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THE FED'S STREET CRED

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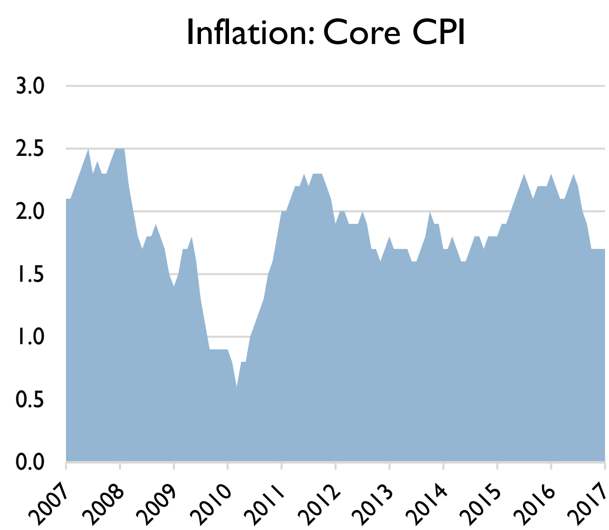
Our last *Market Insight* newsletter highlighted the unusually low level of volatility in financial markets. Since then the Federal Reserve ("the Fed") reiterated its intent to continue removing monetary stimulus as we had hoped, but financial markets have remained surprisingly calm. Stocks and bonds continued to appreciate in unison in the third quarter as long-term interest rates declined. The S&P 500 rose to record high levels following the best six months of earnings growth for the index since 2011. Other than a few brief episodes of volatility driven by geopolitical risk, market and economic fundamentals remain on the same solid trajectory as at the beginning of the quarter. Stock valuations also remain elevated and leave the market vulnerable to a correction in the event of a negative surprise. While stocks can always decline due to an unpredictable event, monetary policy is becoming a predictable risk to stock and bond markets as investors ignore the Fed's guidance.



The Fed has a dual mandate to seek full employment and price stability, which they define as an inflation rate of 2%. The labor market has made steady progress this year and is approaching full employment by some measures, but inflation has declined to the low end of the range it has been in since the financial crisis, as shown in the chart to the right. The low level of inflation has reduced pressure on the Fed to continue increasing interest rates. The Fed has also lost credibility in recent years as they have repeatedly failed to execute the policy changes in their guidance. As a result, the futures market at one point this quarter reflected only a 22% chance of the Fed increasing short-term interest rates again this year as planned. A few weeks later, the Fed provided detailed guidance for the removal of monetary policy accommodation, insisting that recent low inflation readings are expected to be "transitory."

The plan announced by the Fed on September 20th is to reduce its bond holdings and increase interest rates once more in 2017 and three more times in 2018. They also decreased the projection for interest rates over the long term, which has become a pattern in recent years and is being reflected in a "flattening" yield curve where short-term interest rates rise relative to long-term interest rates. A flattening yield curve is typically negative for stock investors as it is inconsistent with the acceleration of the economy and corporate profits. The yield curve is almost as flat today as it was at the post-crisis lows in the summer of 2016 prior to the reacceleration of the economy.

The normalization of the Fed's balance sheet may make it different this time, but the bond market currently implies an alarming level of complacency regarding monetary policy. For example, the futures market is pricing in a 5% probability of the Fed increasing interest rates three times in 2018 as projected and a 41% probability that they will not increase interest rates at all next year. If the Fed increases interest rates as planned and long-term inflation expectations remain contained, it is possible that the yield curve could flatten much further. This could become a problem for investors and especially for banks. A flat yield curve can lead to deteriorating lending standards and eventual credit problems as financial institutions struggle to identify investments with returns higher than their borrowing costs.

On the other hand, the last time 10-year treasury volatility persistently declined over an extended period like this was just prior to the "taper tantrum" in 2013 when long-term interest rates spiked after the Fed announced its intent to stop buying bonds. A replay is possible if significant inflation takes hold and places pressure on the Fed to remove monetary stimulus more aggressively. For the moment, the data seems to support the "don't fight the Fed" adage and continued flattening of the yield curve as inflation gains modest traction. This outlook could change over time and we will reposition portfolios as needed based on incoming economic data and the composition of the Federal Reserve Board as new appointments are made. Going forward, the members of the Fed's board could include practitioners rather than academics and the policies could become more formulaic to rebuild credibility. One way or another, monetary policy uncertainty seems set to increase in coming months and quarters and investors seem too complacent about this possibility. One important implication is the potential appeal of foreign markets where international monetary authorities are much earlier in the process of policy normalization.

We still hope that the Fed will stick to its plan and continue to remove policy stimulus, even if this creates some volatility in financial markets. This could be a timely development as low interest rates have been driving increased risk taking since the financial crisis and there are some signs of excess in the credit markets. The end of near-zero interest rates could be a disruptive force in financial markets and create some short-term volatility while also laying the foundation for more durable financial markets. While current events seem to be a stream of disruption of every kind (corporate, political, monetary, geopolitical, etc.), our focus is on the long-term fundamentals that remain strong. While monetary authorities and policies shift in coming months, we will continue to adapt our investment tactics within the context of each client's long-term needs. Our goal is to develop a long-term investment strategy for each client that we can stick with even as volatility picks up, while allowing for some flexibility to adjust to evolving market circumstances within that context.

2017 Market Diary

		Last 3 Months	Last 12 Months *
U.S. Equities			
	S&P 500	4.48%	18.60%
	Dow Jones Industrials	5.58%	25.45%
	Russell 2000	5.67%	20.71%
	Russell 3000	4.57%	18.70%
International Equities			
	MSCI World Index ex-US	5.70%	19.37%
	MSCI Emerging Markets	8.01%	22.87%
Fixed Income			
	Barclay's U.S. Int. Gov't/Corporate	0.60%	0.23%
	Barclay's U.S. High Yield	1.98%	8.88%

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices