BearBull
Global Investments Group

22nd March 2018

The Fed raises its rates and announces tighter policy for 2019

Is growth already slowing? Gradual rise in expected inflation. Risk of a trade war. Margins, profits and multipliers contract. Caution on the S&P 500.

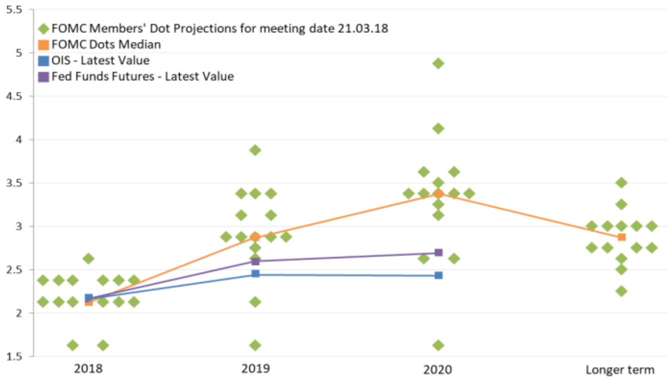
Key Points

- The Fed has announced two further rate rises in 2018, and likely three in 2019
- Key rates at 2.875% in 2019
- Is US growth already slowing?
- GDP forecast to grow +2.7% in 2018 and +2.4% in 2019
- Trump is implementing his protectionist policy
- New risks of a trade war
- Inflation has surpassed the Fed's target
- Gradual rise in expected inflation
- US Treasury long rates above 3%
- The rise in the US dollar is keeping us waiting
- Margins, profits and multipliers are contracting, posing a risk to equity markets
- It is likely that volatility will return
- Caution on US equities

The Fed has announced two further rate rises in 2018, and likely three in 2019

The Federal Reserve has announced that it will stick to the planned pace for key rate rises in 2018 following the first FOMC meeting under Powell. As such, the handover seems to have been seamless, given that these two rises in key rates were to be predicted after yesterday's 0.25% rise, taking Fed Funds to +1.5%-+1.75%; unsurprisingly, the decision was taken unanimously. Key rates are therefore expected to hit +2.125% by the end of 2018, implying two further +0.25% rises. Less predictably, it was also announced that the normalisation already underway would be stepped up in 2019, with three rises in key rates now more likely. As such, the forecast level of Fed Funds at the end of 2019 has now risen from +2.688% to +2.875%.

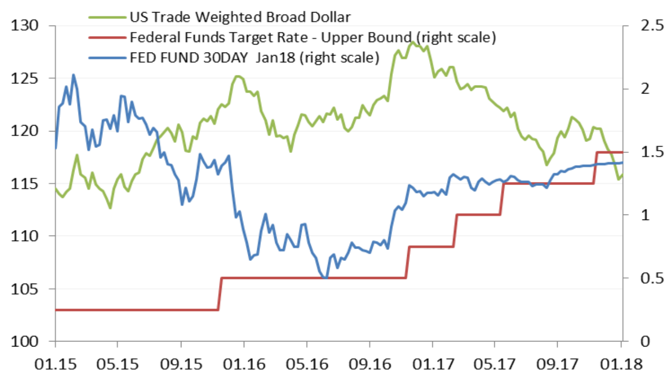
FOMC Fed Funds Projection



Sources: Bloomberg, BBGI Group SA

The US central bank seems increasingly comfortable with communicating its positive analysis of the state of the US economy, and its implications for monetary policy. The trend is towards a likely increase in the pace of rate rises in 2019 and 2020 so as to avoid taking any risks in 2018.

Fed funds, Key Rates and the Trade-Weighted Dollar



Sources: Bloomberg, BBGI Group SA

The flattening of the rate curve should now be gradual and adapted to improved economic activity.

The Federal Reserve is more confident than ever in US growth prospects, and has increased its forecasts for 2018 from +2.5% to +2.7%, and those for 2019 from +2.1% to +2.4%.

