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Fed Eyes Return to Neutral

Equity markets posted solid gains this week, helped by a mix of upbeat U.S. data that point to solid growth, but little imminent inflation pressure. The S&P 500 rose 1.5%, led by health care, utilities and technology. The index is now up 3.2% on the year, with small caps outperforming the big guys by an 11%-to-3% margin. Meantime, the TSX added 0.6%, with strength confined to relatively lightweight sectors—banks and energy were modestly higher on the week. Global markets were mixed, with Europe notching solid 1% or better gains, while China fell 4.2% as the selloff continues—now more than 12% in the past month.

The U.S. economy continues to run at a strong pace, but some mixed messages on the capacity front continue to argue for gradual tightening. One of the key takeaways from the Minutes of the Federal Reserve's June policy meeting, released this week, was that further evolution in language is likely coming. Recall that the June meeting was famous not so much for an as-expected rate hike, but for removing the long-standing guidance (since March 2014) that pointed to the fed funds rate tracking below the longer-run neutral level, for some time. The Minutes also highlighted another looming language change, saying that "a number of [participants] noted that it might soon be appropriate to modify the language in the postmeeting statement indicating that the stance of monetary policy remains accommodative". Indeed, assuming the quarter-per-quarter pace of rate hikes continues, the fed funds rate should reach a neutral level around the middle of 2019. And, given lingering uncertainty around precisely where that level is, the Fed could more or less view policy as no longer stimulative before then.

Market Performance as of July 6, 2018

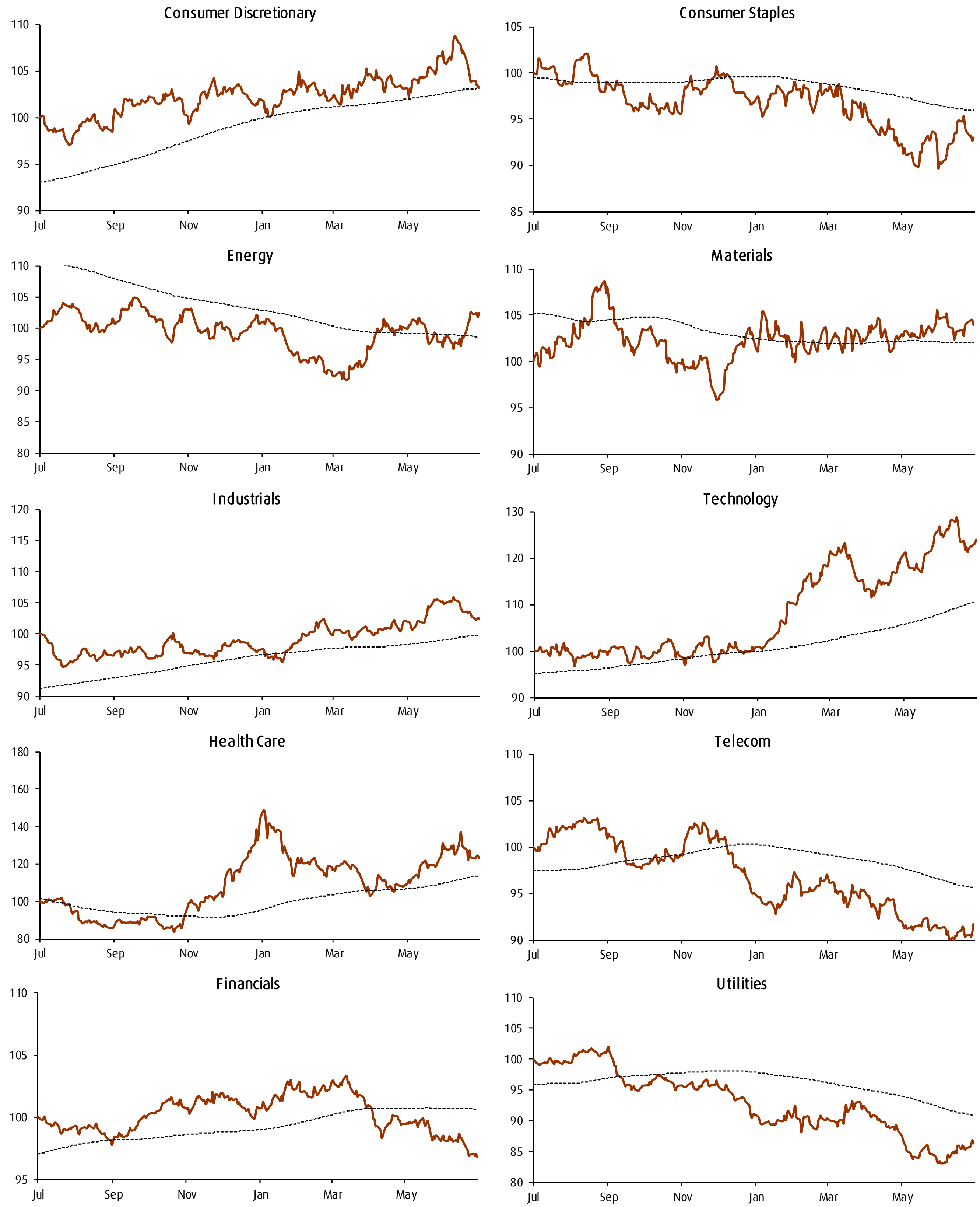
	Current Price	Performance (percent) 1 Week	1 Month	3 Months	1 Year	YTD	2017
NASDAQ	7,688	**2.4**	0.0	11.2	26.3	11.4	28.2
DAX	12,496	**1.5**	-2.6	2.1	0.9	-3.3	12.5
S&P 500	2,760	**1.5**	-0.5	6.0	14.5	3.2	19.4
CAC 40	5,376	**1.0**	-1.5	2.2	4.3	1.2	9.3
Dow Jones	24,456	**0.8**	-2.7	2.2	14.7	-1.1	25.1
S&P/TSX	16,372	**0.6**	1.2	7.7	8.6	1.0	6.0
FTSE 100	7,618	**-0.3**	-1.2	6.0	3.8	-0.9	7.6
NIKKEI 225	21,788	**-2.3**	-3.7	1.0	9.0	-4.3	19.1
China CSI 300	3,365	**-4.2**	-12.3	-12.7	-8.1	-16.5	21.8

