"Lonesome Doves" No More;

A Moderate Fed Lifts Stocks

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"Lonesome Doves" No More; A Moderate Fed Lifts Stocks

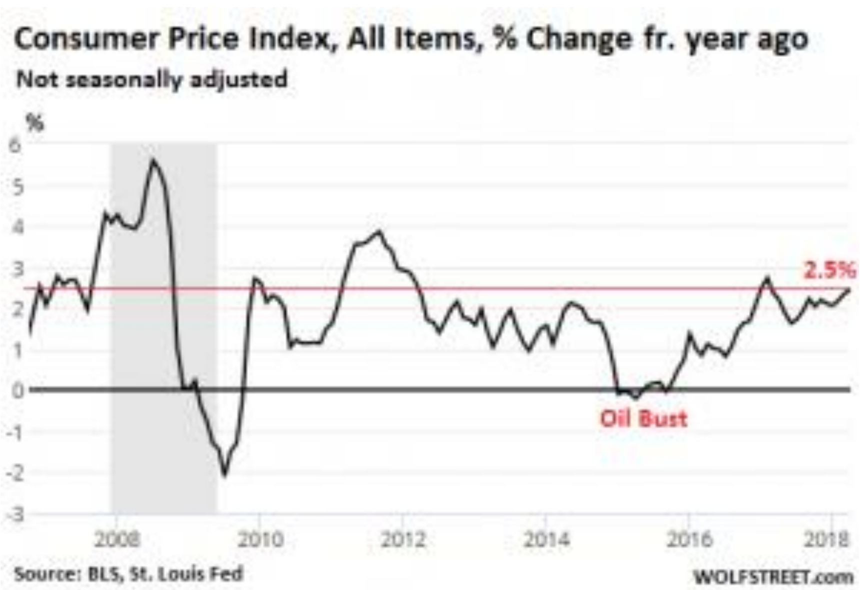
By Linda McDonough (bio at end)
May 30, 2018

These days, there are no "lonesome doves" on the Federal Reserve. The central bank is taking a soft stance on monetary tightening, in the face of only moderate signs of inflation. Here is why that is good news for stock investors.

Last week, dovish remarks from Fed members saved the day. A sloppy market mid-week received some welcome bids immediately after the release of the minutes of the early May Fed meeting. An afternoon rally wiped out a 167 point deficit in the Dow.

Right now all eyes are on the Fed. The seven members of the Federal Reserve Board meet roughly eight times a year to analyze the performance of the economy and to discuss their plan for interest rates. The meetings are closed-door events. However, the board has become more open in communicating with the public about the contents of those meetings. A brief statement, an appetizer if you will, is typically offered immediately after the meeting disclosing any immediate changes made to rates. The main course is served a few weeks later when the minutes from the meeting are released. Investors gobble up the details about the Fed members' thought process regarding the current economic situation.

Investors' biggest concern is how the Fed views recent inflation data, which has been heading up. The Consumer Price Index, known as the CPI, is a favorite measuring tool of inflation. This data point, reported monthly, clocked in near 3% in recent reports (see chart).



Doves vs. Hawks

The Fed has noted that it might become more hawkish (that is, more inclined to raise interest rates), when the CPI registers above 2%. You can see why investors are a bit nervous about the upward trend in inflation.

Thankfully for the markets, the Fed included a calming statement in the minutes of its last meeting. "A temporary period of inflation modestly above 2%" was described as "helpful in anchoring longer-run inflation expectations."

This one statement allowed the market to breathe a sigh of relief. It signals that the Fed is willing to put up with some heated inflation data while it observes the impact on the bigger economy. Despite steady improvement in employment data (typically the precursor to higher prices), inflation has remained stubbornly low. While members of this advisory team try to stick to hard data, they recognize the need to be flexible. Inflation data are imperfect.

As economists, members of the Fed must attempt to tie data trends to consumer behavior. In this way, economists are more psychologists than financiers. One question, of course, is why the CPI has moved so little over time and why it is now inching up.

The CPI is an index compiled of prices of goods and services. The goods component is responsible for the subdued historical move in the CPI. Look no further than the melting prices of digital TVs. A 50-inch TV that cost $2,500 in 2012 can easily be had for less than $500 today.

Cheap imports and increased competition drive down prices for many goods. Innovations in technology also pressure prices for many of these goods. When the newest version of a laptop comes out, the prior versions are discounted immediately. These products, whether it be electronics, a box of cereal, or a pair of shoes, are easily swapped out for a different, cheaper product. To date, declining prices for goods have made up for any upward move in services prices.

Services make up the other part of the CPI. This category is responsible for the slow and steady creep up in recent data. If you are like me, you have noticed the cost of services climbing higher. The price for an oil change jumps $3 each time I visit, and my haircut now costs 20% more than a few years ago. Prices for landscaping, carpenters, and painters are all moving higher.

Those help wanted signs you see in all the windows are part of the issue. The delivery of services is highly dependent on labor costs, and those expenses are escalating. Low unemployment and mandates for higher minimum wages in some states are responsible.

Also, higher service prices tend to stick once increased. Consumers are not conditioned to see service prices drop. Once your landscaper charges $800 for a seasonal clean-up, he knows you expect a similar rate next spring.

To date, declining prices for goods have made up for any upward move in services prices, but this is changing. With increased transportation costs and labor seeping into the price of manufacturing goods, we might see both components of the CPI growing.

No wonder the market was so relieved to hear that the team directing the future of interest rates is willing to sit back and wait for a steady trend to show its face.

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About the Analyst

Linda McDonough is a veteran hedge fund analyst who loves to break down company financial statements and identify market inefficiencies to uncover big opportunities. She believes in a boots-on-the-ground approach that includes surveying customers, interviewing company executives, or doing whatever it takes to see what others don't. She's now brought her experience as a hedge fund analyst to subscribers of her *Profit Catalyst Alert* service. Her system identifies small- and mid-cap stocks that are about to move due to catalytic events that few others can identify…until it's too late. These events often times result in massive gains for her followers.