Fed Raises Rates Based on Strong Labor Market: What Comes Next?

By: Gary Quinzel, CFA, MBA

- **Despite the escalating trade tensions, U.S. equity markets are still mostly positive on the year, while most international stocks and fixed income are in the red. Small caps have outperformed on the strength of the US dollar and growing protectionist rhetoric.**
- **As widely expected, the Fed raised rates in June to 1.75-2.00%, and signaled for two more rate hikes in 2018. With the job market the hottest in decades, fears of the economy overheating are beginning to appear more likely.**
- **Risk of a Fed policy mistake remains one of our primary concerns to this aging bull market. The Fed has quite a dilemma on their hands as they grapple with rising inflation expectations and plans to reduce their balance sheet.**
- **Portfolio implications vary across asset classes, as strong fundamentals in the economy support cyclical sectors while further rate hikes should impact bonds and high dividend paying stocks.**

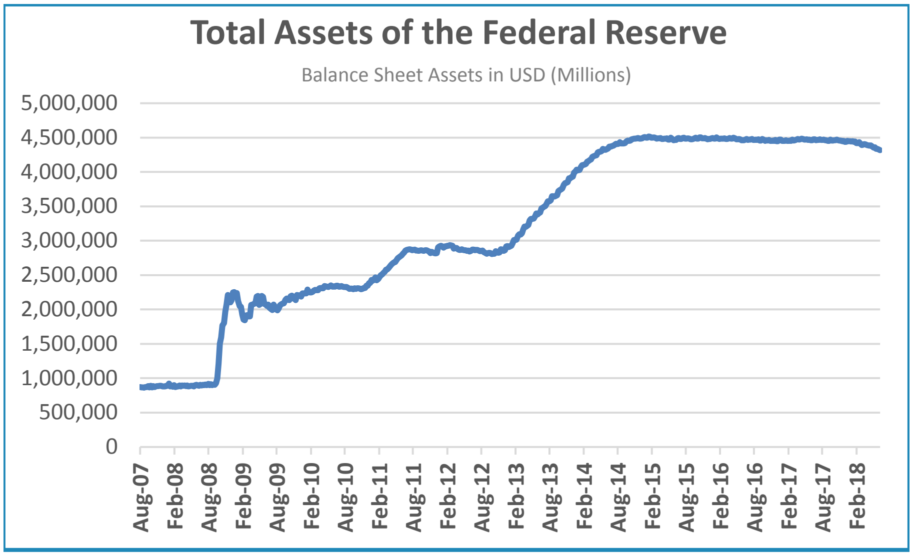
As we approach the midpoint of 2018, equity markets in the U.S. have largely recovered from their early Spring losses and are once again grinding higher in the face of numerous economic uncertainties. Escalated concerns over an increasingly likely global trade war brought upon by the U.S. has notably affected international stocks more so than at home. While U.S. stocks as represented by the Wilshire 5000 were up 5.3% year-to-date on June 18th, stocks in the developed international MSCI EAFE index were down -0.77%. Both the Nasdaq 100 (which is dominated by technology stocks) and the Russell 2000 which covers the small cap universe, both recently traded at all-time highs. Small caps especially have been on a tear the past several months, which can be attributed to President Trump's deregulatory and protectionist policies, as well as the strong U.S. dollar.

Emerging Market (EM) stocks have fared even worse, especially in recent months, as the EM index is lower by -

INDEX NAME	3 Month Change	Year to Date Change	1 Year Change
Wilshire 5000 Total Market	2.22	5.30	16.88
S&P 500	1.52	4.63	15.84
Russell Midcap	2.49	4.41	14.01
Russell 2000 (Small Cap)	7.04	10.08	20.50
MSCI EAFE (Intl. Developed)	-1.01	-0.77	9.45
MSCI Europe	-1.05	-1.51	7.72
MSCI AC Asia Pacific	-2.63	0.33	14.77
MSCI EM (Emerging Markets)	-7.89	-3.07	13.51
Bloomberg Barclays US Aggregate Bonds	-0.03	-1.94	-1.08
Bloomberg Barclays Global Aggregate Bonds	-2.68	-1.71	1.01
Bloomberg Barclays Municipal Bond	0.93	-0.49	0.83
Bloomberg Commodity Index	0.91	0.26	9.91
Wilshire US REIT	6.55	-1.77	-0.86

** All Performance is "Total Return" through 6/18/18 - Source: FactSet*

3.07%. Much of the weakness in emerging market stocks has been precipitated by the stronger U.S. dollar, which is now up over 3.4% versus the Euro this year. Of its major trading partners, only the Japanese Yen has appreciated versus the dollar in 2018, even though many predicted a repeat of 2017 whereas the dollar weakened considerably. Many emerging market countries have external debt denominated in U.S. dollars, so a higher greenback can imply higher borrowing costs, which are already being impacted by higher rates.



