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The Fed and tax reform: What's next for fixed income investors?

INVESTMENT TALKS

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- ***Fed****: The FOMC decided to raise the fed funds target range for the third time this year to 1.25-1.50%.*
- ***Economy****: The US economy is currently benefitting from positive momentum. The delivery of a fiscal package should provide a boost to 2018 and 2019 growth.*
- ***Market****: The US yield curve has flattened since early September. If markets continue to reprice fed funds expectations, long-term yields could rebound from the current levels, especially if the extension of the economic cycle caused by tax reform is confirmed.*
- *In addition to the Fed's commentary about unwinding and tightening expectations, the details about and timetable for rates policy from the European Central Bank and the Bank of Japan will have broad implications for global interest rates as they shift from accommodation to tightening as their economies improve.*
- *We favour diverse credit sectors and we believe most US government debt is unattractive. Many credit sectors should benefit from stronger growth, lower taxes and less regulation. Although credit valuations are elevated, a bias towards higher-quality corporate debt is warranted, in our view.*
- ***US dollar****: We expect the US dollar to fail to gain traction, as markets have already priced in a prolonged and gradual tightening cycle. Only a sharply upward trajectory for inflation, causing a more accelerated pace of Fed tightening than is currently projected, would change sentiment for the dollar.*

What are the major takeaways from the December Federal Open Market Committee meeting?

BD. As expected by the markets, the FOMC decided to raise the fed funds target range for the third time this year to 1.25-1.50%. This is the first year during which the Fed has made the number of hikes it announced in the previous year (in December 2016, the median 'dots' pointed to three rate hikes in 2017, which the Fed has done). In previous years, the Fed made fewer rate changes than what the 'dots' indicated. The median 'dots' for 2018 and 2019 have not been changed: FOMC members expect three further hikes in 2018 and two in 2019. GDP growth forecasts have been revised up strongly (2.4% for 2018 and 2.1% for 2019), though the longer-term level for GDP growth has been revised down slightly again. Once again, the gap between GDP growth forecasts for 2018 and 2019 and the longer-term level for GDP growth has widened. This indicates the belief that the slack in the labour market will continue to diminish. The FOMC statement indicates that future Fed actions will allow labour market conditions to remain strong and not anymore that they would support "some further strengthening". This was Janet Yellen's last press conference as FOMC chair. There remains a question mark about how the future composition of the Board of Governors will impact the trajectory of monetary policy.

"FOMC members expect three rate hikes in 2018 and two in 2019. GDP growth forecasts have been revised up strongly".

On the economic side, do you see as more likely a new acceleration in US economic activity, a slowdown or a recession in the next 12 months, and why?

AU. Barring any substantial external or domestic shock, we do not expect a recession in the next 18 months; instead, we think that the delivery of the fiscal package will boost 2018 and 2019 growth and shift a deceleration of growth towards growth potential to late 2019. The US economy is currently benefitting from positive momentum (growth should be close to 3% in Q4 for the third quarter in a row), notwithstanding the negative effects related to the recent hurricanes. Growth looks solid as domestic consumption remains resilient, supported by both personal consumption expenditure and non-residential investments. The labour market also appears to be tightening further. Without the delivery of a fiscal package, given the global, domestic economic and financial backdrops, we would expect these drivers to be resilient but to moderate slightly into 2018, delivering slightly above potential growth, in line with this year's trend. However, factoring in the passage of a fiscal package, which is looking increasingly likely in early 2018, we estimate that this could cause increases in GDP growth in 2018 and 2019 by as much as 0.5% in total (the range estimated is +0.2-0.5%): this takes our projections in the 2.3-2.6% range and further defers the deceleration to potential growth.

Recently, the US yield curve has flattened dramatically. What is your reading of this?

