

US interest rates: Will they or won't they?

US job numbers for March were lower than expected. In this note, Manulife Asset Management's Portfolio Advisory Group examine labor market conditions and the likely implications of an expected increase in interest rates in the second half of 2015. They conclude that a marginally more conservative asset mix - an allocation closer to an equal split between equities and fixed income may be warranted.

The markets began last week with the fallout over March US jobs numbers, as markets were closed for Good Friday on 3 April, the day of the announcement. The Labor Department announced that US employers added the fewest number of jobs in more than a year. The 126,000 new jobs came in well below the consensus expectations of 245,000 and ended a string of twelve consecutive months of gains greater than 200,000. The unemployment rate, however, remained at a six and a half year low of 5.5%.

To say that the numbers were underwhelming would be an understatement, but it was interesting to watch as the market reacted to the news after a full weekend to digest it. The S&P 500 opened near its closing value on the previous Thursday (remember that markets were closed on Friday), but then immediately dropped about ten points then rallied thirty points to 2086.59. It stayed relatively flat before closing up approximately three quarters of one percent.

On Wednesday, the market waited in anticipation for the release of the minutes of the US Federal Reserve's (Fed) 17-18 March policy meeting. The release comes a full three weeks after the meeting and subsequent statement release. There tends to be very few surprises within the minutes but these days every line is scrutinized to try and unearth a hint as to the timing of the first rate hike. Like Monday, equity markets reacted with rather sharp movements, first to the downside then to the upside as the doves and hawks digested the information and traded accordingly.

It's no longer really a question of if but rather when the Fed will raise rates. If you are a dove, you believe that a rate increase will come later rather than earlier and if you are a hawk, you believe the opposite. The market is expecting the first rate hike in the second half of 2015. The earliest economist expectations are for the first move to occur in June of this year, while there are even those that don't believe the Fed will move until 2016.

Even Federal Reserve officials were divided at their March policy meeting on whether they might raise interest rates in June, and recent soft economic data could make a midyear move even less likely. Minutes of the March policy meeting showed some officials wavering about moving to raise rates too quickly. Inflation has been running below the Fed's 2% objective for nearly three years and some officials saw this trend persisting, citing falling energy prices and a stronger US dollar, which lowers the cost of imported goods.

While "several" officials thought June would be the right time to raise rates, others thought it would be better to wait longer and some thought the Fed might need to wait until 2016, the minutes said, without identifying the participants by name.

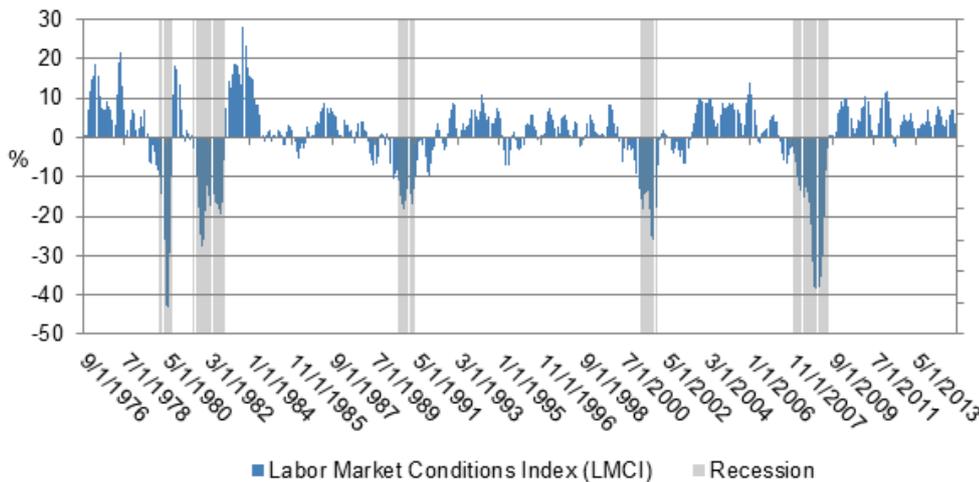
The divisions could present a challenge for Fed Chairwoman Janet Yellen in the months ahead. She led officials to a unanimous vote in March to drop language in the Fed's policy statement assuring the central bank would be "patient" before raising rates. The change effectively opened the door to rate increases by midyear. But tough decisions now loom about whether to move then.

As we all know the Fed's first movement or lack thereof and any subsequent movements will be data dependent. If we look at the jobs numbers as a signal, we would most certainly believe that the Fed will wait longer than expected given that the economy has surely run out of steam with the weak print. However, when analyzing data, you have to look at more than one data point to determine strength or weakness. You need to look at the trends and you have to look below the surface to identify the causes behind the announced data.

