GENERALI INVESTMENTS

Focal Point

Fed policy tightening still underpriced by markets

June 9, 2017

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- Weaker US data in Q1 and political uncertainties have raised doubts among investors about the Fed's willingness to proceed with monetary policy normalization. While a rate hike in June is now (rightly in our view) largely anticipated, markets discount less than two further increases by end-2018, while we deem four further hikes reasonable.
- The blip in US data is likely to prove temporary. With the labor market already tight, underlying price pressures will rise more visibly again. And despite the 50 bps rate hikes since December, financial conditions have in fact eased.
- While the Fed is about to start unwinding its balance sheet, it will proceed extremely carefully and predictably. All this leaves broader scope for further monetary tightening.
- We therefore anticipate markets to revise upwards their rate expectations. Jointly with a gradual unwinding of the Fed balance sheet, this will lay the ground for a renewed upward trend in US Treasury yields.

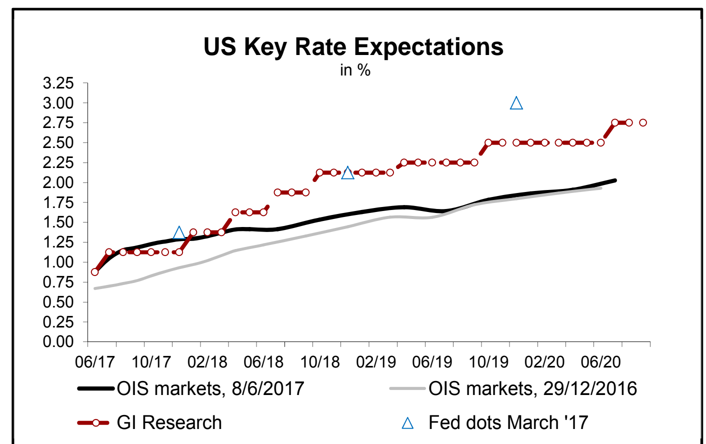
For the upcoming FOMC meeting on June 13/14, markets widely anticipate a rate hike in the Fed funds rate by 25 bps, the third increase since December, and we broadly share this view. Strikingly, however, markets are positioned for a sharp deceleration of monetary policy normalization thereafter, discounting less than two further rate hikes by end-2018 (see chart). In parts, this seems driven by recently softer US data and uncertainties about the Trump administration succeeding with his reform plans, which include a broad tax reform, deregulation and infrastructure spending.

This pricing of future rate hikes appears complacent to us. The Fed may indeed pause its rate hiking cycle in September, but just in order to announce a gradual reduction of its balance sheet. As we argue in the following, however, we see strong reasons to expect the Fed to proceed with four further rate hikes until year-end 2018.

US macroeconomic fundamentals to remain solid

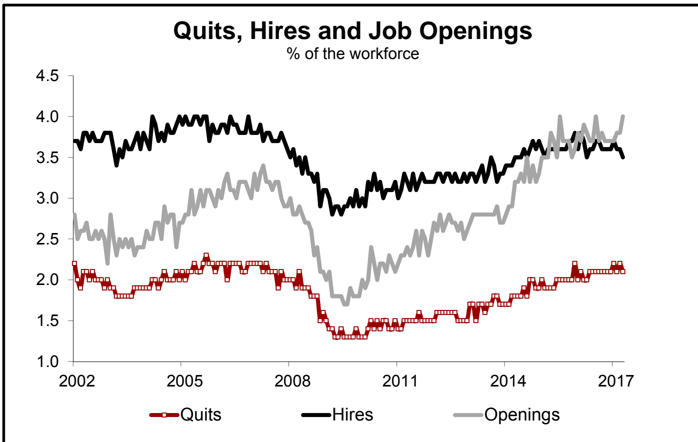
First, as emphasized by the Fed in the minutes of the May FOMC meeting, the weakness in Q1 growth and other US economic indicators at the beginning of the year appears transitory. More recent data, especially the strong performance of personal consumption expenditure (up by 4.6%mom annualized on average in March and April, against a 2.2%mom contraction in the first two months of the year), suggest that growth is set to be solid, as we argued recently (see our Focal Point "US: steady growth but hopes of fiscal boost cool", May 23).

