Market Note

14 June 2018

Robust US economy points to higher rate trajectory

On 13 June 2018 (US Time), the Federal Reserve (Fed) raised interest rates by 25 basis points (bps) to a range of 1.75%-2.00%.[1] Philip Petursson, Chief Investment Strategist, Manulife Investments, believes that robust US growth, coupled with accelerating inflation and low unemployment, will push interest rates higher over the next two years. He thinks that US equities are still attractive in the current environment, but their return may be slightly more modest than the historical average.

Accelerating inflation and low unemployment drive interest rate trajectory

As expected the Federal Open Market Committee (FOMC) raised its target benchmark interest rate. This didn't come as much of a surprise to us, nor to the market. At the start of 2018, the infamous "Fed dot plots" suggested three rate increases for 2018. But in the last few months our team and some in the market started to expect a total of four rate increases for this year.

The reasons? How about the lowest unemployment rate since 2000 of 3.8% for one?[2] Another reason would be that inflation has accelerated in just about every month this year.[3] These two reasons fall squarely at the feet of the Fed's dual mandate of full employment and stable inflation. Not to disappoint, the dot plots and language of the FOMC statement imply a shift to four rate increases for 2018 and an additional three for 2019.[4]

But if a rate hike was widely expected, does it matter? I suppose this is similar to the old philosophical question – if a tree falls in the forest, and no one is around to hear it, does it make a sound? In this case, yes. The fact that the Fed is raising rates at all speaks volumes. It suggests that the US economy is moving ahead at a pace that is not only stable but growing, driving inflation higher and unemployment lower. We are not at the stage yet that warrants the Fed to rein in inflation.

For the first time since the financial crisis, the fed funds rate is above the Fed's preferred measure of inflation of core PCE (personal consumption expenditure) which registered at 1.8% in April.[5] Going forward, the Fed signaled that it would tolerate an above target inflation of 2.0% at least through 2020. But make no mistake, that doesn't mean that the Fed won't be raising rates along the way.

We have seen an upward move in inflation since the summer of 2017. We believe that inflationary pressures will continue to increase in the US throughout 2018. Further supporting higher inflation,

[1] Source: Federal Reserve: FOMC statement, 13 June 2018.
[2] Source: Bureau of Labor Statistics, 1 June 2018.
[3] Source: Bureau of Labor Statistics, 12 June 2018. The index for all items less food and energy recorded month-on-month increase as of May 2018.
[4] Source: Federal Reserve: "Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy", June 2018.
[5] Source: US Department of Commerce, Bureau of Economic Analysis, 31 May 2018; PCE excludes food and energy.

President Trump recently signed into law fiscal stimulus policies, including US$1.5 trillion in tax cuts and a US$1.3 trillion spending package.[6] Aggressive fiscal expansion at this point in the business cycle is "highly unusual" and bolsters concerns. A tight labour market and fiscal expansion are among the top factors behind an upward inflation trend with prices rising over the last three months.

The Fed forecasts continued strength in the US economy with GDP growing at a healthy 2.8%, which is slightly better than earlier forecasts while weakening slightly next year to 2.4%. Strength in the US economy will continue to lower an already tight labour market: The unemployment rate is seen falling to 3.6% in 2019 as compared to 3.8% today.

Equities still attractive in a rising interest rate environment

There are consequences to the messaging today however that investors should pay attention to. We believe inflation and interest rates will continue to trend higher. We anticipate the US 10-year Treasury yield will resume its upward trend towards 3.25% and perhaps higher. The Fed will continue to push up the short end of the yield curve by another 50 bps in 2018 and by 75 bps in 2019. As a result of these forces, we expect the yield curve to continue to flatten and fixed income returns to be much more muted than in the past few years.

Within the equity markets, rising rates will be less of a headwind to portfolio returns but a headwind nonetheless. We expect rising inflation and rising interest rates to compress the price-to-earnings multiple of US stocks. Offset by strong earnings growth we expect US equities to deliver a positive return over the next year but perhaps slightly more modest than the historical average.

Taken together, while we continue to believe that investors should never forget their defense, in the current environment investors may be well served to add to equities.

[6] Source: Bloomberg, 22 December 2017 and 23 March 2018.

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