

Dissecting Fed Normalization and Global Investment Strategy

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Jeremy Schwartz, CFA

Global Chief Investment Officer

On last week's podcast, we had an extended conversation with Professor Jeremy Siegel about interest rates, the economy and the Federal Reserve's (Fed) planned balance sheet reduction. Alongside us were our two guests, Jason Pride, director of investment strategy at Glenmede, a \$35 billion investment manager and family office, and Marc Chandler, a currency strategist at Brown Brothers Harriman.

Pride is worried the Fed's current trajectory will act as a shadow hike in interest rates—a study by the Atlanta Fed showed the Fed's quantitative easing ("QE") program resulted in a shadow rate policy of close to -3%, and the initial outline for its balance sheet reduction program could be two-thirds to three-fourths of the pace of buying. Therefore, the reduction program is essentially a 2% additional hike on top of what the Fed already has done. Pride believes that's more than the economy can handle.

Balance Sheet Reduction to Be Announced in September, Then It's on Autopilot

Chandler commented that he was surprised how quickly consensus thinking has shifted from the Fed being too dovish to now being too hawkish. Chandler thinks the unwinding of the balance sheet will be on automatic pilot—he interpreted Fed Chair Janet Yellen's comment at her last Federal Open Market Committee (FOMC) press conference that this process of normalization would begin "relatively soon" to mean it was two meetings away. That means it would be announced at the September meeting for implementation in October.

Perhaps the best line of the podcast came from Professor Siegel in wrapping up the discussion of the Fed by saying one should be cautious in interpreting the Fed's projections: "Those long-term dots are written on tissue paper. Remember, then-Fed Chair Ben Bernanke said five years ago we'd have to start tightening policy when unemployment got to 6.5%."1

Risks to Recovery?

Pride wanted to cast aside the notion that just the length of this expansion means we are getting the risk of recession. He points to the fact that Australia has gone 26 years without a recession as evidence that timing does not create an imminent recession watch. But the risks are 1) a Federal Reserve that overtightens policy, 2) excesses in the system unwinding and 3) geopolitical event risk. In terms of these, the Fed is tightening, so there is a risk to that, but he doesn't see the excesses at this stage.

Dollar Bull Market Driven by Rate Differentials

Chandler talked about how the currency markets today—especially for the euro and the yen—are being driven by interest rates, and, amazingly, despite the Fed having begun its hiking cycle, long-term interest rates today are lower than when the Fed started hiking interest rates. This has been a drag on the dollar and Chandler's bullish outlook for the dollar. He thinks we are getting closer to a turning point for the dollar because the good political news for the euro already has been fully priced in. Dollar strengthening will be driven by widening rate differentials in favor of the U.S. relative to Europe and Japan, but that hasn't occurred yet.

Emerging Markets with Asian Consumer Tilts

Chandler mentioned how one of the surprises this year for emerging markets is that the Fed was tightening and promising more rate hikes, yet emerging markets equities are up almost 18% in the first part of the year.² Part of the rally was because of valuation, part due to declining long-term interest rates and part due to China's fiscal expansion. Chandler did express worries about Argentina's recently issued 100-year U.S. dollar bond—which commits the sin of issuing debt in a currency it does not control.

Pride likes emerging markets from a valuation perspective today. One of his big investment theses is that as emerging markets develop, they move up the value chain of consumption. A particular area of emerging markets he likes is Asian consumers. He does not believe the market fully appreciates the consumer dynamic happening.

Tilted to International: Asia and Japan

We discussed with Pride how Glenmede utilizes both internal and external managers to get exposure across asset classes. He discussed the limits to market capitalization weighting and fears overpaying for securities that appreciate in value with no adjustment mechanisms baked into a pure cap-weighted portfolio. There's a higher bar for Pride to use active managers in the U.S., where he thinks markets are more efficient, but over in Europe and Japan he sees more potential for active managers. Today he finds valuation opportunities are more robust internationally than in the U.S., particularly for emerging market Asia but also for Japan. While Japan has been oscillating—with some substantial volatility—he still sees the bull market continuing. There's a positive inflection happening from profitability metrics and a renewed focus on dividends, share buybacks and overall return on equity metrics. He sees 60% to 70% of Japanese companies increasing dividends in addition to a surprising amount of private equity activity that pressures public companies as well.

This was a great conversation with Professor Siegel, Marc Chandler, and Jason Pride, and we appreciate their comments. For the full podcast, [click here](#).

¹Federal Open Market Committee Statement, 12/12/12.

²MSCI Emerging Markets Index up 17.34% year-to-date through 5/31/17. [<https://www.msci.com/documents/10199/1493b63f-1ce8-418e-a82d-4aae72951f27>]

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