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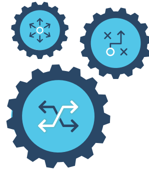

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THE FED'S PIVOT: SIGNIFICANT COURSE CORRECTION OR ECONOMIC REACTIVITY?

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- **Markets now expect the Fed to cut rates or hold, ending the first tightening regime since the global financial crisis**
- **Markets could be caught off guard, however, if a reactive Fed resumes rate hikes in response to a quick rebound in economic indicators**
- **Global central banks may have, once again, engendered a tailwind for financial assets**

At its March meeting, the U.S. Fed hit pause on future policy rate increases. Not only did the Fed reiterate patience with further rate hikes but it also exceeded already-dovish investor expectations by accelerating the end of its quantitative tightening program.[1] Investors remain uncertain about what this policy "pivot," as the media has come to describe it, actually portends for the trajectory of monetary policy and, in turn, the outlook for equities, bonds, and other financial assets. In this brief note, we offer a perspective on both issues.

The Fed had set the stage for its move in January, when it expressed uncertainty about future rate increases amid concern about tepid domestic and global growth. This view marked a material change from prior policy indications of three expected rate increases in 2019. Against that backdrop, the Fed's March messaging offered a strongly supportive tone for risky assets and reaffirmed market expectations of a "Powell put."[2] We could interpret the Fed's actions and messaging in terms of two divergent scenarios: 1) it marks the end of rate hikes or tightening, and we should expect easing going forward, or 2) it's a temporary pause, and we may well see hikes resume.

Currently, markets are leaning towards the former interpretation. Specifically, interest rate futures are pricing in the scenario that policy rate increases have ended and that the Fed either will cut or hold over the next nine months. That timing would be consistent with the historical average duration between the end of tightening and subsequent easing, roughly eight months. (Figure 1) Another piece of evidence to support this view is that the Fed's median long-term expectation for the policy rate has declined over time and is now closer to current levels (Figure 2), leaving less "headroom" for further increases.

In this scenario, the Fed's concerns materialize, global growth slows further, and yields fall. The much-anticipated "normalization" ends without a corresponding return to pre-financial crisis levels of inflation and growth. Despite multiple rounds of quantitative stimulus, and a nearly five-fold increase in the size of the Fed balance sheet,[3] the central bank struggles to keep core inflation from falling below 2%. (Figure 3) The Fed would thus rejoin other central banks that have remained focused on sustaining and expanding stimulus programs, and long-term yields resume their secular decline.

In the second scenario, we would interpret the messaging as reflective of a data-driven and reactive Fed, which leaves open the real possibility of renewed rate hikes after a short pause. For precedent, we only need to look back to early 2016, when economic softness and market stumbles led the Fed to pause for about six months following its first hike from zero, but then to resume its tightening regime. As evidence that we currently may be in a similar scenario, the Fed has achieved price stability in core inflation concurrent with a meaningful recovery in wage growth. (Figures 3 and 4) In addition, some of the macroeconomic indicators that raised the Fed's concern in March, such as consumer spending, have more recently recovered. A further rebound in wages and spending could well push core inflation above 2%, and thus trigger a resumption of rate hikes. The political environment, in particular the "low rates" rhetoric from the White House and the influence

[1] Federal Reserve press release, "Balance Sheet Normalization Principles and Plans," March 20th, 2019.

[2] FOMC minutes released on Jan 3rd, 2019.

[3] Credit and Liquidity Programs and the Balance Sheet: Recent Balance Sheet Trends published by the Federal Reserve at www.federalreserve.gov.

