It's All About those Rates

The stock market finished a turbulent quarter mostly in the red with the S&P 500 and Dow Jones Industrial Average down -1.22% and -2.49% respectively. Even the bond market suffered a quarterly decline with the Barclays Bond Index down -1.05%. Only the technology heavy NASDAQ Composite showed gains with a 2.32% quarterly advance.

Since the almost four-decade bond bull market began, it has been rare for both stocks and bonds to decline in tandem. Indeed, bonds have offered investors a reliable safe haven whose price zigs higher when the stock market suffers a periodic zag lower. The decline in bond prices makes today's stock market volatility all the more difficult to swallow. Boosted by recent tax reform legislation, interest rates are riding the coattails of accelerating U.S. economic growth and reviving fears of a more hawkish Federal Reserve. While we still view the spike in rates to be cyclical, not secular, the yield on the benchmark 10-year U.S. Treasury recently threatened to break through the psychologically important 3% threshold, a level of yield previously thought to be a technical ceiling.

All eyes are on inflation and the Federal Reserve. While unemployment has hovered steadily near 17-year lows at 4% for over one year now, inflation had been falling short of the central bank's 2% target. The Consumer Price Index (CPI) for March increased by 2.4% and the core measure that excludes food and energy increased by 2.1%. And it is widely expected that the Fed's preferred core personal consumption expenditure deflator released later this month will finally hit 2% as well. With unemployment already at the Fed's target and inflation finally following suit, the market's have grown more skittish about the possibility for a steeper path of rate hikes than the consensus currently expects and the increasing potential for policy misstep. Presently, the futures market is pricing in an 83% probability that the next Fed hike will occur in June and a 71% probability for a third and final hike in December. Meanwhile, there is only a 57% chance for a rate hike in September.

The already flattened yield curve suggests that the Fed may be closer to its goal than most forecasters anticipate. If probabilities increase for a September hike, we might expect to see a further flattening of the yield curve and additional stock market volatility. Since a flattened yield curve implies increasing odds for recession, investors will be paying especially close attention to any hints that Fed Chairman Powell and his merry band of governors may be giving us about the future dot-plot for rate hikes. According to the Fed's March minutes, "all participants agreed that the outlook for the economy beyond the current quarter had strengthened in recent months and all participants expected inflation on a 12-month basis to move up in coming months". While increased deficits and federal spending, tax cuts, rising oil prices, record low unemployment and a weaker dollar all point to a continued cyclical uptick in inflation pressures, it is important to measure this uptick against the secular disinflationary backdrop that has dogged markets for the last decade. Through unprecedented quantitative easing measures taken during and after the Great

Recession, the Fed sought to avert a deflationary spiral at all cost. That inflation is finally and only gradually on the incline should be welcome news for all investors, even if there is short-term volatility that must be endured as a result.

As mentioned in our January outlook newsletter, the current Fed rate hike campaign has been compared to previous rate hike campaigns that ended in recession simply on the basis of change in *real* interest rates. This argument and the potential for Fed policy to become restrictive continues to bear watching. Already, the rate for a 30-year mortgage has risen for a ninth consecutive week to just under 4.5%, the highest level in more than four years. Rising mortgage rates are already dampening refinance activity and pushing away potential new homeowners. Especially with home prices high, inventories low and recent tax code changes penalizing new homeowners, rising mortgage rates threaten to hamper a sector that represents about 15% of U.S. GDP. And the London Interbank Offered Rate (LIBOR) recently rose to 2.3%, its highest level since November 2008. LIBOR measures the cost for banks to lend to one another and it is estimated to be linked to more than $200 trillion of derivatives and other dollar-based contracts, including floating-rate corporate loans, student loans and over $1.2 trillion of mortgages. As these increases in interest rates continue to filter through to consumer wallets, we may see the benefits of recent tax reform measures begin to wane.

In the midst of all this interest rate angst, President Trump decided that now was a good time to threaten China with billions of dollars of new tariffs, setting off a tit-for-tat response from the world's most populous nation and stirring fears for an ill-timed trade war. While it remains premature to ascertain whether Trump's tough rhetoric is intended as a negotiating tactic, recent remarks by China's President Xi Jinping and Trump's own consideration to rejoin the Trans-Pacific Partnership (TPP) have dramatically eased concerns for any imminent trade war.

Volatility as measured by the CBOE Volatility Index (VIX) surged 80% in the first quarter while the price of Bitcoin plunged 49%. As volatility returns and air is let out of the most speculative corners of the market in the wake of higher interest rates, it is especially important to remain focused on business and economic fundamentals. While risks to this long-in-the-tooth bull market advance have increased for sure, the U.S. economy and Corporate America are strong. Accelerating corporate earnings and a patient Federal Reserve ought to prevail in helping the markets reach new highs in the coming 12 to 18 months.