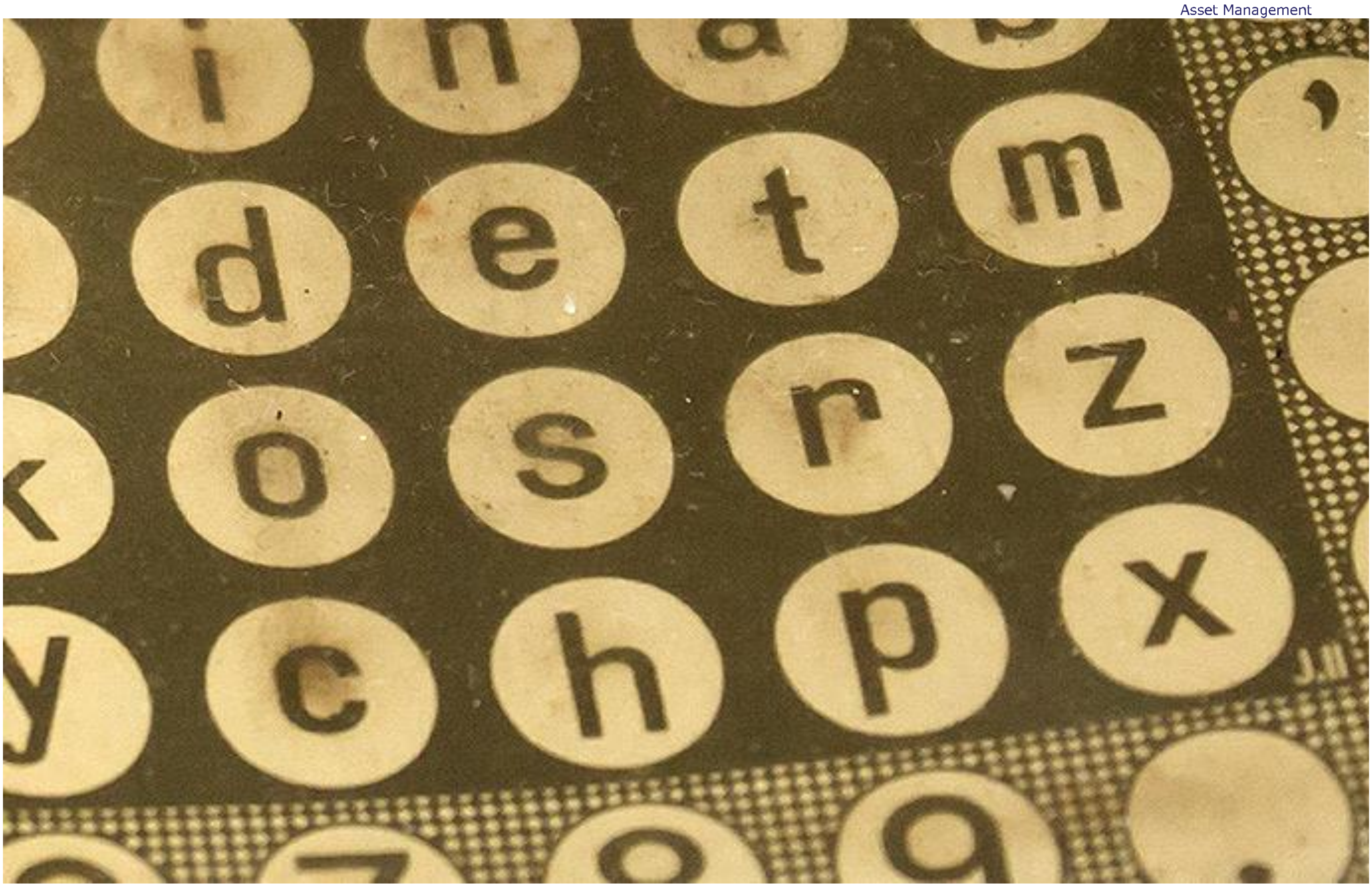

Deciphering Fedspeak

The Fed hikes rates despite a stubborn inflationary backdrop

News Analysis

by
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The Federal Reserve (Fed) raised rates by 25bp as widely expected this week, with Chair Yellen pointing to further rate hikes to come over the months ahead, as the Fed continues to normalise monetary policy towards a neutral stance, after a prolonged period of policy accommodation. The dot plots from the Federal Open Market Committee (FOMC) were essentially unchanged compared to the March meeting and remain much more hawkish than market projections, which discount only two further moves before the end of 2019. However, a slightly more hawkish Fed failed to prevent Treasury yields from rallying, with inflation (or the lack of it) the overriding theme grabbing all of the attention. US core CPI slipped to +1.7% year-on-year and is now 0.5% below the level at the start of this year. Price declines in sectors such as telecoms and cable TV have clearly created one-off disinflationary impacts in recent months, though it is striking to observe how technological change is acting as a restraint on prices more broadly. Although the Fed has been pretty sanguine with respect to one-off effects up to this point, should these trends persist and should wages fail to pick up, then the assumed neutral level of interest rates will probably continue to need to be revised lower.

