The neutral rate: a light at the end of the tunnel?

While there are several reasons behind the recent stock market volatility, the swift upward jump in interest rates has undoubtedly been a significant contributor. The absolute level of rates, however, has not been the primary concern. That honor belongs to the seemingly unwavering stance of the Federal Reserve around its desire to continue raising rates in the face of a slowdown in global growth prospects. We have always felt the Fed, and Chairman Powell in particular, would take a more pragmatic approach on this front than that implied by the most recent Federal Reserve forecast. Indeed, Fed Chairman Powell’s opening statement on Wednesday, November 28th to the Economic Club of New York included an important shift in the language characterizing the future path of interest rates. Specifically, Chairman Powell said, “Interest rates . . . remain just below the broad range of estimates of the level that would be neutral for the economy that is, neither speeding up nor slowing down growth.”

This statement could be parsed in different ways, but the main import for the markets is its contrast to the Chairman’s previous comment on October 3rd where he stated, “We may go past neutral, but we’re a long way from neutral at this point, probably.”

That idea of both being a “long way from neutral” and also the idea of going past neutral contributed to the equity market’s selloff of the past two months. There was simply no light at the end of the rate hike tunnel. Today, while the markets don’t expect that rate hikes are finished, there is light.

Taken together with dovish comments recently by Fed Vice-Chair Richard Clarida that interest rates are close to neutral, the futures market has shifted only modestly on the news as those expectations were already well below the Fed’s “Dot Plot” (Exhibit #2) from its previous meeting. With today’s statement, however, there is less risk of overtightening. Despite the strong one-day reaction, this does not by itself mark an “all clear” signal for the equity markets and an end to recent volatility. The Fed will most likely continue to be data dependent, trade wars and tariff concerns are still in a state of heightened uncertainty, and the oil price finished the day noticeably lower which served as a reminder that the slowing global growth is not likely to reverse course anytime soon. Still, at the margin, Chairman Powell’s remarks represent good news. Unless we get blindsided along the way, it seems the end of the Fed rate hike tunnel is in sight.

Exhibit 1: Fed Rate Path: Market Outlook (11/28/18)

Exhibit 2: Federal Open Market Committee (FOMC) “Dot Plot”

For more insights and information, follow - BMO Wealth Management - U.S. LinkedIn
Disclosure

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

This report contains our opinion as of the date of the report. It is for general information purposes only and is not intended to predict or guarantee the future performance of any investment, investment manager, market sector, or the markets generally. We will not update this report or advise you if there is any change in this report or our opinion. The information, ratings, and opinions in this report are based on numerous sources believed to be reliable, such as investment managers, custodians, mutual fund companies, and third-party data and service providers. We do not represent or warrant that the report is accurate or complete.

To the extent this report contains information about specific companies or securities, including whether they are profitable or not, it is being provided as a means of illustrating the investment manager’s investment thesis. The investment manager may or may not have invested in these securities at the time this report was prepared or is accessed by the reader. References to specific companies or securities are not a complete list of securities selected and not all securities selected in the referenced timeframe were profitable.

Other Bank of Montreal affiliates, and their agents and employees, may provide oral or written market commentary or trading strategies to clients that reflect opinions that are contrary to the opinions expressed in this report. These same persons and affiliates may make investment decisions that are inconsistent with the recommendations or views expressed in this report. We and our affiliates, directors, officers, employees and members of their households, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities referred to in this report. We and our affiliates, directors, officers, employees and members of their households, may have positions in the securities mentioned that are inconsistent with the views expressed by this report.

This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, a recommendation to buy, hold or sell securities, or a recommendation of any investment manager or investment strategy. Do not use this report as the sole basis for your investment decisions. Do not select an asset class, investment product, or investment manager based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Any forward-looking statements in this report involve known and unknown risks, uncertainties and other factors that may cause the actual performance of future markets to differ materially from the projections depicted in the report. Past performance is not indicative of future results and current performance may be higher or lower than that shown in the report. There can be no certainty as to the extent or depth of any market downturn, nor any assurance regarding the nature, extent or timing of markets rebounding. When evaluating the report, you are cautioned not to place undue reliance on these forward-looking statements, which reflect judgments only as of the date of the report. Investment returns fluctuate, and investments when redeemed, may be worth more or less than the original investment.

Standardized performance returns include reinvestment of dividends, other income and capital gains, which depict performance without adjusting for the effects of taxation or the timing of purchases and sales. Performance data is presented without deducting the investment advisory fees and other charges that may be applicable. The deduction of such fees and other charges (and the compounding effect thereof over time) will reduce portfolio return. Unless otherwise indicated, traditional investment performance data generally represents a composite or representative portfolio return and is shown gross of the investment manager’s advisory fees. Unless otherwise indicated, alternative investment performance data is shown as net of fund expenses, management fees, and incentive fees. Index performance data is shown as total return. You cannot invest directly in an index. Due to a system conversion, the ability to manipulate or restate client specific performance data prior to December 31, 2007, may be limited.

Any discussions of specific securities, investment managers, or strategies are for informational purposes only and should not be considered investment advice. The report does not constitute an offer to sell or a solicitation to buy any security or investment product. Any offer to sell or solicitation to buy an interest in any private security, investment product or fund may only be made by receiving a confidential private offering memorandum, prospectus, investment advisory agreement or similar documents from the investment manager, which describes the material terms and various considerations and risks relating to such security, investment product or fund.

Alternative investments, such as private equity and hedge funds, contain risks that are amplified when compared with other asset classes, such as illiquidity, stock or sector concentration, financial leverage, difficulties in valuation, and short selling. Alternative investment vehicles have minimal regulatory oversight and alternative managers have the latitude to employ numerous investment strategies with varying degrees of risk.

We are not licensed or registered with any financial services regulatory authority outside of the United States. Non-U.S. residents who maintain U.S.-based financial services accounts with us may not be afforded certain protections conferred by legislation and regulations in their country of residence with respect to any investments, investment solicitations, investment transactions or communications made with us.

You may not copy this report or distribute or disclose the information contained in the report to any third party, except with our express written consent or as required by law or any regulatory authority.

“BMO Wealth Management” is a brand name that refers to BMO Harris Bank, N.A., CIT myCFO, LLC, BMO Harris Financial Advisers, Inc., BMO Delaware Trust Company, and certain affiliates that provide certain investment, investment advisory, trust, banking, securities, insurance and brokerage products and services. “CIT | myCFO” is a brand name that refers to BMO Harris Bank, N.A., CIT myCFO, LLC, and BMO Delaware Trust Company. The CIT | myCFO brand provides family office, investment advisory, investment management, trust, banking, deposit and loan products and services. These entities are all affiliates and owned by BMO Financial Corp., a wholly-owned subsidiary of the Bank of Montreal. Capital Advisory Services are offered by a division of BMO Harris Bank, N.A. Member FDIC.

NMLS #401052

Broker-dealer and investment advisory services and insurance products are offered through BMO Harris Financial Advisers, Inc. Member FINRA/SIPC. SEC-registered investment adviser.

Not all products and services are available in every state or location or through all entities within BMO Wealth Management or CIT | myCFO. Securities, investment, and insurance products offered are: NOT A DEPOSIT – NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY – NOT GUARANTEED BY ANY BANK – MAY LOSE VALUE.