The Fed hikes and Trump stimulus in 2017 – implications for investors and Australia

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Key points

> After a year since the first Fed rate hike in this cycle, the Fed has finally moved the Fed Funds rate up again from a range of 0.25-0.5% to 0.5-0.75%. The move reflects confidence in the ongoing recovery in the US economy.

> Given ongoing low wages growth, low inflation and a strong $US doing part of the Fed's job for it, future Fed hikes are likely to remain "gradual" for now but fiscal stimulus under Donald Trump could see it speed up. Expect around three Fed rate hikes in 2017.

> It's too early for US monetary tightening to be a cyclical negative for shares, which will also benefit from US fiscal stimulus.

> Bonds are oversold and due for a pause, but gradual Fed rate hikes and US fiscal stimulus will remain a source of upwards pressure on global bond yields.

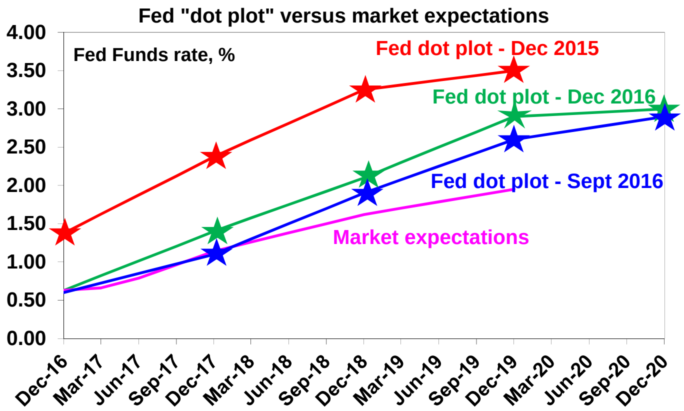
Introduction

A year ago I thought that there was good reason not to fear the Fed raising rates[1]. However, its initial move combined with worries about just about everything to give us a bout of share market weakness into early 2016 before investors realised that there was indeed no reason to fear the Fed after which things got back on track. Now as widely expected we have just seen the Fed move again – raising its Federal Funds target interest rate from a range of 0.25-0.5% to the range of 0.5-0.75%, begging the question whether we will go through another bout of market ructions. However, this time around the backdrop is very different to a year ago. This note looks at the key issues.

Fed hike number 2

In raising the target range for the Fed Funds rate by another 0.25% the Fed noted the stronger US labour market, moderate economic growth and rising inflation. The Fed continues to refer to only "gradual" increases in interest rates and the Fed's so-called "dot plot" median of Fed meeting participants' interest rate expectations is allowing for only three hikes in 2017. However, after continuously declining over the last few years (a year ago the dot plot had four hikes in for 2016 and they only managed one!), the latest dot plot has now increased slightly compared to September's dot plot. Market expectations for rate hikes remain below the Fed's which is understandable given the experience of the last few years, but I suspect that with fiscal stimulus under Donald Trump the Fed will be closer to the mark. So we are allowing for three rate hikes next year.

[1] See "Five reasons not to be too worried about the Fed", Oliver's Insights, Nov 2015

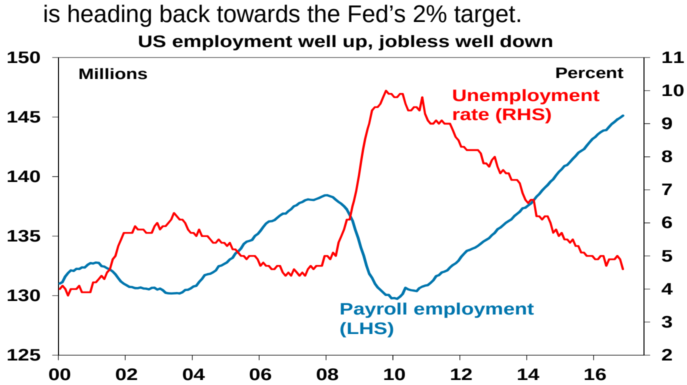


Source: US Federal Reserve, AMP Capital

Reasons not to be too concerned about the Fed

There are good reasons not to be concerned.

