Northern Trust | Bob Browne: The Fed: Getting it Exactly Right

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The Federal Reserve once again did the expected, and they got it exactly right, a prudent and totally predicted interest rate hike and well-telegraphed intentions about the Fed balance sheet. The Fed raised its targeted interest rate range last week to 1% to 1 and 1/4% as it noted confidence and the continued expansion of the US economy. While the Fed's statement acknowledged that inflation is running somewhat below its expectations, Fed chair Janet Yellen later express confidence that low unemployment would help boost wages. We, and the market it seems, have doubts about this traditional assumption. And the data have yet to prove the connection out.

The flattening of the yield curve certainly suggests that investors are not worried about inflation. And we believe the Fed will continue to move cautiously as long as inflation remains below 2%. We believe this cautious one step at a time approach by the Fed is the right policy stance. And risk assets will continue to respond positively.

The Fed also satisfied market expectations by explicitly stating its intention to start normalizing its balance sheet this year. This means it will gradually decrease the reinvestment of bond principal payments. One implied hope for the Fed is that this process will cause a steepening of the yield curve.

The Fed is probably very surprised, as we are, that the 10 year Treasury yield continues to decline despite the Fed rate hikes. The challenge for the Fed is that long term market expectations for modest inflation in a low but steady growth environment along with much lower rates around the developed world may continue to offset Fed policy goals. This makes the Fed cautious. And that's what the markets like.

This is a good environment for investors-- good earnings growth, steady economic expansion, and accommodative monetary policy overseen by a prudent Federal Reserve. The conditions overseas are also positive. And hence we remain overweight risk assets around the world.

We recently reduced our position in natural resource equities because we have reined in our previous reflationary expectations for commodities. But we put the proceeds into international developed market equities, increasing our overweight there. We believe the recent economic momentum outside the US, especially in Europe, is on the verge of accelerating.

So what can go wrong-- well, a policy misstep by the Fed or even the ECB as it approaches its own end to quantitative easing in 2018. Still, this is a risk scenario, not a base case. And while a Fed mistake can certainly upend our positive forecasts, the more likely scenario is that its policy actions remain very supportive for global equities.