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Above the turmoil

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FIRST FOR INVESTMENT STRATEGIES

FED ALERT

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Laura Suter

EDITOR FUND STRATEGY

The year has been filled with much speculation on when the Federal Reserve will raise rates, with economic data coming out of the country pored over for new signs of the financial healthiness of the country and hints as to when the Fed may start ticking rates upwards. The most recent meeting of the Fed saw rates unchanged once again, with softer economic data leading it to revise the country's growth estimates for the year.

This kicks the can down the road – again – and sees the chance of multiple rate rises this year unlikely.

However, the economic results were not all doom and gloom. The US economy expanded slightly, rather than declining, while household spending and jobs gains picked up. The housing sector also saw some improvement. But all are baby steps. Other potential headwinds to a rate rise sooner rather than later include the unfolding Greek crisis, which could have an impact on the US's growth outlook and lead to further delays to the rate rise, pushing it out until the end of the year.

Even when it does come, the Fed is not expected to ramp rates up quickly, instead choosing a softly, softly approach to the rises. Some even predict there will be many months to wait between each incremental rise. However, the comments from chair Janet Yellen show that all but two of the members expect data to improve enough to see a rate rise this year, rather than waiting until 2016.

In the meantime, potential liquidity issues may hamper the bond markets, as the Greek situation and the slowness of the Fed to move lead investors to be reluctant to move themselves, meanwhile traders disappear on their summer holidays. Rather than looking ahead to a quiet summer, markets are still jumpy and July and August appear key in determining the timing of any Fed hike.

Jonathan Davis

MANAGING DIRECTOR, JONATHAN DAVIS WEALTH MANAGEMENT

"The new current market consensus for a Fed hike is December. The consensus expected date has been put back and put back so many times now I wonder why they bother to measure it. The Fed may or may not hike over the next year or so, but it is more likely we see a recession first, which will reduce the chance of any hike to nil. Even if a hike occurs, it will be temporary and the rate will fall back down almost immediately. We are more likely "turning Japanese", where they saw zero rates for nigh on 20 years and counting. What is far more likely is more money printing in that scenario. Buy government bonds – as we have been saying for the past few years.

Adam Barber

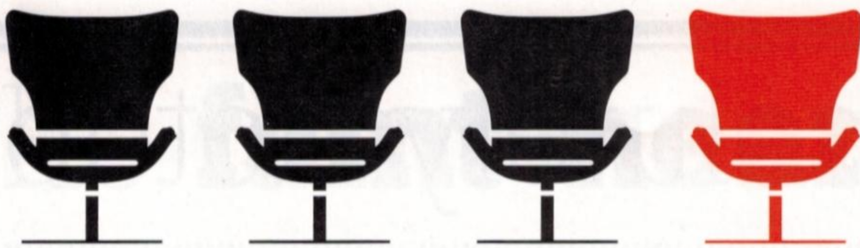
FIXED INCOME ANALYST, CITY ASSET MANAGEMENT

"Our central case is that the Fed will raise rates this year. However, we believe greater focus should be placed on the path of future rates rather than the exact timing of the initial increase. It has been made clear that policy will remain highly accommodative for some time and this should theoretically limit the extent of a sell-off in rates although a short-term market overreaction is a definite possibility. In any case, within fixed income we believe in a rising rate environment duration should be limited to allow the opportunity to reinvest at higher yields. This naturally favours short duration and floating rate strategies although consideration of the steepness of curves remains important. It is important fixed income and duration are not abandoned within portfolios, due to the associated diversification benefit and income stream. As multi-asset investors we are conscious that, as unconventional policy is withdrawn, there is a possibility of yield increases coupled with equity market declines.

Lee Robertson

CHIEF INVESTMENT OFFICER, INVESTMENT QUORUM

"It is widely expected the Fed would raise interest rates this year. However, this may not happen quite as soon as many believe. There are a lot of mixed economic signals, making it very difficult to read the situation. This is being made worse by concerns over a lack of liquidity in US fixed income markets, which could lead to the Fed stalling on the expected rate rises. US banks have been prevented, in the name of stability, from making markets in a number of fixed income assets, leaving fewer buyers and sellers of bonds, which could leave the bond market particularly vulnerable to shocks if the Fed does raise interest rates this year. Assuming the Fed can manage all these factors and begin to raise interest rates, investors should be thinking of holding short-dated bonds over longer term bonds to deal with rising rates, although this will mean lower yields. Blue-chip stocks and large-cap funds will often fare better during periods of rising interest rates so a steady transition from small and mid-cap to large-cap may well be a sensible approach.