At this weeks' meeting, the Fed also gave details regarding its intention to reduce its balance sheet by paring the reinvestment of maturing securities, which it owns. We believe that the FOMC is keen to put the balance sheet onto auto-pilot in order to minimise the risk of a more disruptive outcome, should a new Fed Chair be installed in Q1 next year. Were this process to commence in September, the total extent of balance sheet reduction appears unlikely to exceed US$500 billion before the end of 2018 based on a taper, which starts very modestly. In this context, based on other Fed papers we believe that this move is unlikely to equate to more than 25bp on rates later next year and consequently, this should have little bearing on future interest rate decisions unless market sentiment turns and Treasury yields rise, forcing a tightening of financial conditions. Notwithstanding this, current indicators of financial conditions today, actually suggest that policy is more accommodative today than when the Fed started raising rates in December. Although the Funds rate has now risen by 75bp since December, long dated yields are modestly lower, the US dollar is softer and the US equity market is close to historic highs, helping to generate positive income effects. As we reflect on this, we continue to see the Fed normalising policy and project a further four hikes before the end of 2018. The economy remains in healthy shape in our opinion and although falling inflation is a risk to this view, we believe that a robust labour market will see wage gains hold up and consequently the Fed will be able to continue on its course as long as there are no major external shocks to the global economy in the interim.

Elsewhere, it was interesting to see UK inflation accelerate to 2.9%, even as it goes in the opposite direction elsewhere. As we digest the fallout from last weeks' election, we see less austerity and more scope for an expansionary fiscal policy with the economy appearing to slow as the prospect of Brexit becomes more of a reality. Consequently, we believe that the recent move up in prices is unlikely to be rapidly reversed and therefore the Bank of England is unlikely to accommodate monetary policy further. With 10-year Gilt yields below 1%, real yields are in deeply negative territory and look materially overpriced in our view. We favour Bunds versus Gilts and more broadly seek a bleak outlook for all UK assets looking forward with political upheaval likely to persist in the weeks and months to come.

Meanwhile, the outlook in Europe and elsewhere appears quite a lot more cheerful. Corporate credit spreads have continued to rally on robust growth, earnings and accommodative policies. Most sectors have continued to rally in the past week, notwithstanding a drop in tech stocks in the Nasdaq after recent strong gains. However, commodities have been under some pressure as oil prices have fallen due to concerns regarding inventories and declining Chinese demand growth. This has weighed on some emerging market names in the past week and we continue to see more scope for performance from local market rates, where a number of central banks in emerging markets appear set to cut interest rates as domestic price pressures ease.

Looking forward, we believe that market attention will fall back on economic data. The US data surprise index is currently at a two year low and statistically appears likely to turn in the days ahead. In order for the Fed to hike again in Q3 or Q4, we need to see the labour market remain firm and for inflation to stop falling; though the FOMC has shown us that the bar to them normalising rates further is relatively low and we continue to believe that market pricing of the Fed trajectory remains far too sanguine. There is a risk that a Fed perceived in a hawkish light could cast a shadow over risk assets, yet policy remains very accommodative (as highlighted by financial conditions) and policy tightening remains very gradual compared to past economic cycles. A more abrupt tightening at a later point in time would pose a much bigger threat to the economic expansion and so the actions of the Fed can be seen as prolonging the expansion. Moreover a moderation in inflation and a flatter yield curve should not be over-interpreted as harbingers of a coming economic slowing. Technological advance is likely to accelerate growth in view, even as it pulls inflation structurally lower. This should create a constructive environment for risk assets and ensure that policy remains benign and so we continue to believe that it is appropriate to remain positioned to benefit from carry within the portfolio, whilst protecting from a more general reflation trade should growth pick up and yields start to rise.

Away from the boom in crypto-currencies (it was interesting to global 'peace envoy' Dennis Rodman back in North Korea this week promoting 'Potcoin' as an alternative to Bitcoin), we see little evidence of bubbles in valuations and broadly speaking feel that the summer should see solid performance from risk assets. As for Potcoin itself, given that it is convertible into cannabis, when it inevitably goes up in smoke, as it and its kin most probably will, one supposes that at least investors will manage to stay pretty mellow, even if they are nursing losses on their investment.