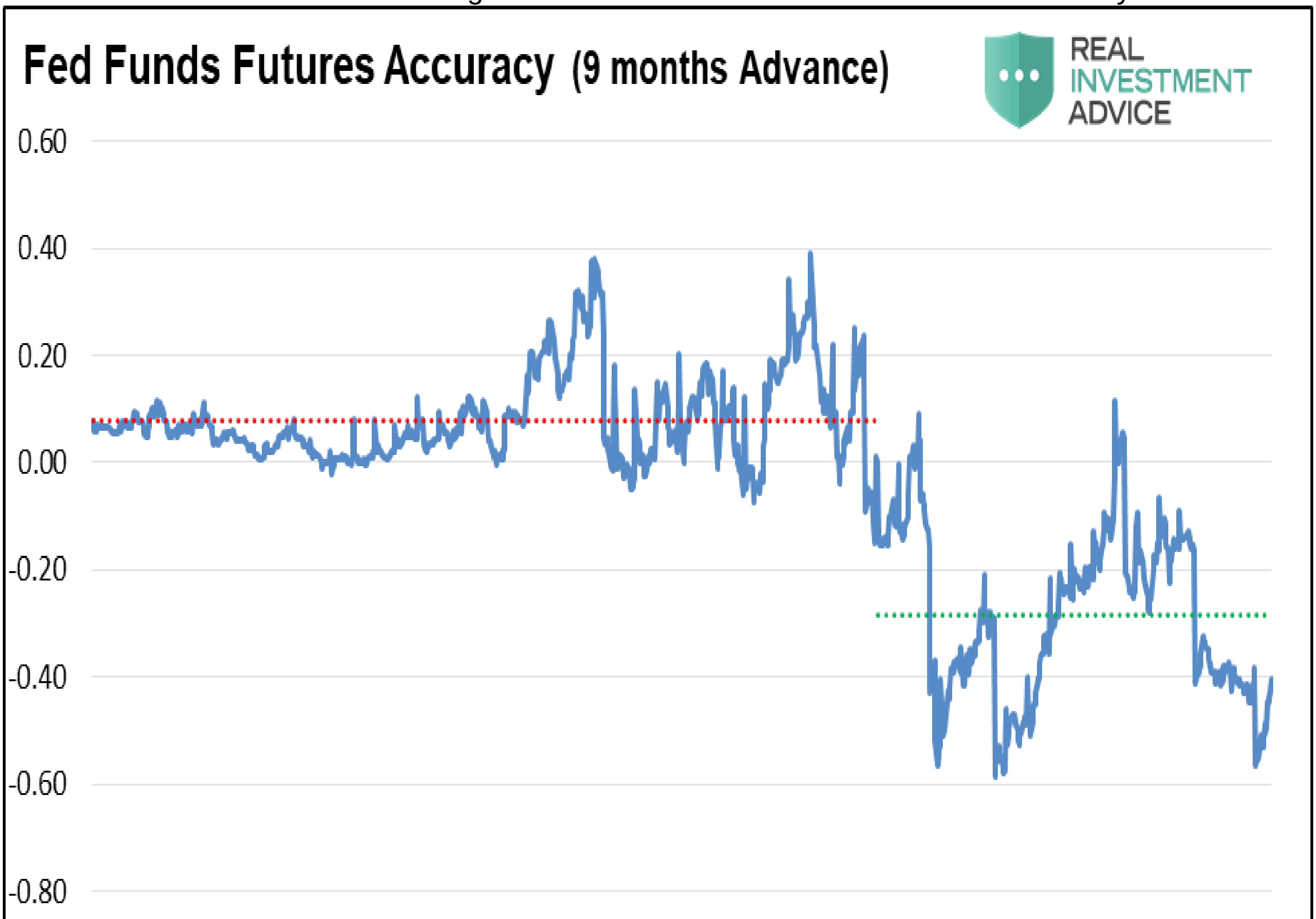
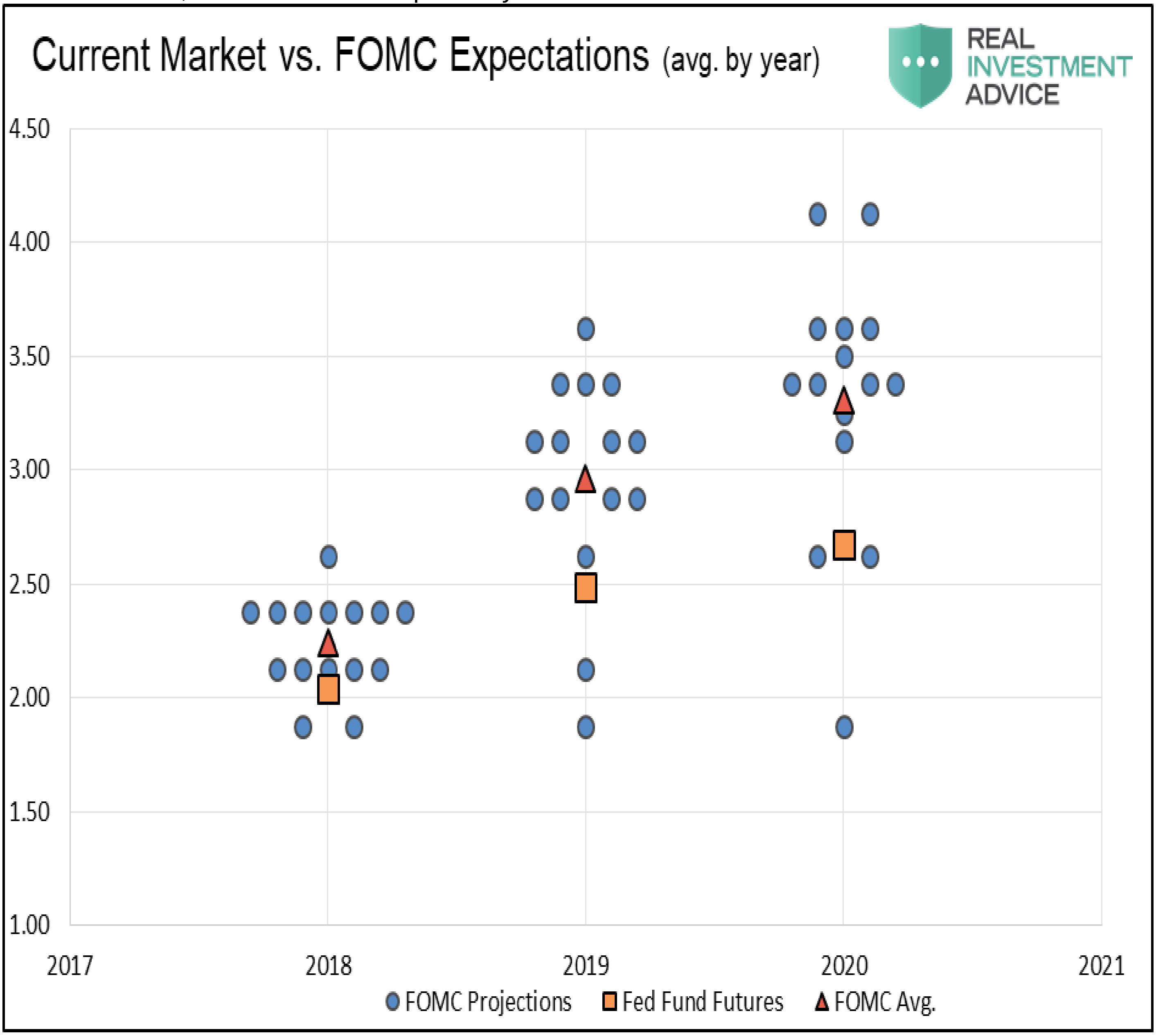
?*See no evil, hear no evil, speak no evil*? Currently, investors appear to be covering their eyes, ears, and mouths and ignoring the Federal Reserve?s (Fed) determination to increase interest rates. This divergence of outlooks between investors and the Fed is a stark departure from the financial crisis and the years following when the Fed and the market were on the same page regarding monetary policy. Often such a discrepancy between the Fed and investors results in sharp changes in asset prices and heightened volatility. In this article, we analyze the current situation to predict whether the market?s dovish expectations will be proven right, or if their unwillingness to heed the Fed?s warnings will cost them dearly. **Trump vs. Powell** As we were putting the final touches on this article, President Trump sent a clear shot across the bow of the Fed and in particular Chairman Powell.• His message to Powell was simple: stop raising rates. As you read this article consider the position that Powell and the Fed are now in. If Powell walks back his hawkish stance, regardless of why, it will be regarded as acquiescing to the President?s request. On the other hand, if he ignores the President and continues to raise rates, we might see his tenure at the Fed limited. Either way the Fed?s independence is likely to be tested. **Divergent Views** Starting in 2017, the Fed took a decidedly more hawkish stance than the market was expecting. Whether this was a result of President Trump?s pro-growth campaign promises or greater confidence in economic growth and renewed inflationary pressures, we are not certain. We do know that the difference between the market?s expectations and the Fed?s plans has persisted to this day, despite the Fed raising interest rates five times over the past couple years and reducing their balance in increasingly larger amounts as they?ve said they would. The following graphs demonstrate the prior and future divergent views. The first graph compares expectations (using fed funds futures) for the fed funds rate nine months forward versus the prevailing fed funds rate nine months later. The current reading of -0.40% denotes that Fed Funds futures were priced for a Fed Funds rate of 1.60% nine months ago while the fed funds rate is close to 2% currently.