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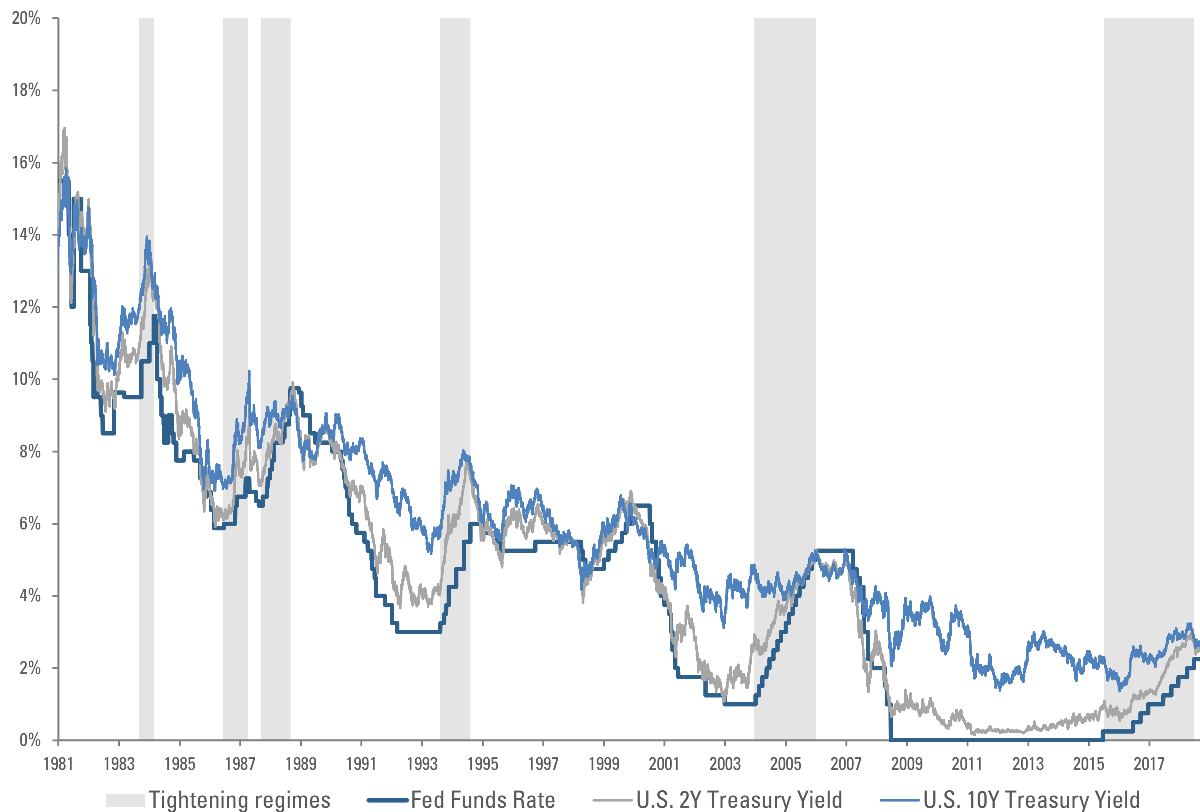
of new FOMC nominees on Fed decisions, represents a wildcard with respect to how the Fed might respond to positive economic news.

Regardless of which scenario unfolds, investors can expect the Fed and other global central banks to continue to play an influential role in driving the performance of assets via stimulus and sentiment. We can use our Multi-Asset Class Strategies (MACS) models to trace the impact of the Fed's "pivot" via these channels. Since December, falling global government bond yields and concomitant positive sentiment, evidenced by narrowing credit spreads, contributed to a markedly better outlook for risk assets such as equities and commodities. According to our models, the outlook for the U.S. dollar improved as well, driven mostly by positive sentiment and despite a partial offset from falling yields' depressive effect on carry. At the same time, our developed market bonds outlook deteriorated sharply, driven by lower real yields, flatter curves, and the higher growth and inflation expectations associated with the positive sentiment in equities and commodities. (See Figures 5 and 6.)

Declining long-term yields and flattening yield curves, however, suggest that slower growth and lower inflation may lie ahead, a view that appears inconsistent with one implied by strengthening equity markets, rising commodities, and improving credit conditions. An outcome that would reconcile the conflict would be lower, yet positive, growth. A material shift towards further easing by global central banks, led by the Fed and the ECB, and ongoing monetary and fiscal stimulus by the BOJ, the PBOC, and other major emerging central banks may have moderated a sharp downturn in global growth prospects and, once again, engendered a tailwind for financial assets.

FIGURE 1: HISTORICAL TIGHTENING REGIMES



Shaded periods indicate historical tightening regimes defined as periods of at least two consecutive Fed policy rate increases. Sources: Acadian analysis, Bloomberg. All Rights Reserved. For illustrative purposes only.

