Volatile markets and politics won't change the Fed's path

by Franck Dixmier | 02/11/2018

Summary

The strong economic foundation in the US continues to validate the Fed's trajectory, despite the increased risk-aversion recently seen in the markets. As a result, we expect the FOMC to stay on its path, free from political pressure, and continue monetary-policy normalisation.

Key takeaways

- The latest economic data continue to give the Fed confidence about the growth prospects for the US economy
- The Fed is willing to stop its monetary stimulus and raise rates beyond the neutral rate – but it will be pragmatic and keep an eye on the economic data
- We expect a rate hike to be announced at the Fed's December meeting, for a total of four rate hikes in 2018

At this stage, we do not expect the recent increase in risk-aversion and stockmarket volatility to deflect the US Federal Reserve from its path. The minutes of the Federal Open Market Committee's 25-26 September meeting are particularly enlightening on this point. The Fed remains confident and optimistic about the growth prospects for the US economy – particularly the ability of most of the firms affected by tariffs to transfer those price increases to households.

The minutes also show that the last rate hike was unanimously passed, and that the majority of the committee members favoured going beyond the neutral rate – the interest-rate level that neither stimulates nor restrains economic growth. Estimates for the neutral rate currently range from 2.5% to 3%.

As a result, the message from the Fed is clear and the markets have understood it. As proof, the markets have not revised their rate-hike expectations and still anticipate three increases by the end of 2019. This view has taken root despite an increase in risk-aversion in the face of slower growth in China, fears about Brexit and Italy's fiscal trajectory, geopolitical tensions and the rise of protectionism – all of which have contributed to high volatility in equity markets.

The Fed's confidence is based on economic data that demonstrate the strength of economic activity in the United States.

- In the third quarter, the US economy grew at a 3.5% annual growth rate – a dip from the second quarter's 4.2% rate, but still well above its potential.
- This growth was driven by consumer spending, which rose for the seventh consecutive month (at a 4% annualized rate) and was a direct consequence of President Donald Trump's tax cuts.
- Core PCE – the inflation indicator favoured by the Fed, which measures personal consumption expenditures – remained stable at 2% for the fifth consecutive month. An increase in prices and wages are being offset by a slowdown in real-estate prices.

This convergence of economic activity clearly indicates a US economy that is rolling along and validates the Fed's willingness to stop the monetary stimulus and go beyond the neutral rate.

As a result, we expect the FOMC to stay on its path, free from political pressure, and continue monetary-policy normalisation. We therefore expect a rate hike to be announced at the Fed's 18-19 December meeting, for a total of four increases in 2018. We also expect two further hikes in 2019.

It is important to note, however, that the Fed will not put its rate-hike plans on autopilot. The central bank wants to find room to manoeuvre in case the US economy reaches its inflexion point. But the FOMC will be pragmatic and keep an eye on the evolution of economic data, in total independence from political pressure.

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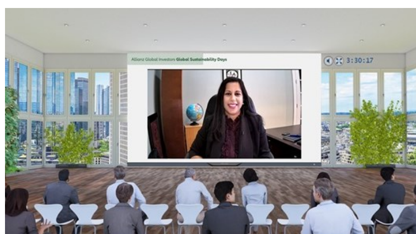

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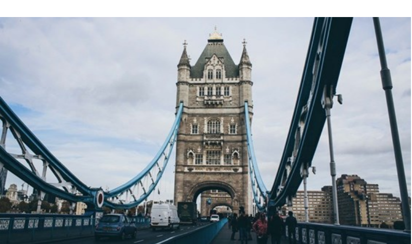

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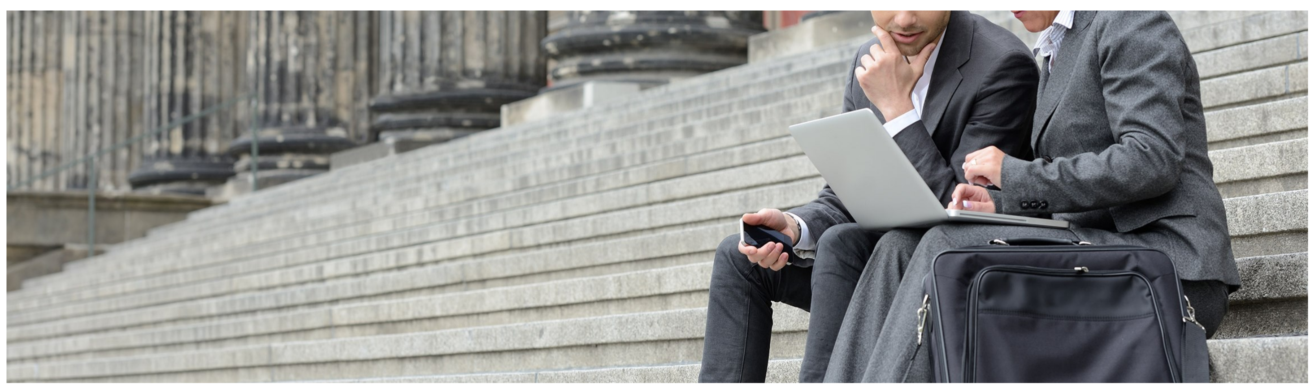

Summary

The response of central banks to the financial crisis 10 years ago may have saved the world from a devastating depression, but it also created a host of unforeseen effects – from more indebtedness to more economic inequality. Looking back at what we got right – and what went wrong – what lessons can we take away for the future?

Key takeaways

- 10 years after the financial crisis, the global economy arguably solved a debt crisis with more debt, made affordable by low interest rates and quantitative easing
- Low yields have made safe returns hard to find – yet strict investment guidelines and risk-aversion have left many investors unable to escape the effects of financial repression
- Fundamental and structural reforms remain elusive for many economies, as Japan has shown over the last 30 years
- Political uncertainty and populist politics could continue to rise as each economy comes under pressure to grow and deleverage simultaneously
- Inflation remains the enemy for investors: it is the "stealth default" solution for a world with too much debt

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