US risks lie to the upside

News Analysis

As the Federal Reserve begins to unwind QE, a robust economic outlook and the prospect for an agreement on tax cuts could push US yields higher.

by
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This week's Federal Reserve (Fed) meeting confirmed the start of quantitative tightening with a gradual reduction in the Fed's balance sheet commencing in October. Although this came as no surprise to markets, a hawkish tilt came from the Committee's dot projections, which indicate that the Fed expects to hike again in December and then three times subsequently in 2018. This rate profile has been very consistent with our own thinking, but stands in marked contrast to market pricing. At the start of September, markets discounted less than one rate hike through December 2018 and even with yields rising in the past month, not more than two such hikes remain accounted for. Like the Fed, we are hopeful that cyclical pressures may lift inflation from its recent lows in the months ahead and with the growth outlook remaining robust, we believe that rates will return to a neutral level between 2% and 3% on a gradual path. Meanwhile, we see the prospect for an agreement on tax cuts as an upside risk to our forecasts and consequently believe that a short duration stance at the front end of the US curve continues to be warranted.

Higher US yields have also pushed yields somewhat higher in the eurozone on the thinking that a more hawkish Fed makes it easier for the European Central Bank (ECB) to taper its bond purchase programme. Here our meetings with policy officials suggest that the ECB will be careful to retain a dovish stance so as to avert further upward pressure on the euro, which could stifle the current economic recovery currently taking hold across the region. This should help to anchor German Bund yields, given a relatively steep yield curve and no real prospect of higher rates for another 18 months. By contrast, UK Gilts appear more vulnerable to the move up in US yields. We continue to look for a larger inflation risk premium and political risk premium in UK assets. Notwithstanding the speech Theresa May is due to give later today, we see any hope of an early agreement with the rest of the EU as likely short lived. We feel the muppets of Westminster remain deluded by the idea that Europe needs the UK more than the UK needs Europe, when the truth is very much the other way around. There remains no incentive for the German government to acquiesce to UK demands and we suspect that the EU is happy to see the political temperature in the UK rise as the clock ticks down to 2019. Holding a tough line with miscreant countries such as Greece has appeared to pay dividends for EU officials and there is a hope that the UK government can be brought to heel or new elections triggered that could see an outcome in which Brexit is reversed. This will surely be an area of much scrutiny as we head through 2018, yet for now, we feel it is very likely for political worries to increase rather than dissipate in the wake of May's upcoming intervention.

Elsewhere in Europe, assets in the periphery were buoyed by a credit upgrade in Portugal, with S&P returning the sovereign to investment grade. Although Portugal won't re-join European government bond indices yet, we see this as a matter of when not if. With Portugal bond supply relatively scarce the rating move saw a sharp revaluation, with Portuguese government bond spreads over 40bps tighter on the week relative to German Bunds. Cyprus saw a move of a similar magnitude with its BB+ rating moved to a positive outlook. Corporate spreads also rallied over the week and it was striking to see the S&P remain at its highs, even with a somewhat more hawkish Fed. However, price action in emerging markets was notably softer during the week, partly due to a firming US dollar, but also owing to some negative newsflow in Turkey (Kurdish referendum in Iraq), Mexico (earthquake) and India (an easier fiscal stance).

As we look ahead, it seems that the key question we and other investors are asking ourselves is whether or not risk assets can continue to trade well, should US yields continue to rise. For the time being, we feel this is likely to be the case as economic data will offer little information of value due to hurricane-related distortions and before we reach the Fed meeting in December, a lot can happen in the meantime. For now, much of our focus remains on Congress but we are also awaiting news on Trump's Fed appointments, which may likely be announced in the next two months. At the moment, we don't have a clear sense of who will be the next Fed Chair, but we think markets may be naïve to assume that Trump will seek a 'low interest rate guy' with a clear dovish bias. Ultimately, the President will want the economic expansion to keep going up until the next election and in this context, it would be wrong to jeopardise financial stability by running accommodative policies for longer than is needed.

In contrast to some of the political and policy intrigue in the US and the UK, it seems like the eurozone looks like something of an oasis of calm. Policymakers across the continent seem to be basking in the afterglow of an improving economy, strengthening banking sector and declining political risk and there is a discernibly upbeat mood in European capitals these days. As for the ECB, there certainly seems to be plenty to dance about.