Fed signals were good, but less than ideal, for stocks near-term

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Interpreting FOMC signals on neutral rates: Look at the dots or listen to the chair?

At the June Federal Open Market Committee (FOMC) meeting, the U.S. Federal Reserve (the Fed) hiked its target rate by 25 basis point (bps) as widely expected. The Fed acknowledged an accelerating economy and a likely new record long U.S. economic expansion. The unemployment rate forecast was lowered slightly to 3.6% & 3.5% for 2018 & 2019. Even with falling employment expected, their inflation forecast was raised by only one-tenth to 2.1% for 2019 with press conference comments pointing to comfort in contained inflation risk and comfort in symmetry on their 2% inflation target. This was no surprise and in our view hints at their awareness of possibly lower the non-accelerating inflation rate of unemployment (NAIRU) and a lower neutral Fed Funds rate than currently estimated. However, we didn't expect the dot plot to suggest a Fed Funds rate above 3% in 2019 and 4 instead of 3 hikes this year, which seems contrary to the other Fed forecasts and tone of comments. We still think the Fed should only hike 3 times this year or communicate likely less hikes in 2019 as we think the neutral Fed Funds rate is below 3% this cycle. Setting up for quarterly hikes for the coming year or more will raise concerns of a hawkish policy mistake.

The hawkish dot plot dampens recent positive equity sentiment

There have already been many premature cries about the risk of inflation this cycle and longer. We have repeatedly argued that wage growth is not inflationary if fueled by rising productivity. If there is any clear signal of inflation it should be in Unit Labor Costs (ULC), which have trended below 2% this cycle and shows no sign of spiking. Even as unemployment falls more this year ULCs have been tame since the end of last year (See our June 12 note "Inflation: Sometimes it skips a generation"). However, this slightly hawkish FOMC decision in our opinions has important repercussions on the path of the S&P 500 this summer and autumn. Before the June FOMC meeting, we expected the S&P to exceed 2750 on the back of 1Q strong earnings and better than expected economic data and approach 2800 if inflation and 10yr yields stayed tame and Fed more acknowledging likely lower NAIRU and neutral rates. But now we see little upside for the S&P 500 until after the mid-term elections due to the extended obscurity of what the Fed thinks is the neutral Fed Funds rate for this cycle.

We change our "Next 5%+ move" call for S&P from Up to Balanced Risk

We think the S&P rally since January's selloff is now capped by the FOMC's signaled September and afterward quarterly hikes. As well as trade tensions and related headline risk that likely remain elevated through the mid-term elections. The positive and negative triggers for US equities moving more than 5% now seem balanced in our view, so we move our "Next 5%+" call for the S&P 500 from "Up" to "Balanced Risk." Yet we still see low risk for any near-term correction given how 10yr yields have not materially exceed 3% and are unlikely to do so near-term in our view. We expect the S&P to trade in a tight range of 2700-2800 through the summer, and then some upside after the midterm elections. Our 2018 year end S&P target remains 2800.

Our style & sector tilts are well aligned with the Fed's forecasts and macro backdrop

We still favor Growth (both large and small caps) over Value, and Large over Small. Regular Fed hikes and a likely stronger dollar support our preference for Emerging Markets (EM) Asia over the rest of EM. Weaker Euro is good for European Industrials provided trade tensions don't intensify. If the Fed hikes to 3% or higher, we expect a completely flat curve as we doubt it drives 10yr yields higher, as these hikes will increase the likelihood of no higher than 2% inflation. We see the flattening curve as not a signal of a looming recession, but rather the Fed hiking above this cycle's neutral rate. We favor big banks over regional banks on this flat curve view. We stick to our overweight on Financials, Tech & Health Care. Energy and Consumer Staples remain our least favored.

Yield curve will flatten more but remain positive in 2018, dollar likely to firm up more

The steeper Fed dot plot, together with the European Central Bank's ECB's communication of no hikes through at least summer 2019 will likely drive the US dollar a bit higher vs. euro. Since the beginning of 2017, the weakening US dollar helped inflation rise from very low levels, but now a strengthening US dollar in 2018 should keep inflation at 2%. U.S. economic growth looks very health with acceleration in 2018 and then likely gradual deceleration in 2019 and beyond. A healthy but slowing economy makes us believe that as the Fed takes more rate hikes, the 10 year treasury yield will not rise significantly above 3%, unless the U.S. deficit jumps above 5% of gross domestic product (GDP). Our 2018&19 S&P earnings per share (EPS) estimates remain $160 and $170. Our 2018 S&P yearend target of 2800 is 17.5x our $160 EPS estimate. We are comfortable with a 17.5-18.0x trailing price to earnings ratio (PE) provided the 10yr yield doesn't surge and doesn't exceed 3.5%.

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Definitions

Basis point - One basis point equals 1/100 of a percentage point.

Consumer staples is a sector of the economy selling essential products.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The non-accelerating inflation rate of unemployment (NAIRU) - also referred to as the long-run Phillips curve - is the specific level of unemployment that is evident in an economy that does not cause inflation to rise up. NAIRU often represents equilibrium between the state of the economy and the labor market.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Unit labor costs (ULC) measure the average cost of labor per unit of output.

The **U.S. Federal Reserve Board**, **often referred to as "the Fed"**, is the central bank of the United States.