15 June 2017

United States: Fed looks through softer inflation prints

- At its June FOMC meeting yesterday, the US Federal Reserve (Fed) raised the target range for the federal funds rate by 25 basis points to 1.00-1.25%. This marks the second increase in US interest rates this year
- The Fed's median forecast signals one additional rate hike in 2017 and three in 2018. The estimate of the "terminal" Fed funds rate was unchanged at 3%, continuing to imply a shallower tightening cycle versus previous cycles
- Recent softness in inflation prints clouds the outlook for Fed policy, with the fed funds futures market implying no further rate hikes in 2017. However, given the strength of the US labour market and assuming inflation data firms (or at the very least stabilises), we expect one additional hike this year
- Our core asset class views are unchanged. We remain underweight government bonds, neutral global equities and overweight selective parts of emerging markets (EM)

Fed raises rates again in June

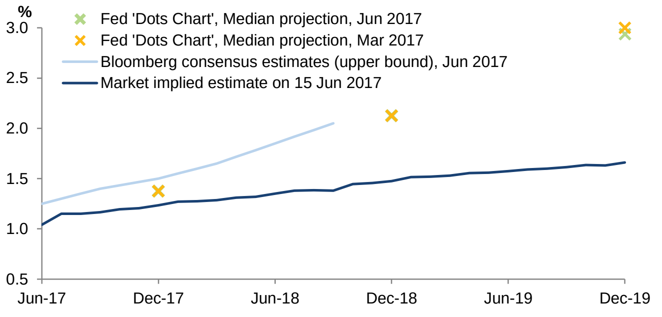
At its two-day June policy meeting, the US Federal Reserve announced an additional 25 basis point rate hike, increasing the target range for the federal funds rate to 1.00-1.25%. This move was in line with market expectations. The Fed has now raised interest rates twice this year, and four times since the hiking cycle began in December 2015.

Recent Fed action has been supported by broadly robust US economic activity in 2017, despite transitory weakness during Q1. Importantly, employment growth remains strong and the unemployment rate has fallen to 4.3%. Furthermore, financial conditions have continued to loosen amid US dollar weakness.

Indeed, the *Summary of Economic Projections* released at this meeting showed the median GDP growth forecast for 2017 and 2018 remaining broadly unchanged (at 2.2% and 2.1%, respectively). However, given the recent softness in US inflation prints, the forecast for core-PCE inflation in 2017 was revised lower (from 1.9% to 1.7%). This clouds the outlook for Fed policy in H2. For now, however, the Fed remains confident that inflation will return to target over the medium-term, with the median estimate of the Fed's "dot plot" continuing to point to one more rate hike in 2017. Nevertheless, the distribution of forecasts moved lower, with four FOMC participants expecting less than three rate increases this year, compared to three in March. The projected destination for US rates remained little changed at 3%, maintaining an "uber-gradual" tightening cycle.

The meeting statement confirmed the FOMC expects to begin normalising the balance sheet this year. The Fed also presented more detail on its "cap" system that would limit the redemption of securities to a fixed amount each month. For Treasuries, this would start at USD6bn per month, and increase in steps of USD6bn at three-month intervals until it reaches USD30bn. For mortgage-backed securities, the cap would be USD4bn per month until USD20bn was reached. The Fed did not set out the target size of its balance sheet, although implied it would be above pre-crisis levels.

Figure 1: Fed rate projections versus the market



Source: Bloomberg, as at 15 June 2017

Investment implications

For now, the Fed appears willing to "look-through" the recent weakness in inflation, continuing to signal its hiking path remains on track. Consequently, there is no change to our broad asset class views.

Assuming inflation prints firm (or at the very least stabilise), and economic data holds up, **we expect one additional hike this year, combined with balance sheet normalisation starting in Q4**. Fed "uber-gradualism" is now effectively on "auto-pilot" mode. However, if softness in inflation persists, they may be forced to hold off on further rate rises. The Fed will be monitoring developments here closely.

Relative to our expected trajectory of cash rates, the implied term premium (i.e. compensation for bearing duration risk) is negative for developed market (DM) government bonds. In a macro environment characterised by solid growth, we would require a positive term premium. We maintain our underweight in DM **government bonds**.

We retain our neutral view for **global equities**. The market-implied global equity risk premium remains close to historical averages. We have a preference for equity markets in Japan and the Eurozone, as well as in emerging markets.

A historically gradual Fed hiking path supports our overweight stance on EM assets. However, EM equities have rallied year-to-date, making the investment case more about economic and price momentum, alongside the upside offered by cheap currencies.

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