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Special report

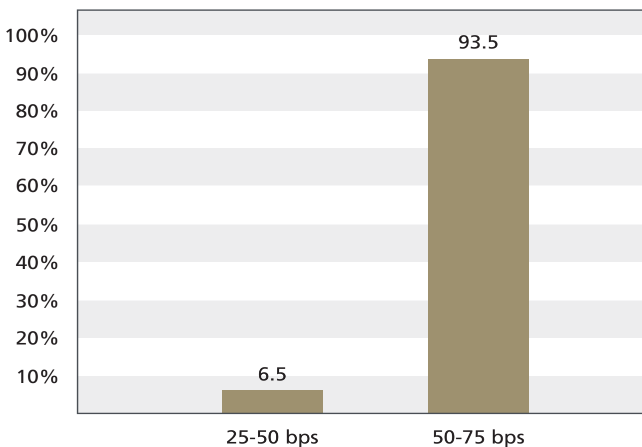
Is a rate hike in December by the Fed a foregone conclusion?

Markets started to price in a December interest rate hike by the US Federal Reserve (Fed), after Fed chair, Janet Yellen hinted at a hike during her recent Congressional testimony.

In her testimony before the Joint Economic Committee on 17 November, Yellen said the election of Trump as US president did nothing to change the Fed's plans for a rate increase 'relatively soon'. She added that the US central bank would change its outlook as necessary as the new administration rolls out plans for tax cuts and additional government spending. Yellen said incoming economic data justified a rate hike 'relatively soon' and, absent any dramatic changes, could be followed by a gradual pace of hikes. November minutes of the Fed meeting share the same view.

While the Fed has continually delayed a second increase in rates since their first timid move of 0.25% in December 2015, the implied probability of a rate hike in December is now above 95%. The CME Group, a US-based derivatives marketplace, uses the Fed funds futures to determine the probability of a rate hike. The chart below shows that there is a 93.5% probability that the Fed could hike rates with 50 to 75 basis points in December.

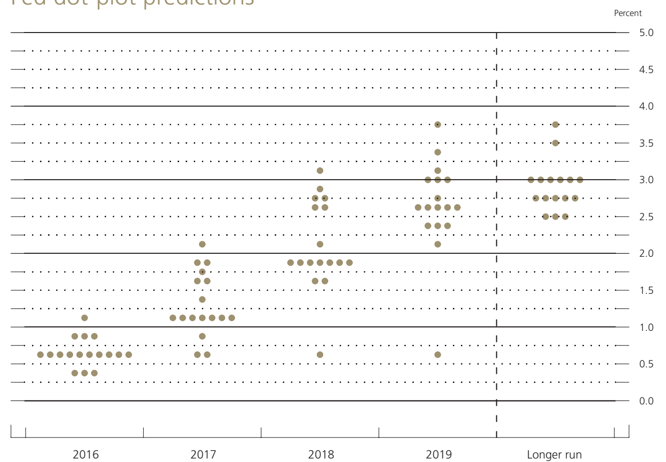
CME Group prediction for December rate hike



Target Rate (bps)	Current Probability %	Previous Day Probability %
25-50	6.5	6.5
50-75	93.5	93.5

Source: CME Group

Fed dot-plot predictions



Source: US Federal Reserve

The Fed's own dot-plot above shows that 10 out of the 17 Federal Open Market Committee (FOMC) members believe a rate hike of 25 basis points should take place in 2016, while four members believe it should be a larger increase. Only three of the members believe the rate will stay where it is. Seeing as the Fed has not hiked rates this year, many believe December is the appropriate time.

THE FED'S DECISION IS ALWAYS 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 informs the FOMC's decision. At their November meeting the FOMC found:

"that progress in the labour market has continued and that economic activity has picked up from the modest pace seen in the first half of this year. And inflation, while still below the Committee's 2% objective, has increased somewhat since earlier this year. Furthermore, the Committee judged that near-term risks to the outlook were roughly balanced."

