# A WORD FROM OUR CIO

## The risks to some of our 2017 forecasts


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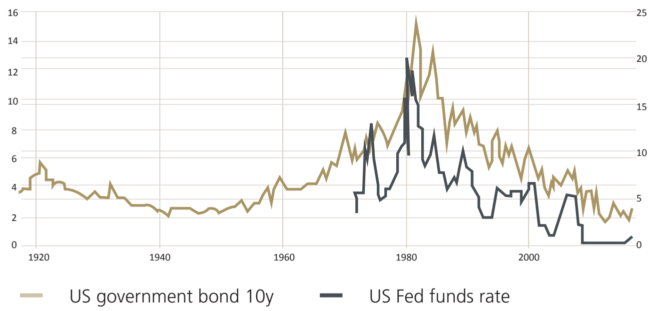
Forecasts serve a variety of purposes. Governments and businesses use economic forecasts to help them determine their strategies, multi-year plans and budgets. Stock market analysts use forecasts to help them estimate the value of a company and its share capital, and to manage potential risks. Although forecasting can attract legitimate criticism, it still assists in the scenario planning process. Forecasting also forces money managers to pay attention to the potential risks to their own viewpoint.

This article explores the risks to two of the scenarios we deemed most likely to play out during 2017. (Read more about all our expectations for 2017 in the latest PSG Wealth Research and Strategy Report.) Firstly, we anticipate that the US Federal Reserve (Fed) will increase interest rates to around 1.5% during 2017. Secondly, we believe that US Treasuries will be under further pressure this year. Most money managers understand that these two points are closely related. Typically, an interest rate hike has the opposite effect on most other fixed income asset classes. As interest rates increase, bond yields also rise, driving down prices for these instruments.

**Performance of US 10-year bond versus the US Fed funds rate**



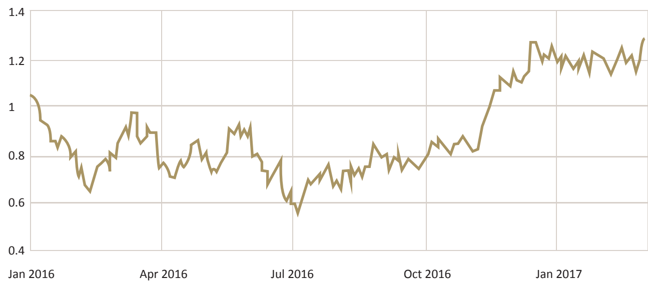

Source: Trading Economics

### We expect yields on US Treasuries to rise this year as we anticipate rate hikes by the Fed

At the beginning of March, Fed funds rate futures priced in about an 80% chance that the US Federal Reserve (Fed) will bump up interest rates by 25 basis points (bps) at its policy meeting on 14 and 15 March. Hawkish comments from Fed officials at the start of the month also stoked expectations of a US interest rate hike in March. Yields on US Treasuries jumped after the comments were made public. On 2 March, the 2-year yield rose to as much as 1.308%, from a previous level of 1.296%.

This was its highest level since August 2009. The 10-year yield rose to 2.462%, still below its two-year peak of 2.641% reached in December 2016. As expected, the Fed raised interest rates on 15 March for the second time in three months, with officials sticking to their outlook of two more rate increases this year and three more in 2018. Fed chair Janet Yellen said that the central bank would stick to a gradual path of interest rate rises even if inflation ran above its 2% target.

**Performance of the US 2-year Treasury yield as at 2 March 2017**




Source: Trading Economics

### Interest rate decisions remain heavily data dependent

Data on the strength of the US economy, the strength of the labour force and inflation are some of the important statistics which inform the Federal Open Market Committee's (FOMC) decision. The minutes of the FOMC's latest meeting showed that members accepted the need to raise the Fed funds rate again 'fairly soon'.

Data reviewed by the members showed that the US real gross domestic product (GDP) expanded at a moderate rate in the fourth quarter of last year and that labour market conditions continued to strengthen. At the time of writing consumer price inflation (CPI) accelerated further above the slow pace seen during the first half of last year, but was still running below the FOMC's longer-term objective of 2%. However, the latest data released by the Fed on 15 March showed that CPI inflation ticked up to its highest level in five years. The headline index moved up to 2.7% year-on-year (y/y) for February. Core CPI, which strips out the volatile food and energy categories, was up 2.2% y/y.

