The Bigger Picture

A weekly snapshot of the markets

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Fed's masterful balancing act keeps equity rally going

USD retreat could positively impact TSX by boosting commodity & energy groups

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The Federal Reserve's March 18 FOMC announcement was a masterful balancing act that has not only succeeded in keeping the market rally going, but has stalled a rally in the US dollar that was threatening to assume runaway proportions.

The increase in market volatility that was especially evident in January, and the 12% surge in the US dollar (as measured by the Dollar Index) from the beginning of the year to mid-March, were largely attributable to concerns about the timing and trajectory of the first U.S. rate hike in almost a decade.

These concerns had admittedly receded to some extent in recent weeks thanks to a spate of unexpectedly soft U.S. economic data. In fact, the Bloomberg ECO Surprise Index (which shows the degree to which analysts under-estimate or over-estimate trends in the business cycle, based on whether economic data beat or miss forecasts) currently has a reading of -0.74, the lowest since the Great Recession of 2009 (Figure 1). While U.S. payroll growth has been a bright spot, personal income, spending, ISM manufacturing, auto sales, factory orders and retail sales have all missed the mark so far in March.

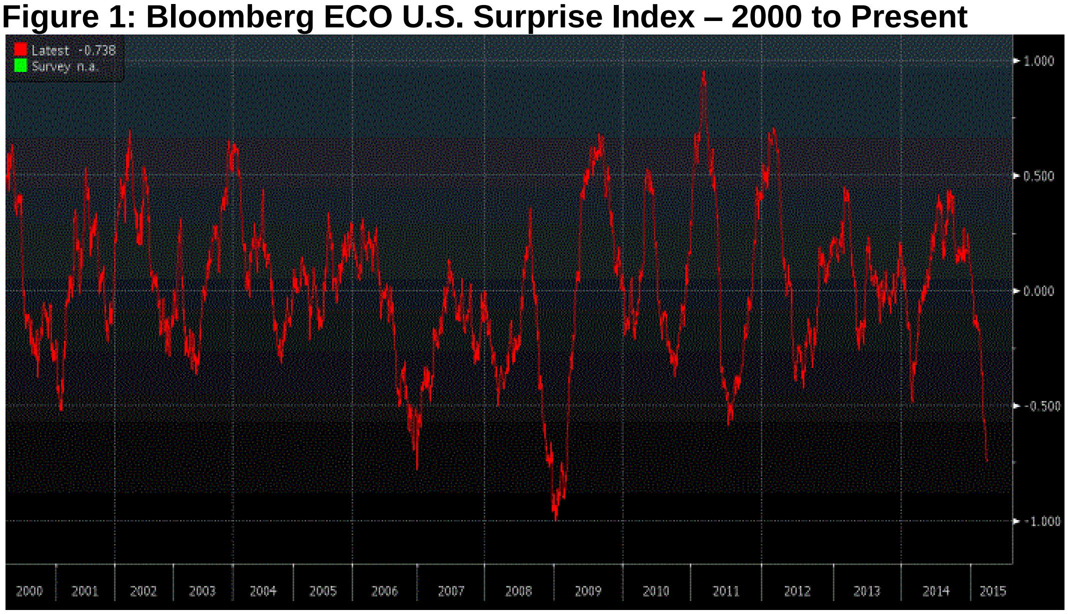
Here are two key reasons why market participants have pushed back the timing for the Fed's first rate hike, as well as expectations for future rate hikes:

1. **The Fed dropped "patient" from the FOMC statement, but signalled it would not be impatient in raising rates**: The Fed dropped the word "patient" from the FOMC statement, as was widely anticipated. In doing so, it marked the end of an era in which it had furnished explicit guidance on the future path of monetary policy; this phase commenced in late-2008, when the Fed first pledged to keep the federal funds rate at exceptionally low levels for an extended period to aid the economic recovery. The Fed said instead in its March 18 announcement that "it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."

Phrases such as "economic growth has moderated somewhat," "recovery in the housing sector remains slows" and "export growth has weakened" that were sprinkled through the announcement suggest that the Fed is cautious about U.S. growth prospects. With regard to the criteria for rate hikes specified by the Fed, note that while the labor market has improved, it has not been accompanied by strong wage growth that would signal a pickup in inflation. Tepid wage growth and the strong dollar have contributed to inflation staying below the Fed's 2% goal for 33 straight months. The Fed's resolve to be judicious in raising rates is underscored by Janet Yellen's remark in the March 18 post-announcement press conference that the removal of "patient" does not equate to impatience.