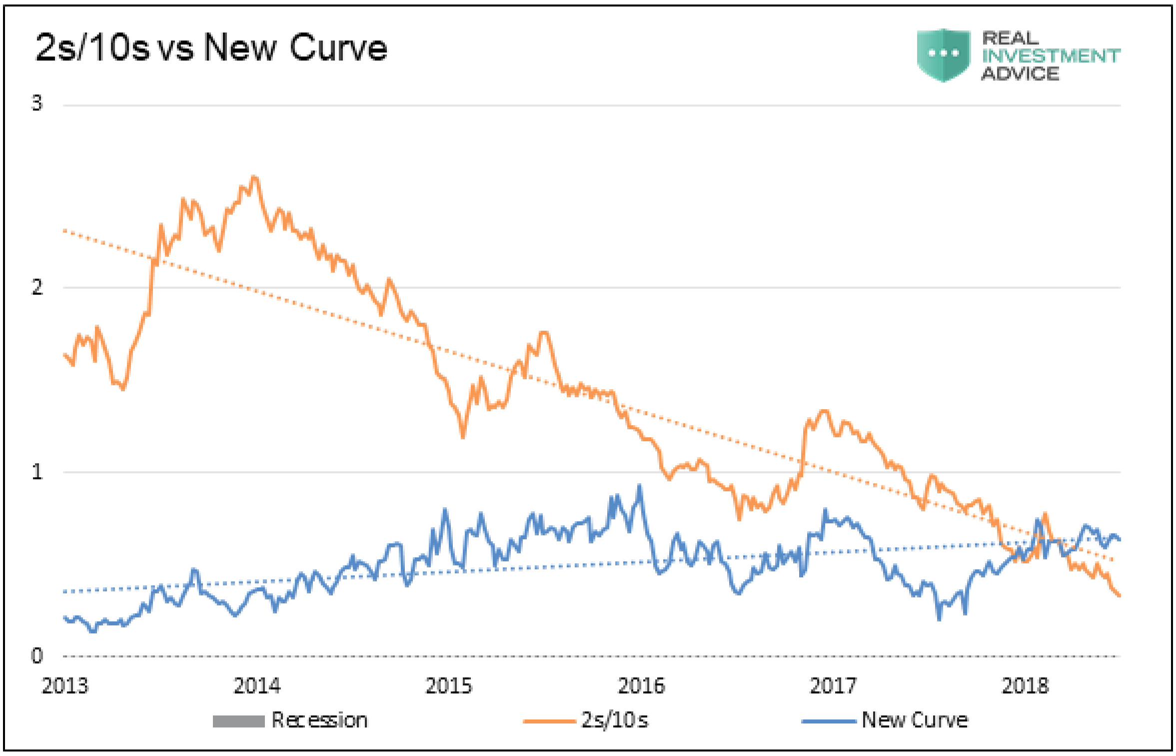
The red dashed line shows investors had slightly higher expectations for the Fed Funds rate than the rate that came to fruition from 2014 through 2016.• Conversely, the green dashed line shows that investors have been too low in their estimates of future Fed Funds rates by approximately 0.25% on average since January 2017. The next graph looks forward and compares Fed Funds futures to the Fed Funds rate expectations for each member of the FOMC. Each dot represents a Fed members? expectation for the average Fed Funds rate for that particular year. The red triangle denotes the FOMC average for the year. To contrast, the orange boxes represent the average of Fed Funds futures, or the markets expectation for the average fed funds rate, for each year. The differences between market based expectations and FOMC expectations are 0.20%, 0.46%, and 0.63% for 2018, 2019 and 2020 respectively.



