—New Albany—
Investment Management

July 7, 2017

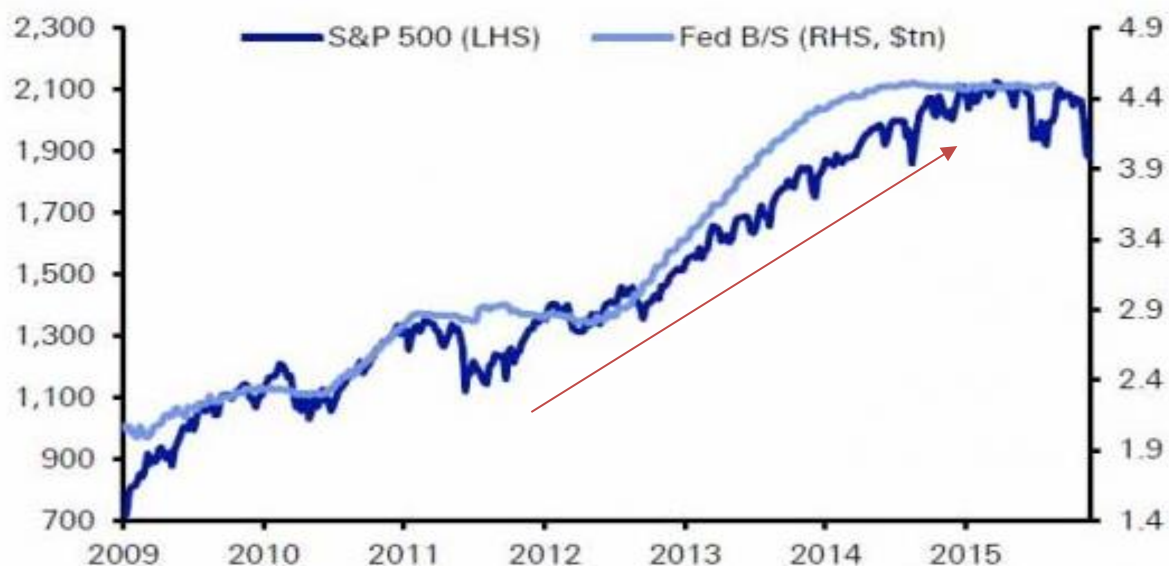
Market Insight: Fed Shifting Policy to Neutral; Sentiment Stalls

Waning expectations of fiscal stimulus and a more hawkish message from the Fed has caused investors to be a bit less confident. Though many indexes made new highs during the 2nd quarter, prices quickly retreated and volatility has returned to both the stock and bond market. Economic data has been mixed with commodity prices (oil) very weak, but employment and housing fairly robust. Without any new initiative on the fiscal side, and a shift to 'neutral' monetary policy, the markets are currently in 'stall' speed, trying to find footing in a changing investing landscape. There are crosscurrents of shifting fundamentals, some which could potentially redirect the market. Interest rates, valuation, earnings, and fiscal policy are key drivers in the months ahead.