Second, the decent growth environment will also tighten the labor market further and lift price pressures more visibly. Solid consumption and investment are likely to keep labor demand strong. In this sense, the disappointing May employment report, which showed payrolls increasing by just 138k, rather reflects labor market tightening than



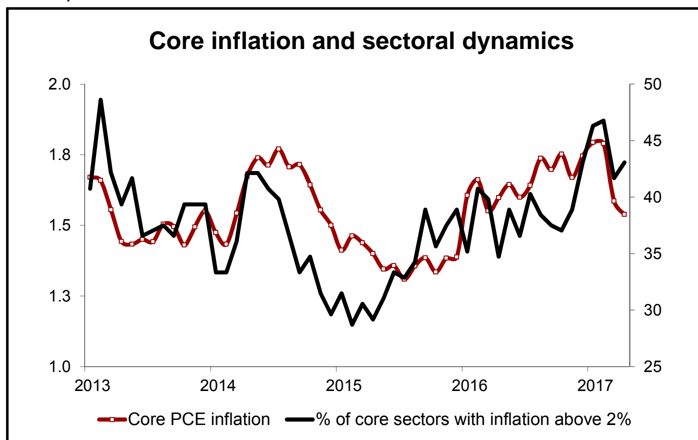
weaker prospective activity. Most strikingly, the unemployment rate has hit a 16-year low at 4.4% and also the U6 unemployment measure, which includes discouraged workers, is back to 2007 levels. Similarly, the NFIB survey on small and medium businesses continues to signal firms facing difficulties in finding suitable workers. This is a reflection of the sharp reduction in labor force participation following the Great Financial Crisis, which limits the pool of resources firms can tap into. Hard data confirm this view. According to the latest (April) release of the Job Openings and Labor Turnover Survey (JOLTS), new hiring, relative to the workforce, remains near pre-crisis highs and job

openings are at the highest value since the series was introduced in December 2000. Finally, the latest (May) employment components of the PMIs point to a brighter outlook for job creation.



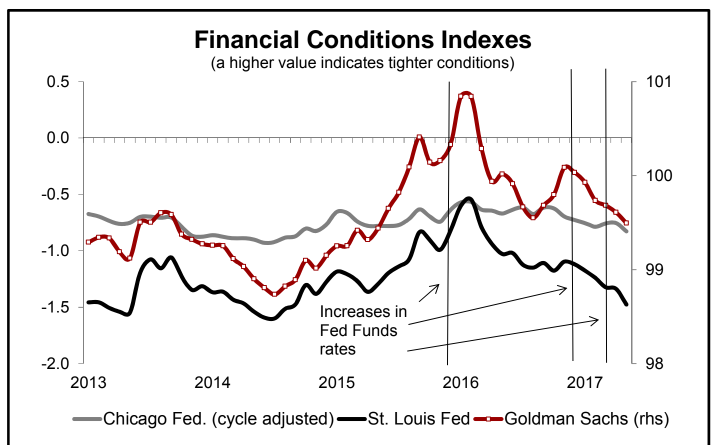
While hourly earnings growth has recently been stuck at 2.5% yoy, we expect an acceleration going forward. Median wages that account also for the demographic structure of employment and especially for the fact that retiring highly paid baby-boomers are replaced by lower paid younger workers have been increasing consistently at an annual rate above 3% since 2015. Going forward, we anticipate these wage pressues to be reflected in overall wage growth, too, contributing to higher inflation.

Admittedly, the latest inflation numbers were unexpectedly weak, with core inflation falling back to 1.9%. However, this was to a large extent due to two temporary factors. First of all, the prices for wireless communication fell sharply amid heightening competition and due to a methodological shift to quality-adjusted prices by the statistical office. In March alone the CPI index for communication was down 3.5% mom, and in April it was 6.5% lower than a year before. Stripping out this one-off effect, core PCE inflation would be 0.2 pp higher than the 1.5% yoy reported for April. Secondly, the contraction in new vehicle sales occurred since the beginning of the year has depressed the prices of used cars (down by 4.6% yoy in March and April). Overall, looking at the core PCE deflator the reflation trend appears increasingly widespread, as more than 40% of the 216 non-food and non-energy index components show annual price increases in excess of 2% (see chart).

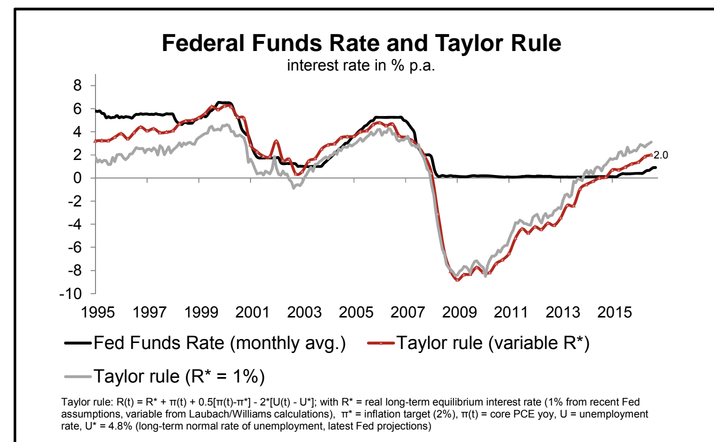


Going forward, we expect the core inflation to accelerate again to 2.2% by year end. Capacity utilization, while still below the longer-term average, is increasing amid firming domestic demand. It has increased since November by 1.2 pp to 76.7% in April, lifting production prices, firms' pricing power and mark-ups. Annual inflation of non-oil import has also been recovering, rising from negative readings until October 2016 to +1.5% in April. In addition, a weaker trade-weighted dollar, down by 4.3% from the late-2016 peak, adds to somewhat higher import inflation.

