Global Investment Event

14 December 2017

United States: Fed signals three more rate hikes in 2018

- At one of the last meetings with Janet Yellen as Chair, the US Federal Reserve (Fed) raised the fed funds rates by 25bps to 1.25-1.50%. It also left unchanged the parameters of the "cap" system via which it shrinks the balance sheet
- The latest Fed quarterly projections continue to highlight robust economic activity. GDP growth expectations for this year and next were revised up to 2.5%. The forecast of the 2017 unemployment rate was also cut to 4.1%
- Despite concerns that the phenomenon of low inflation could be due to something more permanent in the system, core PCE is still projected to rise to the Fed's 2.0% target in 2019
- The new Fed "dot plot" continues to signal three rate hikes in 2018 and two in 2019. The Fed's estimate of the "terminal" fed funds rate was left unchanged at 2.75%, following a 25bps reduction in September
- Our core asset class views are unchanged. We remain underweight government bonds and global corporate credits, and overweight global equities. We also remain constructive on emerging markets equities and local currency debt

Fed signals three more hikes in 2018

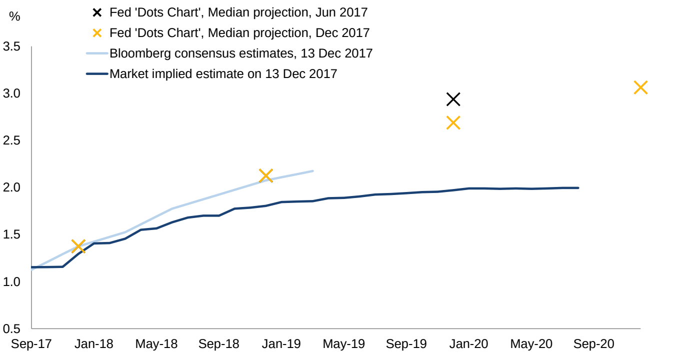
As widely anticipated, the Fed raised the fed funds rates by 25bps to 1.25-1.50% at its December meeting. This was the third and final rate hike this year.

For the first time since 2014, the total number of rate hikes this year is the same as the Fed's median forecast in the December prior. The Fed also left the parameters of the "cap" system via which it shrinks the balance sheet unchanged.

The accompanying statement, Janet Yellen's final press conference as Fed Chair, and the latest Summary of Economic Projections continued to convey an upbeat assessment of US economic activity. The GDP growth forecast for 2017 was revised slightly higher to 2.5% (2.4% previously). Looking ahead, the figures for 2018-2020 were upgraded to 2.5%, 2.1% and 2.0%. The estimate of the 2017 unemployment rate was reduced to 4.1% from 4.3%, whilst the long run value remained unchanged at 4.6%. Meanwhile, core PCE inflation forecasts for 2017 and 2018 were left unchanged at 1.5% and 1.9%, respectively. This followed a slight downgrade in September.

Assuming economic data holds up and cyclical inflation materialises, the Fed's "uber-gradual" normalisation of policy remains in play. Their median projection of interest rates (or "dot plot") still signals three more rate hikes in 2018, two in 2019 and at least one final hike in 2020. The terminal policy rate is left unchanged at 2.75%, following a reduction of 25bps in September.

Figure 1: Fed rate projections versus the market



Source: US Federal Reserve, Bloomberg as at December 2017

Investment implications

The Fed has justified rate hikes in 2017 by good growth and concerns over financial stability, whilst looking through persistently low inflation.

Nevertheless, cyclical inflation is likely to tick up as the labour market strengthens further. There are also upside risks arising from positive base effects of some components (e.g. wireless phone services) and the possibility of tax reforms. However, it is important to note that any inflation uptick is unlikely to be substantial, given prevailing factors such as sticky inflation expectations and reduced bargaining power of labour.

Consequently, the Fed's "uber-gradual" approach to policy normalisation (both via interest rates and its balance sheet) remains our base case. The nomination of Jerome Powell as Fed Chair also signals policy continuity.

For now, we have not adjusted our asset class views. Relative to our expected trajectory of cash rates, the implied term premium (i.e. compensation for bearing duration risk) is negative for developed market (DM) **government bonds**. Good growth and the potential for rising inflation also provide an unfriendly backdrop for fixed income assets. We maintain our underweight positioning here.

Meanwhile, **global equities** continue to offer the best rewards for backing a continuation of good growth. The market-implied global equity risk premium looks attractive, particularly relative to DM government and corporate bonds. We remain overweight with a preference for equity markets in Japan and the Eurozone. Amid a gradualist Fed, we also continue to be constructive on **emerging market** equities and local currency government bonds.

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