Northern Trust | Bob Browne: Wake Up and Smell the Economy

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As expected, the Fed raised its target Fed funds range by 25 basis points last week. Fed chair Powell was almost giddy describing the health of the US economy. And the dot plot forecast from the Fed suggests two more hikes this year. We, on the other hand, think they should be done for the year.

Why is that? Just look at the reaction of the 10-year treasury yield. Despite the Fed rate hike and a statement indicating more hikes are yet to come, the 10-year treasury yield actually declined. So one day after the Fed move and stronger than expected inflation data, the 10-year yield actually was three basis points lower, hitting 2.94%, comfortably below the high of 3.11% seen in mid-May.

Why is this? Because unlike the Fed, long-term bond investors are not making the classic mistake made by amateur investors, extrapolation. The US economy is indeed solid. And inflation is slowly edging up. But that's today. Sometimes today's weather is the best predictor of the weather tomorrow.

But it's never a good predictor of the weather one year from now. We think the US will likely experience its best economic days over the next two quarters, and then things will start to slow down, because of hits from higher rates and the fading effects of fiscal stimulus.

Looking ahead, long-term bond yields are telling us that 2019 will not be nearly as good as 2018. The Fed needs to realize that the more it raises rates, the sooner it will have to cut them. We think this realization will happen before September, when the market expects the next Fed rate hike.

While we think the global economy will slow down next year, we are not forecasting a recession. Instead, US assets are increasingly looking attractive relative to slowing markets outside the US. With this backdrop, we have moved money out of developed ex-US equities earlier this month, and into US high yield bonds and US equities.

And we still recommend in overweight position in risk assets. An environment of moderating growth and stable long-term bond yields should be a good one for both equities and high yield bonds.

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