A New Curve - A New Narrative In our recently issued article, *The Mendoza Line*, we explained that the Fed introduced the validity of using a ?New? yield curve versus the customary 2s/10s yield curve at the most recent FOMC meeting. The article points out that an inversion of the customary 2s/10s yield curve has preceded economic recessions with resounding accuracy. Currently, the 2s/10s yield curve is flattening rapidly and causing the media and investors to take note. The ?New? curve has been meandering over the last few years and does not suggest the same caution. The article?s takeaways include the following:

- ?*The Fed has much more control over the shape of the new curve than the traditional curve.*?

- *?The trend and impending signal from the traditional curve is leading investors to second guess the Fed and their tightening campaign.?*
- *?If, on the other hand, investors buy into the new curve and its upward sloping shape, might they be persuaded a recession is not in sight and their confidence in the Fed will remain strong??*



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Why the Fed

is more Hawkish than investors We believe there is one crucial reason why the Fed is resolute to raise rates mo… …even recessions, the Fed Funds rate was lowered o… …elow. While the last recession of 2008 only saw Fed F… …a $3.6 trillion bond-buying program

Recession	Fed Funds Start	Fed Funds End	Change
1969	9.15	3.29	-5.86
1973	12.92	4.82	-8.10
1979	17.61	9.03	-8.58
1981	19.04	8.80	-10.24
1990	9.81	3.09	-6.72
2001	6.50	1.01	-5.49
2008*	5.26	0.00	-5.26
Average			-7.18

