Confidence must be earned

Amundi ASSET MANAGEMENT

INVESTMENT TALKS

28 December 2018

# The investment perspective on December Fed's Dovish Rate Hike


**Kenneth J. Taubes**
Chief Investment Officer, US
Amundi Pioneer


*In what was one of the more highly anticipated Federal Reserve decisions of the past few years, the Federal Open Market Committee (FOMC) in December voted unanimously to raise rates by 0.25% to a target Fed Funds rate of 2.25% to 2.50%. The Fed's focus was on continued strong US economic data from Main Street, rather than on swooning equity and credit markets on Wall Street. The Fed continued to focus on strong US GDP growth, underpinned by strong employment and inflation near their 2% target, rather than being driven by concerns about near-term weakness in global growth and tightening financial conditions. The market was expecting a dovish hike, but was caught off guard by the tone of the statement and the press conference, which was perceived as not being dovish enough.*
*From an investment perspective, despite the Fed's less accommodative posture,* ***we are beginning to see value in credit markets****. Investors are now being better compensated for risk. We believe the* ***rally in Treasuries has gotten ahead of itself and Treasuries are starting to price in a recession****. But we see little risk of a recession in the coming year. On the USD, we believe that the upward pressure on the US Dollar should begin to wane as we have probably seen the maximum interest rate differentials between the US and other developed markets.*

## Key Takeaways from the December Fed's Rate Hike

- Fed Chairman Jerome Powell confirmed the 25 basis point hike and indicated that future rate hikes may peak at a lower "neutral" Fed Funds rate of 2.75% -- a level where policy is neither accommodative nor restrictive.
- The Fed downshifted from autopilot to data dependent for future rate increases. This was reflected in the FOMC Statement where the language reflecting the rate path was altered from "expects" to "judges".
- The median projection of the Fed Funds rate for future years and long-term each were lower by 25 basis points, as a result of lowering forecast rate increases in 2019 from three to two. Given that longer run growth and inflation projections were little changed, the decline in the long-term expected funds rate likely reflects lower estimates of the neutral funds rate.
- In the press conference, Powell indicated less flexibility with respect to the balance sheet runoff than markets had understood, saying the program was "on autopilot."

While the FOMC moved forward in raising rates in December, they acknowledged that they will monitor "global economic and financial developments" in determining future rate increases. In other words, they appeared to recognise that the weaker global growth and sell-off in equity and credit markets spawning from their own rate increases and balance sheet reductions has engineered the financial conditions tightening now occurring. Their Statement of Economic Projections (SEP) indicated a change in the "dot plot", so that the FOMC now projects only two rate increases in 2019 down from three from the September SEP. This change is consistent with the Fed's view that the neutral rate may be lower than had been previously thought, as the longer run Fed Funds rate moved from 3% to 2.75%.

We were not surprised by the Fed's December rate increase or their decision to reduce future rate increases. Current US economic data remains solid, led by a confident consumer. Wages have continued to rise, spurred by the 3.7% unemployment rate, which is well below the longer run estimates of 4% to 4.6%. However, we do believe growth has peaked. In fact, we anticipate that US GDP growth will slow towards neutral. Future growth expectations have been tempered by concerns about global growth. China's GDP growth is decelerating amid an unresolved tariff situation, leading corporations to pull back on capital investment plans (which the Fed recognised in its statement). Rate increases, rising home prices, and the Trump tax legislation have resulted in slowing residential fixed investment. Finally, the stimulus from the tax bill and the 2018 budget is waning in 2019; the largest remaining impact will be from federal spending, and even that is expected to subtract from growth by year end.

We do not believe the change in the Fed's posture toward future rate increases was a capitulation to pressure from the Trump administration. During the press conference, Chairman Powell was quite clear that political considerations played no role in Fed policy and defended the independence of the institution. The uneasy relationship between the Fed and the President is nothing new. In prior rising rate cycles, the central bank has often been at odds with the executive branch. No president wants to take responsibility for a recession brought about by the Federal Reserve.

## Investment Implications

Despite the Fed's less accommodative posture, we are beginning to see value in credit markets. We anticipate that the economy is solid, even after somewhat slower growth and an expectation that the Fed won't overdo it. Investors are now being better compensated for risk. We believe the rally in Treasuries has gotten ahead of itself and Treasuries are starting to price in a recession. But we see little risk of a recession in the coming year.

We had a period of a strong US dollar versus foreign markets as the Fed continued to systematically raise rates and shrink its balance sheet over the past two years. While the Fed tightened, other developed regions continued to maintain easy monetary policies. The faster growth in the US relative to the rest of the world continued to put upward pressure on the US Dollar. However, while this may continue for a little longer, it's now clear the Fed is nearing the end of its rate hike cycle, and we have probably seen the maximum interest rate differentials between the US and other developed markets. The upward pressure on the US Dollar should begin to wane.

## **AMUNDI** INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

**Discover Amundi investment insights at** **www.amundi.com**

### Important Information



Date of First Use: 28 December 2018.

**Chief Editors**

**Pascal BLANQUÉ**
*Chief Investment Officer*

**Vincent MORTIER**
*Deputy Chief Investment Office*



Amundi
ASSET MANAGEMENT