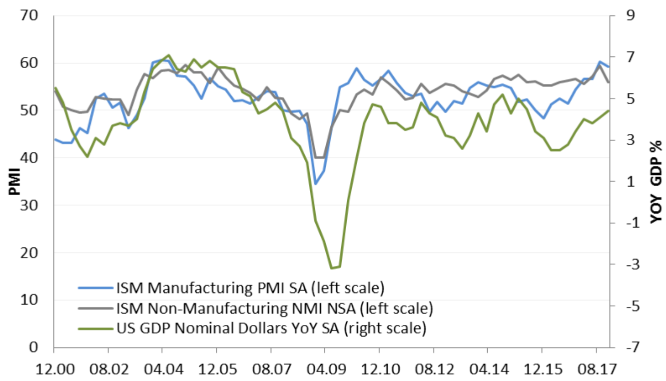
In its analysis of current conditions, it highlighted a temporary dip in the trend in the first quarter, which does not cast doubt over its vision for the year as a whole. The core of the analysis remains focused on labour market conditions, which continue to show an increase in new jobs and a fall in the unemployment rate (3.9%). The latter could even drop to 3.8% in 2018, and perhaps 3.6% in 2019. The Fed's vision for inflation has gone unaltered at the end of the first quarter 2018. It seems likely it will rise above the 2% target in 2018, though with no perceived risk of the target being exceeded quickly and to a considerable degree. It therefore seems that the handover has been smooth, with communication management that leaves little room for interpretation or for significant uncertainty regarding how the Federal Reserve will act in the future. However, in the current context, we do not believe that this will be enough to avoid dangerous new uncertainty bubbling back up within the investment community. For the time being, the bond market has not reacted to this phase of monetary policy being announced. 10-year rates still fall within the +2.8% to +2.95% fluctuation band which they have stuck to for nearly two months. The situation is a little less stable for the US dollar; the trade-weighted dollar index is sitting in the bottom half of its 89.5-90.8 fluctuation band of the past few months.

As regards the US market, although the risk of rate rises coming thicker and faster in 2018 has fizzled out, new forecasts for 2019 tend to confirm the concerns raised in February. As such, we believe that the equity market is still very fragile and at risk of further profit-taking.

Is US growth already slowing?

The US economy closed the year with an annualised growth rate (+2.5%) below that of the 3rd quarter (+3.2%). 1st quarter growth should come in close to +2.4%, somewhat treading water at the start of the year when compared to 2017's figures and the hopes of the economy picking up the pace in 2018. However, the Federal Reserve has not seemed particularly concerned at this rather sluggish start to the year, as yesterday it again raised its target for 2018 to +2.7%. In our forecasts at the start of the year, we mentioned that the US economy had very rarely been able to post two consecutive quarters of growth above +3% since 2000. At the time, we suggested that this pace could undoubtedly not be sustained in 2018, and that we should see a dip in the GDP growth rate. This seems to be what has been happening over the past two quarters. In fact, leading indicators point to economic activity bolstering in 2018. First of all, American consumers should have their minds put at rest by the influx of positive economic news and the increasingly favourable situation on the jobs market. The rise in personal income should further prop up household spending in the longer-term in 2018. In terms of investment, recent economic developments have affected production capacity levels, which will certainly spark new investment in a rather favourable context for company margins.

GDP and PMI



Sources: Bloomberg, BBGI Group SA

In March, manufacturing PMI bounced back to 55.7, after having dwindled to 55.3 in February. It has therefore remained high, while the ISM Manufacturing Index hit a ten-year high (60.8) in February. Non-manufacturing indicators also dipped, such as the ISM Global which dropped from 59.9 to 59.5, remaining close to its highest point over the past ten years. Services PMI slid from 55.9 to 54.1 in March. It seems reasonable to expect the current trend to continue over the coming quarters, propped up by factors that are already having an influence, unless the risks of a trade war, sparked anew by the introduction of customs duties in the United States, weaken the economic situation.

Gradual rate rises should have a limited impact on GDP in 2018. However, expectations are high, and will undoubtedly only be fulfilled if US consumers are up to the task.