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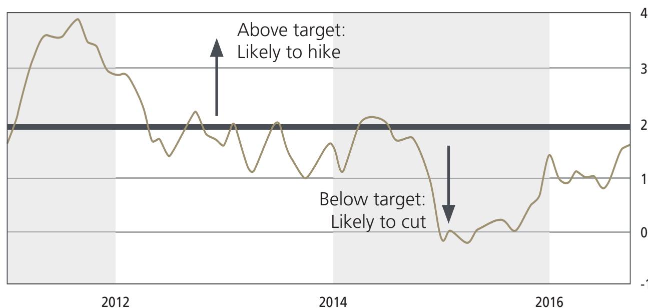
US inflation rate since 2012



Source: Trading Economics

The prospect that President-elect Trump and Congressional Republicans can do something to boost economic growth in the US appears to have simultaneously increased the expectations for future inflation. A stronger economy is poised to generate some consumer price inflation.

Some of the increased expectations for inflation comes from projections that President-elect Trump may cut taxes more than what he aims to reduce federal spending. Therefore, the increased budget deficit would mean more borrowing, which could push up inflation if the federal government pays for that borrowing by printing money (which is essentially what happens when the Fed buys up government debt).

THE US ECONOMY STILL FACES LONG-TERM CHALLENGES

Stanley Fischer, Vice-chair and member of the Board of Governors of the Federal Reserve System, said on 21 November that low equilibrium interest rates and sluggish productivity growth in the US and abroad still hampers GDP growth in this developed nation.

"The federal funds rate and policy rates in other advanced economies remain very low or even negative. Longer-term rates are also low by historical standards, even taking into account the increase of the past two weeks. Such low interest rates, together with only tepid growth, suggest that the equilibrium interest rate - that is, the rate that neither boosts nor slows the economy - has fallen."

This is important because low interest rates make the economy more vulnerable to adverse shocks by constraining the ability of monetary policy to combat recessions using conventional interest rate policy. Low equilibrium rates could threaten financial stability by encouraging a reach for yield and compressing net interest margins. More fundamentally, low equilibrium real rates could signal that the economy's long-run growth prospects are dim.

Fischer explains various reasons for the low interest rates. He points to weak productivity growth as the most important.

"Finally, and most important, weak productivity growth has likely pushed down interest rates both by lowering investment, as firms lower their expectations for the marginal return on investment, and by increasing saving, as consumers lower their expectations for income growth and borrow less and/or save more as a consequence."

Productivity growth over the past decade has been lackluster by post-World War II standards. Output per hour increased only 1.25% per year, on average, from 2006 to 2015. This compares to its long-run average of 2.5% from 1949 to 2005. This halving of productivity growth, if it were to persist, would have wide-ranging consequences for living standards, wage growth, and economic policy more broadly.

Fischer says a number of explanations have been offered for the decline in productivity. He adds: "We should also consider the possibility that weak demand has played a role in holding back productivity growth, although standard economic textbooks generally trace a path from productivity growth to demand rather than vice versa."

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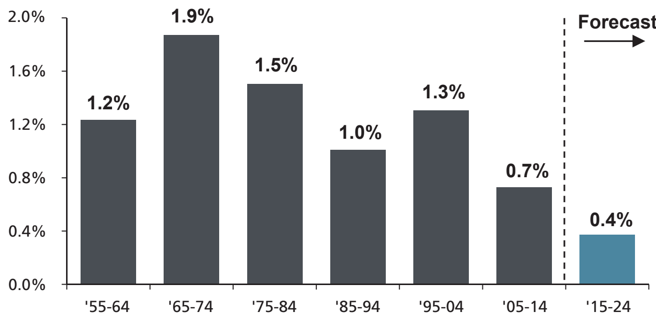
POPULATION GROWTH AND PRODUCTIVITY DATA COULD CHALLENGE THE FEDS ENVISAGED APPROACH

