

Fed Tightening Is A Market Positive

eResearch Corporation is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis advocates the adoption of a freely-functioning market for the U.S. health-care industry.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: [Fed tightening has been a positive for markets](#)

You can also visit Scott Grannis' Home Page for his Blog at the link below:
<http://scottgrannis.blogspot.ca/>



eResearch was established in 2000 as Canada's first equity issuer-sponsored research organization. We write on a variety of small- and mid-cap, under-covered companies. We also provide unsponsored research reports on middle and larger-sized companies, using a combination of fundamental and technical analysis. We complement our corporate research coverage with a diversified selection of informative, insightful, and thought-provoking research publications from a wide variety of investment professionals.

Bob Weir, CFA: Director of Research

Note: All of the comments, views, opinions, suggestions, recommendations, etc., contained in this Article, and which is distributed by eResearch Corporation, are strictly those of the Author and do not necessarily reflect those of eResearch Corporation.



Thursday, May 25, 2017

Fed Tightening Is A Market Positive

For years, people have worried that a Fed "tightening" would derail the economy and the markets, but the facts say otherwise. The Fed first hinted at a tightening a few years ago, with the first hike coming in late 2015. Since then, short-term interest rates have risen by 75 bps and another tightening is virtually assured for next month's FOMC meeting.

Today (Thursday), the dollar is stronger, but not too strong; the yield curve is flatter, but not too flat; credit spreads are tighter, but not too tight; equity prices are up, but the equity risk premium is still positive; commercial real estate is up, but not to record highs; equity and bond market volatility is down; and inflation is relatively low, but not too low.

What's not to like? To be sure, the economy has not yet picked up from the 2% pace that has prevailed for the duration of this rather long recovery, but business and consumer optimism is up significantly in recent months, and that combined with Trump's tax and regulatory reform proposals, if passed, would almost certainly result in a stronger economy. Things could be better, but they are not half bad—except for the growing threat of a nuclear NoKo and radical Islamic terrorism.

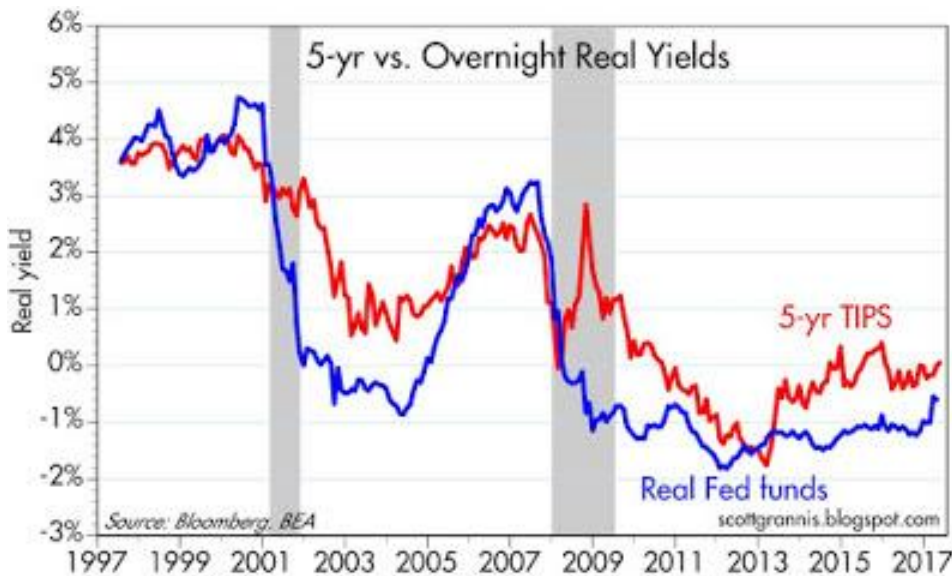
For my money, NoKo is the darkest cloud on the horizon. Unfortunately, there is not much an investor can do in the face of that kind of uncertainty.

Here are some charts which put some meat on the story:

<continued>



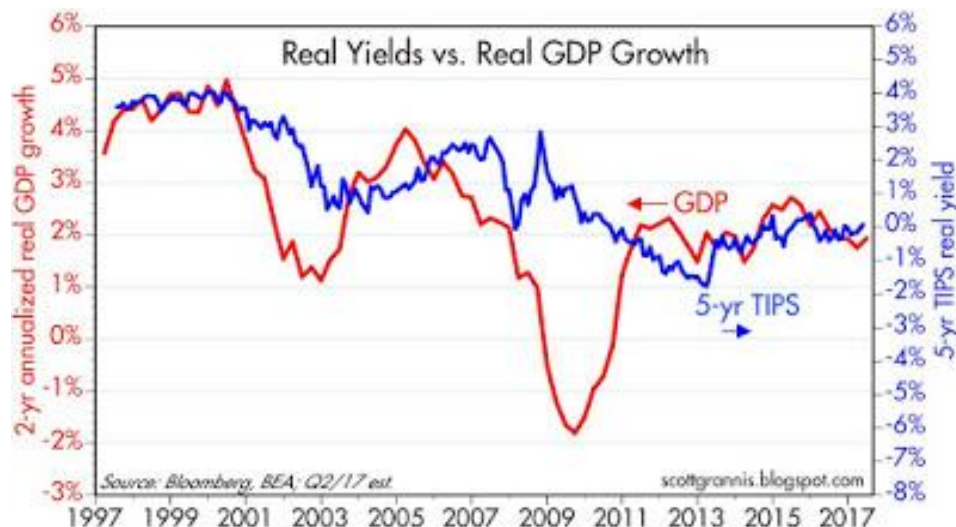
The chart below compares the inflation-adjusted current Fed funds target rate (blue) to what the market expects that rate to average over the next 5 years (red). This is effectively a picture of how the real yield curve has evolved over time and is expected to evolve. Recessions are almost always preceded by a flat to inverted real yield curve, because that is the market's way of saying that monetary policy is too tight and it is hurting the economy. Today the market is saying that the Fed will probably raise the real funds rate another couple of times over the next year or two, but not by much more. That tells me the market is not pricing in a robust economy, nor is it predicting a weaker economy, since that would call for a reduction in the real funds rate. It is more a prediction of "steady and slow as she goes."



<continued>

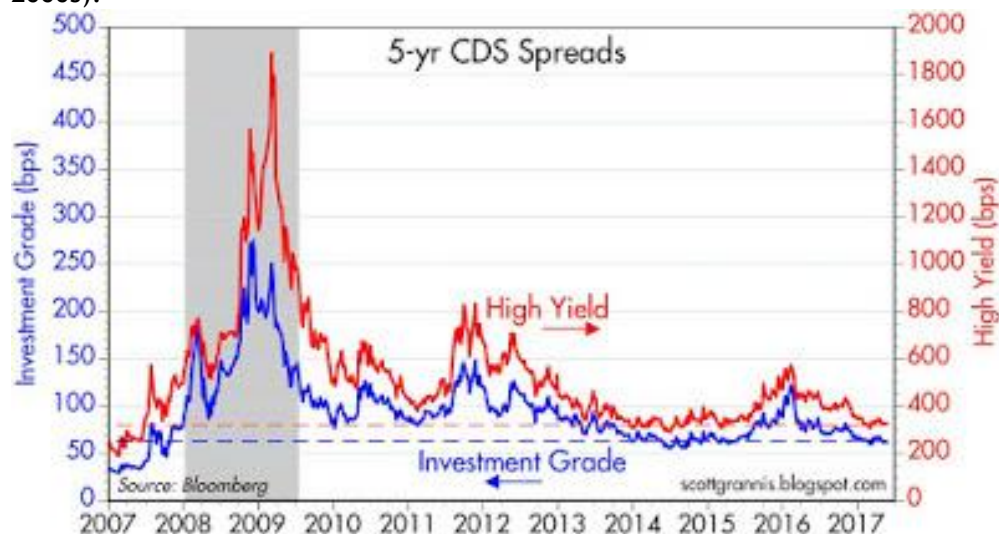


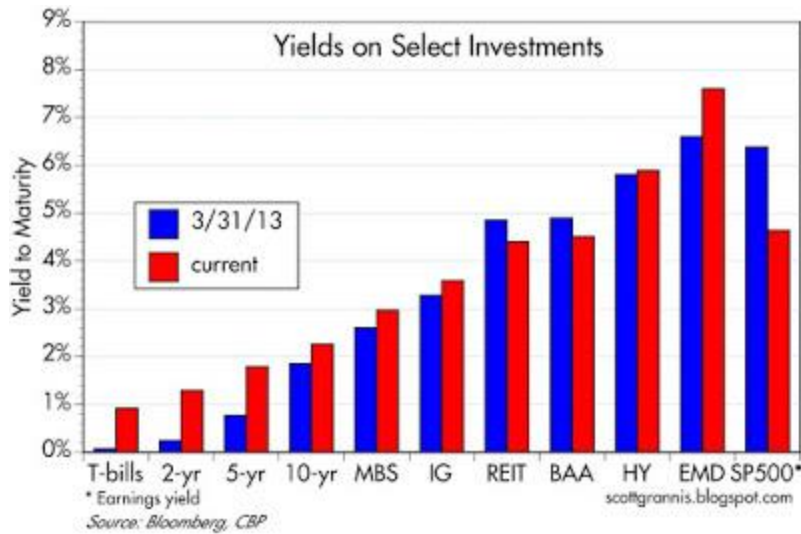
Note also the all-time low in real 5-yr yields in March 2013, when they fell to almost -1.8%. That was a sign that the market was extremely pessimistic. We have come a long way since then, but real yields are still very low from an historical perspective.