New risks of a trade war

There are substantial risks of disappointment regarding US GDP forecasts. These risks could swell in the context of Trump declaring a trade war if the higher customs tariffs, estimated at 60 billion US dollars' worth, are followed by retaliation measures by the United States' main trading partners. This was one of his electoral campaign promises, and he is keeping it in incisive fashion, likely targeting China to a greater degree than

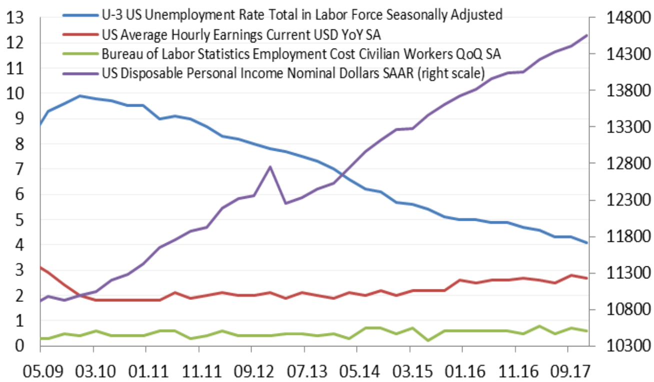
Europe in his strategy. The spectre of a potential world trade war is back, given the protectionist shift taken over the past few days with the introduction of a duty on steel (25%) and aluminium (10%) imports. Europe, of course, has made no protest, whilst not excluding the option of counter-measures, but China has entered the fray and roundly condemned this attack on free trade. US business circles are concerned, but Donald Trump should not stray far from this strategy, which he has always wanted to implement. More directly addressing China, he has declared war, listing more than a hundred products on which duties can be levied, and has promised investment restrictions in the United States.

Donald Trump is not afraid of opening Pandora's box and exposing the US economy, which is currently really getting a boost, to new long-term risks, which are already starting to worry investors.

Gradual rise in expected inflation

The latest inflation figures (+2.2%) published in February surpass the Federal Reserve's +2% target. The index's year on year rise excluding food and energy (+1.8%) was lower than 2%. They have hit the target and should gradually move beyond it.

Unemployment, Income, Labour Costs, Salaries



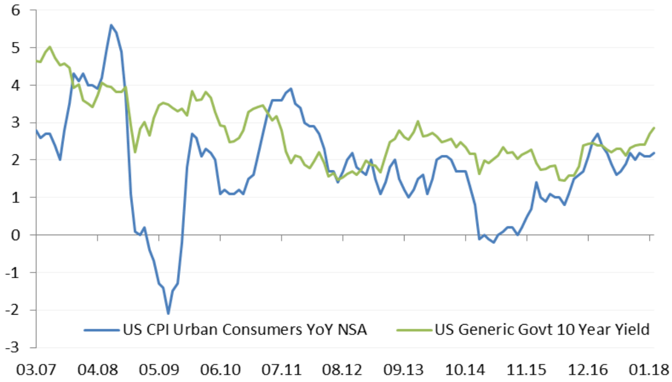
Sources: Bloomberg, BBGI Group SA

The upward trend has remained modest at the start of year, but leading indicators and the situation on the jobs market seem to suggest that the trend will be bolstered over the coming months. Expected year on year inflation has risen more starkly than monthly figures, coming in at +2.9% in March, compared to +2.7% in February.

In the longer-term, expected inflation for the next 5-10 years is also higher, standing at +2.5%. This trend cannot pick up the pace without an increase in salaries, which is taking its time despite the labour market being close to full employment. In contrast to the theory, inflationary pressures are still weak, even though the unemployment rate has stabilised at 4.1%.

2018 could be a year of surprises due to a combination of factors acting together. Indeed, the macro-economic context should foster new salary negotiations and spark tensions on commodity prices, propping up a price rise.

Inflation and US 10-Year Treasury Bonds



Sources: Bloomberg, BBGI Group SA

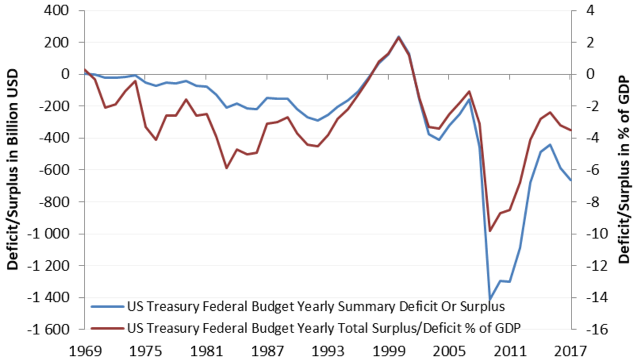
Might US Treasury long rates head above 3%?