- First, the resumption of Fed rate hikes is a sign the world's biggest economy is doing well. Jobs growth is solid, unemployment is 4.6%, confidence is up, the housing sector has recovered and business is investing. And core inflation is heading back towards the Fed's 2% target.

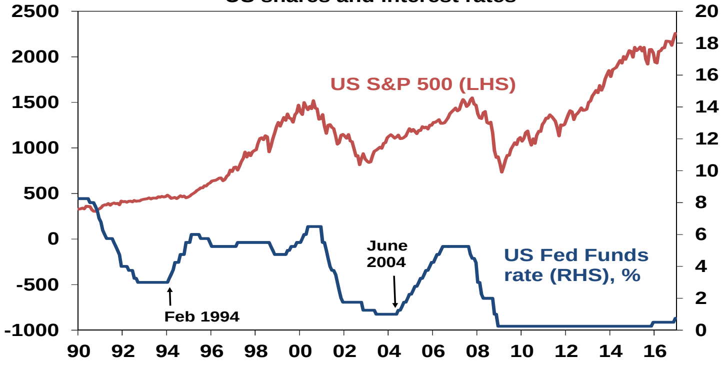


Source: Bloomberg, AMP Capital

- Second, for now at least Fed rate hikes can remain gradual as there is still arguably slack remaining in the US economy, the strong $US is doing part of the Fed's job for it and fiscal stimulus under Donald Trump is still an unknown.
- Third, US economic downturns/recessions have historically only come three years after the first Fed rate hike in a tightening cycle. It's only when monetary policy becomes tight after numerous rate hikes that the economy gets hit. We are a long way from that and the gradual nature of the rate hikes so far could stretch it out further. Shares often have wobbles around the first rate hike – as we saw in second half 2015 and early this year – but again sustained problems usually only set in when monetary policy has become tight. This can be seen in the next chart. Shares

had wobbles when interest rates first started to move up in February 1994 and in June 2004. Thereafter they resumed their rising trends and bear markets did not set in till 2000 and 2007 after multiple hikes and with recessions looming. Again we are a long way from that.

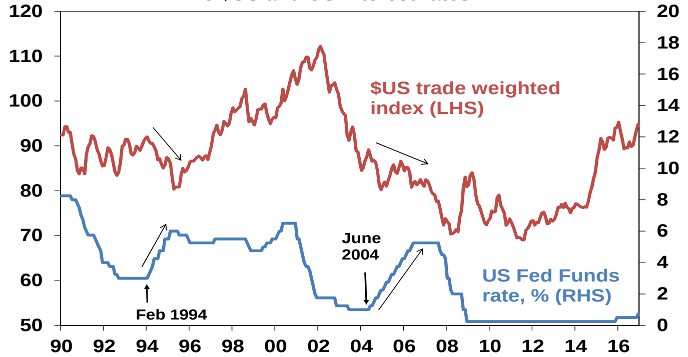
US shares and interest rates



Source: Bloomberg, AMP Capital

- Fourth, other major countries – Europe, Japan and Australia – are still easing or are at least a long way from monetary tightening. So global monetary conditions remain very easy.
- Fifth, fears around a surging US dollar reaping havoc on US multinationals, commodity prices and emerging countries are overdone. For one thing the relationship between US interest rates and the US dollar on a trade weighted basis is rather messy. The $US actually fell through the Fed rate hike cycles of 1994-95 and 2004-06.

