



Clark D. Wagner

Chief Investment Officer,  
Foresters Financial

## Monetary disconnects

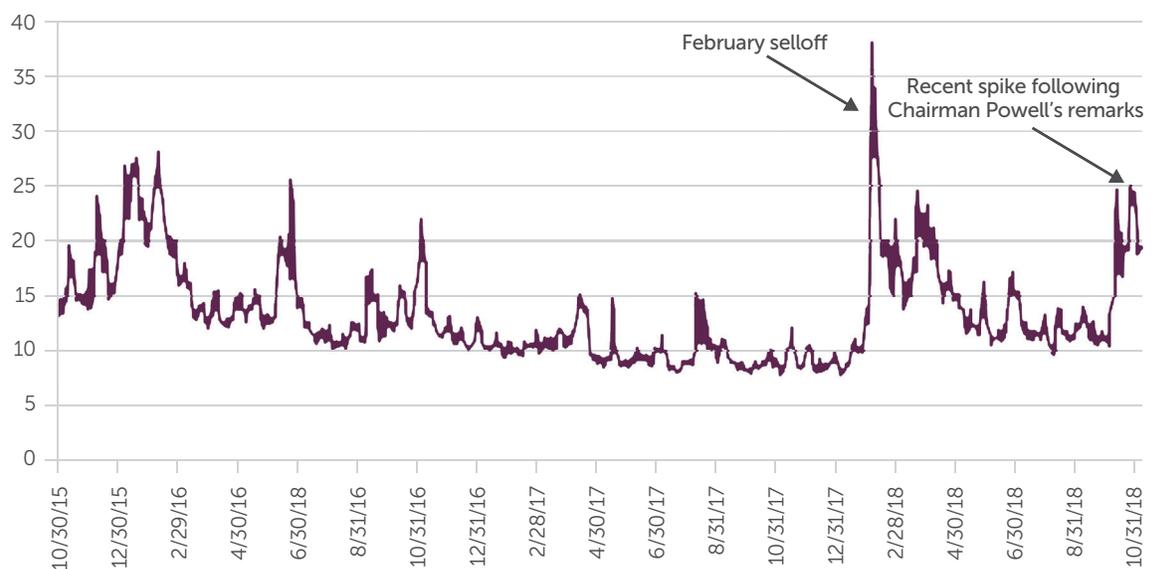
### Key highlights:

- The U.S. economy continues to see strong growth at a time when many of its developed country peers are struggling.
- Major central banks are still supporting their local economies with low interest rates and asset purchase programs.
- A divergence in global monetary policy is underway with the U.S. being seemingly out of step with most central bankers.

### Volatility and the Federal Reserve

The Federal Reserve (Fed) has now embarked upon a seemingly relentless path of interest rate hikes, which has, in turn, contributed to recent market volatility. As *Exhibit 1* illustrates, the market turmoil that spiked in February has returned and may become a more common feature in the days ahead. Chairman Powell's recent comments regarding interest rates still being accommodative triggered a selloff in October and reflected a potential (and growing) disconnect between the Fed and market participants (see *Exhibit 2*).

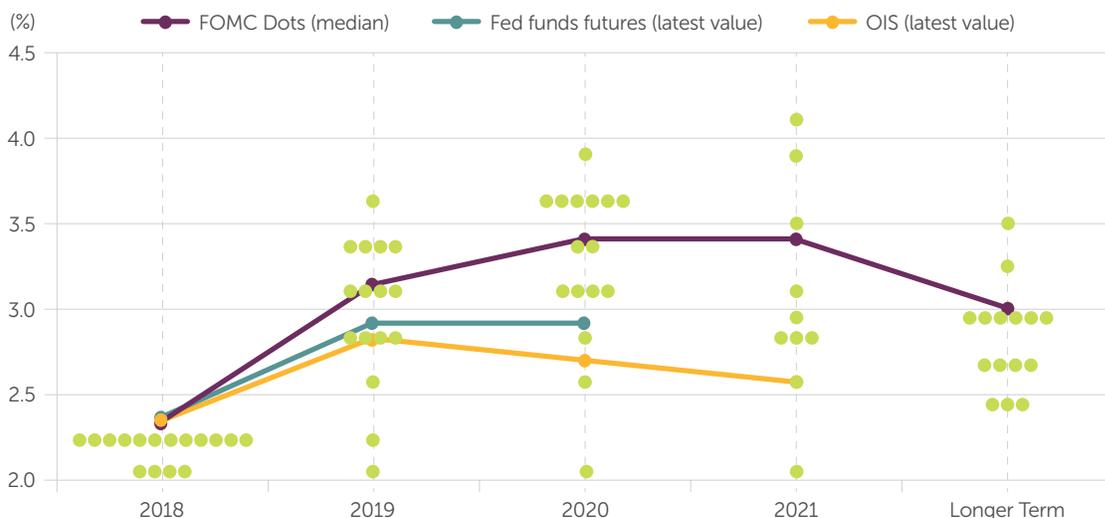
### Exhibit 1: Last 12 months have seen an uptick in volatility



Source: Chicago Board of Exchange, 11/6/18. Trailing three-year daily closing prices shown for the VIX Index.

