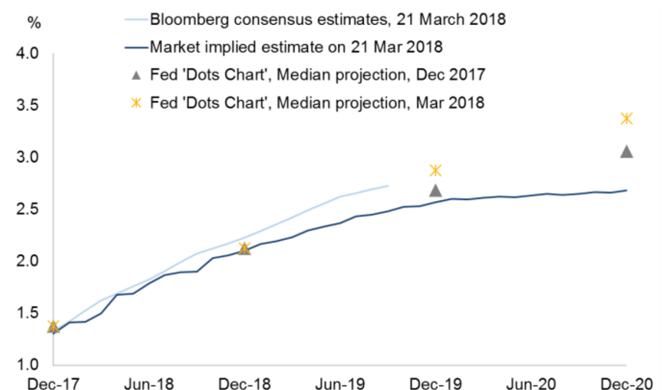
IE
Global Investment Event

22 March 2018

United States: Fed lifts rate projections but remains gradual

- As widely expected, the US Federal Reserve (Fed) raised the target range for fed funds rates by 25bp to 1.50-1.75%. The parameters of the "cap" system via which the Fed shrinks its balance sheet were left unchanged
- The latest Fed quarterly projections continue to highlight an improving economic outlook. GDP growth for this year and next is revised higher to 2.7% and 2.4% (2.5% and 2.1% previously). Unemployment rates for these two years were revised downwards
- The new Fed "dot plot" signals two more rate hikes in 2018, consistent with the December forecast. However, three more rate hikes are now pencilled in for 2019 instead of two. The estimate of the "terminal" fed funds rate was also revised up
- The balance of risks for the rate trajectory is still tilted to the upside. Given current valuations, an underweight positioning in **US Treasuries** still makes sense, although we believe this asset class increasingly offers decent protection against a renewal of economic recession fears. We also maintain a neutral stance on **US equities**

Figure 1: Fed rate projections versus the market



Source: US Federal Reserve, Bloomberg as at March 2018

Fed lifts rates projections from 2019

As widely anticipated, the Fed raised the target range for the fed funds rates by 25bp to 1.50-1.75% at its March meeting. This is the first rate hike of 2018 and the sixth in this tightening cycle which began in December 2015. The Fed also maintained the monthly caps by which it shrinks its balance sheet.

The latest Summary of Economic Projections conveyed an upbeat assessment of economic outlook. GDP growth forecasts for 2018 and 2019 were revised higher to 2.7% and 2.4%, whilst estimates of the unemployment rate for these two years were lowered from 3.9% to 3.8% and 3.6% respectively. The longer run projection for GDP growth was unchanged at 1.8% but the longer run unemployment rate was revised down to 4.5% from 4.6% previously.

In his first post-meeting press conference, Fed Chair Jerome Powell echoed the message in his testimony to Congress in February. He highlighted that "headwinds" to the economic outlook have become "tailwinds", including the recent passage of fiscal stimulus. He also stated that the recent tax reform package could improve supply-side dynamics by inducing an increase in labour supply.

Given this, the median projection of interest rates (or "dot plot") signals two more quarter-point rate hikes in 2018, consistent with the December meeting projection. However, three more rate hikes are now pencilled in for 2019 instead of two. Meanwhile, the terminal rate is revised 10bp higher to 2.9%.

Investment implications

Although the Fed lifts interest rate projections for 2019 onwards, the pace of tightening is still very "gradual" by historical standards. We think that the balance of risks to interest rate hikes is still tilted to the upside.

Economic growth is strong, with our Nowcast tracking US Q1 activity of 3.8% annualised. In addition, US cyclical inflation is likely to pick up as the labour market strengthens further. A more meaningful rise in inflation is a key risk scenario. In this environment, an underweight positioning in **US Treasuries** still makes sense given that prospective returns still look low relative to competing asset classes.

Nevertheless, our measure of the implied term premium (a measure of the compensation for bearing risk associated with unexpected interest rate changes) on 10-year US Treasuries is now significantly higher than for other developed market (DM) government bonds. Therefore, we believe this asset class increasingly offers decent protection against a renewal of economic recession fears.

Meanwhile, strong US (and global) growth is supportive to **US equities**. However, our measure of the implied risk premium (excess returns over cash) remains consistent with a neutral positioning. We have 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 emerging market **local currency government bonds** where we measure relatively high sustainable returns.

Lastly, with the possibility of more aggressive Fed tightening, or the risk of a growth deterioration outside the US, we think that the **US dollar** currently provides cheap portfolio insurance to a multi-asset investor.

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