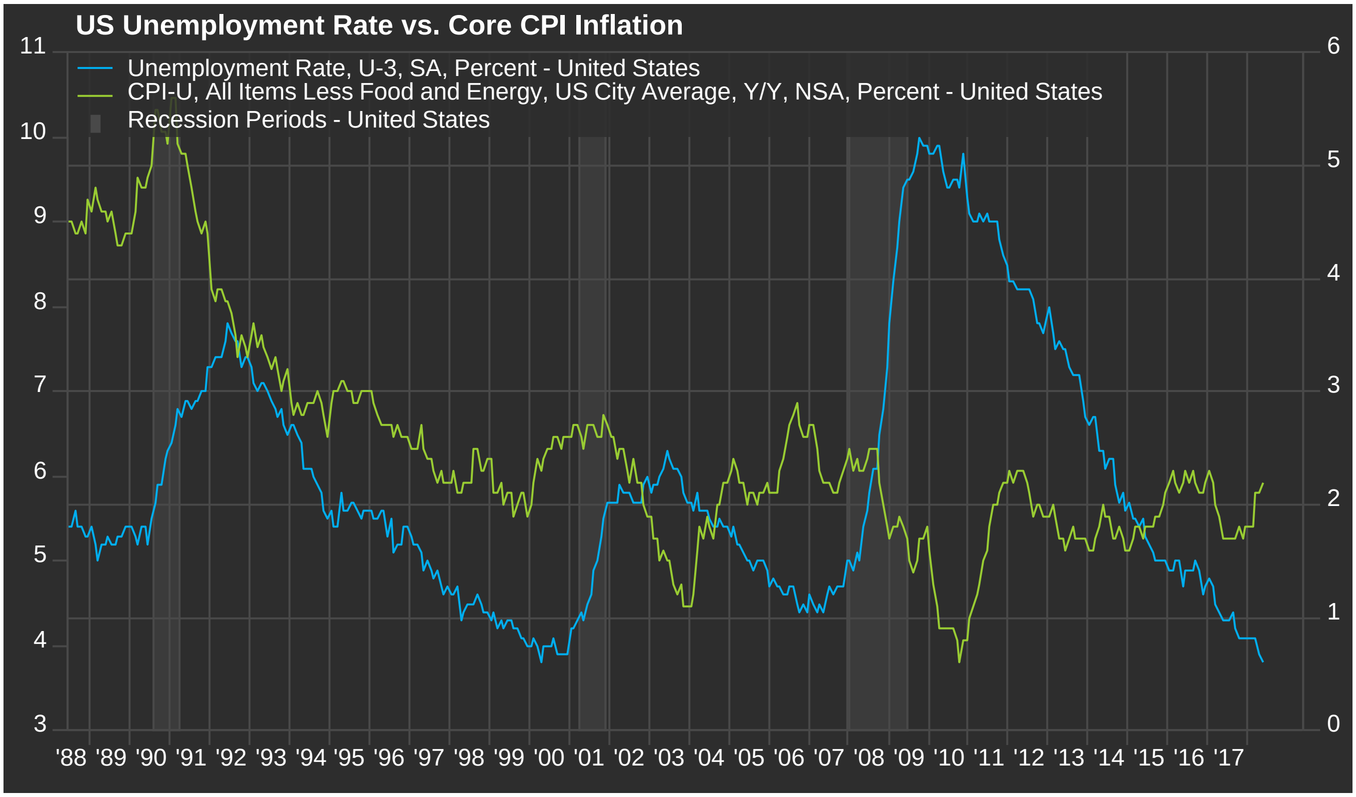
While we don't put too much credence into short-term currency projections, as they often fluctuate irrationally for extended periods of time, we do think that the dollar's recent strength may be temporary. After the U.S. dollar's weakness in 2017, a reversal to the upside was to be expected at some point, and given higher inflation expectations in the U.S. versus other developed nations, this suggests further currency depreciation in the future. Regardless, our outlook on emerging markets remains positive overall due to the strength in the global economy, as well as the continuing evolution of emerging economies from commodity-driven to consumer-driven markets.