In the case of the weak jobs numbers it could be a repeat of last year when weather was the number one factor derailing the economy. March job creation is likely a carry-over from a very tough February, weather-wise. According to the National Oceanic and Atmospheric Administration (NOAA), during February, there were 8,281 cold daily temperature records (4,778 daily cold maximum temperature records and 3,503 daily cold minimum temperature records) broken or tied. Twenty-three states had a top ten cold February, while Buffalo, Chicago and Cleveland had their coldest February on record.

Job growth, as measured by US non-farm payrolls, is only one of nineteen factors that the Fed looks at when trying to identify the quality of the labor market. The Labor Market Conditions Index is the primary employment indicator that Fed has created to gage the health of the US employment market. While the March reading was slightly negative at -0.3% year over year, the trend has been quite positive for the prior months with no signs of a recession.

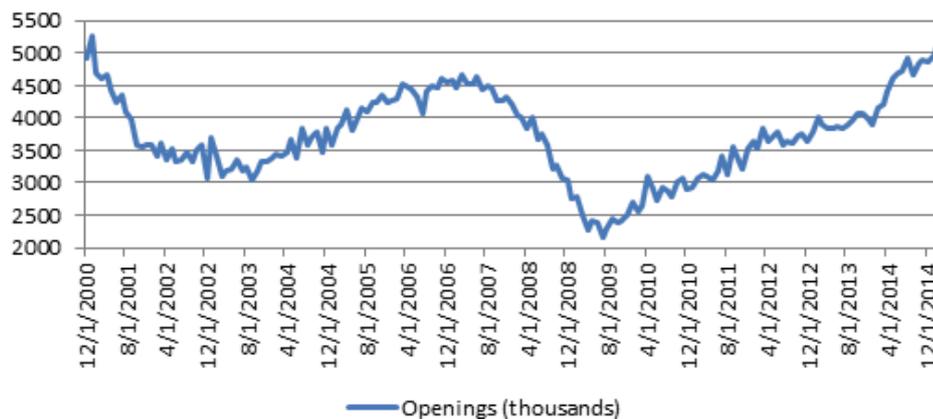
Figure 1: Labor Market Conditions Index



Source: Bloomberg, 31 March 2015.

The current slack in the labor market is another positive indication of an improving and self-sustaining economy. The Job Openings and Labor Turnover Survey (JOLTS) from the Bureau of Labor Statistics shows that job openings as of February reached 5.13 million (see Figure 2), their highest level since December 2000. This index tracks the number of specific job openings in the economy. Job vacancies generally include either newly created or unoccupied positions (or those that are about to become vacant) where an employer is taking specific actions to fill these positions.

Figure 2: US job vacancies



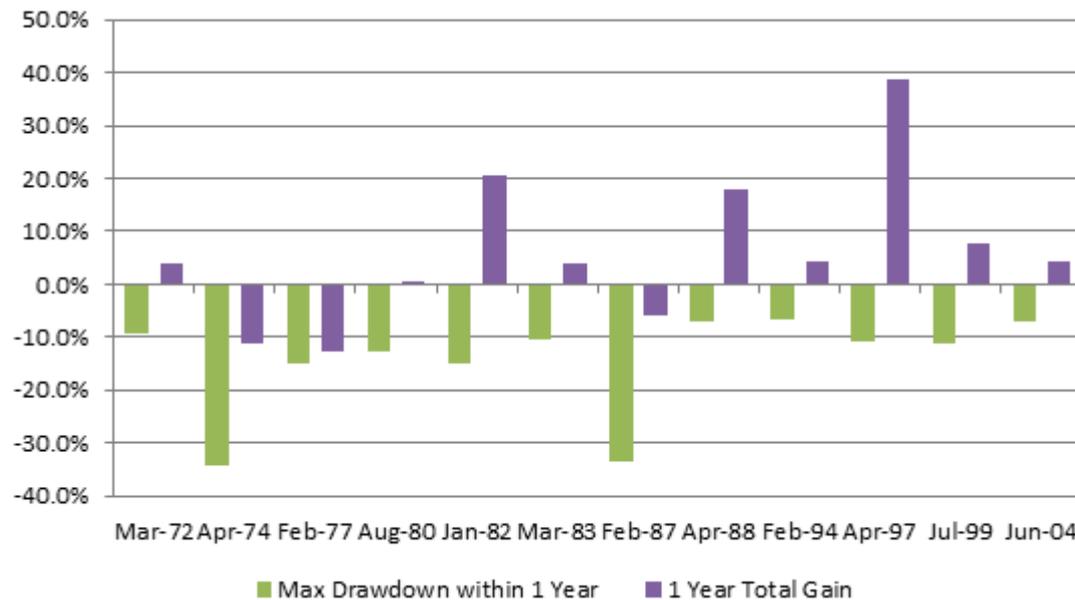
Source: Bloomberg, 28 February 2015.

