RBC Global Asset Management

THE RATE HIKE IS HERE, NOW WHAT?

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With the announcement of a 0.25% (25 basis points) rate increase, the U.S. Federal Reserve (Fed) has now officially begun its first new tightening cycle in 11 years and has finally bid farewell to seven astonishing years with a 0% policy rate.

The rate hike has arguably occurred in the best possible way for investors:

- The outcome is not a surprise to markets
- The vote was unanimous
- The Fed has managed to articulate a positive economic outlook
- The Fed has emphasized that additional tightening will proceed quite slowly

Let us address each of these subjects in more detail.

Expectations

First, markets were well prepared for this outcome. Fed signaling – while spotty earlier in the year, in particular around September's meeting – ultimately succeeded in conveying to markets the high probability of this December rate hike. Moreover, most economic signals agree with the Fed's action: the unemployment rate is already just 5.0% and core inflation is sitting at 2%, signaling that a rock-bottom fed funds rate is no longer appropriate.

As a result of all this, there is no scrambling necessary for financial markets, and moreover the Fed's action is unlikely to be interpreted as a policy error.

Conviction

Second, the unanimous vote indicates that the Fed has a high level of conviction in its action and forecast. A further signal of this is that the range of Fed participant expectations for the level of the policy rate in 2016 has significantly narrowed.

That said, there appears to have been some slight discord internally, as the so-called dot plots indicate that two non-voting regional Fed presidents preferred to leave the policy rate unchanged at this meeting. But even this is an improvement: four participants preferred not to raise in 2015 when last polled in September.

Economic health

Third, the Fed's economic outlook was fairly good. The main message was that growth has been moderate, and should remain moderate. This was no different than before. Similarly, the Fed acknowledged the divide between good household spending, business investment and housing growth, and weak exports. But, at the margin, a few comments revealed a more optimistic interpretation.

Part of this optimism relates to the tracking of recent data. The Fed upgraded its assessment and outlook for the job market, and has concluded that the amount of labour slack has "diminished appreciably" since the start of the year.

From a numerical perspective, the Fed's GDP forecast was revised a hair higher in 2016 (from 2.3% to 2.4%) and the unemployment forecast was lowered slightly for 2016 through 2018 to just 4.7%. Helping to tip the balance further in a positive direction, the Fed has finally concluded that the risks to its economic outlook are "balanced." This had been described as a more conservative "nearly balanced" fashion for some time.

Equally important was what wasn't mentioned. The Fed expressed no new concern about the latest poor ISM Manufacturing reading, and did not see fit to mention recent volatility in the high-yield bond market in its official statement.

Perhaps the one slightly negative element was that the Fed acknowledged that some survey-based measures of inflation expectations have "edged down" (from already low levels), and that it has downgraded its inflation forecast for each of 2016 and 2017 by 0.1%.

Future path of rates

The median Fed participant still looks for four further rate increases in 2016 (to a policy range of 1.25% to 1.50%), but the distribution of expectations around that median has narrowed and declined significantly. Whereas four participants thought the Fed funds rate would end 2016 above 2% at the last forecast, there is now just one participant with that view. Phrased differently, the average dot plot in September looked for a 1.48% fed funds rate by the end of 2016, versus just 1.29% in the latest forecasts.

We look for three further rate increases in 2016 – slightly less than that assumed by the Fed.

The Fed's expected level of the policy rate has also been lowered for subsequent years. For instance, the median expectation has fallen by 25 basis points for 2017, and also slightly for 2018.

Signaling a welcome willingness to change course as the situation demands, the Fed emphasized that the "actual path of the federal funds rate will depend on the economic outlook as informed by incoming data." This serves to emphasize that the Fed could very well find itself again on hold for extended periods of time as it waits for positive economic signals from the economy, especially in the aftermath of this first symbolic rate hike.

Just as important as a slower path of interest rate increases is the Fed's commitment not to reduce the size of its vast balance sheet "until normalization of the level of the federal funds rate is well under way."

Addressing concerns

Naturally, the start of a new tightening cycle tends to surface a variety of concerns.

We view the economic consequences of this rate increase as fairly small. A single rate increase subtracts no more than 0.1% to 0.4% from economic growth over the subsequent year (and we think the lower end is more realistic). Recessions are simply not induced by a single or even handful of rate increases.

The high-yield debt market has been a source of market concern recently. Fed Chair Yellen addressed this issue during the question-and-answer period, indicating that the Fed was evaluating the subject carefully, but she downplayed concerns with the view that "several factors should help to mitigate spillovers."

We have long identified a series of debt-related risks in the world, and acknowledged that some combination of four catalysts – Fed rate hikes, a strong dollar, decelerating emerging-market growth and the commodity collapse – could eventually trigger problems. As such, this start to the tightening cycle – while itself largely trivial in the sense of only increasing borrowing costs slightly – could yet reveal certain excesses. We are watching closely for signs of trouble, but are operating under the assumption that the market has probably already surfaced most of these potential problems since the summer given how well this increase was telegraphed in advance.

Another concern is that the economic cycle could be nearing its end. Interestingly, the dot plots showed that there is a new, small cohort of participants who seem to think that 2018 could mark the end of the tightening cycle (presumably based on concerns that the economic cycle might be ending by then). Two Fed participants now look for fed funds rates of 2.125% and 2.5% at the end of 2018. The previous low forecast was 2.875%. Our own take is that the economic cycle has indeed grown mature, raising the risk of a downturn over the next several years. However, we cannot see the turn occurring right now.

Conclusion

The main message is that the Fed has succeeded in lifting rates without disrupting markets too much. Indeed, the messaging around the decision is about as positive as one could expect for investors: a positive economic assessment paired with fairly dovish central bank guidance (at least relative to expectations).

In our view, it is quite unlikely that the Fed will raise rates at its next meeting on January 27th. The Fed's own dot plots suggest that a pattern of every second meeting is the default assumption. As such, March 16th likely merits closer attention. That said, we think there is a fair chance that tightening is spaced even more widely than this, depending on economic and financial developments.

The market's interpretation has whipsawed back and forth several times, but is now (correctly) settling on a positive interpretation for risk assets. The dollar is now slightly higher, yields are up and U.S. equities have risen.

Over the medium run, a Fed tightening cycle should theoretically increase interest rates across a range of fixed income products, though we believe any increase should be modest given other profound downward forces that remain in place. Stocks have not traditionally loved tightening cycles, but have nevertheless been able to rise on average through tightening cycles.

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