Global Asset Management

BlueBay Asset Management

Investors Risk a ‘Nasty Surprise’ from the Fed

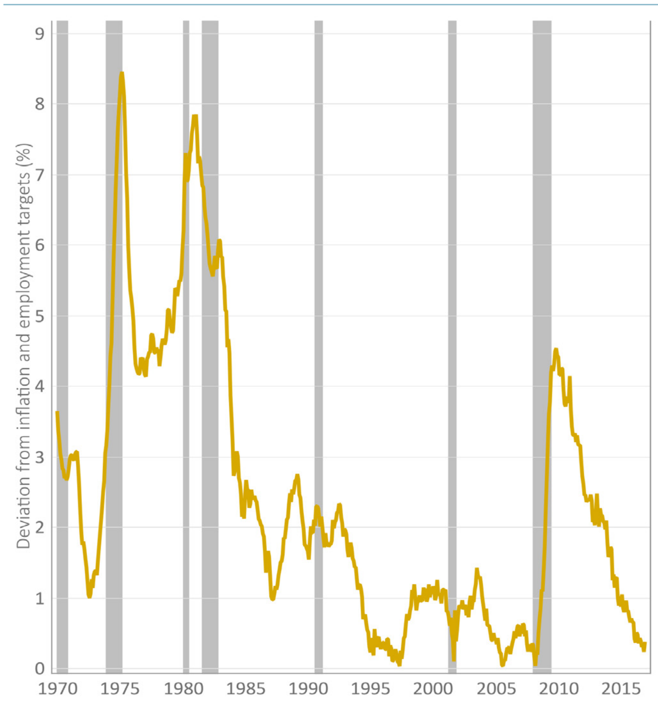
January 20, 2017

Federal Reserve (Fed) Chairwoman Janet Yellen recently warned of the risk of a “..nasty surprise down the road..” if the Fed waits too long before moving interest rates to a ‘neutral’ level. In our view, market expectations under-state the likely magnitude and pace of Fed rate hikes over the coming 18 months, including the likelihood of an interest rate increase at its 14-15 March meeting.

Last Wednesday (18 January 2017), Fed Chair Janet Yellen acknowledged that the US economy is near maximum employment and inflation is moving towards the Fed’s 2% target. She went on to state that the Fed funds rate is expected to be raised a “..few times a year until, by the end of 2019, it is close to our estimate of its longer-run neutral rate of 3%”. In our opinion, the Fed will raise interest rates three or four times this year compared to the two implied in futures markets.

Exhibit 1

Inflation and Employment Close to Fed Target



Note: shading denotes NBER - dated US recessions; see footnote 1 for more detail on the loss function.
Source: Macrobond; BlueBay calculations; latest monthly data for December 2016

The deviation of actual inflation and employment from the Fed’s 2% target and goal of ‘maximum employment’ is illustrated by the gold line in Exhibit 1[1]. In the aftermath of the 2007-08 global financial crisis, unemployment in the US jumped from a pre-crisis low of 4.4% to 10% and inflation (using the Fed’s preferred inflation measure, core PCE) fell from above 2% to 1%. As Exhibit 1 illustrates, the financial crisis and consequent recession resulted in the most dramatic deviation in inflation (to the downside) and employment from the Fed’s target since the recession of the early 1980s (recessions are denoted by shaded columns).

In response to the extraordinary deviation of unemployment and inflation from its objectives, the Fed responded with extraordinary monetary policy, cutting policy rates to almost zero along with large scale bond purchases (QE). As the economy recovered and unemployment fell, the Fed tapered QE and in December 2015 it raised its policy rate (the Fed funds rate) for the first time since June 2006. Yet despite the continuing decline in the unemployment rate to its ‘natural’ rate of around 4¾% and a gradual rise in inflation, the Fed waited a further twelve months before raising interest rates again.

Janet Yellen noted that waiting too long before moving towards the ‘neutral’ policy rate could risk a “nasty surprise down the road” in terms of too much inflation or financial instability, forcing the Fed into rapid rate hikes tipping the economy into recession. In our view, the market under-estimates the willingness and necessity of the Fed raising interest rates at least three times this year and next in order to head off the risk of being forced to raise rates too much too late.