The Fed said in March that it will start raising the rate when it has seen further improvement in the labor market and is reasonably confident inflation will rise toward its 2% target. We are experiencing a fairly strong employment trend; however inflation has been below the target rate. The Fed often emphasizes the price inflation measure for personal consumption expenditures (PCE), produced by the Department of Commerce, largely because the PCE index covers a wide range of household spending. The PCE price index rose 0.3% in February from a year earlier, a strong indication that we are not experiencing any material inflation. Wage growth, as measured by hourly earnings, can also be an indication of potential inflation. Wages grew 2.1% in March, little changed from its 2% annual pace over the last five years.

Given that the Fed has a dual mandate of full employment and stable prices over time and that only one of those mandates seems to be near its goal, the Fed does not *need* to raise rates. However, while they don't *need* to act, they *can* raise rates given the solid trend in unemployment. The Fed has held its benchmark short-term interest rate near zero since December 2008 to boost economic growth and hiring. This policy was enacted under Yellen's predecessor, Ben Bernanke, and there is much speculation that she would like to move away from that zero interest rate policy (ZIRP), even if the move is only twenty-five basis points.

The speculation about timing will run rampant until the Fed starts to raise rates, causing uncertainty and volatility in both fixed income and equity markets. Further adding to that volatility is the historical reaction to the market surrounding the first rate hike of a tightening cycle. Looking at each tightening cycle since 1972, we observed that corrections, defined as a drop of 10% or more, occurred in 8 of 12 years (66% of the time) following the first rate increase, while the odds of a correction in any given year is 26%. The average downside within the first year of a tightening cycle is -14%, while the average downside in any given year since 1972 is -7%. The average upside one year after the first rate hike is 6%, while the average upside in any given year since 1972 is 8%.

Figure 3: Downside in a tightening cycle



Source: Bloomberg and Manulife Asset Management, as of 31 December 2014.

While a tightening cycle is not synonymous with a bear market by any means, there is still more risk to the downside than the upside. We do not believe this will be “Taper Tantrum II”, since the Fed is not actively removing liquidity like they did when they ended their quantitative easing program and plenty of liquidity still exists globally thanks to the European and Japanese central banks. Furthermore, a twenty-five or fifty basis point move should not be material from corporate or personal financing decision.

There is likely to be a decent amount of volatility regardless of the Fed's timing and/or magnitude of any rate hikes. With this in mind, a marginally more conservative asset mix is likely favorable - an allocation closer to an equal split between equities and fixed income may be warranted. On the fixed income side, we continue to favor non-traditional fixed income or, in other words, staying away from North American government bonds. While on the equity side, we are focused on quality, by investing in dividend-paying securities and are taking

advantage of valuation opportunities where they present themselves, such as Asia ex-Japan equities. It is time to manage client expectations and build a portfolio that will help them through the upcoming period of volatility

Manulife Asset Management is the asset management division of Manulife Financial. Manulife Asset Management's diversified group of companies and affiliates provide comprehensive asset management solutions for institutional investors, investment funds and individuals in key markets around the world. This investment expertise extends across a full range of asset classes including equity, fixed income and alternative investments such as oil & gas, real estate, timber, farmland, as well as asset allocation strategies. Manulife Asset Management has investment offices in the United States, Canada, the United Kingdom, Japan, Hong Kong, and throughout Asia. Additional information about Manulife Asset Management may be found at www.manulifeam.com. Manulife Asset Management, Manulife and the block design are trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation.

This material, intended for the exclusive use by the recipients who are allowable to receive this document under the applicable laws and regulations of the relevant jurisdictions, was produced by and the opinions expressed are those of Manulife Asset Management as of the date of writing and are subject to change. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Asset Management does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Information about the portfolio's holdings, asset allocation, or country diversification is historical and is not an indication of future portfolio composition, which will vary. Neither Manulife Asset Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein.

The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations, and is only as current as of the date indicated. There is no assurance that such events will occur, and may be significantly different than that shown here. The information in this material including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. This material was prepared solely for informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Asset Management to any person to buy or sell any security.

This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any investment products or to adopt any investment strategy. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. Past performance is not an indication of future results.

Proprietary and Confidential Information – Please note that this material must not be wholly or partially reproduced, distributed, circulated, disseminated, published or disclosed, in any form and for any purpose, to any third party without prior approval from Manulife Asset Management.

Presented by Manulife Asset Management (Asia), a division of Manulife Asset Management (Hong Kong) Limited.