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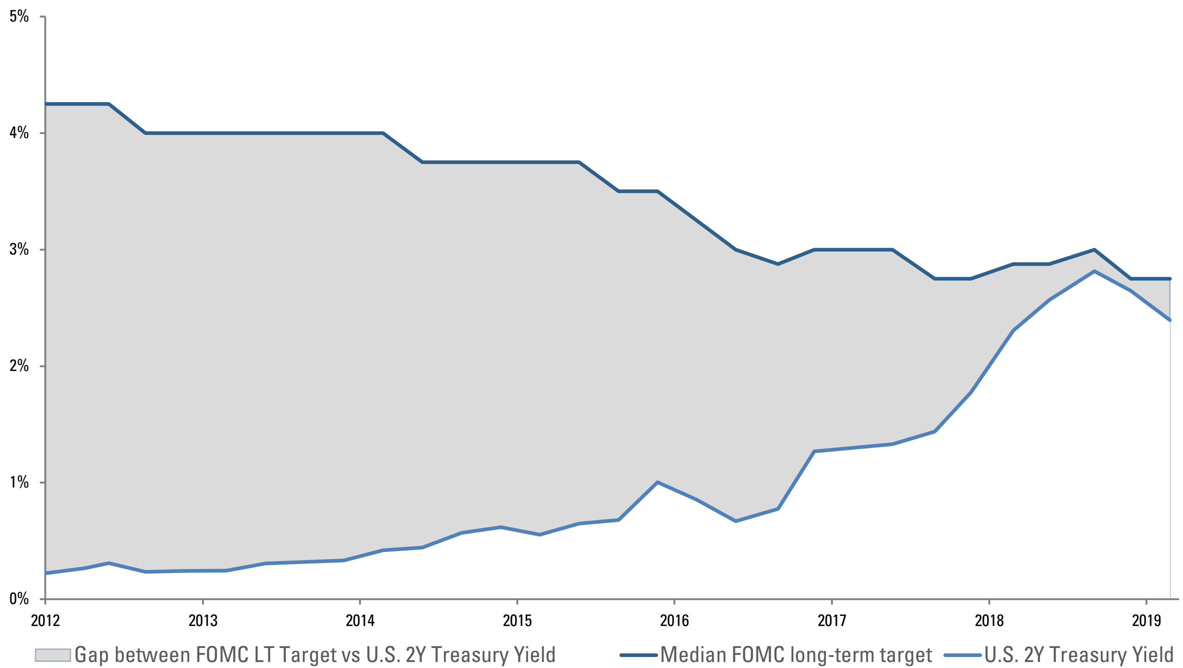
FIGURE 2: MEDIAN FOMC LONG-TERM TARGET VS. U.S. 2Y TREASURY YIELD



Sources: Acadian analysis, Bloomberg. All Rights Reserved. For illustrative purposes only.

FIGURE 3: U.S. CORE CPI—PERCENT CHANGE, YEAR-ON-YEAR

Source: Bloomberg. All Rights Reserved. For illustrative purposes only.

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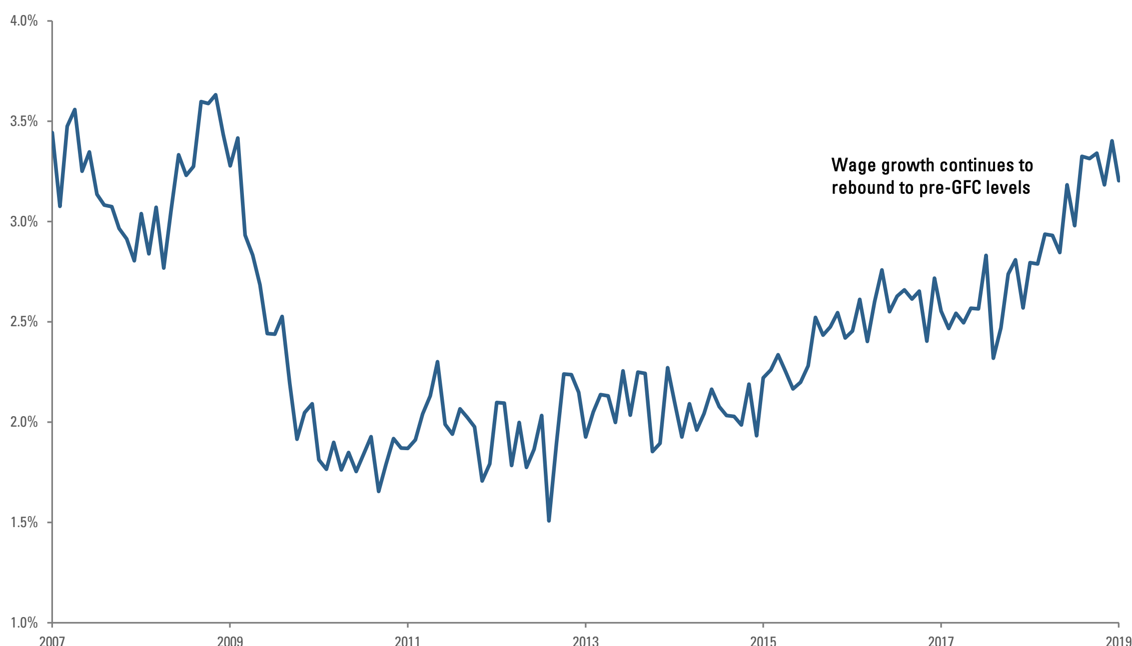
FIGURE 4: U.S. AV. HOURLY EARNINGS OF ALL EMPLOYEES—TOTAL PRIVATE: % CHANGE, YEAR-ON-YEAR



Source: Federal Reserve Economic data from the St. Louis Fed. All Rights Reserved. For illustrative purposes only.