Source: Bloomberg.

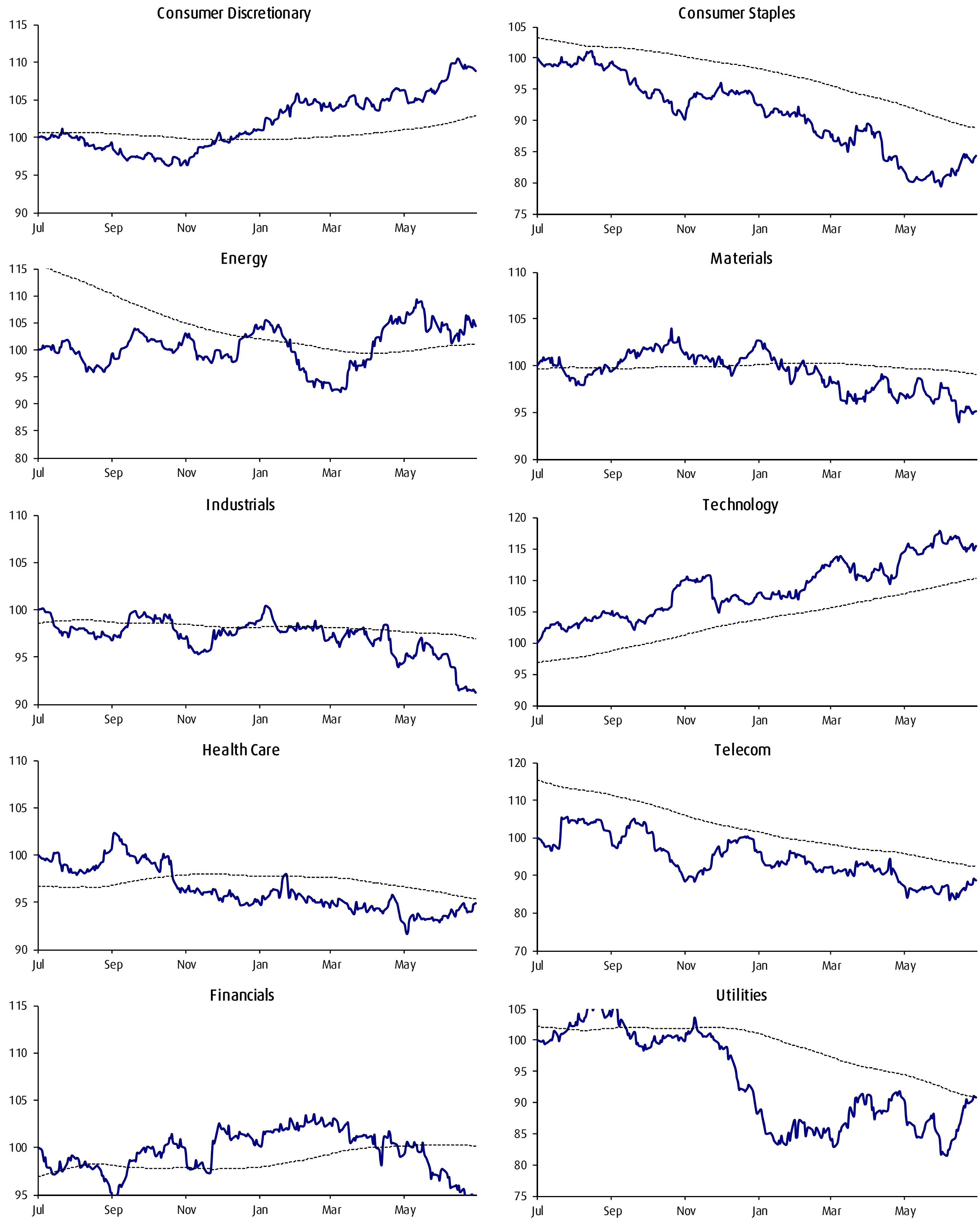
Given what we're seeing in the economy, a stimulative monetary policy stance is hardly in order any longer, but an overly restrictive one might still be premature. The manufacturing ISM rose back above the 60 level in June, with supplier delivery delays surging to the highest in 14 years. This at least partly reflects tightening capacity, particularly for transportation and some electronic components (trade concerns also appear to be at work). And, next week, core CPI inflation is expected to pick up again to 2.3% y/y, matching the highest level of the cycle. But, there appears to be some tolerance at the Fed to let inflation run modestly above 2% to help anchor expectations, given the prolonged undershoot. This week's payrolls report also highlighted solid growth but still-moderate inflation pressure. Headline job growth came in stronger than expected at 213k in June, with positive revisions to boot, while aggregate hours rose for a third straight month and were up 3.1% annualized for all of Q2—that's the strongest clip in four years. However, wage growth came in light at 2.7% y/y, and refuses to break out of its two-year range. This came alongside a 601k increase in the labour force, suggesting that there's still some pent-up slack sitting on the sidelines of the U.S. labour market.