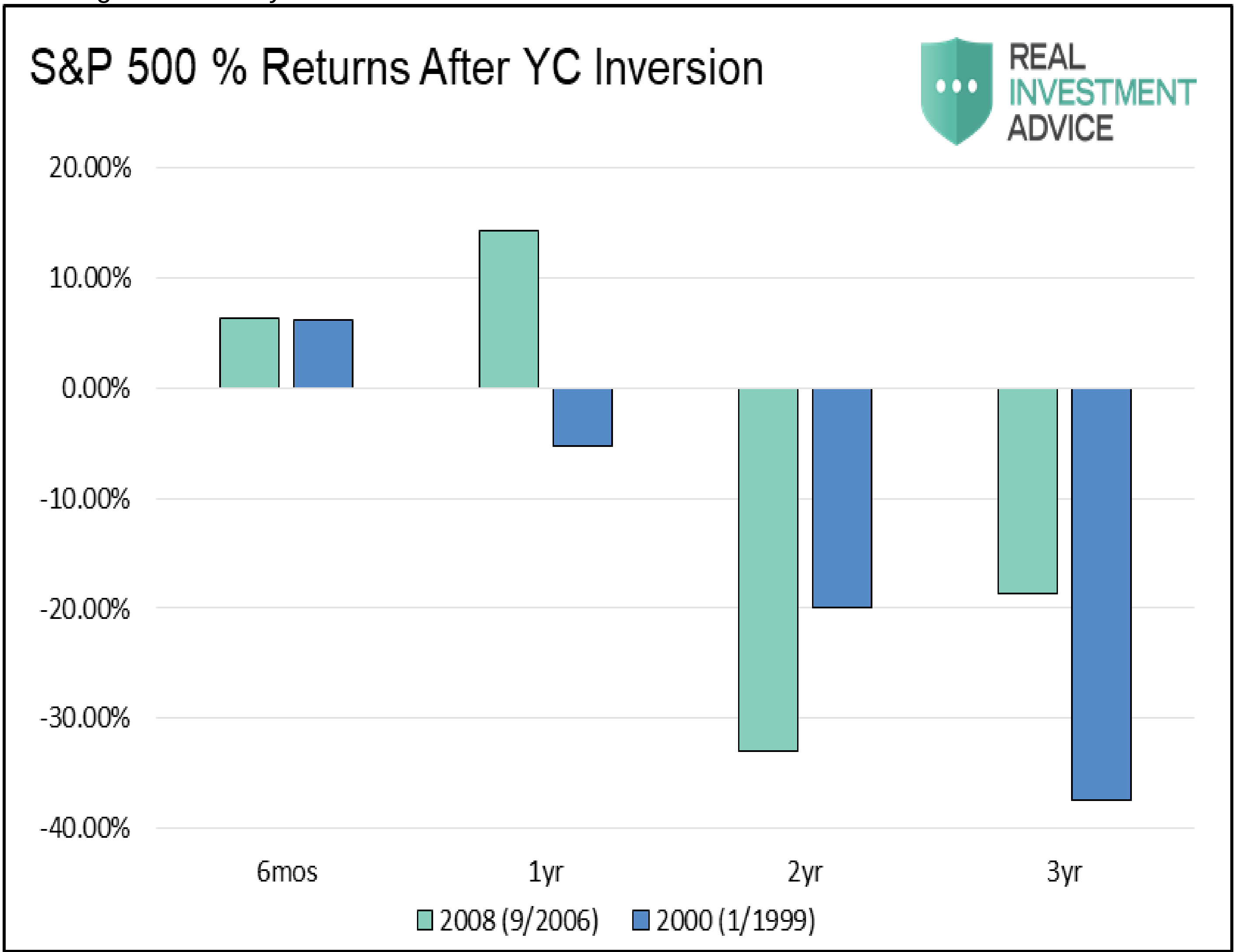
* QE = $3.6 Trln.