Renewed inflation in a robust economic context should quickly lead to new adjustments to long-term nominal rates over the coming months. After remaining stable for a few quarters, US long rates were the first to spark the trend. As much as a few months ago, we had pointed out that the 2.1% correction to 10-year Treasury rates was not compatible with sustained economic activity and regular monetary policy normalisation on the part of the Fed. Our forecasts of long rates rising to around 3% have played out in the meantime, but this came in the context of a likely boost to the economy. However, although we still believe that in the long-term long rates should exceed 3%, it is likely that in the short-term the volatility seen on equity markets, as well as risks of disappointments regarding growth over the coming months could lead to a period of consolidation of these rates at just below the 3% threshold.

The rise in the US dollar is keeping us waiting

The US economic trend should still be higher than that of other economies in 2018. The interest rate differential should further broaden across the whole rate curve, working in the US dollar's favour. In this context, the weakness the US dollar is reflecting seems ungrounded. The approximately -10% depreciation on the trade-weighted USD index against a basket of currencies almost halved the dollar's appreciation in 2014 and 2015. The US dollar's valuation should therefore change over the next few months, unless forecasts of a deterioration in public finances linked to tax reform get the upper hand and punish the dollar. In all, our forecasts are optimistic, predicting the US dollar rising above parity with the Swiss franc.

US Treasury Budget Deficit



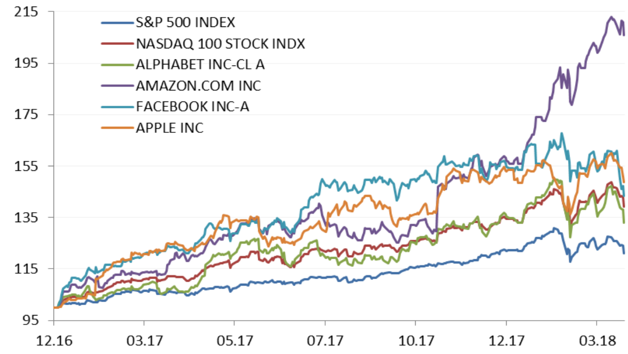
Sources: Bloomberg, BBGI Group SA

Margins, profits and multipliers are contracting, posing a risk to equity markets

Prior to February, it seemed that nothing could stop the march of American assets. But the rise in inflation and interest rates, as well as risks of monetary policy normalisation being bolstered, in the end won at the expense of the, until then unwavering, optimism of investors. For a few weeks now, we have been reacquainting ourselves with the risks that the situation on the jobs market represents for company margins, as well as the risk of profit growth being insufficient to justify the particularly high valuation levels before the correction to stock market prices.

The growth of multinationals' profits may therefore have hit its peak, and come in lower than previously thought in the end, at close to the economy's growth rate. The tax reform could be less important for multinationals on the S&P 500 than for medium-sized American companies.

S&P 500, Nasdaq and GAFA



Sources: Bloomberg, BBGI Group SA

Beyond the fundamental issue of profit growth, we must not forget that the rise in US equities was sparked first and foremost by a strong rise in multipliers. The bounce back in March re-inflated valuation levels. When risks of the trend weakening rise, US assets become more fragile again. As such, the upward rate cycle could lead to a new phase of PE contractions. However company profits may develop, it is likely that interest rate rises will put an end to this ten-year expansion phase. In conclusion, the rise on the equity market has undoubtedly incorporated the positive impact that everyone has been expecting the tax reform to have on profits for more than a year now. This is despite the fact that multinationals will certainly be less affected than other companies, as we have already highlighted.

Following on from US equities bouncing back in March, we predict renewed volatility, which will provide better investment opportunities and more reasonable valuation levels. In the meantime, we are taking a rather cautious approach, and still recommend under-exposure to US assets.

BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae