Federated

Orlando's Outlook: 'Particularly bright moment'

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Bottom line *In a unanimous and widely expected decision, the Federal Reserve voted on Wednesday to raise its benchmark fed funds rate a quarter point to a target range of 2-2.25%. This marks the Fed's third hike this year and its eighth since ending its zero interest-rate policy (ZIRP) in December 2015.*

This also marks the first time the upper band of the range has been above 2% in a decade and the first time it has exceeded core personal consumption expenditure (PCE) inflation during this post-crisis cycle. Through August 2018, the core PCE index (the Fed's preferred measure of inflation) has been running steadily at the Fed's 2% year-over-year (y/y) target for four months, up from a trough of 1.4% in August 2017. Policymakers do not appear worried about a future spike in inflation.

Moreover, Fed Chair Jerome Powell noted in his press conference that economic growth was broadly strengthening, while inflation remains relatively benign and on target. It's a situation that he described as a "particularly bright moment" for the U.S. economy. With a strong labor market, the Fed increased its GDP forecasts for this year and next. It also reaffirmed the potential for five more gradual, data-dependent quarter-point hikes over the next two years and chose to remove the word "accommodative" from its statement for the first time since the end of the financial crisis. Collectively, it gives us greater confidence that the S&P 500 will continue to grind up towards our 3,100 year-end target.

Economy strengthening The Fed raised its forecast for GDP growth in 2018 to 3.1%, which is stronger than our own above-consensus forecast of 3% at Federated. That's important, as the Fed was forecasting 2.8% GDP growth for 2018 in June, 2.7% in March and only 2.1% last September (2017). In our view, this bullish increase in the Fed's estimate suggests it is recognizing the powerful and sustainable supply-side effects of President Trump's structural fiscal-policy reforms of late last year. For 2019, however, policymakers inched up their GDP forecast to only 2.5% from 2.4% in June, compared with our own 3% estimate. Keynesian demand-side habits die hard, and we expect more upward movement in the Fed's 2019 GDP estimate over time.

Another quarter-point hike is widely expected in December That would be the fourth of 2018, taking the upper band of the fed funds rate up to 2.5%. The Fed's current dot plots were largely unchanged from June, suggesting three more hikes in 2019 and a final one in 2020, taking the upper band to 3.5%. That's higher than market expectations of only two more hikes in 2019, stopping at 3% perhaps by midyear.

Policy error brewing? That 50-basis-point gap creates a possible market risk for investors. Will the Fed commit a policy error and over-tighten rates into 2020, just as the economy's growth is beginning to top out? In anticipation, the bond vigilantes might begin to buy bonds under that scenario, pushing yields down and thus inverting the yield curve. That could deliver the impending recession signal so many equity investors have feared. The Powell Fed has promised to be data dependent, but we remain vigilant.

Power troika finally in place The Senate finally confirmed Richard Clarida as Fed vice chair, long after he was nominated by President Trump in April. This seat had been open since Stanley Fischer prematurely retired last October. In June, San Francisco Fed President John Williams moved east to replace the retiring William Dudley as the president of the New York Fed. So this week's meeting had its power troika in place for the first time. Clarida and Williams, who are both Ph.D. economists, supplement Powell's lack of formal economic training, while Powell's plain-spoken market savvy is a refreshing new wrinkle.

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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