IE

15 June 2018
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Investment Event

US Fed: Another step towards policy normalisation

- At its June FOMC meeting yesterday, the US Federal Reserve (Fed) raised the target range for the federal funds rate by 25 basis points to 1.75-2.00%
- The Fed's median forecast signals two additional rate hikes in 2018 and three in 2019. The estimate of the "terminal" Fed funds rate was unchanged at 2.9%, continuing to imply a shallower tightening cycle versus previous cycles

Fed raises rates again in June

The Fed voted unanimously to raise the target range for the fed funds rate by 25bp to 1.75-2.00% at its June meeting. It raised the IOER by just 20bp to 1.95%, a technical modification to the current framework to ensure that the effective fed funds rate stays within its designated range. With respect to balance sheet shrinkage, the monthly "cap" system was left unchanged.

The latest Summary of Economic Projections maintained an upbeat assessment of economic activity. GDP growth forecasts for 2018 and 2019 were little changed at 2.8% and 2.4%. Regarding the labour market, estimates of the unemployment rate for this year and next were revised lower to 3.6% and 3.5%. Meanwhile, core PCE inflation estimate should be 2.0% for 2018.

Our views

We maintain our underweight view on US Treasuries (albeit with a positive bias towards a more neutral stance). We also retain a constructive view in emerging markets equities and local currency debt, partly given that the Fed hiking cycle remains gradual

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There were some technical changes in forward guidance. The phrase “the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run” was removed from the statement. This purely reflects the fact that policy rates are now closer to “neutral” levels.

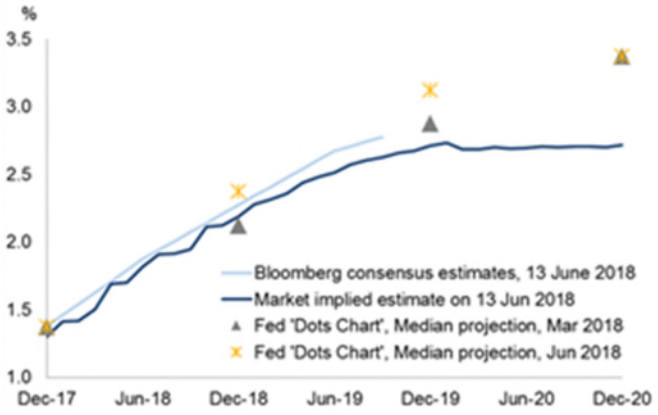
Meanwhile, at the press conference, Fed Chair Powell reiterated that the inflation target is “symmetric”, suggesting that the Fed could tolerate a modest inflation overshoot.

So what next…

The median projection of interest rates (or “dot plot”) now signals a total of four hikes for 2018, one more than March’s forecast. However, this was due to just one FOMC participant upgrading their rate hike view. As before, three hikes are pencilled in for 2019. The median terminal rate was unchanged at 2.9%.

Moreover, Powell announced that the Fed will hold press conferences at every meeting starting January 2019.

Figure 1: Fed rate projections versus the market



Source: US Federal Reserve, Bloomberg as at June 2018

Market considerations

We had fully expected the Fed’s decision, and thus have not altered our asset allocation views. The Fed hiking cycle is “low and slow”, especially relative to historical standards.

For **US Treasuries**, our measure of the implied term premium (the compensation for bearing interest rate and inflation risks) on 10-year notes is now positive, and significantly higher than for other developed market (DM) government bonds. We believe this asset class offers decent protection against a renewal of economic recession fears. We are underweight, but with a positive bias towards a more neutral stance.

Strong US growth on the back of fiscal stimulus has been a tailwind to US equities. However, this optimism is probably already priced in by investors. The implied-equity risk premium (excess returns over cash) for **US equities** is not particularly attractive relative to the rest of the opportunity set. We are neutral here, and have the preference for late-cycle DM’s equity markets such as **Japan and the eurozone.**

We remain constructive on **emerging markets (EM) equities and local currency government bonds**. EM ex. China growth still looks decent, with our Nowcast tracking activity of close to 4% annualised in May. The recent market volatility linked to the re-pricing of US interest rate & inflation risk has boosted valuations, and provided an opportunity to increase tactical allocations in these assets.

A positive inflation shock is the key risk to multi-asset allocators. Such scenario could weigh on performance of both equities and fixed income assets. The US is at the forefront of this risk, and we are monitoring signs of overheating very closely. For now, the Fed appears willing to “look-through” the recent weakness in inflation, continuing to signal its hiking path remains on track. Consequently, there is no change to our broad asset class views.

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