GENERALI INVESTMENTS

Focal Point

Accelerated US rate hikes ahead

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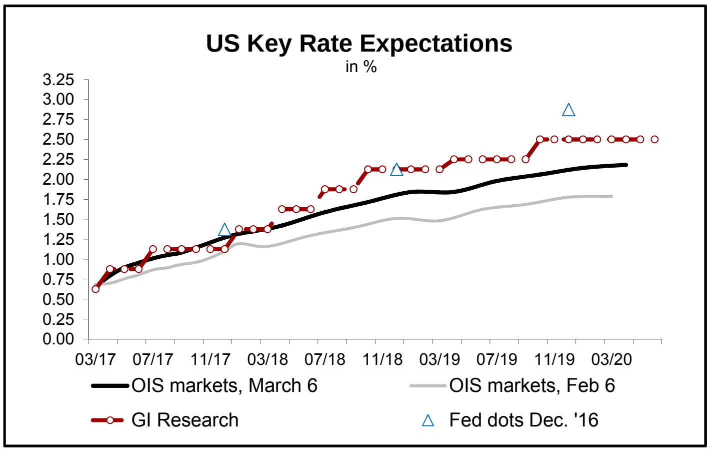
- After hiking its key rate just once last year, the Fed is about to accelerate the pace of monetary policy normalization.
- Despite persistent uncertainty about the fiscal and trade policies under President Trump, Fed officials have recently changed their communication in order to pave the way for a rate hike as soon as in March.
- Macro conditions point to the need for even further action thereafter. With core PCE inflation trending up towards 2% in Q3 and a tighter labor market pushing up wages, the Fed increasingly runs the risk of falling behind the curve.
- We therefore expect the move in March to be followed by two further US rate hikes this year. The Fed will likely also prepare markets for shrinking its balance sheet from 2018 onwards.
- The moves will underpin US yields and the US dollar near term, while keeping a lid on the prospects for US equities.

Reacting to the financial crisis in 2008, the US central bank was fast in cutting interest rates to almost zero within three months and in engaging in outright asset purchases immediately thereafter. Eight years later, and with the US economy almost back to full employment, unwinding the monetary policy support has proven much harder.

It took the Fed until December 2015 before it carefully engineered its first rate hike. And another twelve months passed before the Fed's second move. In the meanwhile, financial markets still struggle to believe that the normalization of US monetary policy will gain momentum. In the past two years investors have been right to put in doubt the Fed's forward guidance. Just two years ago, the Fed's 'dots' implied the fed funds rate (FFR) to climb back to above 3% by end-2017.



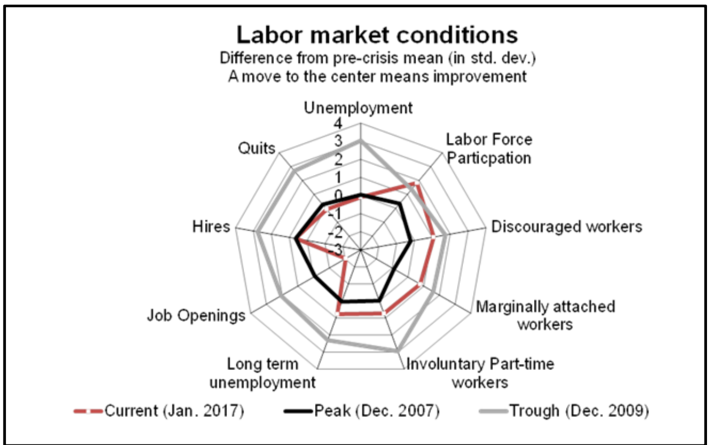
Since then, FOMC members have become more cautious themselves in anticipating higher rates. But there was a shift in late February. Recent comments by Fed officials show that the US central bank is in fact likely to deliver on a swifter normalization in monetary policy. The FOMC is now widely expected to hike its key rate on March 15 again. However, we think that markets have not yet fully adjusted to the Fed's new determinedness to actually proceed further with policy normalization at a swifter pace, given the solid state of the US economy.

Steady job creation, with accelerating wages

Data for December and January show that job creation is continuing at a rather fast pace. Employment prospects for the first part of 2017 look positive too. The recent strong performance of the ISM PMIs was due to a large extent to expectations of rising labor demand. Similarly, the NFIB survey on small businesses for January showed a marked increase in respondents expecting a headcount increase. Other indicators like hiring and job openings suggest that the labor market has returned to the pre-crisis peak of December 2007 (see chart overleaf). However, the legacy of the crisis remains evident in elevated underemployment (e.g. marginally attached and involuntary part-time workers) and still low participation rates.