2. **The Fed's median estimate for the fed funds rate by end-2015 has declined dramatically**: The FOMC's quarterly Summary of Economic Projections, also released on March 18, showed that the median estimate for the federal funds rate at end-2015 fell to 0.625%, compared with 1.125% in December (Figure 2). The median estimate for end-2016 also declined to 1.875%, from 2.50% in December. The number of FOMC participants who judged that the first increase in the target fed funds rate would occur in 2015 or 2016 was unchanged from December at 15 and 2 respectively. However, the lowered rate estimates indicate that the trajectory of future rate hikes is likely to be more gradual than previous expectations. This is largely because FOMC participants now expect the U.S. economy to grow in a range between 2.3% and 2.7% in 2015, compared with their December forecast for growth between 2.6% and 3.0%. Growth forecasts for 2016 and 2017 were also revised lower from the December estimates.

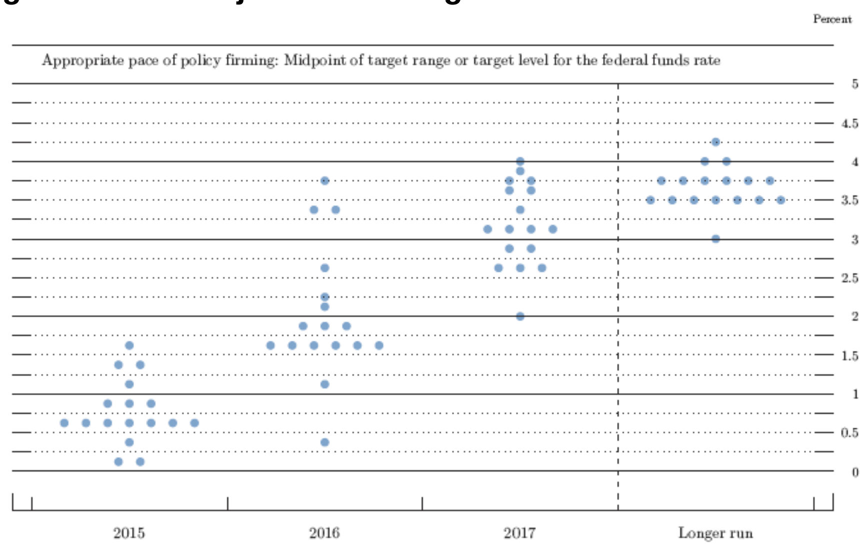
Figure 1: Bloomberg ECO U.S. Surprise Index – 2000 to Present



Source: Bloomberg

Bottom-Line: Futures traders have cut the odds of a Fed rate hike to below 50% by December, while the likelihood of a June hike is now at only 11%. While North American stocks have rallied modestly since the FOMC announcement, the equity rally has been overshadowed by the action in the currency markets. The U.S. dollar had its biggest one-day decline in six years on March 18, and is currently lower against all 16 major currencies since then. It remains to be seen whether this represents a turning point for the rampaging greenback, which is still up almost 21% vs. the euro and 15% vs. the yen over the past year. The dollar's retreat has helped spark a rebound in commodity and energy prices, as a result of which the Materials and Energy groups are the best performers on the TSX since March 17. On the S&P 500, the Utilities sector has benefited from lowered expectations for U.S. rate hikes to post the best performance on the index since March 17. By allaying market concerns about potential rate hikes this year, the Fed has reined in the rampant dollar, thereby temporarily dispelling one of the biggest threats to a bull market that is now in its seventh year.

Figure 2: Fed Projections – Target level for federal funds rate



NOTE: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy, the first increase in the target range for the federal funds rate from its current range of 0 to 1/4 percent will occur in the specified calendar year. In December 2014, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2015, and 2016 were, respectively, 15, and 2. In the lower panel, each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.

Source: Federal Reserve Economic Projections March 2015 www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20150318.pdf

Market Snapshot

At Close today

S&P TSX	14957.21	+14.80	Commodities			Yields (%)	Can.	US
TSX Venture	670.56	-0.03	Canadian $ (US cents)	79.86	+0.20	90 Day T-Bill	0.50	0.01
DJIA	18116.04	-11.61	Gold (Spot)-US$	1189.51	+6.88	2-Year Bond	0.45	0.57
S&P 500	2104.42	-3.68	Oil (WTI-May)	47.45	+0.88	10-Yr.Bond	1.30	1.91
NASDAQ	5010.97	-15.44	CRB Index	215.75	+1.65	30-Yr. Bond	1.94	2.51

Thought for the Day

"Courage is the price that life exacts for granting peace." – Amelia Earhart

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Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.
Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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