After eight hikes since late 2015, the Fed funds rate is now at its highest level (2.25%) since October 2008, following the collapse of Lehman Brothers (see *Exhibit 2*), and the two-year U.S. Treasury note yield is near its highs for 2018 (see *Exhibit 3*) as well as at its highest level since 2008. As a result, the U.S. dollar has strengthened owing to the U.S. being further along in its rate cycle than other central banks.

### Exhibit 2: Fed dot chart



Source: Bloomberg, 11/8/18. Overnight indexed swap (OIS) is an interest rate swap in which the periodic floating payment is generally based on a return calculated from a daily compound interest investment. The dot plot is published after each Fed meeting and shows the projections of the 12 members of the Federal Open Market Committee (FOMC), the rate-setting body within the Fed. Each dot represents a member's view on where the fed funds rate should be at the end of the various calendar years shown, as well as in the long run—the peak for the fed funds rate after the Fed has finished tightening or “normalizing” policy from its current levels. The dot plot represents the Fed’s ongoing effort to become more transparent with respect to its policies.

### Exhibit 3: Two-year U.S. Treasury near highs for 2018



Source: U.S. Department of the Treasury, 11/7/18.

### Monetary policy divergence – U.S. vs. the rest of the world

With unemployment at lows not seen in decades and GDP at 3.5%, the U.S. economy and its accompanying monetary policy are out of step with other major economies as economic growth has been down across Europe and Japan.<sup>1</sup> This de-linking by the U.S. with its global peers is leading to a desynchronization among the major economies. Essentially, it's the U.S. on a path by itself.

#### Federal Reserve

Fed officials left interest rates unchanged at their policy meeting in early November but are expected to lift rates gradually in mid-December and through next year and into 2020. Meanwhile, employment data suggests that demand for workers remains strong and companies are offering better compensation packages to workers amid the lowest unemployment rate since 1969, reinforcing the Fed's outlook for gradual interest rate hikes to keep the economy from overheating.<sup>2</sup>

#### European Central Bank

The European Central Bank (ECB) is expected to continue with its plan to end its net asset purchase by the end of this year. It's actually possible that the ECB may never raise interest rates during the current cycle as

<sup>1</sup> Source: Bureau of Economic Analysis, 10/26/18.

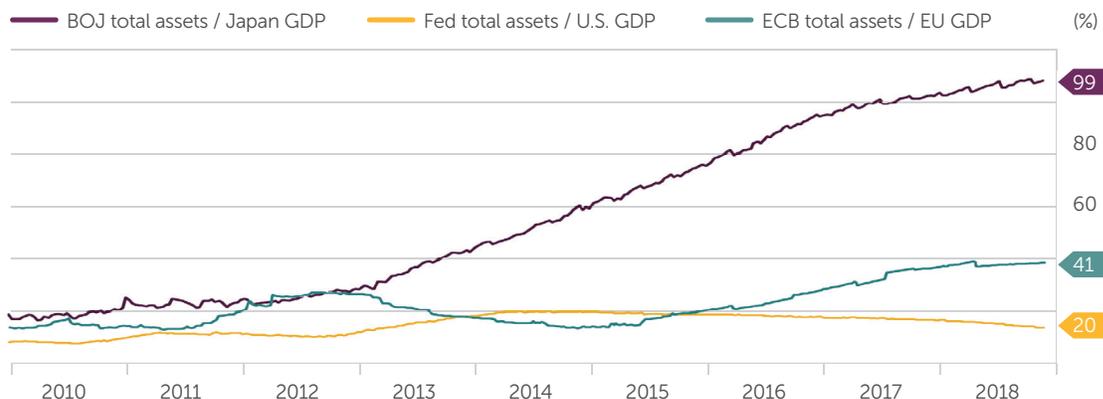
<sup>2</sup> Source: ADP Research Institute, U.S. Department of Labor, 10/31/18.

they're forecasting their first rate hike in 2019. At that point, European economies may be looking toward rate cuts, not increases, especially if tighter monetary policy slows growth in the U.S. The ECB is tapering its balance sheet, but mainly by slowing the rate of new purchases.

**Bank of Japan**

The Bank of Japan (BOJ) has kept its ultra-easy monetary policy (see *Exhibit 4*) in place as concerns grow about the impact of U.S.-China trade tensions on the local economy. The BOJ stayed the course on monetary stimulus despite confirming in its updated forecasts that the central bank will fail to meet its inflation target for several years. Currently, the BOJ has a 2% inflation target but today it stands at roughly 1%—and that's 10 years into the country's recovery.

**Exhibit 4: BOJ keeps on easing policy**



Source: Bloomberg, 10/31/18.

**What does this mean for investors?**

Higher short-term interest rates seem to be a certainty for the foreseeable future in the U.S. compared to other developed markets. Longer-term interest rates are also likely to continue to rise, although not to the same extent as long as the Fed is viewed as being ahead of a potential increase in inflation. In general, this means that bond prices are likely to fall. However, it also suggests that dividend payouts will increase for fixed income investors who stay invested in bond funds as those funds take advantage of higher yields. The Fed appears committed to slowing the economy which suggests lower returns going forward for equity investors. That seems to be the message from the recent stock market correction this October.

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