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Article Highlights

- As expected, the Fed raises interest rates for the third time this year.
- U.S. stocks rally on tax-reform optimism; European shares decline slightly.
- Treasuries take news of the decision in stride, and the yield curve continues to flatten.
- In our view, three Fed rate hikes next year are likely, above market consensus of about two.
- Retail sales and business confidence stand out in a light week for U.S. economic data.
- We remain optimistic about the prospects for emerging-market stocks even after their strong 2017 run.

Quote of the week: “No! Try not. Do, or do not. There is no try.” – Yoda, from “The Empire Strikes Back”

Lead Story: Markets yawn as the Fed raises rates

The past week was dominated by the Federal Reserve’s December 13 decision to lift the target federal funds rate by 25 basis points (0.25%), to a range of 1.25% to 1.50%—its third hike in 2017 and fifth in the past two years.

In its accompanying statement, the Fed cited the economy’s solid performance and a tightening labor market as two key reasons for the move. Moreover, the Fed’s new economic forecasts showed that Federal Open Market Committee (FOMC) members have become more optimistic about GDP growth over the next few years. The closely watched “dots,” representing policymaker expectations for interest-rate policy, were unchanged for 2018 and 2019; the Fed still anticipates three 25-basis-point hikes next year.

Interestingly, two of the nine FOMC members dissented from the Fed’s action, reflecting their concerns over stubbornly low inflation. Stripping out food and energy costs, so-called “core” Consumer Price Index (CPI) inflation rose just 0.1% in November and 1.7% versus a year ago, the eighth consecutive month in which the year-over-year increase has undershot the Fed’s 2% target.

However, in her post-meeting press conference, Chair Janet Yellen expressed confidence that inflation would rise moderately over the next one to two years. She also indicated that the tax policy being considered by Congress would provide “some stimulus” to growth in the near term and,
potentially, in the longer run. More perspective on the Fed’s decision, along with additional insights related to interest rates and the implications for investors, are available here.

Because traders had already priced in close to a 100% chance of a Fed rate hike at this meeting, the fixed-income market’s reaction was relatively muted, even as the U.S. Treasury curve continued to flatten. The 2-year note, which is particularly sensitive to changes in Fed policy, rose by four basis points (0.04%) during the week, closing at 1.84% on December 15. Meanwhile, the yield on the bellwether 10-year security finished the week three basis points lower, at 2.35%, restrained by ongoing low inflation. Despite the Fed’s nudging rates higher in 2017, the 10-year yield is 10 basis points below where it began the year.

We expect three hikes next year, particularly if Congress succeeds in passing tax reform, which now appears likely. Markets have priced in only about two increases, though, as concerns persist that wage growth will fail to manifest, keeping inflation below the Fed’s target.

In addition, many market participants believe the Fed does not want the yield curve to flatten much further, lest short-term yields exceed long-term yields, resulting in an inverted yield curve. An inverted yield curve has historically been viewed as an indicator of a pending recession. Such an outlook could limit the Fed’s ability to raise rates next year.

Any signals from the bond market about the potential effect of higher rates on the economy didn’t trouble equity investors. After slipping on December 14 amid tax-reform doubts in Washington, the S&P 500 Index rallied hard on Friday as lawmakers’ optimism over hammering out a final bill returned. For the week, the index rose 0.9%. Across the Atlantic, Europe’s STOXX 600 Index fell 0.3% in local terms.

**In other news: Emerging-markets stocks haven’t feared the Fed in 2017**

Investors have often shied away from emerging-market (EM) assets during Fed tightening cycles. Conventional wisdom dictates that the resulting higher yields available in the U.S. make EM stocks, bonds, and currencies less attractive. Additionally, a stronger dollar, which frequently accompanies a series of Fed rate hikes, lowers the price of oil and other commodities denominated in dollars, potentially hampering EM economies that are commodity-driven.

This year’s been different. EM economic activity has picked up in unusually coordinated fashion. A surprisingly weak dollar and broad improvement in developed-market growth have provided a “Goldilocks-like” environment of solid GDP expansion and moderate inflation. Against this bullish backdrop, the unhedged MSCI Emerging Markets Index has surged 32.6% for the year to date through December 14, far ahead of the S&P 500’s 20.8% return.

