BEYOND THE HEADLINES

eastspring investments

A member of Prudential plc (UK)

Our thoughts as the US Fed remains on hold

22 September 2016

A PAUSE - ONCE MORE

Amid three dissenting voting members, the Federal Open Market Committee (FOMC) statement noted that;

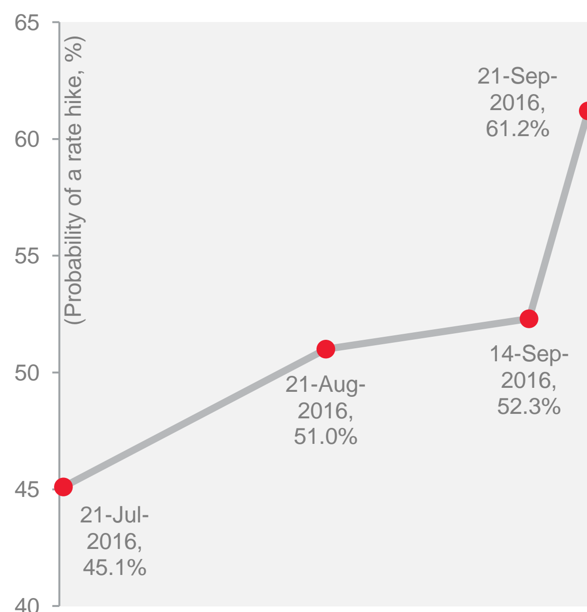
"The committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives."

As per the latest prints, the Fed's preferred measure of inflation (Core PCE)[1] still lags the 2%[2] target while unemployment hovers around the 4.9%[3] mark, the lowest it has been since November 2007. Declining demographics, job quality, lack of participation, income inequality, miniscule wage growth and the under skilled workforce remain key concerns.

During the meeting, the Fed revised the GDP growth potential for 2016 downwards from 2.0% to 1.8% and signaled a shallower rate rise in 2017 and 2018. Its longer-run interest rate forecast (beyond 2019) of 3.0% was also reduced to 2.9%.

The next Fed session is scheduled the week before the US presidential election; while the subsequent meeting falls on 14 December 2016. That is probably when the market expects the Fed to move.

THERE IS A 61.2% CHANCE OF HIGHER RATES ON 14 DECEMBER 2016[4]



VIEWS FROM OUR INVESTMENT TEAMS

Here is a compilation of how our investment teams are digesting the situation.

Asian Equity: The Asian Equity teams are aware that equity markets are sensitive to the Fed's decision, the way they communicate and how they seek to tighten US monetary policy. However, the Asian Equity teams do not react to macro happenings but through its robust investment process, will seek to exploit any opportunities stemming from the volatility or pricing episodes post the FOMC meeting.

Asian Fixed Income: Our views and strategy remain unchanged post the FOMC meeting. Barring exceptional economic weakness and global disruptions, the Fed would likely hike in December, in part to keep its credibility. This is consistent with our view that the sustained US growth and tightening US labour markets does justify a gradual upward rate normalisation. The market continues to underprice the rate hike probability, leaving room for potential backups in US Treasury yields. We are thus maintaining a moderate underweight duration position in our portfolios for now, although we may look to add to our duration positions should interest rates overshoot on the upside. We think the interest rate trajectory is likely to be a gradual one, which is expected to limit the extent of bond price falls over the years.

US Fixed Income*:* In isolation, even a 25 basis points increase in the US federal funds rate should not materially hurt US credit as compelling yield opportunities versus global sovereign debt and ongoing foreign demand remain in place. The risk, although not our base case, is that volatility materially spikes and a risk sell-off ensues. To manage this concern, we have increased our portfolio's liquidity and moved up credit quality as we currently view the potential for spread widening to be greater than that of for spread tightening. We are also positioned to deploy capital if valuations cheapen to take advantage of credit-specific opportunities.

Global Asset Allocation: From a medium term point of view, it can be argued that the Fed should have already raised interest rates based on improved employment figures. However, a fragile global economy and mixed domestic news flow have held the Fed back. Regardless of how the Fed moves, we currently prefer equities over bonds due in part to evidence of cyclical improvement in profits and accommodative policies. In contrast, bonds are pricing in a low trend growth/deflation scenario which is an enormous risk to bonds returns if inflation returns in a large way.

Source: Eastspring Investments, 22 September 2016. [1] Federal Reserve Bank of St. Louis, August 2016. [2]Board of Governors of the Federal Reserve System. [3]U.S. Bureau of Labor Statistics August 2016. [4]Bloomberg, Implied probability of Federal Reserve rate action, September 2016.

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