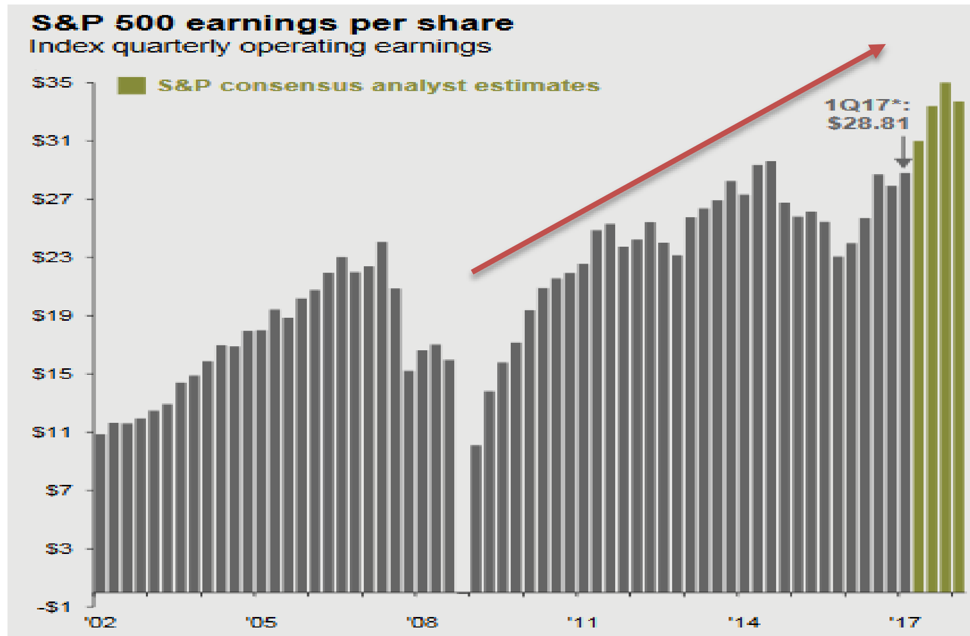
Shifting to Neutral Monetary Policy/Uncharted Waters: The market has enjoyed a decade of extraordinary easy monetary policy with zero short term interest rates and $4.6 trillion of 'extra' liquidity from the Fed's bond buying program (QE). But this era has come to a close, and now the Fed has conveyed its plans to get back to a more 'neutral' policy stance. This means short term rates will need to rise further, and, even more importantly, QE will be reversed through allowing maturing bonds on the Fed's balance sheet to roll off and be absorbed into the market. The pace of this change is quite gradual, but the magnitude is potentially huge and it is unfolding at a time when growth and inflation are muted**.** No one, including the Fed, knows how it will all play out in the global economies and markets as only time will tell the outcome. We are indeed entering uncharted waters.

The charts below give a snapshot of current conditions. Let's take a look:

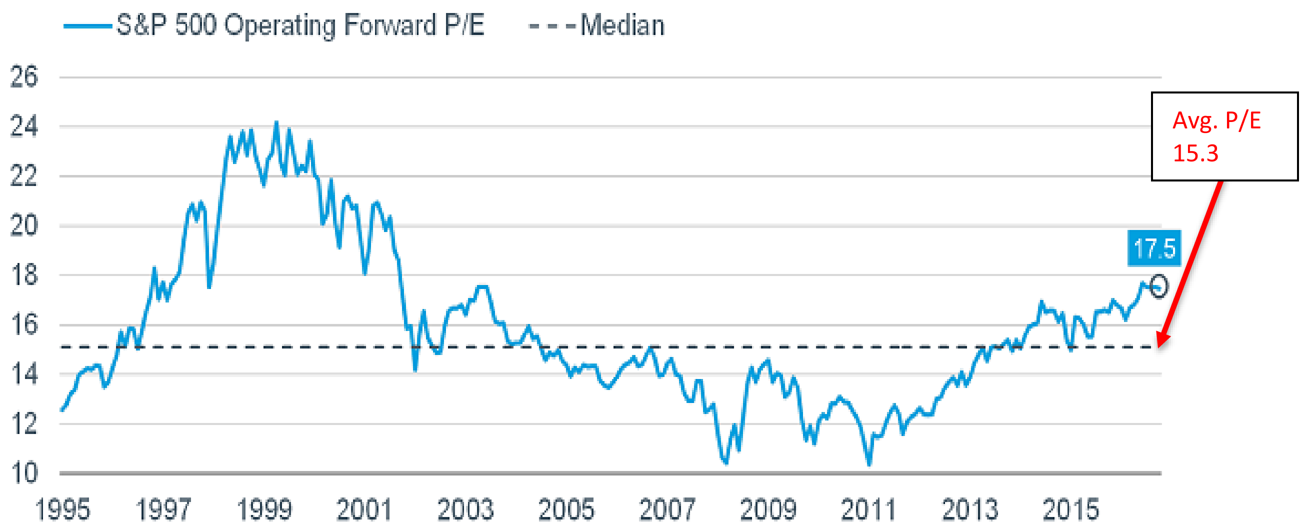
Correlation? How much has Quantitative Easing influenced Stock prices? Investors are on the precipice of discovering how much (if at all) quantitative easing and zero interest rate policy has subdued volatility and inflated asset prices. This has been a hotly debated subject. **Many argue stock prices have risen due to the flood of liquidity by the Fed into the market.** The chart below shows the performance of the S&P 500 (dark blue line, left axis) versus the growth of the Fed's balance sheet (light blue, right axis) from buying $4.6 trillion of bonds, since 2009. It shows a very strong correlation indeed!



