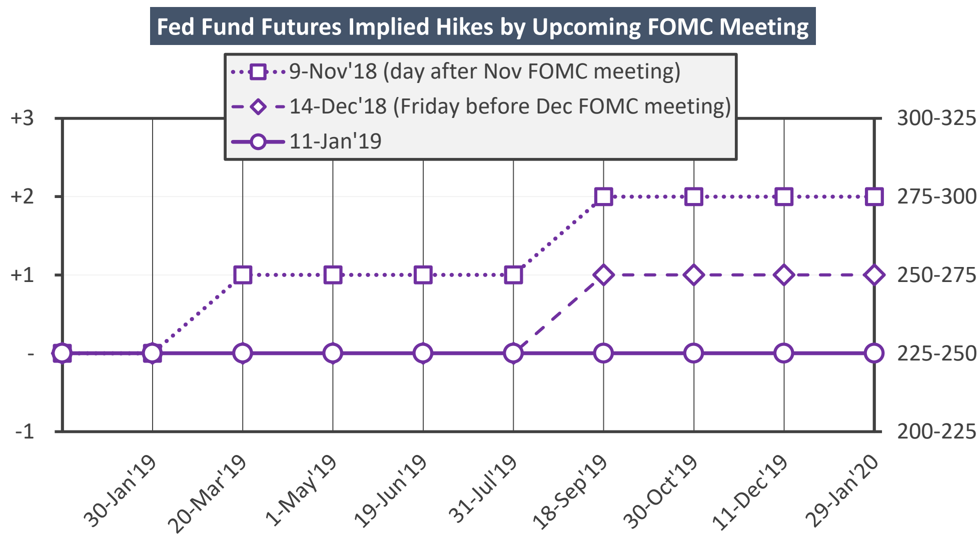
All About the Expectations

Market participants believe that the Federal Reserve has reached the end of its rate hiking cycle with zero hikes priced into Fed fund futures for 2019. Concerns over the effects of tighter financial conditions and slowing global growth led to a change in expectations over the last two months of 2018. More recently, statements from Fed officials and minutes from the December FOMC meeting have firmly anchored dovish expectations at least through the first quarter of the year as policymakers reinforced the ability to remain patient in the implementation of monetary policy.



Source: CME FedWatch Tool, Clearwater Advisors

With the real effective Fed funds rate firmly above zero finally, we think prudence going forward is reasonable given a low probability for a meaningful acceleration in inflation that would necessitate the FOMC to hike more aggressively than the two times they currently project. A continuance of historically modest wage inflation will keep core PCE inflation relatively tame, and economists currently expect wage inflation to top out a little above 3% over the next year. In addition, the removal of tariffs through a mutual resolution of trade tensions, which we believe is achievable, would further depress inflationary pressure as the New York Fed estimated that tariffs added one third of a percent to consumer prices in 2018.

More dovish expectations improve the technical backdrop for investment grade credit as they reduce dollar hedging costs and spur demand from foreign investors. However, as we enter the latter stages of the credit cycle, fundamentals will be a key driver of whether the investment grade market will be able to sustain positive excess returns throughout 2019. Since overseas earnings make up a substantial proportion of S&P 500 earnings, companies' outlooks on global demand will undoubtedly influence the direction of credit spreads during earnings season. After dramatic spread tightening to start the year, we think continued upside in credit will be limited unless clarity emerges from trade negotiations and business sentiment improves.