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Mixed Messages

In Waiting for Perfection, the Fed May Be Clouding Its Exit Framework

- Events in Q1 took the Fed off message and “Brexit” further complicated its story
- Given the limited set of policy tools, the Fed seems to want to play it safe and is reluctant to raise rates until it has strong evidence of inflationary pressures
- The safe road now means more policy uncertainty later
- Markets will hinge, in part, on whether the Fed dramatically changes the exit framework it has spelled out so well in recent years

Market Update

Last quarter, we wrote that negative interest rate policy in Japan and Europe signaled a sense of desperation on the part of foreign central banks as they were perceived to be approaching the limits of their policy tools. Shortly after markets caught their breath from the Q1 volatility, it seemed events would put that theory to test. The UK’s vote to leave the European Union (informally known as Brexit) shocked markets and, for two days, sent global equities and bond yields plunging. Central banks around the developed world pledged to stand by with more stimulus while the US Fed said it was closely monitoring the situation. There are a lot of different views as to what the implications of Brexit will be, ranging from dire to downright mild (though there is well-founded agreement that it’s a net negative for the UK economy). Ultimately, however, we believe the most important question for capital markets is whether or not the central bank divergence story that has dominated markets for more than year is still intact.

In December 2012, the Fed abandoned its date-based guidance on monetary policy in favor of a data-dependent approach, one that would target the levels of unemployment and inflation to guide the future direction of interest rates. For central bank watchers, it was an important departure because it signaled the Fed was adopting a strategy that Japan had used to successfully exit its own quantitative easing program roughly a decade earlier. For market watchers, it was important because it was an acknowledgement by the Fed that it would begin stepping aside to allow economic fundamentals to determine the outcome of interest rates and financial markets more generally.

Data-dependent policy was initially effective, giving markets easily observable guideposts to follow in the process of exiting easy monetary policy. However, as economic growth (and a declining labor force participation rate) drove unemployment well below the Fed's original target of 6.5%, without the expected pickup in inflation, the Fed was forced in 2014 to amend its original targets. By explaining that it would be following a more nuanced interpretation of job market health (rather than the crude top-level unemployment rate), it pivoted credibly enough to avoid spooking markets.

Eventually, in mid-2015 as unemployment dropped below 5% and inflation expectations began to creep up, it became clear in the data and in Fed language that the US central bank was headed in a very different direction than other global central banks, whose economies were still suffering from weak growth, deflation and high unemployment. This departure by the Fed from globally-coordinated monetary policy became known as the "global central bank divergence" story, and was a powerful narrative in terms of understanding much of what was happening (and would happen) in capital markets and risk markets. Tightening financial markets in the US with loose monetary policy abroad set up a logical framework through which to understand currencies, interest rates, credit spreads, equity markets, and so on.

By December 2015, the Fed was emboldened to begin the process of hiking short-term interest rates, albeit in .25% baby steps. At the time, it pledged a gradual trajectory of rate hikes, but one that would remain dependent on incoming data. It estimated it would hike rates another four or so times over the course of 2016, slowly working its way toward its longer-term goal of normalizing rates after years of crisis-era monetary policy. This was very much in line with the data-dependent story it had been telling for the better part of three years.

Then came 2016. Slowing growth in China, weakness in emerging markets, and plunging commodity prices prompted a sharp sell-off in global asset markets in January and February. The Fed responded by introducing the idea that it would be carefully monitoring international developments - not just domestic unemployment and inflation - to guide its way on changes in monetary policy. While this may have been a nod to the likelihood that changing US monetary policy was at the root of the instability abroad, it represented a potential departure from the data-dependent mantra the Fed has been training markets on for so long. Financial markets loved it – the promise of lower rates for longer meant a more stimulative monetary environment for risky assets like stocks – but central bank watchers cried foul, claiming the international wrinkle muddied the waters of an otherwise clear exit framework.

Since then, market watchers have carefully dissected every word out of the Fed to determine whether the central bank had in fact altered its reaction function to include international developments and financial market stress, or whether it remained truly data dependent. In some ways, the Fed was bailed out by an undeniably bad jobs report in May – just 38,000 new jobs for the month, well below the average of 200,000 new jobs per month over the past few years. The timing could not have been better: the Fed was handed a strong data-driven reason to hold off hiking rates at its June meeting, quieting critics just as British citizens were heading to the polls to determine their fate within the European Union.