FIGURE 5: GLOBAL THEMES—SUMMARY OUTLOOK* (AS OF 31-MARCH-19)

Global Markets	Main Drivers	Forecast* (03/31)	Quarterly Change	Monthly Change
Positive on DM equities	Falling yields, favorable credit conditions, attractive valuations albeit earnings strength is weak	0.6	▲ 1.4	0.2
Positive on EM equities relative to DM equities	Driven primarily by attractive relative valuations (other factors have roughly offsetting contributions)	0.8	0.2	-0.2
Negative on DM bonds	Lower real yields and flatter yield curves across global bonds	-0.8	▼ -1.2	-0.1
Positive U.S. Dollar vs DM currencies	Positive sentiment, U.S. offers attractive short-term interest rates relative to DM and positive equity performance	0.9	0.7	0.0
Mildly positive on Petroleum	Positive seasonality and tightening supply-demand balance offset by stronger U.S. dollar and weaker growth indicators	0.3	▲ 2.4	0.0

Source: Acadian Asset Management LLC. Return forecasts are shown in z-scores, which can be interpreted as number of standard deviations attractive or unattractive. Return forecast horizon ranges from 1-3 months.

* Forecasts based on the Dynamic Allocation and Cross-sectional elements in our proprietary models. For illustrative purposes only. The information provided is for illustrative purposes only based on proprietary models. There can be no assurance that the forecasts will be achieved. This is not intended to represent investment returns generated by an actual portfolio. They do not represent actual trading or an actual account but were achieved by means of using Acadian's multi asset universe of securities for the period specified above. Results do not reflect transaction costs or other implementation costs. Past results are no guarantee of future results. Every investment program has an opportunity for losses as well as profits.

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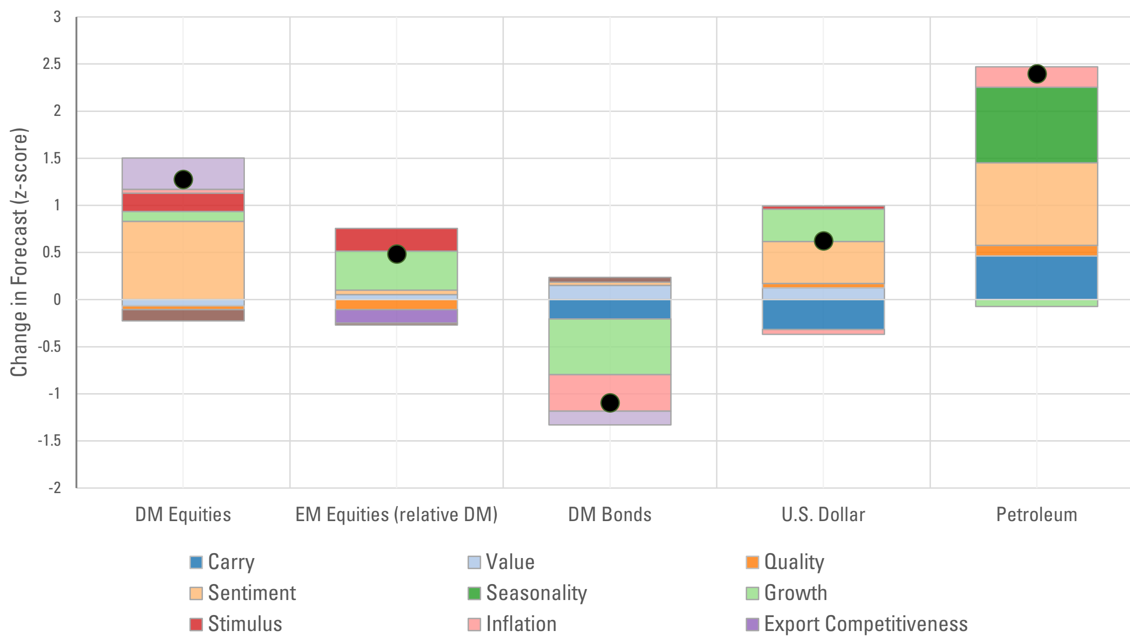
FIGURE 6: GLOBAL THEMES—FACTOR CONTRIBUTION TO OUTLOOK CHANGE* FROM 31-DEC-18 TO 31-MAR-19



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