20 December 2018

An oh-so subtle change in tone leaves markets wanting more

The Federal Open Market Committee voted unanimously to raise the Fed Funds Rate target to a range of 2.25% to 2.5%[1]. This didn't come as a surprise, as the December rate hike already seemed like a done deal and the market had largely priced it in. However, given current volatility in the equity and commodity markets, and slower global economic growth, expectations had been building that the Fed would signal an end to further rate increases in 2019. The market didn't quite get what it wanted.

Philip Petursson, Chief Investment Strategist, Manulife Investments – Canada, believes that with Fed's latest move, the Fed appears to support our thesis that the worst is behind us, 2019 looks much improved, and bonds are likely to mark a return to their defensive characteristics.

What should investors take away from the rate hike and statement?

While raising its benchmark rate, the Fed also lowered its projections for 2019 GDP growth from 2.5% to 2.3%, and for core inflation from 2.1% to 2.0%. However, the FOMC statement's language suggested additional rate hikes are still on the table.

"The Committee judges that some ***further gradual increases in the target range for the Federal Funds Rate*** will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2% objective over the medium term. The Committee judges that risks to the economic outlook are roughly balanced but ***will continue to monitor global economic and financial developments*** and assess their implications for the economic outlook."[2]

We are not surprised that the Fed maintained its tightening bias. We wouldn't suggest that the US economy is at the point where it needs monetary stimulus (if you're not tightening, you're easing). Nor would we suggest the Fed Funds Rate is at a level we would call "normalised". It's close, but not there just yet. We believe we can see one to two more rate hikes in 2019 before the Fed pauses. This marks a change from earlier in the year, when we believed we would see 3 rate increases next year. The reason for our shift is that the inflationary impulse we saw in the middle of the summer is fading and will give way to modest disinflation (chart 1).

[1] Federal Reserve, 19 December 2018,
[2] FOMC statement, 19 December 2018.

Market Note

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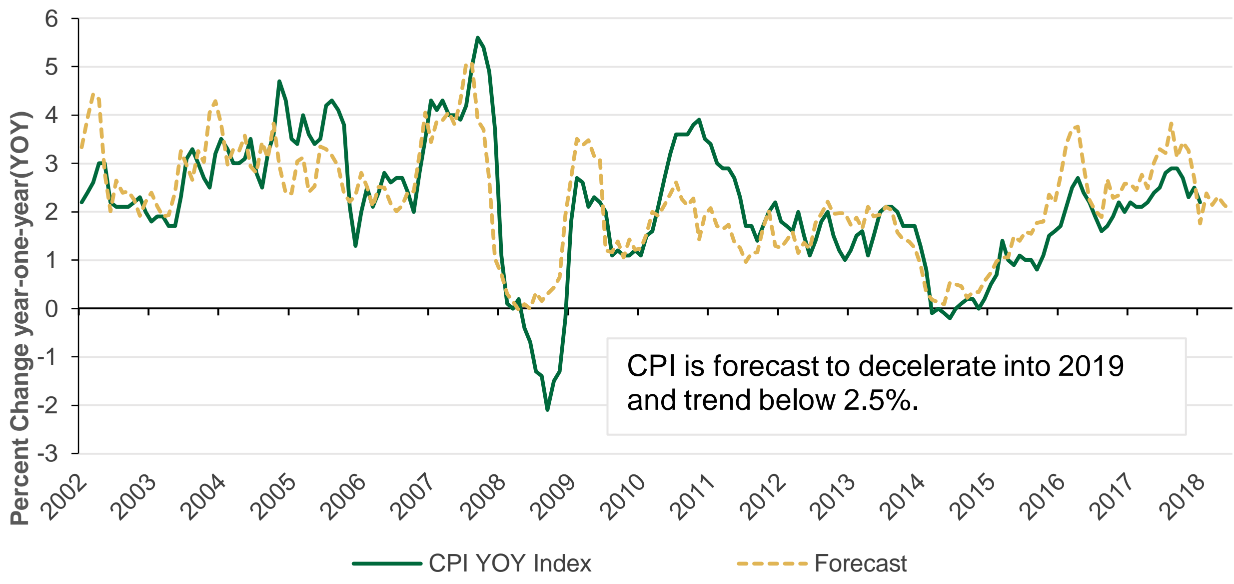
Chart 1: Forecast US consumer price index (CPI) and actual CPI[3]



What should investors take away from the rate hike and statement? First, we believe that the immediate negative reaction by the equity markets is akin to a child throwing a tantrum having been refused another piece of chocolate cake[4]. Investors were hoping for a "Powell put" to mark the end of the current correction. Despite what some might believe, this isn't Powell's mess to clean up. At some point, after global macro-economic data stabilises, we believe investors will return to the attractive fundamentals of the equity markets.

Powell was put in a difficult position heading into this meeting. If the Fed paused, it could have been seen to be pandering to political opinion. The Fed is supposed to be neutral and independent. If the Fed signaled a more dovish posture it could have been seen as pandering to equity investors. A pause would have run counter to inflation that, while slowing, is still expected to be above the Fed's target, while unemployment remains at multi-decade lows. Powell and the FOMC did the right thing by raising and suggesting that there are fewer rate hikes to come in 2019 than in 2018[5].

We are closer to the end of this tightening cycle

What may be more encouraging for investors is the fact that we are closer to the end of this tightening cycle. At times like these I return to that old riddle: "How far can someone run into the woods?" The answer: "Half way, then they are running out of the woods." We have more than passed the halfway point of this tightening cycle. And with that, following what has been a disappointing year for fixed-income investors, our expectations heading into 2019 are much improved. We expect equity investors will be rewarded with a much better environment in 2019 as well. Valuation is much more attractive today than it

[3] Bloomberg, Manulife, as of 30 November 2018.
[4] Bloomberg, 19 December 2018. S&P 500 index and Dow Jones Industrial Average index both declined 1.5%.
[5] According to the "Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy, December 2018", the median forecast for 2019 fed fund rate is 2.9%, which signals the number of rate hikes they foresee in 2019 is trimmed to two from three. Officials had a median projection of one hike in 2020.

was at the beginning of the year. Earnings expectations are healthy for next year, and with lower interest rates at the longer end of the curve, the equity risk premium on US stocks is much improved.

With the Fed signaling perhaps only two more rate hikes, inflation no longer accelerating, and moderating economic growth, bond yields are less likely to see a rapid ascent. In fact, we are inclining more to the belief that 3.23% may have been the top for the US 10-Year Treasury yield. With its latest move, the Fed appears to support our thesis that the worst is behind us, 2019 looks much improved, and bonds are likely to mark a return to their defensive characteristics.

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