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

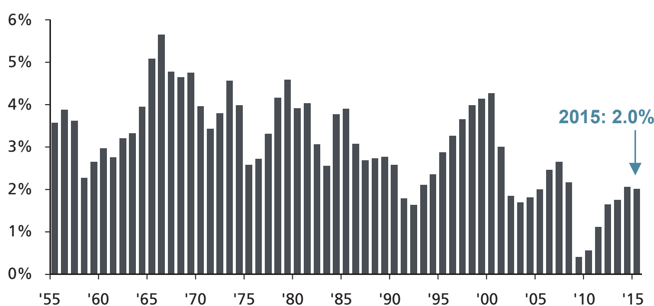
Growth in working age population

Percent increase in civilian non-institutional population ages 16-64



Growth in investment in structures and equipment

Non-residential fixed assets, year-over-year % change

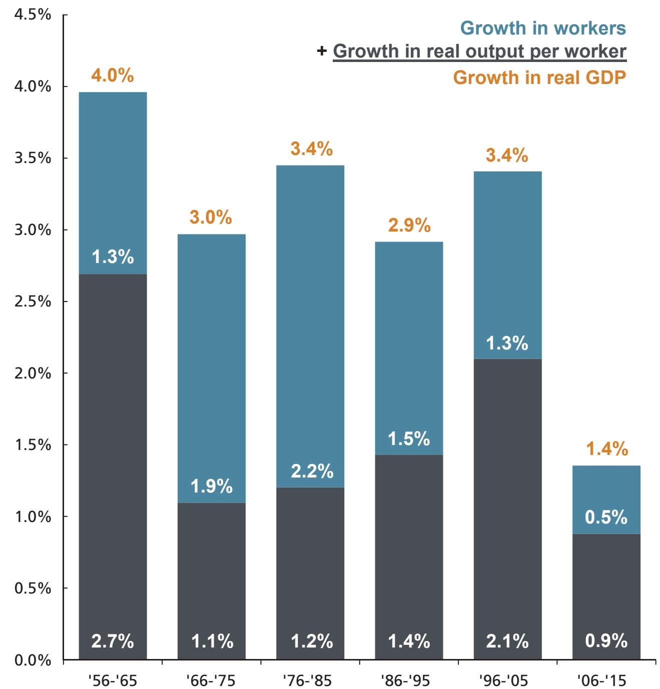


Source: JPMorgan

Currently expansionary monetary policy is supportive of economic growth, if this support is removed one has to wonder what policy action or potential drivers of economic growth could take over the baton from monetary policy. There has been comments than the envisaged replacement driver will be fiscal policy, but the FOMC must wonder if that will be sufficient to ensure sustainable economic growth.

Drivers of GDP growth

Average year-over-year percent change



Source: JPMorgan

In addition, there has been remarks that future policy will be aimed at a more closed approach to international trade, which could compromise the contribution of net trade to GDP. Also government spending has been a negative contributor to GDP growth in recent times.

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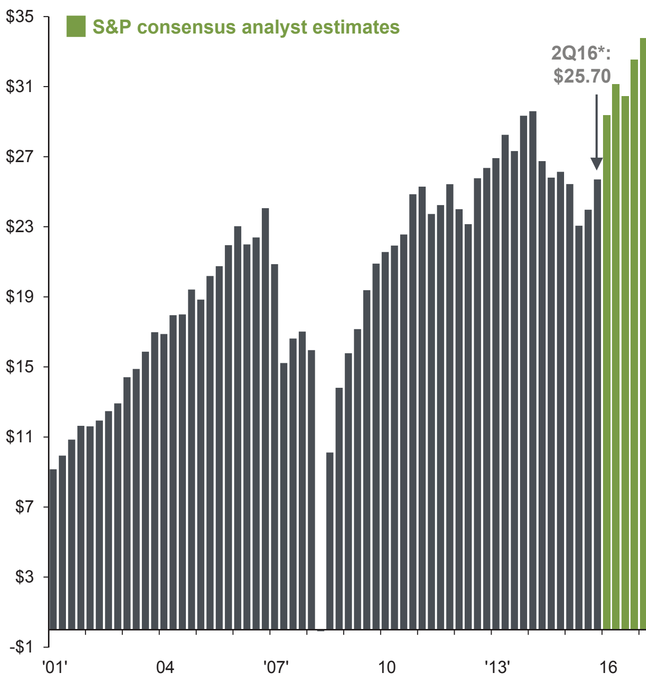
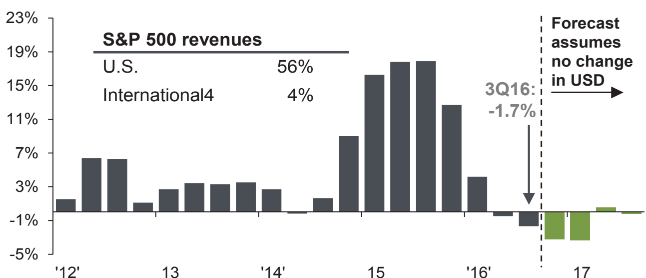
THE CORPORATE EARNINGS CATALYST

