The Market is Frequently Wrong About What the Fed Will Do

The chairman of the world's most powerful central bank has said what the market wanted to hear. Jerome Powell of the Federal Reserve indicated on June 19th that the case for a more accommodative policy has strengthened despite making the decision to keep rates steady. He even pointed at pre-emptive cuts, which are essentially insurance cuts that aim to act sooner and more forcefully than expected. The Fed Funds futures market, which represents the market outlook on where the Fed funds interest rate will be on a future date, reacted strongly to and perhaps misinterpreted this and other statements by the Fed. Based on these futures prices, the market initially expected a decline of almost a full percentage point in the Fed Funds rate over the course of the next year; however, this softened to approximately 80 bps after the strong jobs number on July 5 .

Brompton believes these market expectations are overblown and that rates are unlikely to fall this far over the next year. One of the reasons why Brompton believes the market is wrong is because the market has frequently been a poor predictor of what the Fed will do next. In Figure 1, the red line represents the actual interest rate on overnight loans of bank reserves that is determined by the Fed. The thin dotted lines represent the futures curves at different points in time and show the difference between market expectations and the eventual reality of where the Fed Funds rate ended up. The longer these dotted lines, the larger the discrepancy between market expectations and reality. For example, between 2009 and 2015 investors expected interest rates to rise but rates stayed flat.

Figure 1: Fed Funds Effective Rate vs Futures Market Expectations[1]

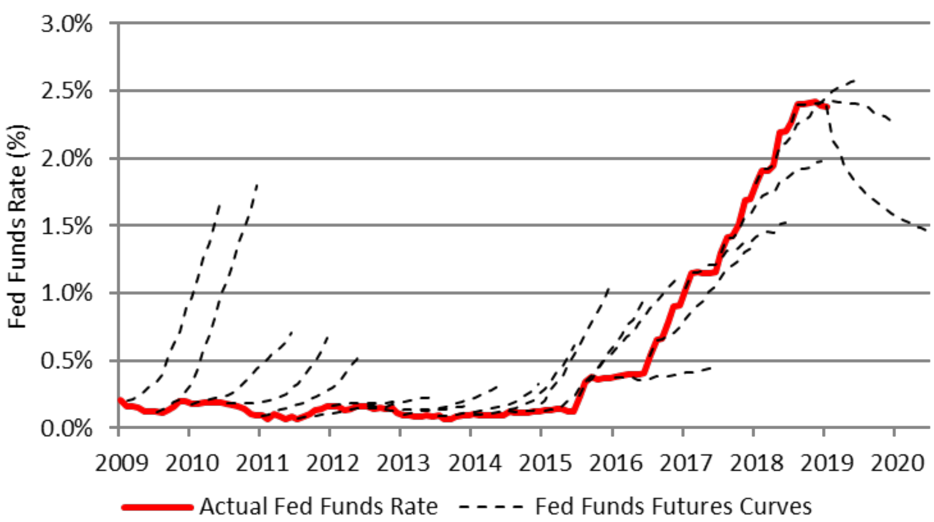
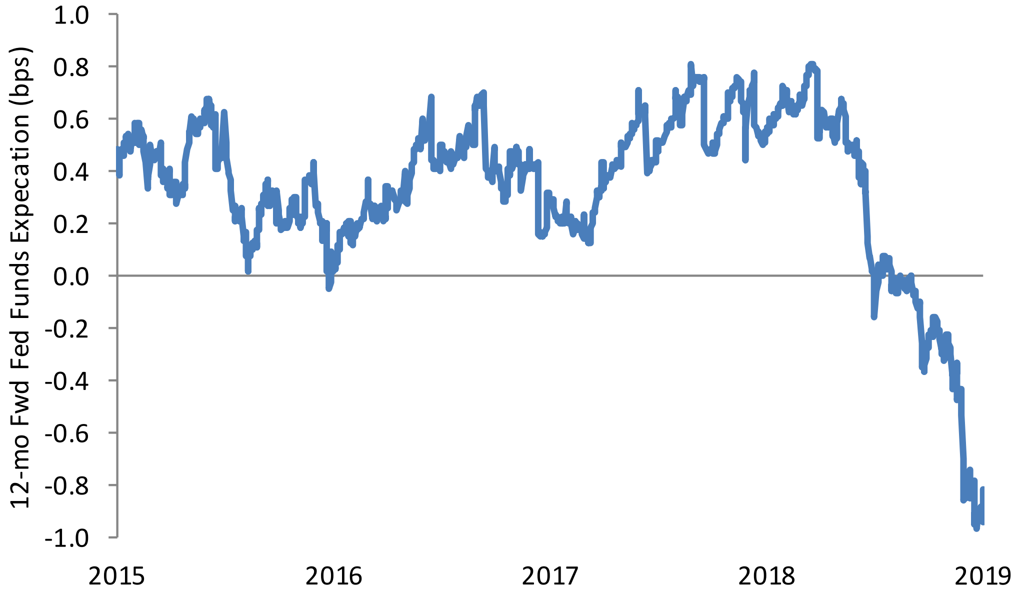


Figure 2 shows the anticipated 12 month change in the Fed funds rate by the markets over time. For example, a negative number of -0.92 on June 26, 2019 indicated that the market believed that the Fed funds rate would fall by 0.92 percent over the next 12 months[1].

Figure 2: 12-month Fed Funds Rate Expectations[1]



Although Brompton Funds is cognizant of the fact that there are several areas of concern in the market, such as weaker business investment, trade concerns and slow global growth, there are also several positives that rate markets seem to be ignoring. Wages are growing at a rate of 3.4% yoy[1], unemployment stands at 3.7%[1] and there's strength in consumer spending. Additionally, a large cut in the Fed Funds rate could artificially inflate risk assets, which may pose a risk to the economy. The Fed is aware of this and therefore might be reluctant to decrease rates too rapidly.

If rates don't fall as far as the Fed futures would suggest, then there are several areas of the market that could benefit. For example Banks, which have sold off on expectations that lower rates would pressure interest rate margins, would likely trade to the upside. Additionally, cyclical sectors like Technology and Industrials would likely outperform defensive sectors such as Utilities and Real Estate, which benefit from lower rates and have performed well as yields have declined over the past several months. Regardless of how much the Fed cuts rates, Brompton believes that inflation and yields will stay at persistently low levels for the foreseeable future, and we believe that dividend growth stocks are poised to outperform in this type of environment.

Our views on banks have been implemented in Brompton North American Financials Dividend ETF (TSX:BFIN), Brompton Split Bank Corp. (SBC) and Life & Banc Split Corp. (LBS). Additionally, our views for dividend growers have been implemented in Brompton Global Dividend Growth ETF (TSX: BDIV), Global Dividend Growth Split Corp. (TSX: GDV), Brompton European Dividend Growth ETF (TSX: EDGF) and Dividend Growth Split Corp. (TSX:DGS).

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[1]Bloomberg as of July 5, 2019

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