The Fed Dilemma

Is the job market getting too hot? What is the true rate of inflation, and is it rising? Will the Fed escalate their balance sheet normalization plans, or perhaps end earlier than expected? These are some of the driving questions which will almost certainly help determine when this economic cycle will come to its end. As we have said in the past, the fear of a Fed policy mistake is one of the foremost risks we see today. As the Fed attempts to fulfill their dual mandate of maximum employment and price stability, they must also grapple with reducing their $4.5 trillion balance sheet, which began last Fall. According to statistics from the Federal Reserve, the Fed's balance sheet was around $4.3 trillion as of June 6, which is about $125 billion lower than where it started the year. The monthly reductions are picking up in pace as this unprecedented experiment of quantitative tightening takes place in concert with rising short-term rates. Steven Kaye had the pleasure of meeting with prior Fed chairperson Janet Yellen recently, who indicated that the U.S. is experiencing the best labor market in 20 years. Dr. Yellen also spoke about the importance of communication from the Fed, and how the "taper tantrum" of 2013 could have easily been prevented.

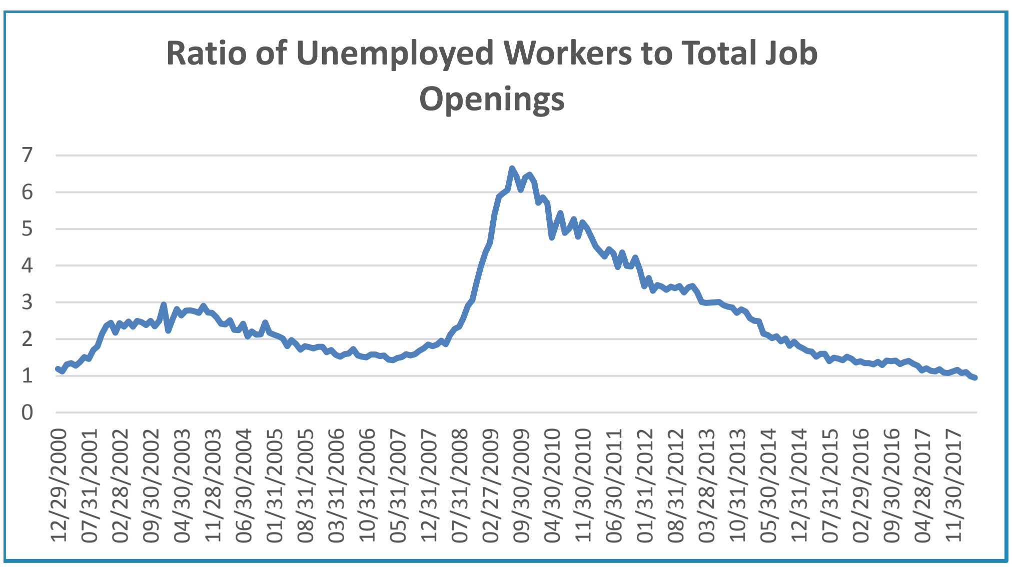
On June 13th, the Federal Reserve announced a rate hike of 0.25% to the Federal Funds Rate, its second rate hike of the year, bringing the new range to 1.75-2.00%. This marks the seventh rate hike the Fed has implemented since beginning its tightening cycle back in December 2015, when rates were held at 0.0-0.25% due to the impacts of the financial crisis. In his post-meeting press conference, Fed chief Jerome Powell presented a bullish assessment of the US economy, citing accelerating growth and solid job creation. The officials at the Fed also lifted their median outlook from one to two more rate hikes this year, further increasing the likelihood of higher rates and a flatter yield curve. They stated that the inflation risks are "roughly balanced" and in their communication dropped their long-term assurance of keeping rates below their long-term norms.

One of the key drivers of the Fed's rate decision has been the strong labor market here in the U.S. According to the Bureau of Labor Statistics (BLS), total nonfarm payrolls increased by 233,000 people in May, while the unemployment rate ticked down to 3.8%. In addition, employment gains in March and April were revised



upwards by 15,000 combined, resulting in average job gains of 179,000 over the past three months. The BLS specifically noted that employment was trending higher in several industries, including retail trade (+31,000 jobs), health care (+29,000), and construction (+25,000). Meanwhile, the average hourly earnings for all employees rose to $26.92, which equates to 2.7% annual growth. As we have noted several times in the past, hourly earnings have remained stubbornly low throughout this economic cycle, but we are finally starting to see improvement in this area. The challenge for the Fed will be how to maintain this current level of healthy job growth without the economy overheating.

