Wealth Management

QUARTERLY PERSPECTIVE
SUMMER 2019

What's Your Interest in Interest Rates?

Second quarter 2019 market performance ended positive following a stepped up-down-up monthly pattern, continuing the first quarter's advances. Risks remain, though, as fading fiscal stimulus, the administration's aggressive trade stance with China and a decelerating manufacturing cycle are worrisome. Large cap stocks outpaced small cap stocks in the quarter, and growth trumped value. The economy may have slowed, but it still grew, and markets marched ahead.

2019 Performance 1/1/2019 - 6/30/2019	2nd Quarter 2019	1st Quarter 2019	YTD 2019
S&P 500 Index	4.30%	13.65%	18.54%
Dow Jones Industrial Average	3.21%	11.81%	15.40%
Nasdaq Composite (tech)	3.87%	16.81%	21.33%
Russell 2000 Index (small cap)	2.10%	14.58%	16.98%
MSCI EAFE (net) (foreign developed)	3.68%	9.98%	14.03%
MSCI Emerging Markets (net)	0.61%	9.93%	10.59%
Bloomberg Barclays US Aggregate Bond Index (bonds)	3.08%	2.94%	6.11%
BofA Merrill Lynch 3-month Treasury Bill (cash)	0.64%	.060%	1.24%

Source: Zephyr StyleADVISOR

The US Federal Reserve (the Fed) raised the federal funds rate (a benchmark for a range of consumer interest rates) in December 2018, its ninth consecutive hike since December 2015. It then hit the pause button, reneging on earlier forecasts of further hikes into 2019 and beyond. With inflation no immediate threat, the Fed was more concerned about inhibiting current economic growth than preventing a surge in inflation. Now, in mid-2019, they're looking to reverse course and cut rates.

When the Fed raises or lowers interest rates, you feel it. In setting monetary policy by regulating the target for the federal funds rate, their impact on your financial life may be greater than the IRS.

Fed actions have an indirect impact on the prices you pay for everyday items. That's because the cost and availability of money affects people's willingness to pay for goods and services. When interest rates are low, money is cheap and plentiful. People and businesses borrow more to finance big purchases. When they pay less in interest charges, they have more to spend, causing a ripple effect of increased spending throughout the economy. Productivity increases, businesses hire more people, and the economy grows. On the other hand, when interest rates are high, consumers don't have as much disposable income and cut back on spending. Higher interest rates and increased lending standards mean banks make fewer loans. Businesses cut back on expenditures, slowing productivity and reducing the number of employees.

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These changes in rates can also influence inflation and recessions. Inflation refers to the rise in the prices of goods and services over time. It is the result of a strong and healthy economy. If left unchecked, it can lead to a significant loss of purchasing power. To manage inflation, the Fed watches inflation indicators such as the Personal Consumption Expenditure (PCE) index and the Consumer Price Index (CPI). When these metrics rise above average, the Fed can keep price increases under control by increasing the fed funds rate, dampening demand and spending. Inflation will then moderate and, eventually, fall.

Stock and bond market prices are prejudiced by interest rate movements, too. Investors have a wide variety of investment options to choose from. When comparing the dividend yield on a blue chip stock to the interest rate on a CD or US Treasury bond, investors often select an option based on its expected rate of return. Since the returns of both CDs and Treasuries are affected by the fed funds rate, how investors invest their money is as well.

Consumer and business psychology can be swayed by rate movement. Appetite for spending decreases when rates rise, causing earnings to fall and stock prices to drop. Conversely, spending ticks up and stock prices generally rise when rates fall. Bond prices are greatly impacted by interest rates as well. They have an inverse relationship, meaning that as interest rates fall, bond prices rise, and as interest rates rise, bond prices fall. Also, the longer the maturity of a bond, the more its price will fluctuate in relation to interest rates.

How these securities then fit into an investor's asset allocation entails important trade-offs relative to risk and return expectations. Assumptions made under current economic conditions and current monetary policy offer opportunities to improve risk and return characteristics. It also exposes investors to suboptimal outcomes if events develop differently than expected. A portfolio constructed last fall when interest rates were rising likely overweight equities and underweight long bonds. Now, with the Fed intimating rate cuts amid weaker than expected global growth, allocations might underweight stocks and overweight long bonds.

The Federal Reserve's monetary goals are to foster economic conditions that achieve both stable prices and full employment, known as the "Dual Mandate." Lately, they have continually messaged they would remain data dependent, and that all future movement of interest rates would be informed by good data. June's unemployment rate dropped to 3.7%, its lowest level in nearly 50 years, and inflation indicators were in the range of 1.5-2.1% (Federal Reserve Bank of Richmond). With both of these figures at the lower end of the Fed's unofficial target guidelines, it would seem the Fed is doing its job quite well. So, why is the Fed contemplating an interest rate cut?

Faced with a slowing global economy and elevated trade tensions, the policy makers are likely looking to support the current US economic expansion further. In the absence of inflation pressures, the Fed (and possibly other central banks later) feels free to consider easing monetary policy to extend the runway of economic and market growth. The probability of recession in the US is low, and the forward stock earnings growth outlook, while weaker, still expects low single digit year-over-year growth. A July rate cut may not immediately stimulate the economy and inflation, and may signal a second cut later in the year. At that point, the Fed would likely pause and allow natural economic forces to play out.

By adjusting the federal funds rate, the Federal Reserve helps keep the economy in balance over the long term. As long as economic conditions don't deteriorate meaningfully, now is a great time for the Fed to reassert its independence and allow the markets to regain the confidence needed to sustain itself without artificial stimulus. Your CNB wealth advisor is ready to educate and advise you on how all of these factors affect you and your family's financial picture, now and in the future.