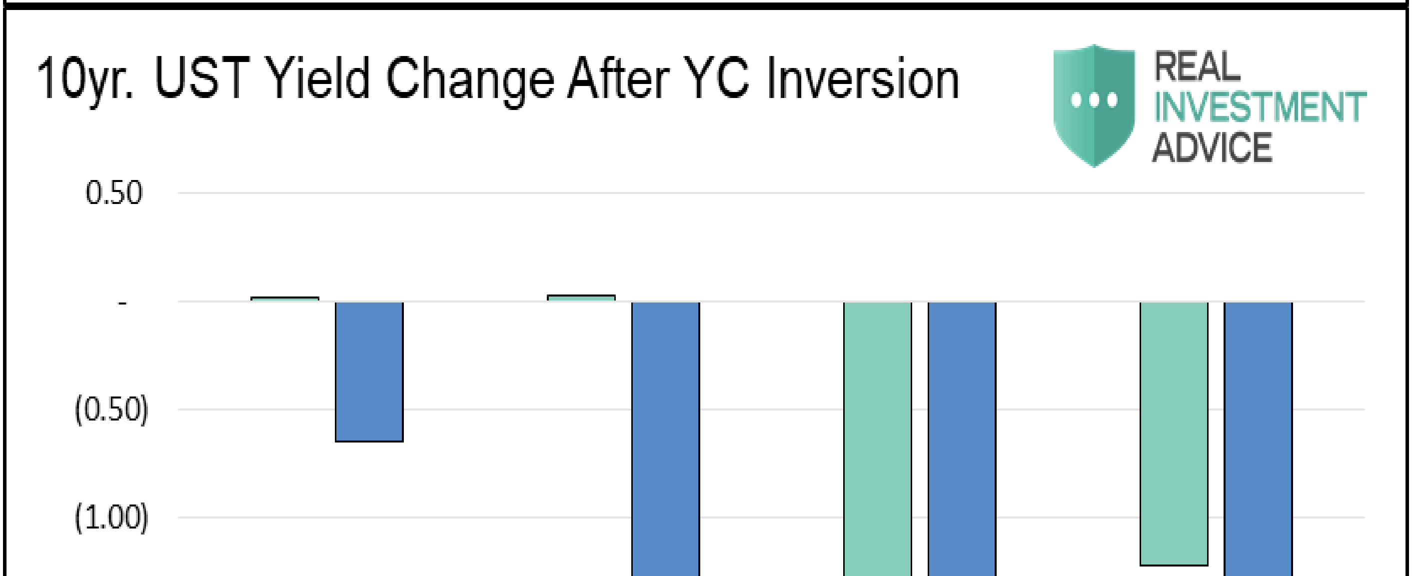
known as QE. If a recession were to start this year or

next, with Fed Funds trading between 2% and 3%, the Fed would be significantly limited in their ability to lower interest rates and boost economic activity. **The Fed is quite likely providing themselves more room to lower rates in the future, and thus are intent on getting the fed funds rate higher than what the market believes.** The following are other concerns that may also be driving the Fed aggressiveness:

- Surging fiscal deficits ? ?Fed's Dudley Worries Tax Cuts Risk Overheating U.S. Economy?- Bloomberg
- Tariffs ?"The Latest Proposed Tariffs Would Significantly Boost Core Inflation? ? Ian Sheppard
- Employment ? ?Moreover, if the labor market were to tighten much further, there would be a greater risk that inflation could rise substantially above our objective,? ? Jerome Powell
- Deficit Funding ? Foreign holdings of U.S. Treasuries have declined over the last six Higher interest rates may be required to incentivize domestic capital to offset foreign demand.

Investment Implications In the second part of this series we will discuss how the resolution of the market?s dovish opinion versus the Fed?s hawkish stance might affect various asset classes. In the meantime, we share data on how equities and bonds performed during various periods following the last two yield curve inversions.





Summary As mentioned at the opening, when the market and the Fed have a sharp difference of opinion as is currently the case, the possibility of significant market volatility increases. The Fed is leaving us few doubts that they would like to keep raising rates at a measured pace. Chairman Powell has also voiced more concern than his two predecessors with the prices of financial assets. In fact he has shown unease that some assets are in valuation bubbles. Chairman Powell brings one distinct advantage to his new role over his three predecessors ? he has an odd tendency to speak plain English. That does not eliminate the uncertainties of the economy and a possible change in plans for monetary policy, but it certainly reduces them. **Market participants and Fed watchers seem to have been too well-conditioned to the PhD-like jargon of Greenspan, Bernanke, and Yellen and fail to recognize the clear signals the current Chairman is sending.** As stewards of capital who understand the importance of the Fed?s interactions, our obligation is to appreciate that this Chairman says what he means and, in all likelihood, means what he says. Rate hikes, although gradual in pace, are likely to keep coming.