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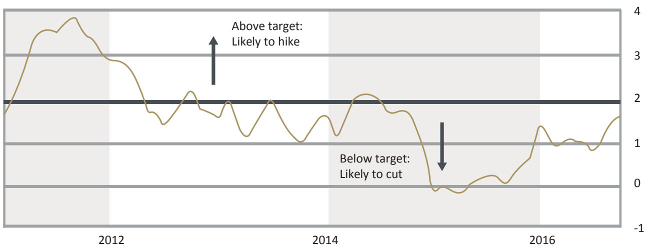
### US inflation rate since 2012




Source: Trading Economics

## Better-than-expected data released in the middle of February also placed the US Treasury market under pressure

CPI, retail sales and the Empire Manufacturing Index all exceeded estimates. Bond yields have been climbing over the past few weeks as hopes of reflation in the US economy mounted. At the time of writing the benchmark 10-year yield had risen almost 20 bps since 8 February. A higher interest rate outlook has taken the fizz out of the bond market. However, it is not only interest rates that are resulting in withdrawals. Uncertainty regarding US policy is contributing to the Treasury yield exceeding government-set rates. Global investors and central banks are reducing their investment in US Treasuries as President Donald Trump's expansionary policy is expected to lead to a higher fiscal deficit and rising inflation.

### US Treasury yields

| US Treasury | Yields at 3 January 2017 | Yields at 28 February 2017 |
|---|---|---|
| 2-year | 1.22% | 1.22% |
| 3-year | 1.50% | 1.49% |
| 5-year | 1.94% | 1.89% |
| 7-year | 2.26% | 2.19% |
| 10-year | 2.45% | 2.36% |
| 30-year | 3.04% | 2.97% |

Source: US Treasury

A Fed rate hike has been on the cards for some time.

## The preceding information supports our expectations, but now we need to clarify under which conditions our view may not play out as expected

A reverse in US employment, retail sales and, amongst others, inflation data could delay further hikes by the Fed.

The Fed defines the natural rate of unemployment as between 4.7% and 5.8%. The latest data shows that the US unemployment rate rose to 4.8% in January 2017. If the US economy takes an unexpected knock, economic growth could slow, which could lead to fewer available jobs and the unemployment rate rising. If corporate earnings are low and companies can't sustain the recent growth in wages, then the Fed would think twice before hiking rates.

Productivity growth in the US has also been lacklustre by post-World War II standards over the past decade. The FOMC noted at the end of 2016 that output per hour increased only 1.25% on average per year from 2006 to 2015. This compares to its long-run average of 2.5% from 1949 to 2005. If this halving of productivity growth were to persist, it could have wide-ranging consequences for living standards, wage growth and, more broadly, for economic policy.

If the major tax reforms proposed by the new Republican government in the US do not pass stringent tests, corporate earnings could also suffer. Some market commentators believe President Trump's tax plans will support economic growth and, in turn, corporate earnings. However, if these changes are not enacted, corporates will not grow as much as they might currently expect. This could lead to job losses, less retail sales and the economy growing more slowly.

The graphs on the next page show that both population growth and productivity are at lower levels. This could prompt concerns among FOMC members as these factors underpin the sustainability of the economic growth outlook in the US.

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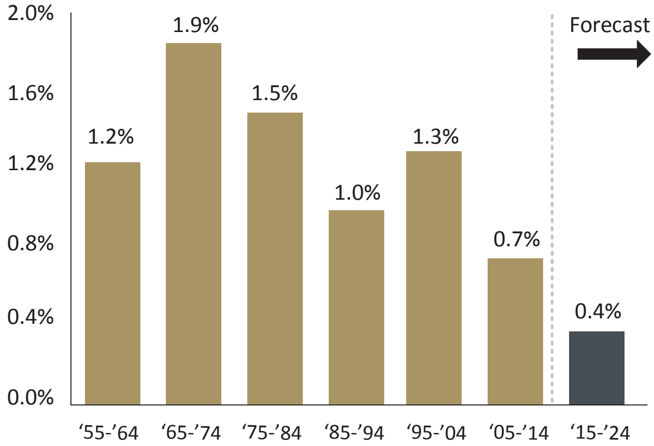
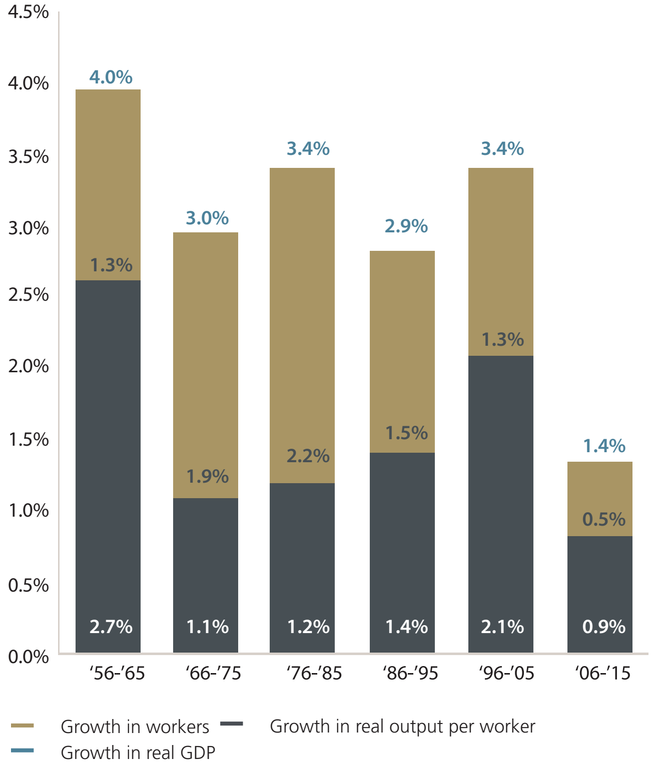
**Growth in working age population**
Percentage increase in civilian non-institutional population ages 16-64




