MV CAPITAL MANAGEMENT

Weekly Market Flash

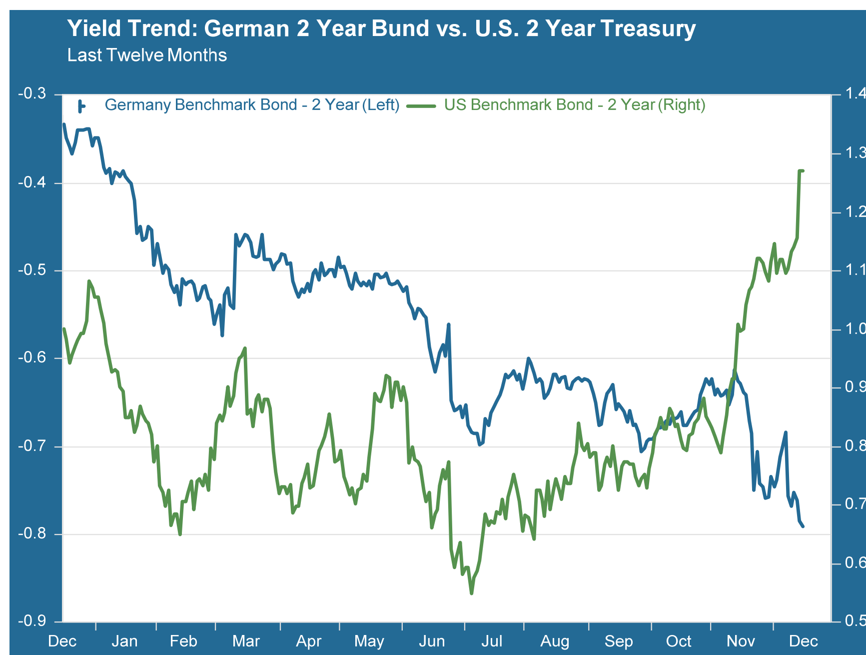
Return of the Dot-Plotters

December 16, 2016

Fiscal policy is where all the cool kids hang out now, as we noted in [last week's commentary](). But the monetary policy nerds at the Fed got at least a modicum of attention this week as the dots settled on the Fed funds plot chart Wednesday afternoon. As was widely expected, the meeting resulted in a 0.25 percent target rate hike and some meaningful, if subtle, changes to the 2017 outlook. Three policy actions are on tap for next year, and this time the market seems to take this outlook seriously. Chair Yellen & Co. expect the recently favorable trends in output growth and employment to continue, while expecting to see headline prices reach the two percent target by 2018. These observations appear to be largely irrespective of what does or does not happen with all the hyped-up fiscal policy that has been driving markets of late. Be well advised: monetary policy will still matter, quite a bit, in 2017. It will have an impact on many things, not least of which will be the opportunity set of fiscal policy choices.

Divergent Today, Insurgent Tomorrow

Market watchers on Wednesday made much of the (temporary, as it turns out) pullback in stock indexes in post-FOMC trading. But the real action, as has often been the case in the last six weeks, was in the bond market. The yield spike is noteworthy in absolute terms, but even more striking on a relative basis. Consider the chart below, showing the spread between the 2-year U.S. Treasury note and its German Bund counterpart.



Source: MVF Research, FactSet

Short-term U.S. rates are at 52-week highs while German rates are at their 2016 lows. The spread between the two is wider, at 2.07 percent, than it has been at any time since 2003. Remember divergence? That was the big theme in the discourse one year ago, when the Fed followed through on its 2015 policy action last December. The Eurozone and Bank of Japan were full steam ahead with their respective stimulus programs as the Fed prepared to zag in the other direction. Then markets hit a speed bump in January, the Fed backed off any further action and rates came back down. As the above chart shows, U.S. and German short-term rates followed a more or less similar trajectory for most of the year.

But divergence is back with vengeance. Holders of U.S. dollar-denominated assets will be pleased, as the euro gets pushed ever closer to parity. Policy divergence leads to dollar insurgence. On the negative side, that insurgence looks set to redouble the FX headwinds that have clipped corporate top line revenue growth for much of the past two years. That, in turn, will make it challenging to achieve the kind of double-digit earnings growth investors are banking on to justify another couple laps of the bull market.

Three Times the Charm?

What we took away from Chair Yellen's post-meeting press conference was a sense that the Fed's world view has changed only modestly amid all the hoopla of the post-election environment. She took pains to note that the outlook shift to three possible rate changes in 2017 does not reflect a seismic change in thinking among the dot-plotters, but an incremental shift reflecting a somewhat more positive take on the latest growth, employment and price data.

And fiscal policy? Yellen could hardly avoid the topic; it was the point of the vast majority of the questions she fielded from the press. Over the course of her tenure at the Fed she has spoken many times of the need for monetary and fiscal policy to complement each other at appropriate times in the business cycle. This, however, may not be one of those times. Consider her comment in response to one question: "So I would say at this point that fiscal policy is not obviously needed to help get us back to full employment." For the moment, at least, and in the absence of any tangible data to suggest otherwise, the Fed does not appear to be giving undue attention to the fiscal variable.

As Location Is To Real Estate, Productivity Is to Growth

Chair Yellen did make a point of emphasizing what kind of fiscal policy she does like: namely, that which directly helps boost productivity. That's a point you have heard us make in this space ad nauseum, so it was good to hear it from the Eccles Building. What kind of fiscal policy could that be? Education, jobs and skills training programs and improving the quality of installed capital used by American workers were specifically called out by the Fed chair. Of course, there is no clarity of any kind that such productivity-friendly programs will make it through the legislative sausage factory. One can always hope, though.

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