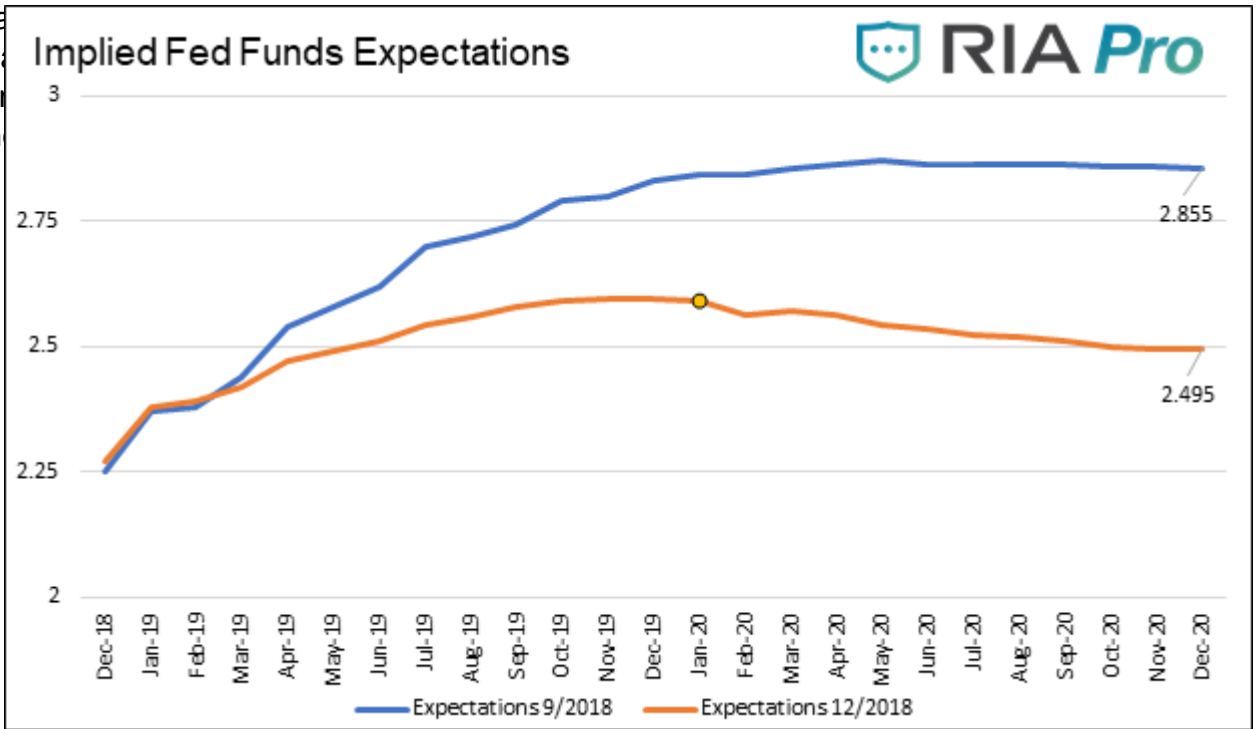


Preview: Federal Reserve Meeting 12/19/2018

In our article, [Everyone Hears the Fed But Few Listen](#) we showed the divergence between the market (Fed Funds Futures) and Federal Reserve members in regards to the future path of the Fed Funds rate. We believed at the time we wrote the article, and still do, that the differing views could be setting the stock market up for extreme volatility. This opinion does not necessarily mean an extreme sell-off but the potential for large movements up or down. In July, when the article was published and Fed Funds stood at 2.00%, market levels implied that Fed Funds would average 2.50% in 2019 and 2.625% in 2020. In September, with the stock market on firm footing, approaching record highs, and the economy humming along, the market's estimates rose by 0.125% for both years. At that time, the market implied levels were 0.32% and 0.44% lower than current average forecasts from the members of the Federal Reserve. Said differently, the market thought the Fed would raise rates twice in quarter point increments while the Fed was leaning to between three and four more hikes. On September 20, 2018, the stock market peaked and has since declined over 10%. Further, global economic growth has weakened measurably with Germany, Italy, Japan, and Switzerland all reporting a negative rate of economic growth in the last quarter. Possibly more important, China, has reported a sharp slowdown in economic activity. While the U.S. economy has only shown vague signs of economic weakness, the number of economists issuing growth warnings has increased. The clouding of the economic skies along with trade concerns and a host of geopolitical issues has certainly affected the market's Fed Funds expectations. Before the Fed meeting on Wednesday December 19, 2018, the market is expecting a 0.25% increase and a tiny chance of another 0.25% hike by summer of next year. In other words, over the last few months, the market is expecting a decline in the Fed Funds rate.



probable.

Given the decline in the market-based implied Fed Funds rate, the difference between market

opinion and the Fed's forecast has widened to 0.43% in 2019 and 0.76% in 2020. When we wrote the article in July the gap between the market and the Fed members was concerning. Our concern is only heightened given the stark increase in the gap.

What to Expect

If the Fed does not change their hawkish tone at Wednesday's meeting it is likely the stock market will continue to head lower and possibly in a disorderly fashion. The yield curve would likely continue to flatten in this scenario as the Fed continues to signal rising rates despite growing signs of economic weakness. Therefore, short-term interest rates would track Fed rate hikes higher while longer term interest rates would decline on recession concerns. Alternatively, if the Fed relents and uses more dovish language, short-term interest rates may rally as they reverse out prior expected rate hikes. While we do not expect a surge in equity prices to new highs, we do think, given the oversold conditions, stocks could rally on the order of 3-5%. As we have said, such a scenario is likely an opportunity to reduce equity exposure. Our chief concern in this short-term bullish situation is that the market begins to worry about the sudden change in the Fed's language and the rising implications for a recession.