However, there is more to the story. **Earnings have also increased,** (though not in a straight line) which have been very supportive for stock prices to rise.



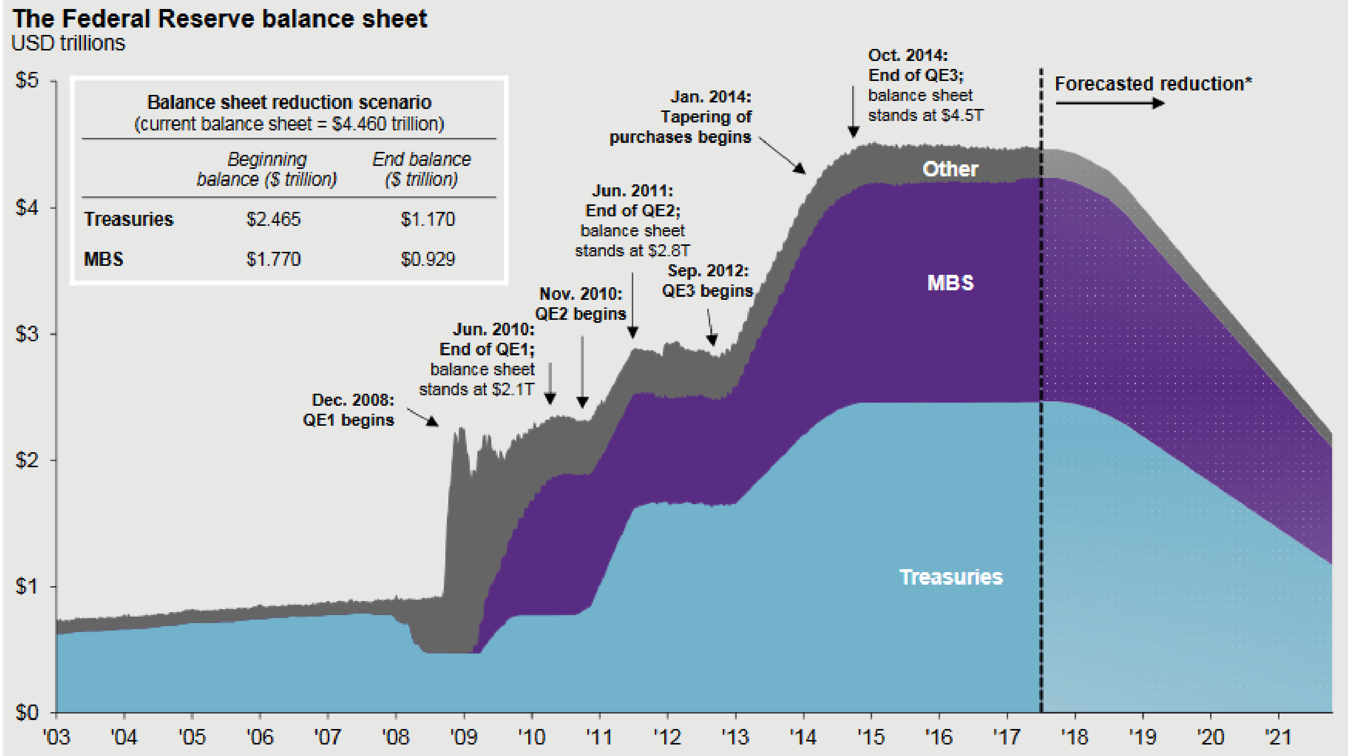
But, stock **prices have risen faster than earnings have grown**, thus the current valuation in terms of P/E, is now at 17.5, and above the historical average of 15.3.



Source: FactSet, as of June 30, 2017. P/Es are based on forward 12-month consensus operating earnings.

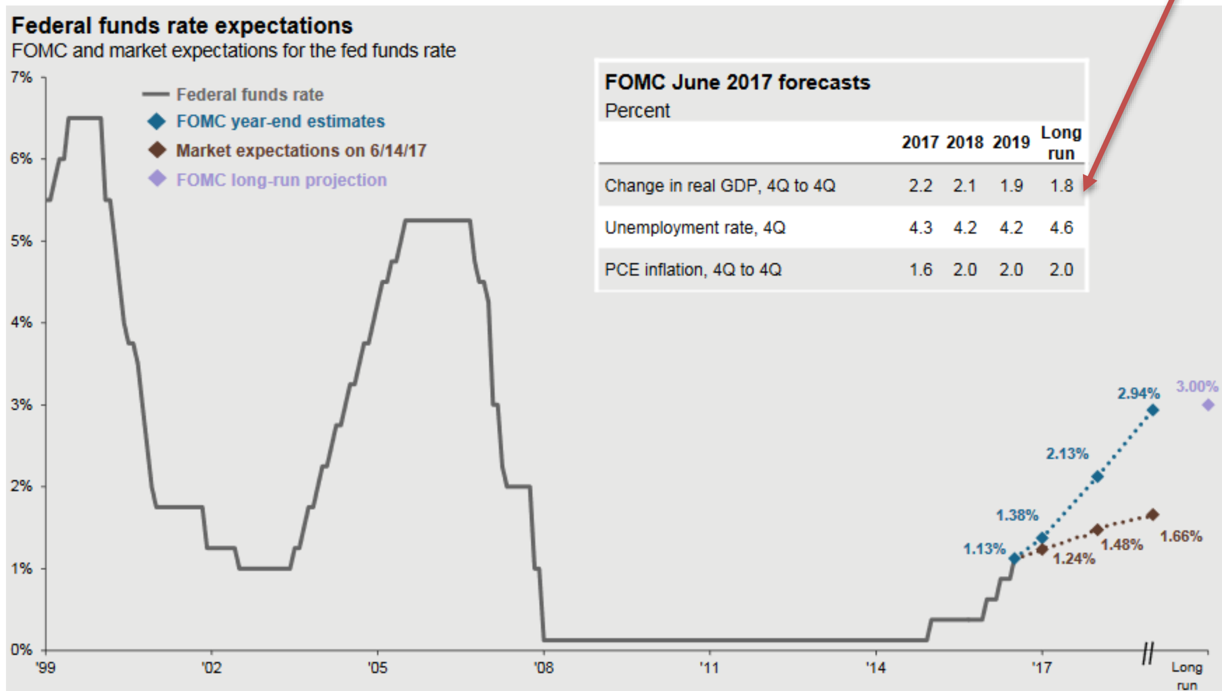
Low Inflation, Interest Rates, and Earnings Growth have supported Stock prices: Although valuations are above historical average, they can be justified given the low level of inflation and interest rates. And recently, valuations have also been supported by double digit growth in earnings. However, any significant change could cause prices to retreat and head back to more 'normal' level. To put this in perspective, the market would have to drop by over 13% to get the P/E back to its historical average of 15.3.

Road to Neutral Policy- Bond Market Beware: The chart below shows the progression of bond purchases by the Fed and their schedule to roll off of $4.6 trillion of maturing bonds through 2021. The plan is to start slowly and then accelerate the unwinding each year. The additional supply of bonds should push rates higher.