All told, the Fed is well on its way to returning to a neutral policy stance, and we judge it will effectively get there around the middle of next year. How restrictive policy needs to get from there remains to be seen—at this point, it doesn't look like there is a big hurry.

TSX Sector Performance (Relative to the index, year-ago = 100, dashed line = 200-day m.a.)



S&P 500 Sector Performance (Relative to the index, year-ago = 100, dashed line = 200-day m.a.)



North American Sector Performances as of July 6, 2018

S&P 500 Sectors	1 Week	1 Month	3 Months	1 Year	YTD	2017
Health Care	**3.1**	2.0	7.6	9.3	4.1	20.0
Utilities	**2.4**	10.6	5.4	3.4	0.9	8.3
Information Technology	**2.3**	-1.8	11.8	33.5	12.7	36.9
Telecom Services	**2.2**	2.2	0.0	0.0	-8.9	-6.0
Cons Staples	**1.4**	5.2	-0.7	-4.6	-8.6	10.5
Cons Discretionary	**0.9**	0.9	9.5	24.8	11.8	21.2
Industrials	**0.7**	-4.7	-0.9	4.1	-4.9	18.5
Materials	**0.6**	-3.9	3.5	8.4	-3.4	21.4
Financials	**0.3**	-4.4	-1.8	7.1	-4.6	20.0
Banks	**0.2**	-4.4	-1.8	7.3	-4.7	20.0
Energy	**-0.3**	0.4	12.4	18.5	4.9	-3.8
S&P 600 Small Cap	**2.4**	0.2	11.5	23.3	11.2	11.7
S&P 400 Mid Cap	**1.9**	0.0	7.3	14.9	4.7	14.5
S&P 100 Large Cap	**1.6**	-0.5	6.1	14.2	2.6	19.3
S&P 500	**1.5**	**-0.5**	**6.0**	**14.5**	**3.2**	**19.4**

TSX Sectors						
Information Technology	**2.8**	-1.1	18.2	36.2	25.4	16.2
Telecom Services	**2.1**	1.6	3.5	-1.0	-5.2	9.9
Gold	**2.0**	4.6	8.6	0.5	0.9	-2.6
Utilities	**1.8**	4.8	0.6	-6.9	-6.8	6.2
Materials	**0.7**	-0.4	9.3	13.8	3.4	6.3
Banks	**0.6**	0.4	3.5	7.1	-1.8	10.4
Financials	**0.4**	-0.2	3.5	5.1	-2.8	9.4
Energy	**0.4**	6.8	13.7	10.5	3.2	-10.0
Health Care	**0.0**	-5.0	24.9	33.1	-1.5	32.7
Cons Discretionary	**-0.1**	-2.5	6.1	12.7	2.3	20.4
Industrials	**-0.2**	-1.5	9.8	11.8	5.5	17.9
Cons Staples	**-0.7**	2.2	5.0	0.8	-4.0	6.4
Income Trusts	**2.3**	2.6	4.2	4.1	0.8	4.5
REITs	**1.4**	1.4	5.3	8.7	4.7	3.8
S&P/TSX Mid Cap	**1.0**	0.3	6.8	7.1	0.9	4.2
S&P/TSX 60 Large Cap	**0.4**	1.4	7.9	9.1	1.0	6.6
S&P/TSX Small Cap	**0.3**	-0.6	5.6	5.7	-2.5	0.3
TSX	**0.6**	**1.2**	**7.7**	**8.6**	**1.0**	**6.0**

Source: Bloomberg.