US corporate earnings have recovered strongly since the global financial crisis (GFC) of 2008. Corporate earnings are currently nearly double that of pre-GFC levels of 2007. The estimates by S&P consensus analysts indicates that further earnings growth is expected. The next few graphs show that earnings per share have been increasing and the outlook is improving.

S&P 500 earnings per share
Index quarterly operating earnings



U.S. dollar
Year-over-year % change, quarterly, USD major currencies index

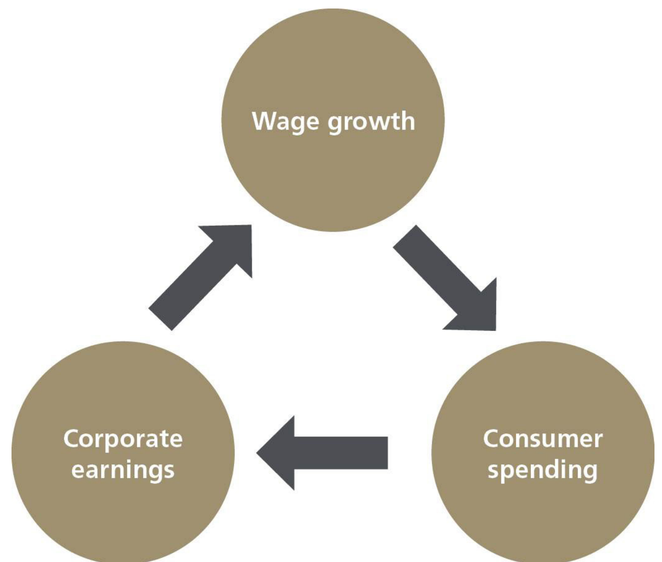


Source: JPMorgan

Even though some might expect the Fed to hike interest rates now, the Fed will need to know who will step in to support monetary policy if they make this decision now. President-elect Trump has indicated that fiscal policy could be this support, but no clear indication has been given about what exactly this fiscal support will be. The US cannot really rely on government spending, because this has not truly contributed to GDP growth. The graphs on the next page illustrate this.

We believe corporate earnings will be the catalyst that could support the Fed's decision.

Wage growth/Consumer spending/Corporate earnings wheel



Source: PSG Wealth research team

Corporate earnings could further benefit from lower corporate taxes as indicated in the republican policy strategy. We believe that corporate earnings growth in 2017 may trigger growth in wages, employment and act as the catalyst for economic growth. This could introduce greater consumer spending, ultimately acting as a catalyst for US economic growth going forward.

This could ultimaltely trigger a virtuous cycle between wage growth, consumer spending and corporate earnings.

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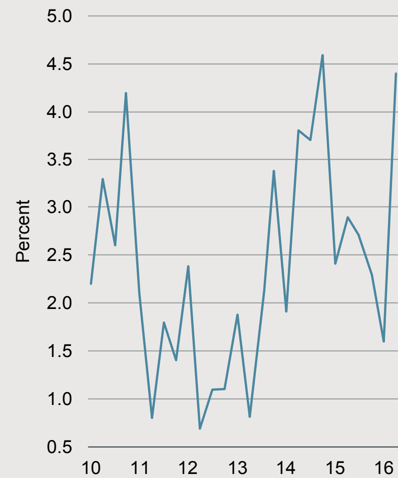
The US growth debate: jobs and income versus GDP and productivity

Private secotor GDP has been solid
Real GDP growth (percent)

