The Mantra of Lower for Longer

The stock market continued to climb the proverbial wall of worry, with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite up 6.08%, 5.07% and 6.08% respectively for the year through the end of the 3rd quarter.

As we embark on the beginning of the fourth and final quarter of 2016, investors have become hyper-focused on the Fed's next move and the growing expectation for a quarter point rate hike in December. Indeed, the fed fund futures market is pricing in a 70% probability of such a move; and 74% of economists recently surveyed by the Wall Street Journal reported that they expect the Fed's next move in December. While similar expectations simmered ahead of the Fed's September meeting, since 1990 the Fed has increased interest rates only once during the two-month period prior to a presidential election. This year was no different.

The Fed itself seems to be telegraphing an imminent move with recent minutes revealing an intention to hike the federal funds rate "relatively soon if economic developments unfolded". Yet those same recent minutes also reveal a central bank openly concerned about "downside" risks:

"The risks to the forecast for real GDP were seen as tilted to the downside, reflecting the staff's assessment that both monetary and fiscal policy appeared to be better positioned to offset large positive shocks than adverse ones. In addition, the staff continued to see the risks to the forecast from developments abroad as skewed to the downside. Consistent with the downside risks to aggregate demand, the staff viewed the risks to its outlook for the unemployment rate as tilted to the upside. The risks to the projection for inflation were still judged as weighted somewhat to the downside, partly reflecting the possibility that longer-term inflation expectations may have edged down."

With such an outlook, it's no wonder that the stock market's knee-jerk reaction to Fed hawkishness is as tilted to the downside as the Fed's assessment. Seven years after the Great Recession, the economy continues to muddle along at sub optimal speed and inflation continues to be muted, while unemployment has ticked up very slightly, indicating that we may have already seen the top of employment for this cycle as more and more people return to the work force.

The International Monetary Fund just downgraded expectations for 2016 U.S. economic growth to 1.6% from its July estimate of 2.2%. Inflation as measured by core CPI continues to remain below the Fed's 2% target and unemployment has risen from 4.9% to 5%. While the ISM Services index remains stable and comfortably positive, ISM Manufacturing has been more volatile of late and recently spent one month's print below the recession-warning 50 threshold. A plummeting British Pound reminds us that we are not out of the Brexit woods and the sharp decline in the shares of Deutsche Bank conjure the ghosts of Lehman's past. Meanwhile, ECB and Japanese monetary policies continue to tinker with negative and pegged interest rates to stimulate their beleaguered economies.

With the U.S. Presidential election imminent, the uncertainty that would accompany a Trump Presidency is now matched by the uncertainty that would accompany a Hillary victory and congressional sweep by the Democrats in the wake of the Donald's "locker room talk" fiasco. It is very possible if not probable that election uncertainties are weighing on business and consumers alike and will dampen GDP prospects for the 4th quarter.

Despite these Fed-telegraphed downside risks, muted economic data and growing election uncertainty, interest rates have risen in anticipation of a December rate hike, with the 10-year Treasury bond seemingly destined to test a 2-handle, and the U.S. dollar has strengthened in accord. The move higher in the dollar and interest rates is further dampening expectations for GDP expansion and may ease the building hawkishness within the Fed.

It is our base case scenario that Hillary is elected our next President and Republicans are able to maintain control of the House, implying four more years of Washington gridlock. Markets tend to favor the status quo offered by gridlock and would equally favor the likely extension of Janet Yellen's tenure and subsequent continuation of easy monetary policy.

Whether the Fed hikes in December or not, the more critical reality is that economic growth must normalize in order for interest rates to normalize. With a normalized bottom range for the fed funds rate at 2% and current rates at 0.25%, the ramp leading to normalization is quite extended as the Fed's forecasted plot diagrams will illustrate. Especially with already modest economic conditions having stalled, our base case is that interest rates will remain lower for longer. With inflation muted despite unprecedented monetary stimulus, lukewarm economic data and global pressures that seem to pop up in whack-a-mole fashion, it is difficult to imagine the catalyst that might catapult our economy beyond the current subdued pace and therefore warrant a more aggressive slope towards Fed normalization.

With this backdrop of moderate economic growth, historically low and even negative interest rates around the globe and little inflation pressure to be found, our focus on high quality growth stocks that raise their dividend each and every year (see Dividend Progress Report inside) will continue to serve our clients well.