PSG Wealth

FED HIKES INTEREST RATES

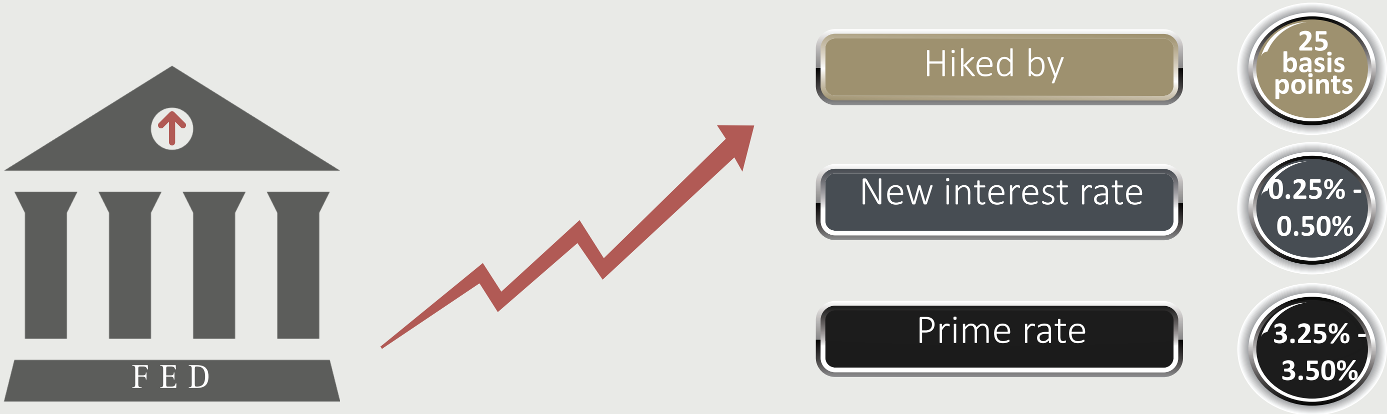
Throughout recent history, the fund rates of the United States Federal Reserve (Fed) usually hovered between 2% to 5%. That's because the Fed has found that a healthy economy functions best with an inflation target of 2% (for the core inflation rate). However, there were certain times in history where the Fed funds rate was well above that, to curb runaway inflation. Other times, it was well below - to stimulate economic growth.

Federal Open Market Committee (FOMC) latest decision

The Fed has maintained for some time that any move they make will be 'data dependent'. Their decision to raise interest rates was largely dependent on incoming data which continued to show improvement in the labour market, inflation that returned to just beneath target and that no unanticipated shocks would affect the economic outlook of the U.S. During the Fed's meeting these past two days, Fed Chairman Janet Yellen highlighted the following reasons why they hiked interest rates:

- The U.S. economy performing well, and expected to continue to do so;
- Recent data showed 'considerable improvement' in U.S. labour market; and
- Fed confident inflation will return to its 2% target.

Latest decision by FOMC



PSG Wealth's view on hiked rate

The Fed made its most eagerly awaited monetary policy decision in years, when it decided to hike U.S. interest rates yesterday. Given the improvement in employment data, most analysts were correct in predicting that the Fed would raise rates in December, for the first time since 2006.

We expect interest rates to normalise further over time. Since the Fed finalised their bond repurchase programme, the logical next monetary policy decision would be to hike rates. However, as the Fed has mentioned on numerous occasions – their decision would be 'data dependent'. Data that indicates the health of the economy, such as inflation returning to its target of 2%, relative rates, a growing labour market and the state of capital markets were all important considerations.

Seeing that these economic conditions improved over the past few months, expectations that rates would be raised were validated.

The increased interest rates do not necessarily mean that the consumer will be placed under more financial pressure, because the absolute values of the current interest rates are still abnormally low. At this stage bond markets are relatively expensive, but we expect that interest rates will, in time, normalise the valuations of offshore bonds by rerating on capital amounts. As such, we are underweight offshore fixed interest instruments.

At PSG Wealth we are never sure what the FOMC will decide at each meeting, but we know that we are entering a trend of upward interest rates. For this reason we position our products defensively to react positively to interest rate fluctuations.

From an asset class valuation perspective however, not much has changed. To raise rates is only one event in a continuous series of events that will influence financial markets over the coming months and years.

Short history of Fed interest rates

March 1980

20%

Raised rates in February and March. The Fed funds rate reached a high of 20% in 1979 and 1980. This was to combat double-digit inflation.

2008

Fed lowers interest rates six times between January and October.

24 Nov 2008: Fed unveils $800bn plan to bolster lending, housing.

3.5% - 1%

16 December 2008

0% -0.25%

Interest rates lowered to previous level.

17 March 2009 - 11 December 2012

President Obama took office in 2009, while the Fed started quantitive easing projects e.g.:

- Fed buys $900bn in bonds over this period
- Fed extends ‘Operation Twist’
- Fed launches QE3 by buying mortgage securities

18 June 2013

Ben Bernanke, chairman of Fed from 2006 to 2014, says central bank may scale back its bond purchases, depending on economic outlook.

17 Sept 2013- Fed decides not to taper.

16 December 2015

Rates remained at this level till the Fed raised rates yesterday for the first time in almost a decade.

0 - 25%