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Powell Now Owns the Fed's Balance-Sheet Problem; The Fed's signal that it may stop shrinking its balance sheet soon sent stocks soaring but may store up future trouble for Fed Chairman Jerome Powell

By Spencer Jakab
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Eight proved to be a lucky number for markets, though it might not be for Jerome Powell.

The past seven times that the Federal Reserve's rate-setting committee had met, stocks fell for the day, the longest streak of any Fed chair under the current rate-setting system. The last one in December was a doozy: 1,800 points were wiped off of the Dow Jones Industrial Average over the next four sessions.

On Wednesday, Mr. Powell broke the streak. That is especially notable since some 3,000 points had been tacked back onto the index since the December swoon, in no small part because the prospects of further tightening this year have nearly vanished. Wednesday's Fed statement and Mr. Powell's press conference put an exclamation pointon the shifting proclivities of America's monetary policy makers, sending stock prices surging and the U.S. dollar and bond yields tumbling.

As usual, market expectations accurately predicted a coming official shift in the Fed's intentions. By Wednesday morning, the chances implied by the futures market of any rate increase over the course of 2019 had shriveled to barely 25% and the odds of a cut were over 5%, according to analysts at Bespoke Investment Group. The famously plain-spoken Mr. Powell left the market with little doubt that the probability of tightening had shifted, noting on Wednesday that "the case for raising rates has weakened."

But policy rates are only part of the story these days. Since the financial crisis, the Fed has used its balance sheet as a powerful tool, buying bonds to affect the shape of the yield curve. Since late 2016, it had begun to slowly unwind those purchases, most recently at a pace of $50 billion a month—a huge number in almost any other context, but not much compared with what was a $4.4 trillion balance sheet. The Fed's balance sheet has only shrunk by about 10%.

In what arguably was Mr. Powell's most significant statement on Wednesday, he struck a dovish tone on this process of "balance-sheet normalization." The signal was that so-called quantitative tightening would continue for now but end sooner than expected. Moreover, he also raised the possibility that the balance sheet could be "an active tool" in the future if warranted—in other words, more bond purchases if markets or the economy cry out for help. Until recently, Fed officials had been insisting the balance-sheet shrinkage was on autopilot.

The new stance also is a huge shift from Mr. Powell's stance as a Fed governor back in January 2013, according to recently released minutes. He warned at the time, when the Dow Jones Industrials were around 10,000 points lower than today, that the policies risked "driving securities above fundamental values" and that "there is every reason to expect a sharp and painful correction."

With stocks nearly entering a bear market following the December meeting, it seems he was right. Now, though, taming the Fed's monster balance sheet is Mr. Powell's problem.

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Consumer-Staples Stocks Fall Out of Favor as Investors Embrace Risk; Shifting consumer habits and rising costs are also pressuring staples companies

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Investors aren't hiding out in the consumer-staples sector anymore.

Shares of companies selling everyday household goods such as cereal, shampoo and dish soap are underperforming the S&P 500 in January. That is partly due to a series of disappointing earnings reports from companies including McCormick & Co. Inc., Colgate-Palmolive Co. and Kimberly-Clark Corp., along with signs that investors are willing to take on more risk in other corners of the stock market.

The S&P 500 has rallied 7% to start 2019 after suffering its worst December selloff since 1931. But the staples sector largely has been left behind, adding just 3.1%. Only the utilities sector has posted smaller gains.

January's performance is a reversal from late last year when some investors found solace in shares of staples companies, which are popular during periods of volatility because of their hefty dividend yields and the steady nature of their businesses. Because consumers usually continue buying the products that staples firms sell regardless of market or economic conditions, investors tend to view the sector as a haven.

Staples companies in the S&P 500 shed just 6% in the last three months of year, well short of the losses in the financial, industrials, energy and discretionary groups, which all declined at least 14%. Those four groups are back in favor in January, all surging more than 8.5%.

"As the market continues to go up, we're slowly taking the shackles off," said Ken Mahoney, president at Mahoney Asset Management, which has $200 million under management, referring to investors' recent rotation out of safety stocks like staples and utilities.

Mr. Mahoney said his firm added exposure to the First Trust Consumer Staples AlphaDEX Fund, whose largest holdings include Molson Coors Brewing Co., meat processor Tyson Foods Inc. and packaged-food company J.M. Smucker Co., at the beginning of the fourth quarter in a bid to be more defensive. But it decreased those holdings in early January, he said, after Federal Reserve Chairman Jerome Powell signaled the central bank would take a more cautious path toward raising interest rates, removing one of the market's big overhangs.

Other investors say they are maintaining some exposure to the stocks in the sector because of their defensive nature. Scott Snyder, portfolio manager at ICON Advisers, which has roughly $1.5 billion in assets under management, said his firm has been buying shares of consumer-products giant Procter & Gamble Co. and beverage maker Coca-Cola Co. in recent months because of their strong earnings growth and favorable dividend yields.

The staples sector has a dividend yield of about 3.07%, exceeding the broader S&P 500's 1.99% yield and topping the 2.712% yield on the 10-year U.S. Treasury note.

"When the market is in full risk-on mode like it is so far this year, you don't expect this sector to be the shining star or the darling of your portfolio," Mr. Snyder said.

Other headwinds facing staples stocks: shifting consumer habits and rising costs. Spice maker McCormick has tumbled 12% since projecting weaker earnings and sales for the year last week. Colgate, meanwhile, said its earnings are also expected to slump, amid higher raw material prices and global economic uncertainty. And

Kimberly-Clark, the maker of Huggies diapers and Kleenex tissues, blamed rising commodity costs and currency swings for its slowdown in profit and sales in the final quarter of 2018.

The staples sector as a whole is expected to post among the weakest fourth-quarter earnings growth of the 11 sectors in the S&P 500. With results in from 30% of the companies in the group, profits are projected to rise 3.6%, versus an 11% expected gain for the broad index.

"This has been a really frustrating sector for the past few years," said Timothy Chubb, chief investment officer at Girard, which has $3.6 billion in assets under management. "A lot of these companies in the consumer-goods space haven't been able to progress and stay on top of the consumer as they change tastes."

Mr. Chubb said his firm has maintained its position in tobacco maker Altria Group Inc. because of the company's decision to become more nimble but has stayed away from Campbell Soup Co., which has shed 25% over the past 12 months, because of slowing sales.

Some investors still say staples stocks are too pricey. They were trading at about 18.03 times trailing earnings as of Tuesday, down from 22.12 at the end of 2017, while the S&P 500 was trading at 16.39 times earnings, down from 20.49, according to FactSet.

"It's a space that's gotten shaken up, but it will be attractive at some point," said Brian Sterz, portfolio manager at Miracle Mile Advisors, which has $1.5 billion in assets under management. "If we do get a pullback in the market, that's a sector we're going to look at much more closely."

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