Manulife Asset Management

Market Note

27 September 2018

Fed stays on target

On 26 September 2018 (US Time), the Federal Reserve (Fed) raised interest rates by 25 basis points (bps) to a range of 2.00%-2.25%[1]. Philip Petursson, Chief Investment Strategist, Manulife Investments – Canada, believes that although the Fed will continue to raise rates into 2019, bonds may have reached an inflection point.

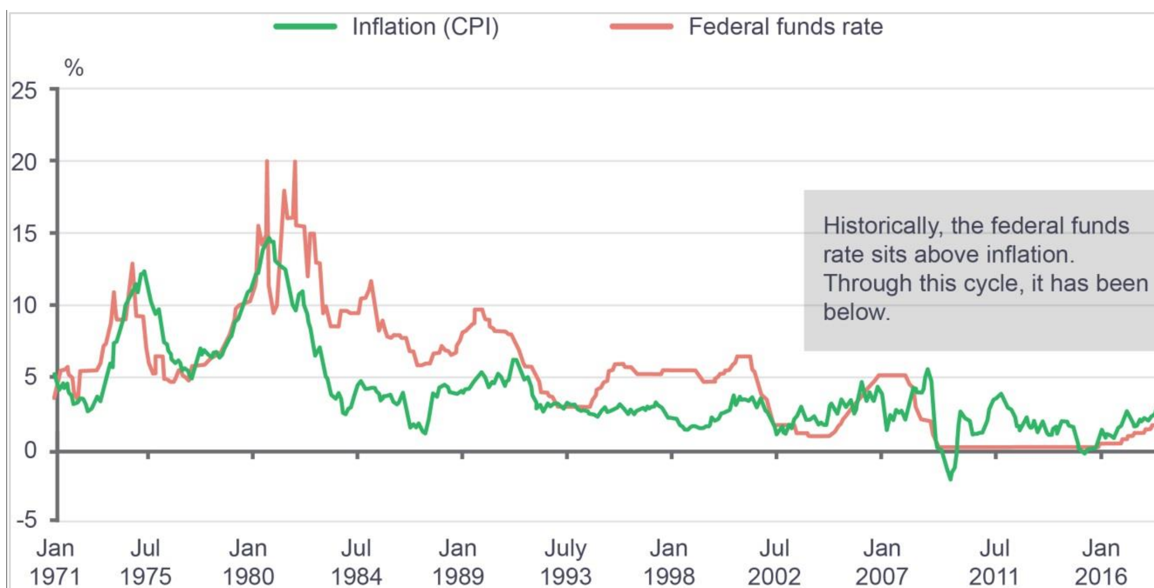
Fed rate hikes likely to continue in 2019

The Federal Open Market Committee (FOMC) raised its target benchmark for the third time in 2018 to 2.00-2.25% on Wednesday (US time). Given that this continues along the path of the Fed's objectives to normalise interest rates, the only surprise here would be whether any market observer was surprised at all.

Our contention this year has been that we would see four rate increases out of the Fed through 2018. To that end, we fully expect one more rate increase in December to bring the upper bound to 2.50%. That would correspond to what the Fed's "dot plots" would suggest as the majority of the committee members (12 out of 16) project the federal funds rate to be 2.25-2.50% by year end.

Going in to 2019, the FOMC is unlikely to stop, as the median dot plots suggest a further three rate increases in 2019 and one more in 2020. While we are reluctant to speculate on Fed policy more than a year out, we would certainly agree with three more rate increases into 2019. That would line up with our expectations for the fed funds rate to settle in approximately 50-100 bps above inflation (Chart 1).

Chart 1: Fed funds rate and inflation[2]



[1] Source: Federal Reserve: FOMC statement, 26 September 2018.
[2] Source: Bloomberg & Manulife Investments, September 2018.

We have often said it is less the level of the fed funds rate that investors need to pay attention to, and more the fact that the Fed is raising rates at all. After raising rates eight times since the shift in policy in late 2015, the Fed is now suggesting that the extended accommodative monetary policy is over. The US economy continues to grow at a healthy pace.

The Fed's projections would suggest GDP growth of 3.1% for 2018 (an increase over the last statement of 2.8%) and 2.5% in 2019 (also an increase, from 2.4% projected in the last statement). Unemployment is likely to remain low and inflation based on our projections is likely to remain above 2.0% through the beginning of 2019. Therefore, the economic environment would certainly justify further rate increases. More importantly, we don't believe continued tightening will grind the economy to a halt.

Inflection point for bonds

We continue to believe the US 10-year Treasury yield will resume its upward trend towards 3.25%. The Fed will continue to push up the short end of the yield curve by another 25 bps this year and by 75 bps next. Because of these forces, we expect the yield curve to continue to flatten and fixed income returns to remain modest. However, bond investors may start to breathe a sigh of relief as we believe the bulk of rate increases, and magnitude of their impact are largely behind us.

As well, the long-run level for the federal funds rate is projected by the committee to be 3% which is lower than the historical average yet lines up well with their long-run inflation expectations of 2.1%. To that end, we would suggest that yields across the curve are near their peak and how far they are headed is certainly going to be more muted than how far they have come. Investors may read this as a reprieve to what has been an otherwise challenging year for fixed income. Suffice it to say, while the Fed is certainly not finished in their rate hiking cycle, we believe we have hit an inflection point with an improved outlook for bonds into 2019.

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