Jobs and income data are strong

Economic indicator*	Latest number	Best since…
Average hourly earnings	+2.8%	Largest YOY change since 2007
Household incomes	+5.2%	Only YoY change greater than 4% ever
Average monthly jobs gain	239 000	Long-term average of 132 000
Unemployment initial claims	235 500	Lowest since 1973
Small businesses with job opening(s)	29%	Highest since 2006
Small businesses with few or no qualified applicants	48%	Tied for highest since financial crisis

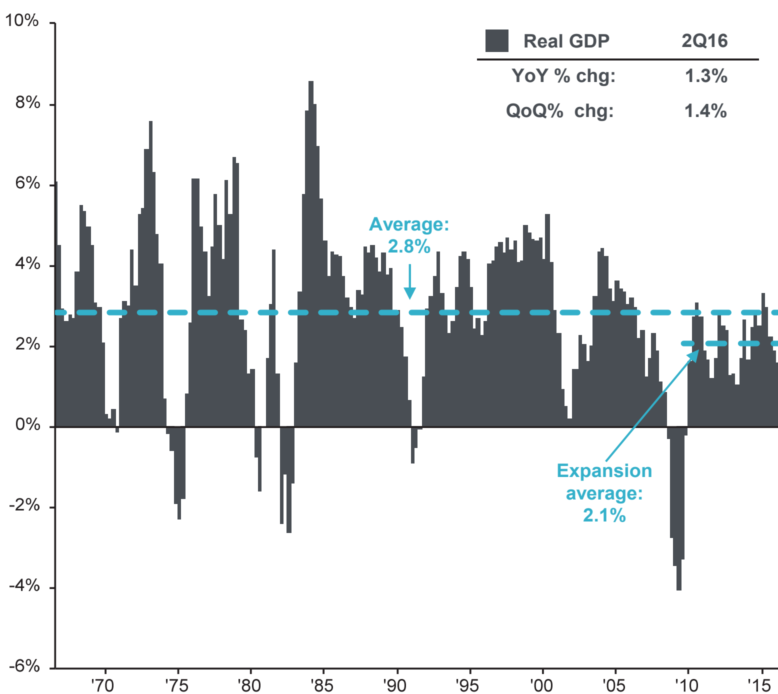
Consumer spending revised up
Percent change in real personal consumption expenditure (QoQ)

