Weekly Market Flash

Yellen's Lesson, Powell's Challenge

December 15, 2017

As 2017 draws to a close, two data points strike us as particularly noteworthy candidates for summing up the year in asset markets. The S&P 500 is up more than 20 percent in total return, and the Fed has raised interest rates three times. Investors have good cause to bemoan the exit of Janet Yellen at the end of next month, for the good professor has given us an extended seminar in how to handle interest rate policy with minimal collateral damage either in financial markets or the real economy of goods and services. Incoming Fed Chair Jerome Powell has some large shoes to fill; fortunately he, by all appearances, has been a diligent student under Yellen's tutelage over the past several years. He will need all the benign tailwinds he can get, because the road ahead may not be quite so calm as that we leave behind heading into 2018.

Follow the Dots

This week's 25 basis point increase in the Fed funds target range was widely anticipated by the market (again, thanks to clear and prudent forward guidance). Investors quickly skimmed past the headline announcement to see where Fed minds were regarding policy action for next year: the famous "dot-plot" showing where FOMC voting members think rates will be in the coming three years and beyond. Very little has changed since the dot-plot's last iteration in September, with the mean expectation of three more rate hikes in 2018. The lack of upward movement on rate expectations came at the same time that the Fed raised somewhat its expectations about economic growth and labor market conditions.

Dr. Pangloss's Market

From an investor's standpoint the market would seem reminiscent of Dr. Pangloss in Voltaire's "Candide" -- the best of all possible worlds, with growth supported by still-accommodative monetary policy. That pleasing state of affairs, of course, comes courtesy of inflation that refuses to budge out of its narrow range of about 1.3 to 1.8 percent, depending on which measure you prefer. Markets seem satisfied this best of all worlds will continue. Even now, Fed funds futures markets ascribe only a 20 percent or so chance of even those three rate hikes occurring next year. An unexpected surge in inflation is quite likely the most impactful variable that could upset the present state of things. It would cause a rethink in the pricing of most assets, starting with intermediate and long term bonds. Intermediate Treasuries, in particular the 10-year note, serve as a proxy for the "risk-free rate" calculations used in valuing and pricing most risk assets. Disrupt expectations for the 10-year, and you disrupt most everything else.

The Curvature of Markets

In July 2016 the 10-year yield dipped as low as 1.36 percent, which by some accounts was the lowest yield for a benchmark risk-free rate ever in the 800-plus year-history of recorded interest rates. Today, the 2-year yield -- a short term reference benchmark closely tied to monetary policy trends -- is over 1.8 percent. With today's 10-year around 2.4 percent, the spread between short and intermediate yields is lower (flatter in yield curve-speak) than it has been any time since 2007. Intermediate yields are affected by many market variables, but inflationary expectations are prominent among them. Briefly put: if that inflationary surge were to happen, there would be plenty of upward curved space for the 10-year yield to occupy. Up go all those discount rates used to make present value computations for risk assets. All else being equal, a higher discount rate lowers the net present value of a future series of cash flows. The calm waters of 2017 would likely seem a distant memory.

All that being said, there is no hard evidence today suggesting that this kind of inflationary surge is around the corner. Other factors, such as low productivity growth and hitherto modest wage growth, continue to keep consumer prices in check. But sub-2 percent inflation in an economy where unemployment is just 4 percent runs counter to all the data and experience that have informed monetary policymakers for the past seventy years. It has been a pleasant, if confounding, feature of the Yellen years. Figuring out where it goes from here may well be incoming Chair Powell's biggest challenge.

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