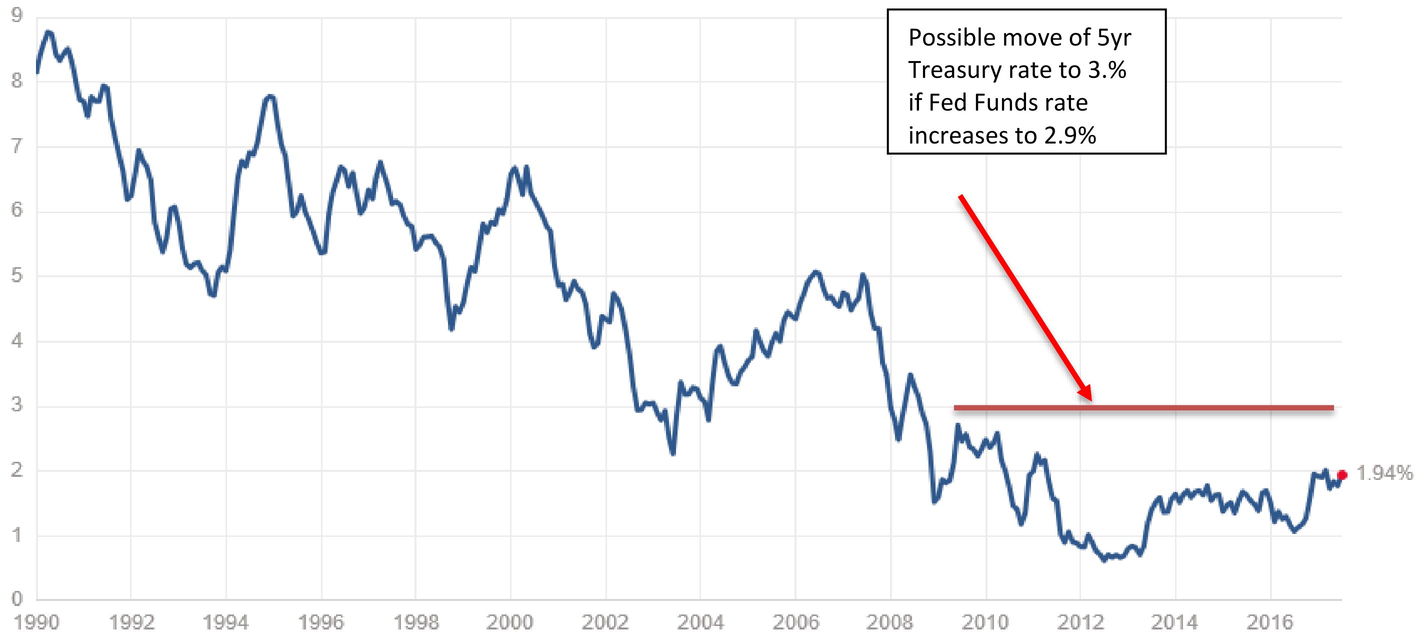
Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.

Potential magnitude of interest rate moves warrants caution; potential correction of Bond prices ahead. The next two charts give perspective on how far rates have fallen, and how far rates could move to get back to a neutral stance. The chart below shows the change in the Fed Funds rate which is the overnight borrowing rate between banks, and is what the Fed controls. It has moved from zero to 1.25% and is expected to continue to rise to 2.9% by 2019. Notice, the Fed's projections of GDP and employment are slightly lower than today's readings, despite their plans to raise rates!

