NBAD

From West to East

Weekly Investment View

18th December, 2016

Reviewing last week's Fed transcript

Last week the US Federal Reserve increased the Federal funds rate by 25 basis points, to a range of 0.50% to 0.75%, only the second rate increase in ten years. We watched the press conference and have reviewed the transcript in detail, including the Q&A session, attempting to get to the most important points of interest to clients.

"Other things being equal, 2% US inflation could still be a few years away"

Chair Janet Yellen noted: "…the considerable progress the economy has made toward our dual objectives of maximum employment and price stability…". She continued, "…Overall, we expect the economy will expand at a moderate pace over the next few years… Looking ahead, we expect that job conditions will strengthen somewhat further… The price index for personal consumption expenditures was nearly 1.50% in October, still short of our 2% objective… we expect overall inflation to rise to 2% over the next couple of years… Market-based measures of inflation compensation (expectations) have moved up considerably but are still low". **Comment: Based on what they expect today the 'moderate' growth envisaged does not get inflation above 2% anytime soon. They may expect a rise in the labour participation rate to 'strengthen job conditions'.**

On GDP growth, unemployment and inflation, Ms Yellen said: "The median projection for growth of (real) GDP rises from 1.9% this year to 2.1% in 2017 and stays close to 2% in 2018 and 2019, slightly above its estimated longer-run rate… Unemployment stands at 4.7% in the fourth quarter of this year. Over the next three years, the median unemployment rate runs at 4.5%, modestly below the median estimate of its longer-run normal rate… The median inflation projection is 1.5% this year and rises to 1.9% next year and 2% in 2018 and 2019… GDP growth is a touch stronger, the unemployment rate is a shade lower, and inflation, beyond this year, is unchanged". "We continue to expect that the evolution of the economy will warrant only gradual increases in the federal funds rate over time to achieve and maintain our objectives… The median projection for the federal funds rate rises to 1.4% at the end of next year, 2.1% at the end of 2018, and 2.9% by the end of 2019… the median path for the federal funds rate has been revised up just 1/4 of a percentage point, to 3%". "…of course, the economic outlook is highly uncertain…". **Comment: Of course they have to state that the economic outlook is uncertain, yet the scenario described - if in any way realized - should not unduly worry investors. Also, the FOMC is only targeting a cushion of Fed funds being about 1% above forecast inflation in the medium-term.**

"Three hikes for 2017 is fine, if there's good growth"

Moving to the Q&A section of the press conference, often much more interesting: Q: Why does the Fed now see three rate increases next year instead of two? Is this a reaction to Donald Trump's election? YELLEN: "…. I would like to emphasize that this is a very modest adjustment in the path of the federal funds rate… The unemployment rate is perhaps a touch lower than previously… For this year, there was a slight upward revision to inflation and some of the participants did incorporate some assumption of a change in fiscal policy into their projections…the shifts that you see here are really very tiny". **Comment: Going by the 'dots', it has to be said that three increases vs. the original two expected makes little difference, especially given that growth is expected to be 'a touch stronger'.**

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Q: Should the average American feel more confident in the economy now that you are raising rates to a slightly faster pace? YELLEN. "…So it is a vote of confidence in the economy… It could boost very slightly some short-term interest rates linked to them… I think that households and firms will see very modest changes from this decision… my colleagues and I have judged the course of the U.S. economy to be strong…". **Comment: The 'strong' reference to the envisaged path of the economy could be a clue to what she really thinks, vs. the 'moderate' growth in the prepared statement.**

"Average workforce quality continues to be a problem for the US"

Q: Unemployment is already below the longer run projection under the policy rule you cited in your August speech… (so) is there a risk that the Fed is already behind the curve even before any fiscal impact next year? YELLEN. "…We're not seeing evidence in labor markets of very substantial upward pressures on labor that could signify extreme shortages of labor that could propel inflation higher in a very rapid way…". **Comment: Perhaps she expects a number of low-quality workers to re-join the work force, keeping wage growth under control?**

Q: You and your predecessor had both called for more fiscal stimulus to help with the growth outlook; I'm wondering how much do you judge the economy has capacity for fiscal stimulus right now? YELLEN: "…fiscal policy is not obviously needed to provide stimulus to help us get back to full employment. But nevertheless, let me be careful that I'm not trying to provide advice to the new administration or to Congress as to what is the appropriate stance of policy". **Comment: It's a good question, and what Yellen says suggests she believes full employment has in reality yet to be reached.**

"We would expect Ms Yellen to weather any political pressure"

Q: How comfortable are you with possible interference on Fed policy by the incoming president? YELLEN: "I'm not going to offer the incoming president advice about how to conduct himself in policy. I'm a strong believer in the independence of the Fed. We have been given the independence by Congress to make decisions about monetary policy in pursuit of our dual mandate objectives". **Comment: The FOMC will and has the power to do whatever it deems to be correct!**

