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Investment Perspectives

Resilient U.S. Economy Leads Fed to Pause

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Key Takeaways

- The economic outlook is stabilizing, with better U.S. GDP growth than expected amidst a tight labor market
- Market overhangs from U.S. – China trade tensions and Brexit have begun to pull back
- After three rate cuts, the Fed believes the current policy stance will be appropriate going forward
- With yields likely to remain lower for longer and consumer spending still strong, this remains a favorable environment for stock investments

The October meeting of the Federal Open Market Committee (FOMC) saw the Fed delivering its third 25bp rate cut so far this year. The Committee's post-meeting statement and Chairman Powell's press conference sent a clear message that this cut is expected to be the last of their "mid-cycle adjustment", giving the meeting a more hawkish tone than markets had anticipated but one that was nonetheless received favorably by investors.

Equity markets have been moving sideways for several months as global economic growth slowed, while ramped up U.S. – China trade tensions have been weighing on sentiment and dragging down business spending. Manufacturing activity in the U.S. declined and investors began to question whether conditions had deteriorated to the point that a recession could be a near-term risk.

In recent weeks, however, the picture seems to have stabilized. As we had expected, American consumers remain healthy and continue to drive growth. U.S. GDP rose by 1.9% in the third quarter, higher than expectations. Personal consumption slowed but continued to grow at a strong pace, up 2.9% vs. 4.6% in the second quarter. Business investment declined for the second quarter in a row, as companies held off on spending due to the uncertainty surrounding global trade policy and the upcoming U.S. elections, but these declines have been more than offset by robust consumer activity. Residential investment rose for the first time in over a year and a half as lower interest rates boosted construction and home sales.

The domestic labor market also continues to show strength. Nonfarm payrolls rose by 128,000 in October, 43K above consensus, and job growth in prior months was revised up by an additional 95K. Service sector payrolls were particularly positive, with broad strength across leisure and hospitality, education and health, and trade, transportation and utilities, which helped to offset the drag from the GM strike. The unemployment rate increased slightly as the labor force participation rate rose to a 6-year high.

Additionally, key market risks have begun to subside. Trade relations between the U.S. and China remain very uncertain but the direct overall impact on the domestic economy remains relatively muted and the two countries appear to be poised to sign a phase one deal. Brexit has been delayed yet again and does not appear to be impacting equity performance. Markets have largely ignored developments in Washington, including the recent vote to move forward with the impeachment inquiry into President Trump.

All in all, the U.S. economy appears to be on still-solid footing thanks to robust consumer activity heading into the holiday season, giving the Fed room to hold steady on rates for the foreseeable future. The strong October jobs report lends further credibility to this policy stance.

The S&P 500 reached new highs as investors digested the Fed's statement and the slew of economic data, as well as a better-than-expected season of earnings announcements. More than three quarters of firms that have reported Q3 results have beaten expectations. Equities continue to appear fairly valued relative to the level of interest rates, and with the 10-year Treasury yield at just 1.7%, investors will continue to look to stocks for long-term returns. We believe the environment remains favorable for equity investments for the foreseeable future.