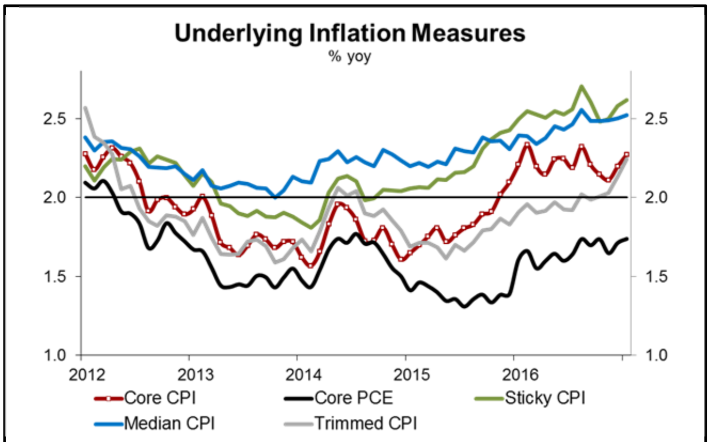
Rising employment and volatile labor supply have led the unemployment rate to fluctuate around the estimated 4.7% equilibrium rate since the summer 2016. Labor market participation has recently increased slightly as better employment prospects have prompted long-term unemployed to restart seeking a job. But over the medium term we expect the participation rate to remain capped by adverse demographics and a skill mismatch. As a consequence, the unemployment rate will likely fall to 4.6% by mid-year.

Labor market tightening has so far had a limited impact on wages, in parts due to the downward trend in household expected inflation. However, over the last few months average hourly earnings have started accelerating meaningfully, and the rise in inflation expectation reflected by latest consumer surveys is likely to provide further support in the coming months.



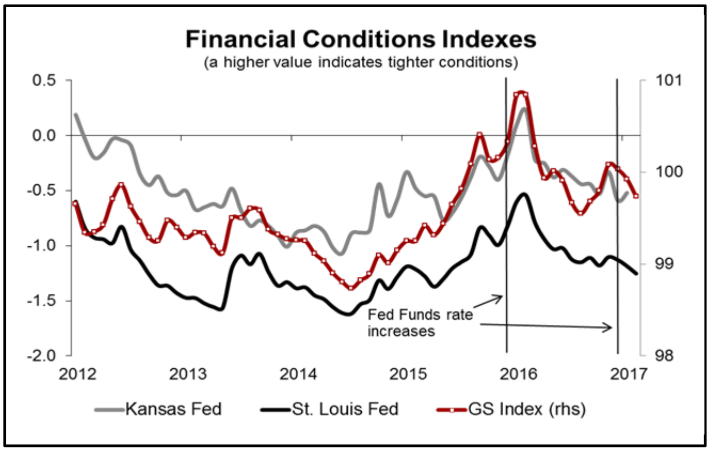
Core PCE inflation to rise further

Several measures of underlying inflation have already crossed the 2% threshold and share an upward trend visible since mid-2015. Core PCE inflation (the Fed's preferred gauge of price pressures) is lagging behind as far as the level is concerned but is heading steadily up. We project a gradual path of increase and expect core PCE to reach the 2% threshold by the end of Q3. A tighter labor market will add to pressures on wage costs. Moreover two of the most important headwinds to core prices, the effect of lower oil prices and past dollar increases on non-oil imports, will gradually fade.



Easier financial conditions support a rates hike

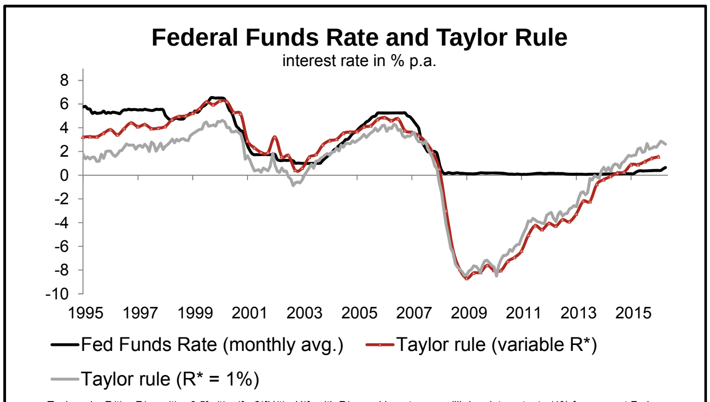
Meanwhile, overall financial conditions have eased. After the December 2015 hike, falling equity prices and a stronger dollar contributed to tighter financial conditions, providing a justification to the year-long pause in monetary policy normalization. On the contrary, the rate increase decided at last December meeting was accompanied by a surge in stock prices. This, together with a slightly falling exchange rate and lower long-term yields more than offset the impact of higher policy rates on financial conditions. The loosening in these conditions is even more pronounced when compared to the levels seen a year ago, supporting the case for swifter Fed action.



