

Northern Trust | This Fed Meeting: An Exception to the Rule

[MUSIC PLAYING]

It is important for investors to have good general rules which guide them. But they should also know that sometimes there are important exceptions to a good general rule. The upcoming Federal Reserve meeting is an excellent example of this.

The general rule is that a new piece of information isn't enough to make significant decisions. This is an example of recency bias, where investors assign too much weight to current news. Usually, they should take a mosaic approach to gathering varied information over time and then make a decision. But this month, we have an exception. We really do think the Federal Reserve interest rate decision due on December 19 is a critical piece of information that should set the market tone for months to come.

The Fed basically has two options. The first is more of the same, a rate hike accompanied by language used previously that reinforces its commitment to gradual rate increases. The second option is also a hike, but where the Fed declares victory by saying a state of neutrality has been reached, and it's ready to take a break.

The first scenario is not likely to be a good one for the markets, while the second one provides stability. We actually think a third option, no hike with dovish language, is what they should do, because the Fed already has moved too far. That may be wishful thinking, but recent low inflation and weaker than expected employment data might put this third scenario on the table.

We are still neutral toward risk, especially with such an important binary event just around the corner. We prefer US high-yield bonds in an environment where the economy should slow down, but not go into recession. And we especially prefer high-yield, the least risky risk asset, to equities. This is why we are underweight emerging market equities. If the Fed does finally announce a pause in the tightening cycle, then that should remove an important headwind for emerging markets and risk assets more broadly.

[MUSIC PLAYING]