US interest rate rise comment

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Monetary tightening – no death knell for global equities

So it finally happened and the "will-they-won't they?" debate regarding US interest rates is over. Last night, US monetary policy tightened for the first time since 2006. The Federal Reserve increased its federal funds rate, the key US interest rate, by 0.25 percentage points from the 0-0.25% target range it has occupied since 2009 to 0.25-0.5%. For months, opinion has been divided on the wisdom of such a move. Some commentators questioned whether the economy was sufficiently strong to withstand tighter monetary policy while others believed it was long overdue. Even amongst the five-member Federal Reserve board of governors there appeared to be dissent. Lael Brainard, for example, used a recent speech to focus on the potential downside risks facing the US economy. In the end, however, Janet Yellen, the Fed chair, won over both her colleagues and the markets. The decision was unanimous and the US equity market rose – and volatility, an indication of investor fear, fell on the news.

So why did the Fed raise interest rates now? The US central bank has a dual mandate and aims to achieve both maximum employment and stable prices. Looking at employment, the Fed has largely achieved this goal, at least for the moment. Employment data are strong. US unemployment is currently 5%, with monthly job creation figures having averaged an impressive 210,000 per month from January to November 2015. There are a few residual doubts about the strength of the labour market because workforce participation has fallen and some part-time workers may be seeking full-time employment but the employment picture has improved sharply since unemployment reached 10% in 2009.

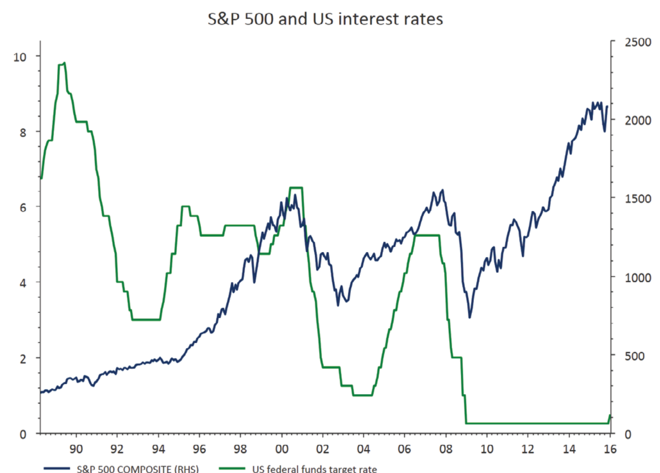
The jury is still out, however, on the Fed's success in delivering stable prices. Inflation data have fallen below the 2% target rate and there is, as yet, no sign of a major acceleration in wage inflation. Yellen has ascribed inflation weakness to "transitory factors" such as the falls in the prices of oil and other commodities. In her press conference yesterday, she cited the risk that employment and inflation would overshoot on the upside if ultra-loose monetary policy persisted for too long. US inflation, however, remains vulnerable both to further commodity price weakness and to any repetition of the potentially deflationary fall of the Chinese renminbi against the dollar that caused equities to fall sharply in August. So what does the rate rise mean for investors?

Dollar strength set to continue

Yesterday's rate rise widens the divergence in monetary policy between the US and the eurozone, where the European Central Bank recently announced that money-printing would continue into 2017.

Developed economy equities to rise

The turn upwards in the interest rate cycle, especially from such an historically low level, is a sign of confidence in the strength of the US economy. In previous rate-tightening cycles, US equities have risen.



Source: Thomson Reuters Datastream

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Eurozone and Japan to outperform

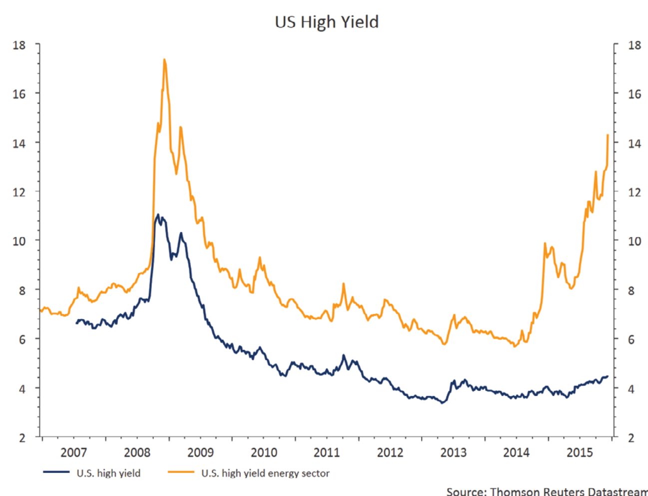
US equities have performed well but may find it harder going on a relative basis as interest rates rise and the dollar strengthens. Investors may now seek out undervalued opportunities in less expensive equity markets where central bank policy remains highly accommodative. Europe ex-UK and Japanese equities should do well in this environment.

Bond yields will rise but only gradually

Yellen's speech contained much to soothe bond investors. Interest rates will rise only gradually and the "neutral" rate, the rate at which monetary policy is neither expansionary nor contractionary, is much lower today than in previous cycles for a host of reasons including tighter lending conditions, private sector deleveraging, the dollar's strength and threats to US economic growth from abroad.

There are signs of illiquidity and stress in some bond market sectors, most notably in the US high yield market, where the oil price fall has hurt some energy sector issuers, causing yields to spike. In recent days, a number of US high-yield funds said they would "gate" investors or suspend redemptions owing to market illiquidity. This development is uncomfortably reminiscent of the hedge fund failures that proved the "canary in the mineshaft" warning of the distress in the mortgage-backed securities market that presaged the 2007-08 credit crisis.

The Fed governors will be monitoring markets closely in the coming days to assess the impact of their policy change.



No relief for gold and industrial commodities

The stronger dollar spells more bad news for companies and economies heavily exposed to commodity price swings.

Outlook

This first US interest rate rise does not mark the end of the opportunities for investors in risky assets such as equities and commercial property, far from it. Global equities can perform well in the early stages of a rate-tightening cycle and this cycle is likely to be slow and shallow. The Fed will be anxious to avoid a sharp sell-off in bond markets and will be watching closely for any signs of distress in this asset class that might spread to other financial markets. The fall in oil and other commodity prices will bring tough times for a minority of countries and companies but it is a major stimulus to the majority and will underpin global growth while the Fed takes the first steps to normalise monetary policy.

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