As the chart above shows, 5-yr real yields are still right around zero, where they have been for several years now. It is not a coincidence, I would argue, that real GDP growth has been stuck at 2% for about the same length of time. Translation: the market does not see much, if any, improvement for the foreseeable future. This is not an optimistic market.

In the next chart, Credit Default Swap spreads are a little tighter than they were in March 2013, despite higher real yields and a flatter yield curve. They have been tighter before (e.g., in the late 2000s).





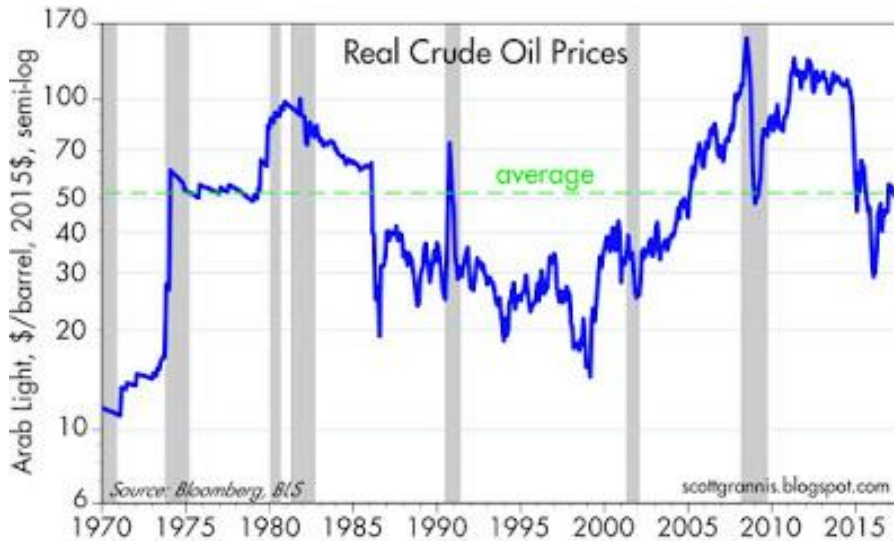
The chart above compares the yield on a variety of assets as of March 31, 2013 (when real yields hit their all-time lows and Fed policy was effectively extremely easy), and as of today (red). Note that short-term yields have risen much more than longer-term yields, resulting in a flatter yield curve. Note also that yields on REITS, BAA bonds, and equities have declined even as the Fed has tightened and market yields have risen. All of this is pretty straightforward, right out of the textbooks. Tighter money flattens the yield curve, and when it is not too tight it is good for most asset classes, because a positively-sloped yield curve is symptomatic of a reasonably healthy economy. The Fed is not threatening anybody these days.

As shown in the next chart, the dollar began rising once the market started pricing in Fed tightening. That is a good thing. But the dollar today is far from being too strong, as it was in 1985 and 2001. Today it is only marginally higher than its long-term historical average.





With the dollar just above the middle of its long-term range, it is not surprising to see real oil prices trading close to their long-term range. Oil is neither expensive nor cheap, and that cannot be bad for the outlook for the economy.



As the chart below shows, 5-yr inflation expectations (as embodied in the market for TIPS and Treasuries) say that consumer price inflation will likely average about 1.7% for the foreseeable future. That is not bad at all: not too high, not too low. In my ideal world, inflation would be close to zero and stable, but nobody is going to worry much if it is 1.7%. Indeed, the Fed would prefer to see inflation above zero. The Fed is not a threat in these conditions.





As the next chart shows, the equity market has suffered from numerous panic attacks in recent years (i.e., spikes in the Vix/10-yr ratio, accompanied by declines in equity prices). Today, however, implied equity volatility is quite low and nobody expects anything outrageous from the Fed, so it is not surprising that equity prices are floating higher.



PE ratios (using earnings from continuing operations) today are a bit over 21, according to Bloomberg, but that is not at all unusual given the very low level of 10-yr nominal and 5-yr real yields. As the chart below shows, the earnings yield on the S&P 500 tends to follow the inverse of the real yield on 5-yr TIPS. If anything, the current earnings yield on stocks suggests that real yields are too low (meaning the Fed could be tighter and real yields higher). Stocks, in other words, appear priced to higher yields than the bond market is assuming.





As the next chart shows, the equity risk premium (the difference between earnings yields on stocks and the yield on 10-yr Treasuries) is still relatively high. That means investors are quite willing to forego the yields and capital gains potential of stocks in exchange for the safety of Treasuries. Again, this is not an overly-optimistic market. If the market were exuberant, the equity risk premium would be negative, not positive.



What is driving equity prices higher is not anything sinister nor dangerous. Given that the market does not expect things to change much, investors are reluctantly conceding that the much higher yields on equities and other asset classes—relative to cash and Treasury note and bond yields—are attractive.

BW: See ABOUT THE AUTHOR on the following page.



ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

#####