The committee gives its views on when the Federal Reserve could start ticking rates upwards

Tim Cockerill

INVESTMENT DIRECTOR, ROWAN DARTINGTON

"We expect the first rate rise in Q3 and that this will be the start of a rising trend. Expectations will be for more to come slowly and for the rises to be small, at 0.25 per cent, and cautiously applied. This will set the tone for both equity and bond markets. In this scenario bond yields should rise but the equity market is harder to call. Rising rates should be taken positively by equities because the economy is back on track – in a normal economic cycle this is still an expansionary phase. However, equities have been anticipating this moment for a long time and the US market is not cheap; in fact it's looking quite expensive on a price-to-earnings multiple of 18. The dollar has appreciated, which creates a headwind for exporting businesses but of course helps reduce inflation as imports are cheaper. So there is a risk equities sell-off in the short term, but long term we think the reaction will be positive as earning should continue to grow. In positioning portfolios we have reduced fixed interest exposure and brought our overweight to the US back to neutral for now.

Graeme Black

INVESTMENT MANAGER, EQUILIBRIUM

"The recent FOMC announcement and economic figures coming out of the States indicate rates to rise by the end of the year. Although growth stalled in Q1, the employment figures are looking positive, albeit without the desired upward pressure on wages. Any rise or rate of increase will affect treasuries but the ripple from this spans to other securities. You would imagine the UK would be close on the heels to increase base rates, currency and asset classes, as can be seen looking back to 'taper tantrum' in 2013. US Dollar has strengthened against trade partners by around 17 per cent over the past year so we don't see as much impact, although if rates rise faster than expected we may see this strengthen further. We've already seen this bite into earnings with 70 per cent of S&P 500 companies citing this as a negative impact in Q1 earnings. We are currently underweight fixed interest in portfolios as a direct concern for the asset class in a rising rate environment. Our bond funds will typically have low interest rate sensitivity with credit risk more favourable.

John Husselbee

HEAD OF MULTI-ASSET, LIONTRUST

"The countdown to "lift off," the so-called first interest rate hike of this cycle, has been delayed so many times in the past couple of years. As a result, while most investors believe they know the direction they are travelling, they are just not quite sure when they will arrive. In the meantime, the Fed, and indeed other central banks, maintain their policy is working and they can successfully manage this interest rate cycle. For an investor who chooses not to believe this rhetoric they will need to sit on the sidelines in cash and learn to be patient, as it has been and could be a long wait. Those who refuse to fight the Fed and take the courageous approach of being fully invested in risk assets, this for now continues to be rewarded. For us, we see that neither of the traditional asset classes are particularly cheap so we continue to build exposure to alternative sources of capital growth, income and capital preservation. This is found either directly in alternative asset classes or traditional asset classes using alternative strategies.

The Fed meeting in June established it was in "wait and see" mode. Fed Chair Yellen emphasised that more important than which month the Fed begins to increase interest rates would be how quickly they rose thereafter. She repeated the Fed's expectation was for policy to be tightened only gradually.

Nevertheless, financial markets do care which month the Fed begins to tighten policy. June's announcements added to market doubts that the committee would be ready to tighten policy as soon as September. While the Fed acknowledged activity had resumed a "moderate pace" of growth, it lowered its 2015 GDP forecast and the number of Federal open market committee participants seeing a maximum of just one hike in 2015 rose to seven of 17 from two in March. Yellen stated that the Fed needed "more decisive evidence" that moderate growth would be sustained before tightening policy.

Recent economic data suggests the growth outlook is improving: consumer activity appears to be accelerating; business investment stabilising; and net trade overcoming port disruptions that affected Q1. We envisage relatively buoyant Q2 GDP growth, which should underpin ongoing improvement in the labour market. Accordingly, domestic news looks likely to increasingly argue for the need for tighter policy.

With the domestic economy showing signs of solid growth momentum and waning spare capacity, the point at which the Fed begins to remove some of its extraordinary monetary policy accommodation appears close. Whether it will come as soon as September will depend greatly on events over the course of this month. On balance, we maintain that the Fed will begin a gradual tightening cycle in September.

THE INDEPENDENT VIEW

David Page

ECONOMIST, AXA INVESTMENT MANAGERS