March 2018

Much of the past 18 months has been marked by its lack of volatility. This led to a sense of complacency by market participants. Since the end of January, market gyrations have returned. The moves over the past two months have shaken the markets out of its lethargy. Participants have also been awakened to the realization that the stock market rally and general economic growth could be at risk.

The initial signal was attributed to the jump in wage inflation in late January, moving up to a 2.9% annualized increase, well above expectations. This figure has since retreated to a more recent 2.6% figure allaying some concerns, but also highlighting the state of the labor market. Current official unemployment rates have been just above 4.1% but there is a strong possibility of this slipping below 4% before the end of the year. Jobs opening reports indicate a jump in available jobs, but many employers are reporting inability to match skills with positions available.

Adding fuel to market concerns were what were considered to be "hawkish" comments from new Fed Chair Jerome Powell in his initial Congressional testimony. Analysts had to consider the possibility of another rate hike, in addition to the Fed's own forecast of 3 hikes during 2018. The next day, he had to walk these comments back a bit. The Fed may raise rates if inflation picks up, and there are a myriad of reasons that could happen: acceleration of wages, a weaker dollar, higher commodity prices, growing risks of protectionism, or overseas cash repatriation.

The markets were jittery about the possibility of inflation, a jump in interest rates, and a Federal Reserve misstep. Inflation readings continue to show little inflationary pressure, but the $1 trillion tax cut and subsequent budget deal adding another $200-300 billion of fresh stimulus are yet to work their way into the system. Will consumers increase demand with larger paychecks and will business respond with investment to increase production? Will business add to payrolls or, rather, increase production with further automation? Instead, will business use the tax cuts to increase stock buy-backs, which is estimated to account for 72% of earnings-per-share growth since 2012 and 40% since 2009? Much of this buying has been funded through low rate loans and bond issuance. Should interest rates rise, the funding mechanism will halt and a large source of demand for stocks will also dry up.

Possibly the largest shift in perception of interest rates is the supply and demand for bonds, particularly government bonds. In recent years, the largest buyer has been the Federal Reserve, but this is likely to change as the Fed pares its balance sheet, buying fewer treasury bonds and mortgage backed securities. As rates rise overseas in response to a reduction of policy accommodation, foreign buyers will have less reason to hunt for yield in U.S. bonds. Two major sources of demand are being reduced at the same time supply is rising as the U.S. government is issuing more debt to finance a growing deficit (tax cuts) and increased spending (2 year budget agreement).

Yields on treasury securities have been moving higher with the 10-year note testing 3% recently but not above it. The restraint may be due to some movement out of equities and into treasuries, a modest flight to quality move. But with no recession in sight, rising inflation risks and supply and

demand picture deteriorating, it is not difficult to see yields moving above 3%. The only question is how far and how fast this move might be. The jump in short term rates is not entirely due to just these factors. The Treasury has wanted a large cash balance position for some time, but has been constrained by the debt ceiling. This was suspended in early February as part of the 2 year budget deal allowing unlimited borrowing until March 1, 2019. The Treasury has increased issuance as part of a policy to increase cash to protect against interruption in market access. The national debt recently crossed the $21 trillion level.

Although every increase in interest rates by the Fed have not triggered recessions in the past, over the past 70 years every significant stock market decline and recession has been preceded by the Fed raising short term interest rates. Should the Fed move aggressively to raise rates it could trigger significant market events. The Fed has a new Chair and has a number of vacancies to fill. Should these positions be filled with more hawkish members, they could move quickly to raise rates, and possibly overshoot what may be necessary.

A well communicated and predictable move up in interest rates in order to tamper inflationary pressures will likely be absorbed by the markets in good order. A precipitous, sudden, or overly aggressive move in rates could disrupt the markets and increase the level of uncertainty of continued economic growth. This is a concern for the markets and for participants.