Basis Points – March 21, 2019

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Above the Fold

The Fed met yesterday and made no change to interest rates, which was expected. The Fed surely got the message from the 4Q2018 financial market swoon that the market did not appreciate the Fed's earlier path of tightening. Fed Chairman Powell said, "The economy is in a good place." Powell also noted that we are now at the "neutral" level in rates — a level where rates neither help nor hinder economic growth.

In the statement released after the meeting's conclusion, there were four important points:

1. The FOMC does not see any rate hikes in 2019. They also forecast just one hike in 2020. No change in rates in 2019 was already reflected in Fed Funds futures prior to the meeting, as the futures showed a less than 1% chance of a hike in 2019. The Fed just confirmed that.
2. Although the Fed is on hold for rate tightening, the Fed balance sheet runoff is a form of tightening that they were going forward with and said at the prior meeting that they would detail the path of runoff at this March meeting. The Fed today said that they would begin to decrease the runoff in May and complete the runoff by September. This is positive as it shows that the second tightening plan, in addition to rate hikes, is ending also.
3. The Fed noted that although they see the current economy as strong and robust, they mentioned that there was some weakness in the first quarter. (The Fed did not give a reason why, but this may be as a result of the government shutdown or the effects of the ongoing trade war.)
4. The Fed now sees GDP growth of just 2.1% this year, down from the 2.3% estimate in December. They see inflation reaching 1.8% this year, a 0.1% reduction from the last meeting. Inflation is clearly not a worry, so there is no reason to raise rates any further.

Three Things

- The equity markets have rallied both sharply and broadly in the first quarter of 2019. The S&P 500 has risen 13.7% this year and 92% of stocks in the index are positive for the year. Many individual sectors have fared much better than the broad index, such as Technology (up 18.5%), Energy (up 16.2%) and Industrials (up 15.4%). Both large growth and large value have seen strong gains this year, with the Russell 1000 Growth index up 15.1% and the Russell 1000 Value index up 11.0%. Globally, stocks have seen strong gains in 2019 as well, with the Emerging Markets index up 11.0% and the Global index up 12.9%. The large gains off the December lows are clearly due to the shift of the Fed stance from a set program of interest rate increases to the current plan to be patient, gradual and data dependent with interest rate moves.
- Consumer confidence remains very high, standing at its highest level since 2001 in a recent CNN poll. Although many news items have reported that tax refunds are well below expectations so far this tax season, the latest data show that concern has been overstated. As of March 18, tax filers have received $164.1 billion in refunds vs. $169.8 billion in 2017.
- Wolfe Research notes that they expect corporate capital spending to be much higher than expected in 2019, and their indicators show that it is poised for a pick-up. Their favorite capex forward indicators, such as capacity utilization and corporate profits, are consistent with U.S. capex growth of roughly 8% in 2019, compared to consensus estimates for 3%-4%. Improving business confidence on the back of a U.S.-China trade deal and the immediate expensing of capital investments from the tax reform bill will provide additional capital spending tailwinds for capex spending.

Did You Know – Why Do Bond Prices Go Up and Down?

First, you need to know what a bond is. A bond is a contract between a borrower and a lender. The contract states how much money is being lent, for how long, and how much interest the borrower must pay the lender over that period. A bond can also be referred to as a fixed income security, as the amount of interest that a bond owner receives over time is fixed and cannot be changed.

Let’s say that you think that Apple is a great company and feel comfortable lending your money to the company to use as it sees fit. You do some research and discover that Apple will sell new 10-year bonds in a bond issuance tomorrow. Apple will sell these bonds with a coupon yield of 5%. Great, you say, and you then purchase $100 in 10-year Apple bonds. At the end of each year, for the next 10 years, you can expect to receive interest payments of $5 (a 5% yield). And at the end of the 10-year life of the bond, Apple will pay back your original principal of $100.

However, if after two years you decided to sell the Apple bond, you will discover that the price of the underlying bond may have changed since you purchased it for $100. Let's say that in those two years since your purchase, interest rates had increased and new 10-year Apple bonds were being sold with a 6% coupon rate. "Wow," you think. "Why would anyone want to buy my bond paying a 5% rate of interest when new similar bonds are paying a 6% rate of interest?" The short answer is, they would not, unless you sold the bond for a cheaper price that made up for the difference between your bond at 5% and new bonds trading in the market at a 6% yield. In order to make your bond equal to a higher yielding bond, and therefore making it an equally attractive purchase as the new bond, the price you sell it for needs to be lower than your purchase price.

Your bond yields 5% (you receive $5 a year in interest, divided by your purchase price of $100, equals 5%). When you research the current price of your bond, you find that the price has declined to $93. This is the price that makes the yield on your bond equal to the yield on the newer bonds. Your bond will only sell in the market if it is priced at $93 or lower, as this is the price at which investors would see no difference between your 5% bond and a newer 6% bond. Alternatively, if interest declined and new Apple bonds were sold to yield 4%, then the price of your 5% bond would rise to $108, the price at which your bond is equivalent to a 4% yield.

If you held the bond for the entire 10 years, and you never tried to sell the bond prior to maturity, you would not know or care if the bond's price in the market had gone up or down, as you will receive your fixed coupon payments each year and your entire principal will be returned at maturity.