Moreover, the U.S. reached another significant milestone this Spring, as ***for the first time in decades there are more job openings than unemployed workers to fill them!*** According to the April Job Openings & Labor Turnover Survey (JOLTS), total nonfarm job openings climbed to 6.7 million, while total unemployed were 6.3 million, resulting in a ratio of about 0.95. This is quite significant, and is the lowest ratio going back to when data began in 2000. According to a Bloomberg article, based upon research by Nick Bunker at the Washington



Source: U.S. Bureau of Labor Statistics, FactSet

Center for Equitable Growth, this is the lowest ratio going all the way back to 1970. In another significant post-Fed meeting development, the Fed announced that starting in January 2019 they will hold a press conference after each meeting, which will hopefully increase the transparency of the Fed's future moves. The market had become largely accustomed to the Fed only raising rates at meetings which are followed by a scheduled press conference. The Fed began the press conferences back in 2011, to help elaborate and provide clarity to the standard post-meeting statement. However, since the Fed first started raising rates back in 2015, they have always scheduled press conference on rate hike days, leaving investors to believe that rates will remain untouched on non-press conference meetings. As referenced above, Dr. Yellen is a big believer in open communication from the Fed, and it appears for now that current Fed chief Jerome Powell is following in her footsteps.

Finally, one day after the Fed made their announcement, on June 14th the European Central Bank (ECB) announced that they will end their quantitative easing program by the end of 2018, and will reduce their monthly bond purchases from €30B to €15B in September (down from €60B last year). Mario Draghi, the ECB president, also pledged that the ECB would hold rates at record lows (essentially 0%) until at least the middle of 2019. In his press conference, Draghi noted that the economic backdrop for the Eurozone was still positive, yet not as strong as last year, alongside an "undeniable increase in geopolitical uncertainty." The ECB also cut its forecast for eurozone growth in 2018 from 2.4% to 2.1%, which is likely correlated to the higher risk of trade wars brought upon by the U.S. The ECB also predicted that inflation would hit 1.7% in 2018, where just 3 months ago they called for just 1.4%.

Portfolio Implications

So, what does all this mean for our investment portfolio? The Fed's hawkish tone and the increased certainty of rate hikes this year implies that interest-rate sensitive securities are likely to face headwinds for the foreseeable future. This of course includes bonds, but also high-dividend paying stocks such as consumer staples, utilities, and telecoms. Preferred stocks and publicly traded REITs will likely also suffer. On the other hand, the strong fundamentals which warrant the higher rates suggests that cyclical sectors such as financials, consumer discretionary, and technology may outperform.

Regarding the flattening of the yield curve, which many view as the preeminent recession indicator, it is important to note that equities historically have performed well during flattening periods. Given that the 10-year still about 0.43% higher than the 2-year treasury, we still have a way to go before the yield curve actually inverts. It should also be noted that this time really may be different. That is, Central Banks have never had so much influence on the long end of the curve, as typically their open market operations focus purely on the short end. As the Fed and other central banks attempt to shrink their balance sheets, thus reducing demand for longer term bonds, this could potentially put upward pressure on rates. How much impact this may have remains unclear, however we are certainly in unchartered territory when it comes to global central bank policy, therefore relying on old indicators in isolation seems a bit naïve.

Here at AEPG® we have taken a risk-balanced approach to investing as we navigate through this period of increasing volatility and uncertainty. From an allocation standpoint, our growth models have a slight tilt towards growth over value, and our models have higher allocations to small and mid-cap stocks compared to most broad benchmarks. We also believe in global diversification, which includes both international developed and emerging stocks, which together comprise roughly 30% of our equity exposure. As always, we believe in taking less risk than the market, which over time leads to lower volatility and improved risk adjusted returns. Our fixed income portfolio is constructed to have significantly lower duration (interest rate sensitivity) with an emphasis on high quality bonds to help protect the portfolio whenever the next economic crisis might come. By focusing on risk mitigation and taking a total return perspective, we are able to help our clients achieve their financial objectives and sleep better at night. Our list of concerns has been growing as of late: trade wars, inflation, high levels of debt, and signs of the economy overheating, all of which could further escalate at some point. However, the economy in the U.S. and abroad is still strong and the risks to the market still seem skewed to the upside. Fed policy will be important to follow in the coming months, and here at AEPG® we will be monitoring closely.

AEPG WEALTH STRATEGIES

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