BD. We would make three general comments about the yield curve situation. First, let us make a historical comparison. The last time that the slope of the 2-30Y segment hit 100 bps during a monetary tightening cycle was in April 2005. From this point, it took 14 months for the Fed to make the last fed funds hike of the cycle (June 2006), 2.5 years before the S&P 500 hit the peak of that cycle (October 2007), and 2.6 years before the US economy experienced a recession (December 2007). Second, we can be unsure about the quality of the signal sent by the slope of the yield curve. For a long time, academic research has shown that the slope of the yield curve contains useful information for signaling future recessions. But, it has also been shown that "forecasting recessions that use both the level of the federal funds rate and the term spread give better predictive performance than models with the term spread alone"[1]. However, the level of the fed funds rate remains low (currently 1.25-1.50%) and technical factors continue to weigh heavily on long-term interest rates. Without the latter factors, the curve would be slightly steeper. Third, the flattening of the US yield curve has probably moved too far too fast recently. The curve has flattened as markets have started to revise up their fed funds expectations for 2018 from those made in early September. Consequently, the short end of the curve has risen more than the long-end. It is quite common to see a flattening of the yield curve when a central bank raises its key rates and this is what could happen in 2018, but the recent move has been too extreme. Basic macro models of the slope indicate that the curve should be steeper at this stage of the cycle. If markets continue to reprice fed funds expectations, long-term yields will likely rebound from current levels, especially if the extension of the economic cycle caused by tax reform is confirmed.

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What is your expectation for Fed monetary policy in 2018?

AU. We expect the Federal Reserve to act in continuity with the principles of gradualism and data dependency. In line with our economic forecasts, we think that, at this stage of the cycle, the stronger growth derived from now very likely delivery of fiscal stimulus in 1Q18 should allow the Fed to implement the hikes for 2018 that the "dots" indicate. We thus currently expect two rate hikes in 2018, but forecast three rate hikes if tax cuts are passed by Congress soon.
In line with the FOMC, we expect inflation to gradually move towards target in a context of a tighter labour market and a narrowing output gap, but without any significant prolonged overshooting, as some factors anchoring inflation should continue to play a relevant role.

Which forces do you see prevailing in US fixed income markets in the next six months?

KT. Central bank policies globally will continue to have a meaningful impact on US fixed income markets. Investors will be closely monitoring the effects of central bank policies on the yield curve and supply/demand balances in the US fixed income market. In particular, in addition to the Fed's disclosures about unwinding and tightening expectations, the details about and timetable for rate policy at the European Central Bank and the Bank of Japan will have broad implications for global interest rates as they change from accommodation to tightening as their economies improve. With the Fed's unwinding programme under way, any change in the trajectory of easing in Europe or Asia could have ripple effects in US fixed income markets.

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[1] *The yield curve and predicting recession, Jonathan H Wright, Federal Reserve Board, February 2006*

The US political landscape also bears close watching. Tax reform should spur corporate growth in several ways. For example, a proposed new rule allowing 100% expensing of investments in equipment in one year should increase capital investment. Cash flow should increase following a cut in the corporate tax rate from 35% to the projected 21%, as well as the ability to repatriate foreign earnings at a much lower rate. Less regulation and strong global growth would also contribute to increased corporate profitability, further supporting US economic activity.

How should US fixed income investors address the new market phase ahead?

"We believe investors should continue to be positioned for rising interest rates and a solid economy".

KT. We believe investors should continue to be positioned for rising interest rates and a solid economy. We favour a number of credit sectors, but are negative on US Treasuries. We view most US government debt as unattractive. We believe that many credit sectors should benefit from stronger growth, lower taxes and less regulation. Although given that credit valuations are elevated, a bias towards higher-quality corporate debt is warranted. For conservative investors, a short- or ultra-short-duration position potentially could be beneficial in a rising rate environment. As another year of a long bull market in bonds comes to an end, valuations in US fixed income have become extended. One way to help protect fixed income portfolios is to reduce credit risk. Strong corporate fundamentals, strong economic growth, and the prospects for corporate tax cuts are counterbalanced by stretched valuations. Total investment-grade corporate spreads stand at post-crisis lows, adjusted for duration, and reflect lower quality and overall longer duration relative to their historical levels.

What are your short- and medium-term views regarding the US dollar?

KT. We expect the US dollar to fail to gain traction, as the markets have already priced in a prolonged and gradual tightening cycle. Scepticism that the tax bill will raise US long-term growth potential has also worked against dollar appreciation. Finally, growth differentials between the US and the rest of the world no longer favour the US, which has lessened the attractiveness of the dollar. In our view, only a sharply upward trajectory for inflation, causing a more accelerated pace of Fed tightening than is currently projected, would change sentiment for the dollar.