MARKETWATCH: ZERO TO 25BPS, AND WE’RE OFF…

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The Cayman Islands Journal, 6 January 2016: In the final policy meeting of 2015, the Federal Reserve did not disappoint markets and offered up a generous 25bps lift off in rates. The quarter of a percentage point increase pushed rates off the zero bound for the first time since 2008! Immediately following the announcement, the move was met with much jubilation on Wall Street, strengthening the US dollar and sending equity markets higher.

Prior to the start of the FOMC meeting on 16 December, the treasury curve began a flattening trend as the two-year US treasury climbed to a five-year high of 1%. The longer end of the curve, evidenced by the ten-year US treasury, remained quite muted at 2.30%.

In a valiant attempt to defend their currencies, global central bankers with policies affixed to the Federal Reserve system were also forced to raise rates in tandem. The Bank of Japan (BOJ) and European Central Bank (ECB) remain the noticeable outliers, both announcing quantitative easing efforts to stem the rising threat of deflation and shore up their respective economies.

Boasting a strong dollar, 2.3% GDP rate for the first half of 2015, and average monthly payrolls gains of 210,000 as the unemployment rate approaches full employment, the decision to hike rates was unanimous among voting committee members. In the press conference following the meeting, Fed Chair Janet Yellen acknowledged the rate increase was warranted, citing the considerable progress in the economy following the crisis. Ms Yellen would later caution, however, that any further hikes would be gradual, estimating an additional four hikes in 2016 according to the median FOMC projections.

The implication from the first increase in rates in almost ten years is expected to lift the market’s forecast of the Fed futures curve closer to the FOMC projections, an indicator that has been trailing significantly lower over the past 12 months. Given the start of a new policy normalisation cycle, what factors are expected to drive markets in 2016?

Global economic growth will certainly play a key role in determining the path of future interest rate hikes. With sluggish demand, weakness in emerging markets and policy divergence among global central banks, there is much concern the US economy will not generate enough tailwinds to drive its economy forward. As the Fed embarks on its tightening cycle, sectors highly sensitive to interest rate moves, such as housing and consumer durables, will no longer benefit from a declining borrowing rate. An increase in the Fed funds rate will certainly stem the strength of consumer spending, which accounts for approximately 70% of US GDP.

Regardless, some may argue that the expected improvement in employment and wage growth should uphold spending as the underemployment rate (which adds back temporary and discouraged workers) fell to 9.9%. Any incremental improvements in employment, therefore, may not be enough to offset the impact of falling demand from higher priced goods as this indicator approaches the natural rate of unemployment. With wage growth being a major contributor to inflation, coupled with its exponential relationship with the underemployment rate, mounting wage pressures could force the committee to switch its focus from employment generation to battling inflation.
Another major factor expected to impact markets in 2016 will undoubtedly be the continued strength of the US dollar. The early implementation of quantitative easing by the Federal Reserve and steady progression to policy normalisation has resulted in a powerful bull run in the US dollar. Now that a clear path for additional hikes has been established, the US will continue to attract global investment dollars even as other developed central bank policies are pushing yields lower. Such monetary policy divergences, sluggish growth expectations and net capital outflows from struggling economies, will continue to favour the US as a safe haven for those seeking refuge.

At the present time, it is important to create a defensive strategy to protect your portfolios. Should global growth continue to struggle limiting the Fed's flexibility to raise rates aggressively, the risk of inflation as the economy approaches full employment may force the Fed's hands at a most inopportune time. Given the cross hairs of diverging global growth, dollar strength and toss up in potential inflation from wage growth and full employment, the pendulum has the potential to shift ever so swiftly to either side of the scale for US investors. Consequently, expect trading conditions to remain extremely challenging over the next six to 12 months, as there appears very little place to hide for global bond market investors.

Statistics and Data Source: Bloomberg L.P., BCA Research, Federal Reserve

Chart Source: BCA Research

Median Fed Funds Rate vs. Market Expectations

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