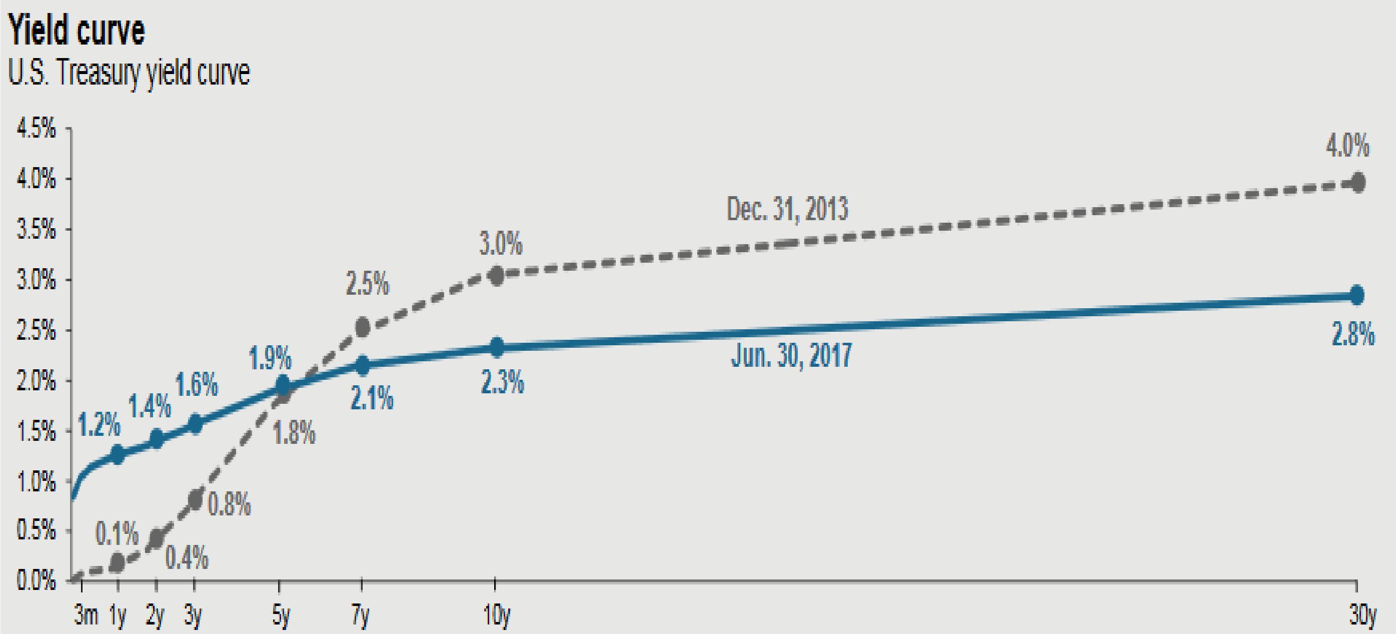


	2017	2018	2019	Long run
Change in real GDP, 4Q to 4Q	2.2	2.1	1.9	1.8
Unemployment rate, 4Q	4.3	4.2	4.2	4.6
PCE inflation, 4Q to 4Q	1.6	2.0	2.0	2.0

This next **chart is of the 5yr US Treasury** rate since 1990. Extrapolating from where the projected Fed Funds rate will be in 2019 at 2.9%, the 5yrs Treasury rate could rise from 1.9% today to approximately 3.0%. That move equates to a -5% drop in 5yr maturity bond prices. And extrapolating further out the curve, 10yr US Treasuries could move from 2.3% today to approximately 3.3%, an -8% drop in prices! Ouch!



Defying logic: Ironically, since the Fed's announcement to move to neutral monetary policy, the bond market has actually pushed long term rates down about 40bpts this year, and rates have declined by 120 bpts since the end of QE. The chart below shows the shape of the yield curve at two very different points of monetary policy. In December 2013 (grey line), the Fed was still in ultra-easing mode, with the Fed Funds rate at zero, and the third round of QE being implemented. In contrast, today the Fed is in tightening mode. The blue line shows the impact of the Fed raising short term rates, however, long term rates (which are dictated by the market) are actually lower.



Good News and Not so Good News. The fundamentals are still positive, but road ahead will likely be choppy. The good news is that inflation remains quite subdued at only 1.7% and Global GDP is stable to improving. Both of these factors will continue to support stock prices. And, a potential big positive (and wild card) is Tax reform. Assuming the Health Care bill is resolved sometime this year, tax reform will move to the front burner and light a fire under equity prices. The not so good news is the Fed is moving monetary policy back to neutral which will put pressure on rates to rise, and will be a headwind for all financial asset prices.

Investment Strategy:
Stocks: Equity exposure remains broadly diversified, with some reallocation outside the US, as growth around the globe is gradually accelerating.

Bonds: With interest rates likely to creep higher over the year, duration is short with exposure to investment grade and high yield corporates, and floating rate bank loans.

These are my thoughts on the current market environment and investment strategy. As always, please contact me with any questions or concerns.

Kind Regards,

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