Will Dovish Fed Policy Fuel US Stocks?

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Equity markets recovered in June as the US Federal Reserve turned decidedly dovish, coming in line with most central banks around the world. But after posting strong gains, to end the quarter close to a record high, how much more steam do US stocks have left?

Over the last seven months, the Fed shifted its policy stance dramatically. From a perceived hawkish bias in December, the US central bank turned neutral by February and became accommodative in June. Increasing signs of a weakening macroeconomic environment in the US and around the world precipitated the adjustments.

Fed Policy Moves: Two Effects on US Stocks

From a stock investor's perspective, the market is valuing two dynamics: lower interest rates and an expectation that the Fed is now ready to stimulate the US economy if needed. The 10-year Treasury has fallen to around 2%, which has both a conceptual and a real impact on equity valuations.

The conceptual impact is driven by the discount rate. When future company cash flows are discounted back at a lower discount rate, those cash flows are worth more today. The real impact is because a meager 2% yield from Treasury bonds over the next 10 years makes the higher return potential of equities look more attractive. Both forces serve to push up equity prices—especially for growth stocks, which have more distant cash flows—as we saw in June.

What if the Economy Weakens Further?

The Fed's position is more controversial for several reasons. First, much of today's economic weakness has been driven by political decisions. Second, the US economy is still relatively robust, with an average GDP growth of 3% over the last two years, unemployment at generational lows below 4% and wage inflation over 3%. Third, by loosening policy today, it's unclear whether the Fed will have any weapons left in its arsenal to combat a real downturn, should one emerge.

Two questions are worth asking: will the cuts stimulate the economy, and what happens in 2020 and beyond if we really need stimulus? The answer to the first question is unclear. Lower rates aim to incentivize companies to borrow and invest more. But capital-spending projects that weren't feasible at a 2.5% interest rate probably won't make sense at 2.0%, so the decline in rates is unlikely to energize the economy on that front. Regarding the second question, in the event of a significant economic pullback, the Fed will have to get extremely creative because the cupboard is relatively bare. That's why the Fed wanted to bring rates back up toward long-term norms before its recent shift.

More Attractive Environment for Equities

No matter how these questions are answered, the Fed change is meaningful for investors. And with most major central banks also loosening monetary policy, the environment for equities has become more attractive, in our view.

Even after the rally this year, US stocks only trade at a valuation of about 17 times expected earnings over the next 12 months. Considering the 2% dividend yield on the S&P 500 Index, we think stocks are attractive versus bonds.

The biggest concern now is about corporate earnings. Earnings growth expectations have been slipping but haven't turned negative. Considering today's risks, the likelihood of a negative shock similar to the 40% earnings crash in 2008 is slim. As a result, we think equities offer solid return potential. Still, selectivity is paramount, since earnings growth is harder to come by.

Quality Growth Companies Offer Advantages

With all the market turbulence, we believe that several characteristics of resilient growth potential are especially important today. We're looking for companies in attractive industries with strong company-specific volume growth and a stable or

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widening business moat. Strong profitability characteristics (measured by return on invested capital), as well as robust cash-flow characteristics and a healthy balance sheet, are also important.

Even so, trade risks and political concerns can’t be completely avoided. In our view, equity portfolios with a smaller number of stocks have an advantage in their ability to tilt away from certain exposures and to invest in less-vulnerable sectors. But avoiding all risk exposures is nearly impossible given the magnitude of issues raised over the last year and the speed with which issues emerge. That’s why good management teams are especially important to successfully navigate this environment.

So even after a strong performance this year, equities remain an attractive asset class, especially because of the supportive stance of central banks, in our view. With GDP growth slowing, a selective focus on quality growth companies can provide a portfolio with advantages in a challenging environment.

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