The $US and US interest rates



Source: Bloomberg, AMP Capital

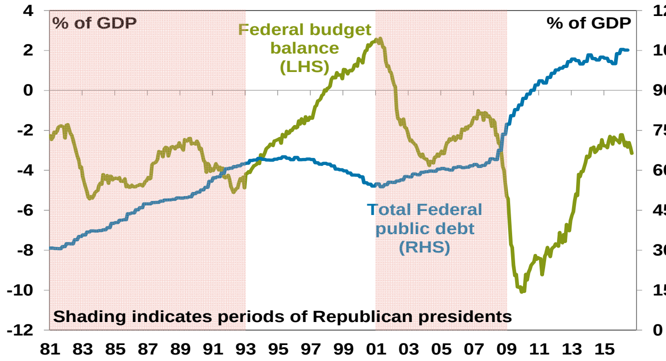
- Finally, global conditions are very different compared to a year ago: global growth indicators are rising whereas a year ago they were falling; a year ago the falling oil price was weighing on US energy producers, this is no longer the case; Donald Trump is promising significant fiscal stimulus and deregulation; there is more understanding around China's new currency system; and the Fed by its cautious approach to rate hikes this year has shown that it takes account of global conditions and the $US.

Fiscal stimulus versus trade wars under Trump

One of the biggest differences compared to a year ago is the election of Donald Trump. The main issue remains whether we get Trump the Pragmatist focussing mostly on fiscal stimulus and growth boosting deregulation - or Trump the Populist setting off a debilitating trade war with China. It still early days but his more conciliatory tone since his election on balance has us leaning towards a pragmatic Trump. On his key policies:

- Expect a fiscal stimulus package involving corporate and personal tax rate cuts and support for infrastructure spending to be agreed with Congress in the first half of the year. Yes some in Congress have expressed a valid concern about America's already high public debt (over 100% of GDP compared to around 30% when Ronald Reagan was elected). But there is a lot of support amongst Republicans for tax cuts and infrastructure spending. And history tells us that budgets and debt usually blow out under Republicans and Democrats try to get them back under control. But Trump will likely have to compromise a bit (e.g. 20% corporate tax rate rather than 15%). Such a stimulus can pass through Congress with simple majorities which the GOP has under the budget reconciliation process. Congressional Republicans who stand in the way risk retribution at the 2018 mid-term elections.

US Federal budget deficit and debt



Source: Federal Reserve of St Louis, AMP Capital

- Changes to the Dodd-Frank financial regulations may take time because it will likely need support of some Democrats to get through the Senate. However, Trump's pick to head the Environmental Protection Agency and for Secretary of Energy both point to a significant reduction in environmental regulation (good for energy stocks).
- Trade remains the greatest risk factor under Trump (from an economic perspective). Getting better deals for the US on trade was a key part of the support for him so it's hard to see him backing away from it. While I doubt that it's as simple as it looks (China has been battling a falling - not rising - Renminbi in recent times and if manufacturing jobs come back to the US they will mostly be for robots), indications that Trump is looking to use recognition of One China as a bargaining chip on trade with China risks a major dispute. Trump is also a businessman however, and I suspect he will ultimately look for a win-win outcome with China on trade, but the issue is likely to cause bouts of investment market turbulence along the way.

What does it mean for investors?

There are several implications for investors:

- It's too early for US monetary tightening to be a cyclical negative for shares, which will also benefit from US fiscal stimulus. Our view remains that other markets remain more attractive than US shares though – notably Eurozone and Japanese shares that will benefit from lower currencies.
- Bonds are oversold and due for a pause, but gradual Fed rate hikes and US fiscal stimulus in 2017 will remain a source of upwards pressure on global bond yields. With the RBA unlikely to follow the Fed though until maybe 2018 we continue to favour Australian over US bonds.

Impact on Australia

To the extent that the Fed's interest rate hike signals a stronger US, it's good for Australia. It doesn't signal that the RBA will soon follow and hike next year though. With the Australian economy remaining weaker relative to its potential than the US and inflation running further below target, we remain of the view that the RBA will be cutting rates again in 2017 not hiking them.

The main relevance of the US rate hike is that it helps keep the $A down. This is essential if Australia is to continue rebalancing its economy as mining investment continues to unwind and the housing construction cycle peaks in 2017. We see the $A falling below $US0.70 in 2017.

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