Markets had a poor initial reaction to the surprise outcome of the British vote, but ultimately rallied back strongly after digesting the news. While the European Central Bank, Bank of England and the Bank of Japan pledged further easing to mitigate market instability, markets realized that the direct implications of Brexit would be fairly minimal. Furthermore, rather than being a binary outcome as British voters were led to believe, people came to understand that Brexit is a complex process that will take years to work through (renegotiating policies ranging from trade, competition, immigration, welfare, government spending, taxes, security, monetary policy, the environment and so on). Far from being a "Lehman moment" as many predicted, Brexit turned out to be an event too distant and complex for markets to promote it to being imminently crisis worthy.

If the Fed got "lucky" with weak data before the Brexit vote, it got very unlucky with strong data after the vote and shortly after reiterating its promise to pay careful attention to international developments. A whole host of data poured in in early July that showed a far more robust economy than previously thought: jobs numbers came in exceptionally strong (a 287,000 increase for June), while prices, wages, manufacturing, retail sales, among others were solid. This puts the Fed in a bit of a tight spot.

On net, when the Fed faces a mixed message, it tends to move slower than faster. It's better to be vaguely right than exactly wrong, as the saying goes. The problem is that it's not clear just what mixed message the Fed is reacting to (domestic or international?). The Fed seems concerned about downside risks to the economy, particularly those coming from abroad. It also recognizes that it has limited policy tools to deal with shocks should they happen, whether they come at home or from abroad. So, it appears to be taking (understandably so) the safe road, making sure the economy is healthy enough to withstand shocks before hiking rates any further.

The safe road is prudent for now, but it means the Fed will remain reluctant to raise rates until it has strong evidence of inflationary pressures. When it gets that evidence, it will be required to move at a much faster pace than the four-times-per-year guidance it gave last December. Inflation takes time to build and interest rates take time to have an effect. In other words, the safe road now means more policy uncertainty later. To the extent that inflation builds at a time when the rest of the world is on its knees, it will represent a particularly confusing policy environment for markets. The Fed would be wise to clarify its reaction function – defining the factors it is using to determine the path of interest rates - soon to avoid that mess.

We do expect the Fed to clarify its position in the coming months, likely in favor of its long-standing data-dependent approach. Isolating Brexit as an "event" that clouded the economic waters will buy the Fed time and still allow it to remain focused on incoming domestic data. Should the Fed continue to emphasize international developments, we would view it as a meaningful change in the divergence story. The Fed is well aware, however, that waiting for perfection may erode its hard-earned credibility; the last thing it needs is to be perceived as playing a game of whack-a-mole with monetary policy.

In the meantime, our portfolio construction will focus on minimizing the effect of extreme outcomes and, as always, will remain positioned to withstand a wide range of economic scenarios.

Rain Portfolios

Benchmarks, which have a full allocation to longer-duration bonds, were hard to beat during the quarter as the Brexit scare drove interest rates down to historic levels and pushed bond prices to all-time highs. We have been deliberately underweight duration in portfolios because investors simply do not get paid for the risk they take by holding longer-dated bonds; the meager income most bonds offer cannot offset the capital losses that would occur from a small jump in rates. The last time this positioning was a drag on performance during the Russian invasion of Crimea, the effects proved to be transient. We expect the same will be true this time, particularly given the strength of data in recent weeks and the extreme pessimism the market currently has about the Fed's interest rate path. The choice between positive yields in the US and negative yields in Japan and Europe may make US bonds attractive on a relative basis, but that additional yield will come at a high cost should US growth accelerate.

On the growth side of portfolios, the low volatility strategies we are using to counteract the lack of duration in portfolios have performed well throughout the market volatility. In most cases they are several hundred basis points or more ahead of their respective benchmarks for the year. We would expect these to continue to do well in choppy markets, particularly as we approach the high-stakes US presidential election in November.

Company announcements

We are pleased to announce the addition of a familiar name. John Bala has joined Rain Capital as a Senior Client Advisor and Portfolio Manager. Some of you may remember John from Pacific Investment Advisers, where he also held the position of client advisor. John brings more than 25 years of experience, a client focused attitude and some wonderful new clients to the firm. We are pleased to have him as part of the Rain team.