Q: The President-elect has said that overhauling financial regulation is a high priority for him. I'm curious whether the Fed has been asked to provide any advice on how that might be done. YELLEN: "Our staff have been in touch with the Trump transition team and (want) a smooth transition. I've not been in touch beyond that and it's not something that I would expect… it's important to look for ways to relieve regulatory burden on community banks and smaller institutions to tailor regulation… But I would urge that it's important to keep (the Dodd-Frank systemic regulations) in place". **Comment: That is clear, but in answering a similar question she sounds tougher: "There have been many ways in which there have been compliance failures at large organizations and you've seen a series of enforcement actions by the banking regulators over a range of practices that suggest some breakdown of compliance or culture, whether it involves violations of sanctions or a foreign exchange or LIBOR or other matters…. the failings that we have seen in a number of institutions suggest there is certainly room for improvement". So the Fed will fight proposed regulatory relaxation that it deems irresponsible.**

"The FOMC clearly wants evidence of Trump policies, the markets not so"

Q: The election of Donald Trump seemed to have sparked a major reaction in financial markets. Did any of this get discussed in the meeting, including Trump's economic plan? YELLEN: "We did discuss these topics… We will have to factor that into our outlook and figure out what is an appropriate response. But we're operating under a cloud of uncertainty at the moment and we have time to wait to see what changes occur…". **Comment: It looks as though the FOMC members have certainly not assumed Trump policies in the way that markets have.**

Q: You've suggested you will serve out your term, but I'm curious if that statement still holds if you would like another term as Fed chair, if you would accept another term as a Fed chair, and would you stay on the committee if you were not Fed chair? YELLEN: "…I was confirmed by the Senate to a four-year term. The term of the Fed chair was not meant to coincide with that of the president… It's part of ensuring the independence of the Fed. And so, I do intend to serve out my four-year term. I haven't made any decision about the future…". **Comment: Yellen was clear enough, and will not be bullied - of course.**

"Ms Yellen has said such low rates today justifies equity valuations in this range"

Q: The Dow is about to hit 20,000. It's up substantially since the election on, apparently, investor optimism about the (likely) impact of President-Elect Trump's policies on the economy; I wonder if you share that optimism, number one, and if not, are we seeing a bout of, perhaps, irrational exuberance right now? YELLEN: "…stock prices may have been boosted by expectations about tax policy, possible cuts in corporate tax rates… or by expectations about growth, possible reductions and downside risk to the economy. But, you know, these are things that market participants are trying to view… I don't want to offer a view as to whether they're appropriate". Upon being pressed regarding whether the Dow near 20,000 was within historical norms (of valuation), Ms Yellen responded: "Remember that the level of interest rates is low and taking that into account, I believe it's fair to say that they (stock valuations) remain within normal ranges". **Comment: To the extent that she does comment, there is no question that with rates still being in the low range, stocks are in 'normal ranges' of valuation.**

Q: Both times you've raised rates in this cycle the market expectations of a rate hike have been over 50 percent. The market has priced it in. Is that a pre-requisite going forward? YELLEN: "It's not a pre-requisite but we do try to explain our evolving views… It's not surprising that it would often be true that moves are well anticipated by the market… there are good reasons why the market should have anticipated a move today". **Comment: Absolutely – and they don't want to be in a position of ever shocking the market unless unavoidable as a rapid response to an external shock. The 98-100% probability reading was helpful to the Fed in enabling them to make the next step towards 'normalization'. While for at least a few years the Fed was behind the curve, Trump's policies should allow normalization to gradually proceed.**

"The QE amounts in the system would have to be drained very slowly, if that ever happens"

Q: The Fed's balance sheet has grown to over $4 trillion dollars; as the Fed begins removing policy accommodation, under what circumstances would you see the Fed removing or possibly winding down its balance sheet? YELLEN: We've indicated that we expect to diminish the size of our portfolio over time largely by ceasing reinvestments of principal rather than by selling securities… We want to feel that if the economy were to suffer an adverse shock, that we have some scope through traditional means of interest rate cuts to be able to respond… And we would end up if all goes well with a substantially smaller balance sheet than we have at present". **Comment: When the Fed talks about the continuing accommodation in monetary policy, they will be referring to the huge QE that has already occurred and which remains in the system - plus the fact that rates are still historically close to all-time lows. So when they finally rein-in, they know they must do it very gradually.**

INVESTMENT SUMMARY: Overall, we do not see the increase in the Fed funds rate by itself being bearish for developed market equities, and remain overweight in the US and the Eurozone. We are neutral in global bonds, and underweight in cash.

In addition, the Asset Allocation Committee met last week and decided to: (1) Go overweight in MENA equities, emphasizing UAE stocks; these have been looking rather bombed-out yet the recent higher trading range in crude oil price provides encouragement that they can now participate with other global equity markets; (2) In developed market bond portfolios it was decided to increase average duration from close to four years, to six years, consistent with the thought that (at 2.59%) the US 10-year Treasury yield has the potential to correct to about the 2.20% area, thus driving a worthwhile relative switching opportunity, and lastly, (3) it was decided to take off the final half of the yen hedge, given the extraordinary rally in the dollar relative to the yen as investors have generally embraced a 'risk-on' mood in many asset classes. The 100% hedge on euro-based assets remains, while a hedge position in precious metals remains across the model portfolios.

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