PRIVATE BANKING INSIGHTS

Market Update

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NOT ALL FED TIGHTENING CYCLES ARE CREATED EQUAL

The first rate hike by the Fed in more than nine years is coming soon. While some uncertainty remains as to the exact timing of this move, a shift towards tighter monetary policy appears imminent. It will probably qualify as the most widely anticipated rate hike in history. One could therefore argue that this will be a non-event because it will hardly come as a surprise to anyone. History also shows that the first rate hike does very little to damage the uptrend in risk assets as monetary conditions remain accommodative and the initial tightening is mostly seen as a confirmation that the economy is in good shape. However, this cycle has been atypical in many ways that history is likely to be a poor guide for what lies ahead. While a 0.25% increase in the Fed funds rate is only a minor change, it has to be put in the context of where we are coming from — zero interest rate policy (ZIRP) implemented in 2008 and maintained since then. Since nominal rates cannot move below the zero bound (although the ECB later proved that this is not necessarily true), the Fed added three rounds of quantitative easing and kept interest rates at the current level for a very unusual length of time as a way to stimulate a highly damaged economy. And from that perspective, the first rate hike will also be atypical as it will come at a time when the economy is not exactly going gangbusters. In order to better understand what the Fed's anticipated departure from ZIRP means for the economy and markets, we need to answer the following questions: Why, When, How Much, and How Fast?

WHY?

As the Fed has a dual mandate — price stability and growth/full employment — tightening cycles can be driven predominantly by one or the other factor. In the current context, there is another likely rationale — normalization. From a growth perspective, I continue to believe that the Fed should be in no urgency to tighten monetary policy. The current recovery has been by far the most tepid recovery in post-war history and recent GDP revisions have made things even worse. In terms of price stability, overheating risks appear very limited with headline and core inflation running well below the 2% target. In recent months, economists have highlighted the healthy improvement in the labor markets and pointed to the danger of rising wages. Despite the sharp drop in the unemployment rate, wage gains have remained anemic and the latest employment cost index came in a lot weaker than anticipated. While a more significant pickup in wages remains a risk going forward, the inflation picture does not seem to warrant an immediate shift in monetary policy. This is particularly true in light of global developments with rapidly falling commodity prices and a surging USD. Despite a lack of obvious catalysts for a rate hike, I do expect the Fed to raise rates before yearend and the key factor behind this decision will be policy normalization.

WHEN?

Investors have become very sensitive to the timing of the first rate hike — reading through Fed statements for any subtle change in words in order to fine-tune their expectations for liftoff. The reality is that "When?" is probably the least relevant question. The Fed has made it clear that they are data-dependent but my feeling is that growth and/or inflation will have to come in well below expectations for the Fed to continue to push back the timing of the first rate hike. As such, I would hope we can get over with this relatively useless timing game and move on to the much bigger questions of how much and how fast.

HOW MUCH?

The issue of the cumulative magnitude of rate hikes during this tightening cycle is very much related to the other intense debate currently dividing economists — what is the potential growth rate of the U.S. economy? The latest revisions to U.S. GDP (going back to 2011) have made the current recovery even weaker than previously estimated, at a paltry 2.1% annualized growth. The Fed continues to rely on the output gap model — the difference between estimates of how much the economy can grow and how much it has actually grown. With growth revised lower, this either means that the output gap is even wider than previously thought (and the economy would therefore need ongoing monetary policy support to close that gap) or that the Fed has been overestimating how fast the economy can expand. A growing number of economists are in the latter camp and believe that the growth potential of the economy has been reduced to less than 2%.

If potential growth is indeed much lower than in the past, the output gap is likely to be less significant and inflationary pressures will soon develop. This would be consistent with other measures of slack such as the unemployment rate or capacity utilization rates. In this scenario, the Fed should be hiking rates sooner rather than later. On the other hand, slower potential growth should also result in a lower equilibrium interest rate. Indeed, if the natural growth rate of the economy is only 1.5%, monetary conditions will become too tight relatively faster.

HOW FAST?

Because of these uncertainties, we expect the pace of rate hikes to be abnormally slow compared to previous cycles. While market-implied forecasts are volatile, the current consensus among investors is that by the end of 2017, the federal funds rate will still be below 2%, a very slow process indeed by historical standards.

WHAT DOES IT MEAN FOR THE MARKETS?

The Fed will soon raise rates for the first time since 2006 and embark on a process of policy normalization. By definition, monetary policy will become tighter, but it will take considerable time before it actually becomes tight. Indeed, the Fed is likely to be very cautious and proceed at a snail's pace. We think the Fed will also pause several times during this cycle to gauge the impact of their actions on financial conditions (in particular renewed USD strength and credit conditions) as well as the trajectory of its own balance sheet. Even assuming a lower equilibrium rate, monetary policy is unlikely to become tight until 2018, based on current market expectations. The next equity bear market will likely develop once tight monetary conditions lead to a pronounced economic slowdown and eventually a recession. But we are clearly not there yet. While we expect the current bull market to continue once the tightening cycle starts, we have nevertheless positioned our portfolios more defensively ahead of the Fed move given the unprecedented nature of this cycle. Equity markets sold off during the "taper tantrum" in 2013 and the end of QE last October, and another correction could materialize around the first rate hike. Market-based expectations for the path of the Fed funds rate remain well below the Fed's own forecasts, and any adjustment towards the Fed's guidance could rattle the markets, at least in the near term. This observation also applies to bond markets which seem to have discounted a glacial tightening pace and a very low equilibrium rate. Any rebound in inflation and/or growth expectations could also lead to higher bond yields. The USD would normally benefit from the tightening cycle, particularly in a context of global monetary easing, but we believe that a lot has already been discounted and further dollar strength would require a more aggressive tightening than currently priced by investors. While the Fed is unlikely to put an end to the current bull market, a major shift in financial markets is about to happen. To be prepared is half the victory.

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