis-specified in some fundamental way." It's not too harsh to translate this as, "We, who play a critical role in management of the U.S.

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[2] September's jobs report showed a loss of 33,000 jobs. However, that number was likely depressed by the recent hurricanes. The "household survey," which is used to calculate the unemployment rate, is based on a different methodology and may be less susceptible to weather effect. The September household survey showed an increase in the labor force and a drop in the unemployment rate to 4.2%, strongly suggesting that labor markets remain very healthy.

[3] There are very recent hints that inflation may be moving closer to the Fed's target, but it's way too early to draw any conclusions.

[4] There are other theories too. For example, some would ascribe a key role to technology, pointing out that the ability of consumers to comparison shop has been vastly enhanced by the likes of Amazon. The easier it is to comparison shop, the harder it is for companies to raise prices.

economy, may be clueless when it comes to our most important mandate." While Trump's choice to run the Fed is contemplating all of this, he or she will face a number of wild cards from Capitol Hill, including the prospect of major tax legislation. Congressional Republicans, having failed to repeal and replace Obamacare, are under tremendous pressure to pass some version of the tax reform package they outlined several weeks ago. Passing anything like the announced plan would seem to be an enormous challenge, but Republicans consider tax reform critical to retaining their Congressional majorities, so who knows. Needless to say, if something did pass, it could factor significantly into the Fed's calculations.

While Congress wrestles with a tax bill, it also faces deadlines regarding the current year budget and increasing the debt ceiling. Those will probably require Democratic votes and may well get entangled with what is likely to be a messy battle to authorize an extension of DACA, the program that has allowed 800,000 "dreamers" to remain in the U.S. (Just prior to the completion of this commentary, two additional items were added to an already very crowded legislative agenda, with President Trump's decertification of the Iran nuclear deal and termination of Obamacare cost sharing payments likely to trigger Congressional action.) It could be well into next year before everything on the legislative agenda shakes out, but a lot will happen in the next few months, especially because some Republicans in Congress believe they need to pass tax legislation before Senator Luther Strange's successor is seated. Alabama voters will go to the polls in mid-December and choose Democrat Doug Jones (unlikely) or (much more likely) firebrand Roy Moore, who defeated Strange in the Republican primary, and has vowed to make Majority Leader Mitch McConnell's life miserable.

There is no shortage of interesting and pertinent situations evolving outside the U.S.: China's once every five years Communist Party Congress begins in a matter of days; the travails of UK Prime Minister Theresa May raise the prospect she may be succeeded by Jeremy Corbyn, whose past views make Bernie Sanders seem like a free-market zealot; and, negotiations between the U.S., Canada and Mexico over NAFTA have gone poorly enough to raise the specter of Trump unilaterally terminating the agreement. However, the confluence of a new Fed Chair, the need for the Fed to come to grips with its inability to get inflation up to its 2.0% target, and a potentially chaotic few months on Capitol Hill, could cause capital markets to focus intently this fall and winter on Washington, and specifically the Federal Reserve.

Three months ago, we discussed how the surge in corporate profits has been critical to underpinning the strength of the U.S. stock market. We're still inclined to think that corporate profit slowdown is the biggest risk to the eight-year plus bull market. But a leadership transition at the Fed during an especially delicate time in the rate hike cycle is another risk that bears watching.

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