Mounting risks of Fed falling behind the curve

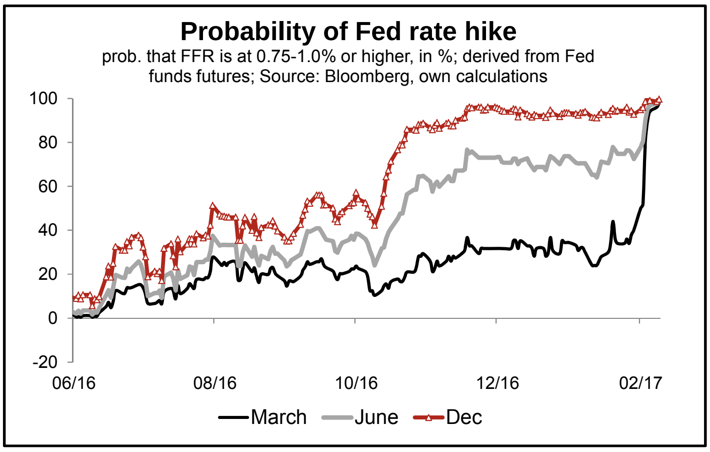
Amid the current macroeconomic picture, the Fed is also incurring mounting risks of "falling behind the curve". If the normalization of monetary policy is delayed for too long, the Fed may be forced to hike rates unwarrantedly sharply at a later stage. Fed Chair Yellen highlighted these risks in her testimony before Congress on Feb. 14: "*Waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession*."

Estimates based on the so-called "Taylor rule" point to a widening gap between the current FFR at 0.5-0.75% and economically appropriate levels. The Taylor rule derives the justified policy rate from the so called neutral (neither stimulating nor restrictive) real interest rate, inflation and the output gap. Even when applying more sophisticated (lower) estimates of the assumed "neutral" rate, the current FFR may be 90 bps too low (see chart above). With inflation trending up and the labor market tightening, this gap will widen even further.



Taylor rule: R(t) = R* + π(t) + 0.5[π(t)-π*] - 2*[U(t) - U*]; with R* = real long-term equilibrium interest rate (1% from recent Fed assumptions, variable from Laubach/Williams calculations), π* = inflation target (2%), π(t) = core PCE yoy, U = unemployment rate, U* = 4.8% (long-term normal rate of unemployment, latest Fed projections)

Just after the US elections, the Fed had been reluctant to lean towards an imminent acceleration in hiking rates, citing also the uncertainty regarding the future path of fiscal policy. More recently, however, the Fed has signaled that it deemed the current economic momentum strong enough to proceed with normalizing rates. On Feb. 28, the influential New York Fed President Dudley noted that the case for tightening monetary policy “has become a lot more compelling”. This hawkish remark was echoed by John Williams, President of the San Francisco Fed, who explicitly pointed to the March meeting for seriously considering the next rate hike. This was enough for markets to sharply raise expectations of a March rate hike from roughly a third in mid-February to more than 90% now (see chart).



We think that markets are still underestimating the future speed of monetary policy normalization. Based on our current economic projections, which incorporate some fiscal expansion taking effect from autumn onwards, we anticipate the Fed to deliver two additional hikes over the course of this year. These steps are likely to be followed by another cumulated 75 bps in rate increases next year, in line with the Fed ‘dots’. Market expectations on the FFR rate at the end of 2018 have already increased by 30 bps. But they are still 30 bps short of our own projections. leaving further leeway for markets to adjust (see chart).

But rate hikes will not be the only factor to observe over the coming weeks. Given the solid economic outlook, we would not be surprised to see some FOMC participants to also raise their rate projections at the March meeting.

Timing of Fed balance sheet reduction

Furthermore, the Fed will increasingly discuss the timing and speed of shrinking its balance sheet. This may happen once the Fed has raised the FFR to levels high enough to allow for sufficient rate cuts in case economic conditions deteriorate. We expect this to happen in mid-next year, when the FFR surpasses 1.5%. That said, the Fed is likely to proceed with seizing the reinvestment of maturing assets only very gradually, most likely by stopping to reinvest maturing MBS of US$ 15 to 20 bn per month in a first step.

Continued rate hikes by the Fed amid mounting US price pressures will in our view also sustain upside pressures on US yields over the coming months. The US dollar will benefit too. However, this should materialize more likely against EM currencies and the yen, while the EUR/USD may find growing support in H2 from easing political worries in the euro area and mounting speculation about the ECB tapering its QE. Finally, US equities, which are already dear, may be increasingly burdened by the outlook of rising US rates. So far, US stocks focused on the reassuring economic outlook implied by Fed rate hikes, but this may change once PCE core inflation has come closer to the 2% threshold.

Imprint

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