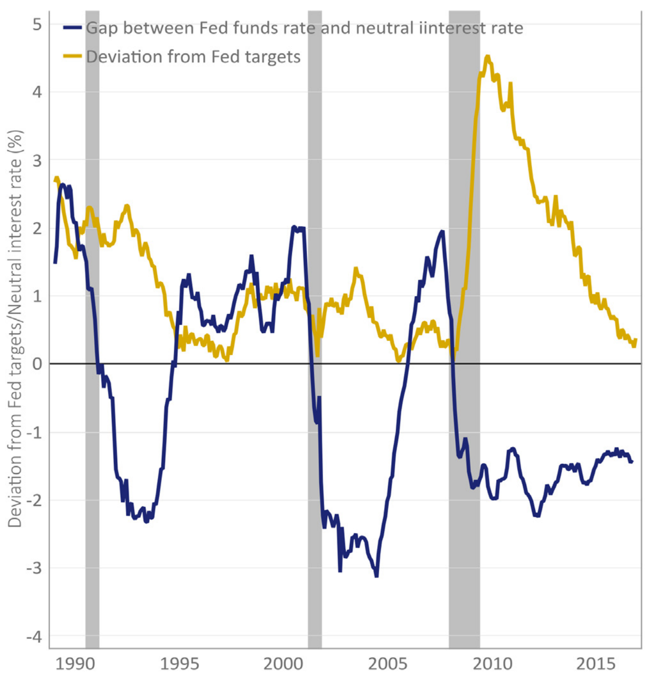
In Exhibit 2 the deviation in inflation and employment from target is overlaid by the gap between the real (inflation-adjusted) Fed policy rate and the ‘neutral’ real interest rate – the level of short-term interest rates that at full employment is neither simulative or restrictive and consistent with stable growth and inflation.[2] It shows that the Fed interest rate remains far below the ‘neutral’ rate despite the Fed being close to fully meeting its inflation and employment goals. Even without a meaningful fiscal stimulus from the incoming Trump administration, we believe the Fed will reduce its monetary stimulus by eliminating the gap with the neutral rate,

[1]The gold line is based on a simple ‘loss function’ defined as follows: $L = (\pi\text{-}\tilde{\pi})^2 + (u\text{-}\tilde{u})^2$ where π is currently inflation and π is current inflation and $\tilde{\pi}$ is the inflation target, u is current unemployment rate and $\tilde{u}$ is the ‘natural’ rate of unemployment, ie that leve of unemployment associated with full employment in light of structural economic features of the labour market and economy.

[2]Laubach-Williams neutral (real) rate of interest estimates, Federal Reserve Bank of San Francisco

implying at least 150bps of rate hikes over the next 18 months. If labour market and inflation data continue to show convergence to the Fed's goals over the next few months, the likelihood of the Fed raising interest rates at its March 14-15 meeting is greater than the one-in-three chance priced in futures markets.

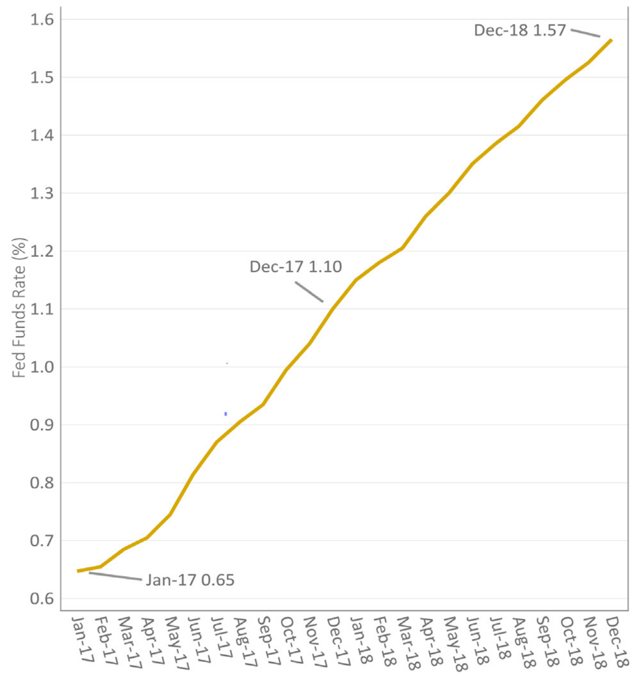
Exhibit 2
Gap Between Current and Neutral Fed Policy Rate



Note: shading denotes NBER - dated US recessions; see footnote 1 for more detail on the loss function; Laubach-Williams estimate of the 'neutral' rate policy rate.
Source: Macrobond; BlueBay calculations; latest monthly data for December 2016

Despite the 'consensus' amongst many market participants that higher US interest rates are likely, interest rate futures markets are only anticipating two 25bps Fed hikes in 2017 and the same in 2018 (see Exhibit 3). In our view, the most likely 'nasty surprise down the road' is for investors that have too much duration and too little risk premia in their portfolios as the Fed moves further and fasterthan currently priced in bond and futures markets.

Exhibit 3
Fed Funds Futures Curve



Source: Macrobond; BlueBay calculations; latest monthly data at 18 January 2017

David Riley
Partner, Head of Credit Strategy
BlueBay Asset Management