A third reason to expect further monetary tightening by the Fed is that overall financial conditions have been easing, leaving scope for the Fed to tighten policy rates. This is the result of lower long-term rates and a weaker dollar, matched by still high equity prices. Looser market conditions have more than offset the effect of the two Fed rate hikes since December 2016. This is in stark contrast with what happened in early 2016, when tighter financial conditions prevented the Fed from implementing additional hikes after the December 2015 one.



Also more fundamental approaches highlight the case for continued monetary tightening. Variants of the so-called Taylor rule link the appropriate rate level to the output gap, the distance between actual inflation and the 2% target inflation and the so-called real 'neutral' rate (which would be neither accommodating nor stimulating given the current economic conditions). Even assuming, conservatively, that this rate is virtualy zero, the currently appropriate Fed funds rate would be seen rather at 2% instead of the current 0.75-1.0% range, leaving considerable leeway for further hikes (see chart).



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)

Only very cautious Fed balance sheet adjustment

Apart from rate hikes, the Fed may tighten monetary conditions also by starting to reduce its balance sheet. Assets

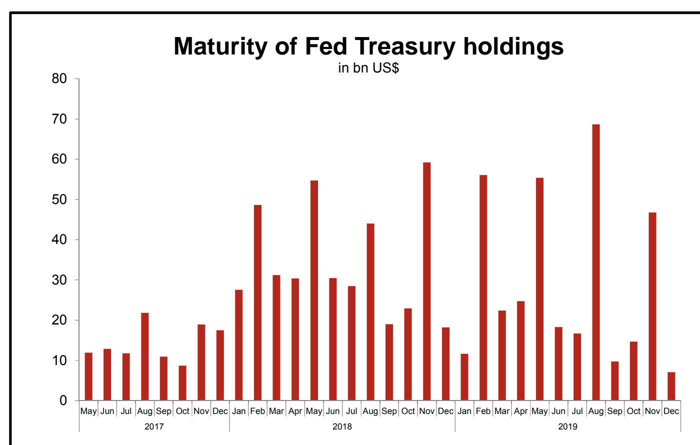
held by the Fed have ballooned to US$ 4.5 tr in May, after the three rounds of QE since the start of the global financial crisis. While discretionary policy decisions will remain tied to the fed funds rate, the reduction of theassets held by the Fed will likely happen extremely gradually and predictably to prevent a repeat of the so-called 'taper tantrum' in 2013, when QE tapering comments by Fed officials had spooked bond markets. Importantly, the Fed will not outright sell bonds but phase out reinvestment of maturing securities.

The Fed has signaled that it will implement this tapering only very cautiously, setting initally low caps for the amounts to be run off. These caps may then rise every three months, likely in a preannounced manner.

Neither is the Fed likely to target a very big reduction in its balance sheet. Considering the liability side of the Fed balance sheet points to a target value in the range of US$ 2.5-3.0 tr, which would still be far above the pre-crisis level of around US$ 900. Currency in circulation is likely to grow from currently US$ 1.5 tr to close to US$ 2 tr over the coming years. Furthermore, we expect the Fed to stick to the current US$ 500 bn reverse repo facility to keep markets afloat with liquidity. Finally, while the Fed may aim to reduce bank reserves substantially from the current US$ 2.2 bn, it may still opt for a level of around US$ 500 bn. This would serve as a liquidity safeguard for the banking sector and for ensuring the effectiveness of the Fed's 'floor' system, i.e. using the interest rate on excess reserves (IOER) for controlling the Fed funds rate. The resulting US$ 2.5-3 tr level of the targeted balance sheet size would still be on the lower end of the range suggested by former Fed Chair Bernanke.

We deem an announcement of a gradual balance sheet run-off likely for the September 19/20 meeting. Since this step would amount to a monetary tightening, the Fed is likely to refrain from a rate hike at this instance but would then resume its rate hike cycle in December in our view.

An unspectacular, gradual and predictable balance sheet reduction has two implications in our view. First, it will still leave the key role for monetary policy normalization with the Fed funds rate which can be raised further in parallel with the gradual balance sheet unwinding. Second, regarding financial market impacts, the looming phasing out of reinvestment activity will likely help to reinstate mild upside pressures on longer-dated Treasuries and mortgage-backed securities.



Upside pressures on US yields to prevail again

Summing up, given our forecast of gradual labor market tightening and slightly higher core inflation, we anticipate the gradual albeit visible normalization of monetary policy in the US to prevail as a key market mover again over the coming quarters. Current median rate projections by FOMC members envisage five further rate hikes to levels slightly above 2% by end 2018, which we deem both reasonable and credible. Markets appear too sanguine in pricing a markedly lower rate path. Jointly with a gradual unwinding of the Fed balance sheet, this sems likely to lay the ground for a renewed upward trend in US Treasury yields.

Imprint

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Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

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