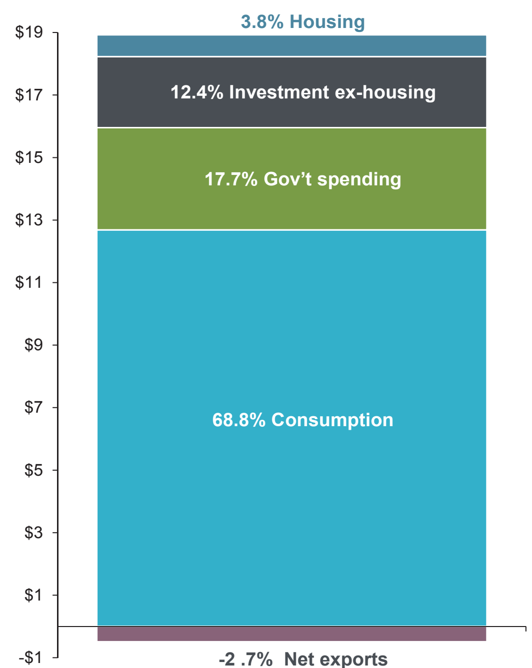


Source: AllianceBernstein Q42016 Global capital markets outlook

Economic growth and the composition of GDP

Real GDP
Year-over-year % change





Source: JPMorgan

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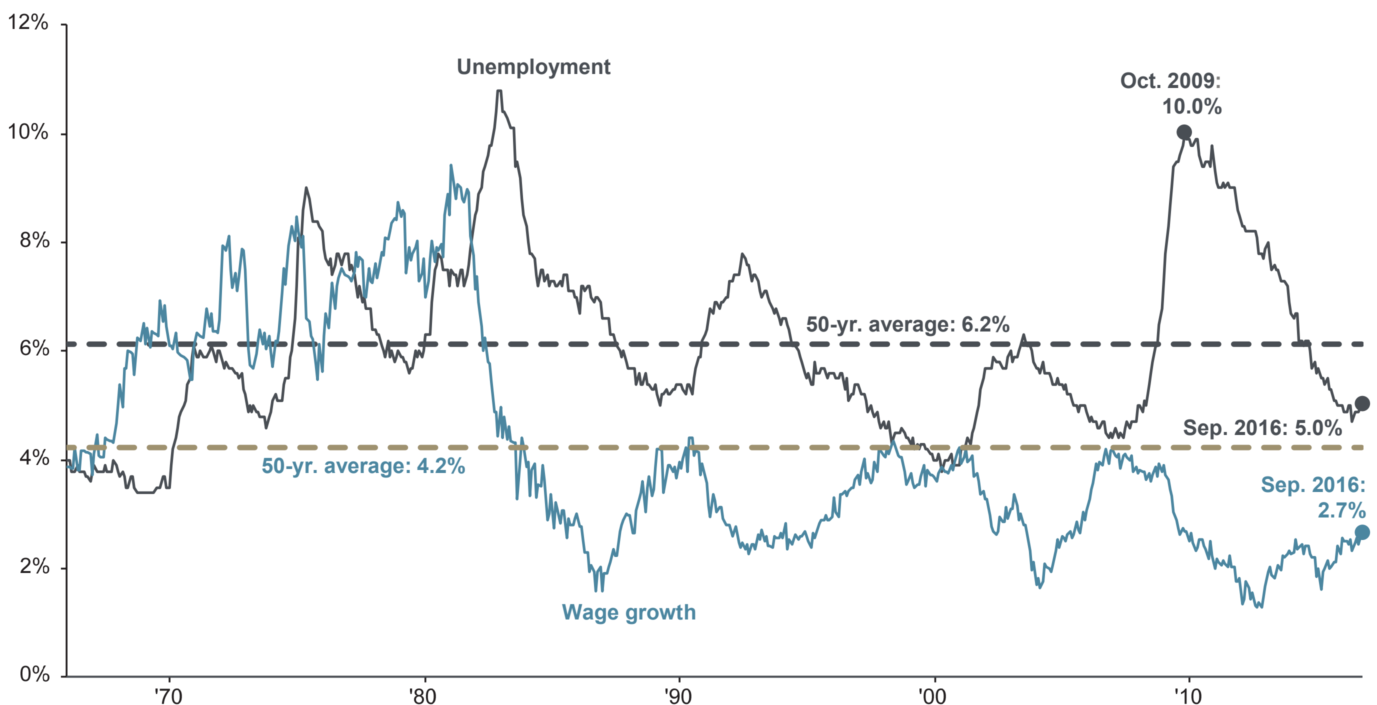
Unemployment and wages

Civilian unemployment rate and year-over-year growth in wages of production and non-supervisory workers
Seasonally adjusted, percent



Source: JPMorgan

THE OUTLOOK

We believe that although US inflation is moving closer to the targeted 2%, and although unemployment numbers have improved dramatically, that the population growth and labour productivity numbers does not bode well for a rate hike in December.

Although we support the sentiments that keeping rates unsustainably low for prolonged periods does pose a potential threat to monetary policy efficacy over the long term, a sense of more sustainable economic growth could take precedence over more short-term inflation and labour data numbers.

In our view a clearer outlook on fiscal policy combined with improved corporate earnings should support economic growth over the medium term. The FOMC could opt to wait for clarity regarding these numbers, and also rather wait for inflation numbers to approach the 2% target, to ensure a firmer footing before starting a further rate hike cycle.

BOTTOM LINE

In short, we don't believe the Fed should hike US rates just yet. Although there has been a marked improvement in key areas of the US economy, we believe the Fed could wait for additional data or reforms that will support the sustainability of the improving trend, once monetary policy support has been reduced.

From an asset class perspective, we believe that rates will have to normalise over the medium term which will not bode well for many fixed income asset types. On the other hand improved corporate earnings and lower taxes will provide tailwinds for US equities over the long term. Equities therefore remain our preferred asset class.