After such a brisk advance, investors might think EM equity valuations have become rich, but that’s not been the case. Share prices have climbed roughly on par with earnings expectations: the MSCI EM’s 12-month forward earnings-per-share consensus estimate has risen 25% from a year ago. As a result, EM stocks broadly look no more expensive than they did last December, and remain cheap relative to U.S. shares.
Also noteworthy has been the broad participation among EM equity markets. Argentina (74.4% year to date through December 14), Poland (+48.3%), and South Korea (+39.9%) lead their respective regions. Mexico (+12.6%) and Colombia (+12.4%), two relative laggards, have nonetheless posted attractive returns.

On an EM sector level, Technology (+58.2%) has performed the best this year, just as it has in the U.S. This stellar gain marks a stark reversal from prior EM rallies that saw banks and energy companies benefit from higher interest rates and the “reflation” trade. This time around, a number of EM central banks are in easing mode—in contrast to the Fed and, sometime soon, the European Central Bank. Tech stocks tend to move higher when borrowing costs are low.

As examples of countries we currently favor, “up-and-comers” like Argentina and Brazil are enjoying better governance and accelerating growth rates. Likewise, India (+33%) stands to benefit from stronger domestic growth in 2018.

The main risks to our generally optimistic EM outlook include the possibility of an economic slowdown that hurts corporate earnings or an uptick in inflation that could reduce profit margins. We peg the odds of either event as low, however, and believe that investors who approach EM equity markets selectively should fare well in 2018.

Below the fold: Retail sales are up, and business confidence is way up

On the heels of consumer confidence reaching a fresh 17-year peak, shoppers are doing their part to jump-start the 2017 holiday season. Retail sales leaped 0.8% in November (versus a 0.3% forecast) and 5.8% compared to a year ago, and October sales were revised up to 0.5% from 0.2%.

Meanwhile, business owners are feeling exuberant: in November the NFIB Small Business Optimism Index hit its highest level in 34 years and second-best in its 44-year history. Those surveyed overwhelmingly expect better business conditions and rising sales. Finding qualified workers, though, continues to be challenging.

Back Page: Janet Yellen’s swan song

Yellen’s appearance at the Fed’s post-meeting press conference felt like a finale, even though she’ll remain at her current post until February 3, 2018. Jay Powell assumes leadership the next day, his 65th birthday. This transition marks the first time in 39 years that a Fed Chair has served only one four-year term; G. William Miller lasted a mere 18 months before Jimmy Carter named him Secretary of the Treasury and replaced him with Paul Volcker in 1979.

Yet Yellen’s accomplishments shouldn’t be discounted.

In relatively seamless fashion, she continued where Ben Bemanke had left off, engineering a soft landing for the U.S. economy after its worst economic calamity since the Great Depression. As Chair, she will likely be remembered most for stating clearly that the Fed would keep interest rates lower than normal—until well beyond the end of quantitative easing—and for sticking to that promise.
As she and the other FOMC members continued to dial down their longer-run interest-rate forecasts, markets reduced theirs as well, easing financial conditions. Additionally, amid the declining unemployment rate the Fed faced when Yellen took office in 2014, another Chair may have advocated raising rates earlier and more rapidly. But Yellen’s belief that the shrinking unemployment rate masked significant labor-market slack now appears to be correct.

That said, Yellen struggled moderately in two respects. First, she stumbled early on with communicating changes in the Fed’s plans for interest-rate policy. However, she soon found her sea legs and succeeded in telegraphing rate moves unambiguously. (Indeed, markets shrugged off the December 13 hike precisely because it was 100% priced in.) Her communication style could not have been farther from that of former Chair Alan Greenspan, who once quipped, “I guess I should warn you. If I turn out to be particularly clear, you’ve probably misunderstood what I said.”

Second, core inflation has stayed below the Fed’s target, calling into question the FOMC’s ability to control the general level of prices. But keep in mind that Fed policy operates on a lag, so she should get “credit” for any rise in the next year or so.

Yellen’s tenure was not as historically consequential as Bernanke’s or Volcker’s (which featured a dramatic series of rate hikes designed to halt runaway inflation). Nevertheless, she should be regarded as an inarguable success for shepherding the U.S. economy from crisis to normalcy in a well-communicated, orderly fashion.