Source: JPMorgan, Q4 2016 figures

**Drivers of GDP growth**
Average year-over-year percentage change




Source: JPMorgan, Q4 2016 figures

## Wage acceleration appears not to be high enough

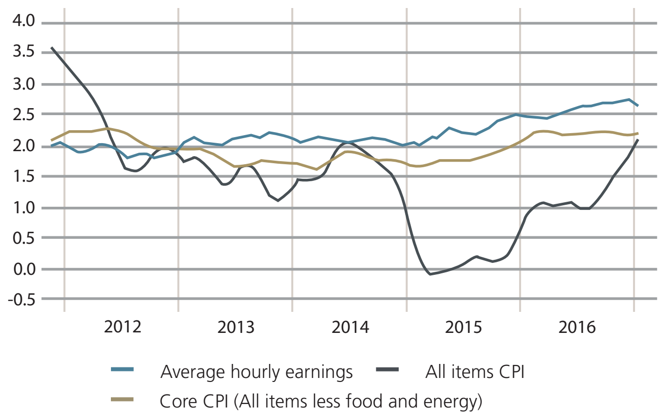
Robert Johnson, director of economic analysis at Morningstar, says they have been concerned about inflation for some time, mainly because higher inflation will put consumers under pressure.

"While the popular press has been cheering wage increases, and although it has done nice things for consumers, we beg to differ. Wage growth made its big jump a couple of years ago. Since then there hasn't been all that much change. For some time, consumers reaped a considerable benefit from a combination of demographically induced wage increases and low inflation."

Morningstar data shows that in early 2015, hourly wages were growing at 2.0% and, for all practical purposes on an economy-wide basis, there was no inflation. This gap persisted for almost all of 2015. Inflation increased somewhat in early 2016 to the 1% level and wage growth moved to 2.5%. This represents a smaller but still healthy spread. In February 2017, wage growth sneaked up to 2.65%, but the all-items CPI increased to 2.11%.

"After enjoying a spread of more than 2% in early 2015, that spread has shrunk to a meagre 0.5% on a year-over-year averaged basis. On a single-month basis the spread has all but disappeared in January, with inflation and wage growth hovering around 2.5%," Johnson noted.

**CPI change versus wage growth (3-month average %)**




Source: Morningstar Inc.

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If the economic indicators discussed above start to signal a weakening US economy, the Fed could decide to delay rate normalisation. This, in turn, could boost US Treasuries, which could start to outperform. This asset class would then not come under pressure as we expect in 2017.

Thomson Reuters thinks the Fed will let the economy run a little hot, rather than tightening interest rates aggressively this year. If they are right, then investors and the FOMC will reassess the prospects for monetary policy further ahead, bidding up the US dollar and Treasury yields later this year. Admittedly, this outlook is subject to greater-than-usual political uncertainty.

Analysts at Thomson Reuters feel that not only will the scale and timing of Trump's promised fiscal spree have a significant effect on the economy, but the newly assigned Republican seats in the FOMC could also cause unexpected changes in monetary policy.

In general, if economic conditions in the US worsen, the Fed could be forced to delay its proposed hike in rates. This in turn will boost US Treasuries, contrary to our expectations for this year. We feel these odds are currently quite slim, but remain cognisant of this tail risk and will make adjustments to our portfolio positioning if appropriate.