Economic Research

WEEKLY ANALYSIS

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18th June 2018

The Fed will not derail a booming economy

Acceleration in GDP growth in Q2 to +3.4%. Revision of outlook for GDP and inflation. Contraction in margins, profits and multiples. Remain cautious on the S&P 500.

Key points

- US Federal Reserve unsurprisingly raises key rates by +0.25%
- Seventh hike since 2015
- The Fed's latest message is clear, monetary policy will not derail a booming economy
- US Fed raises GDP growth prospects (+2.8%)
- Serenity at the Fed and in the financial markets?
- Inevitable deceleration in growth
- Reassessing the risks of a trade war
- Increases in wages, inflation and interest rates
- Inflation running well above 2%
- Stabilisation of long-term rates at close to 3%
- Dollar finally on the rise
- Trade weighted dollar rises +7%
- Contraction in margins a threat to the S&P500
- Rebound in May and June increases valuation levels to 17.4x earnings

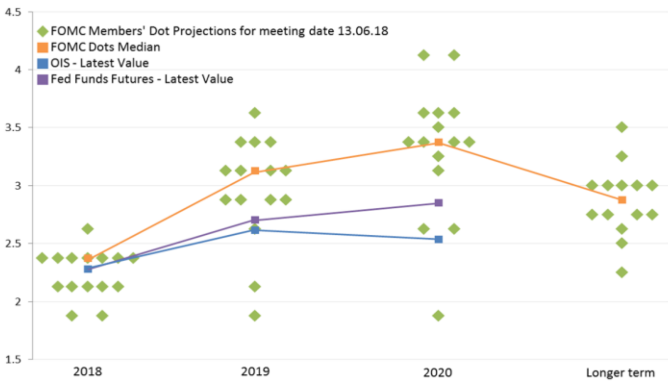
The Fed's latest message is crystal clear, monetary policy will not derail a booming economy

The US Federal Reserve once again aimed to reassure investors potentially concerned about the pace at which it intends to raise interest rates. The Fed is clearly committed to implementing its monetary policy gradually and without any risk to the ongoing economic recovery. Let us recall that these concerns have arisen although the US economy is enjoying its second longest expansion phase and inflation is progressing faster than expected. The Fed's stance on the issue of raising key rates is therefore meant to reassure investors.

On 13 June, the Fed raised its key rates by 0.25% for the second time in 2018 in a context of robust growth and particularly positive prospects for the US economy. The discount rate went from 2% to 2.25%, and the target for the Fed Funds rate rose by 0.25% with low and high targets standing at 1.75% and 2%.

This seventh hike since the change in monetary policy, decided unanimously, was widely expected and did not come as a shock to the markets. It should therefore have no major impact on the investment climate. If anything, the potential risks related to the Fed's analysis and assessment of the country's economic situation and to the resulting possible changes in monetary policy. On that point, let us mention that we may now expect four rate increases in 2018 instead of the three expected until now.

FOMC projection of Fed Funds

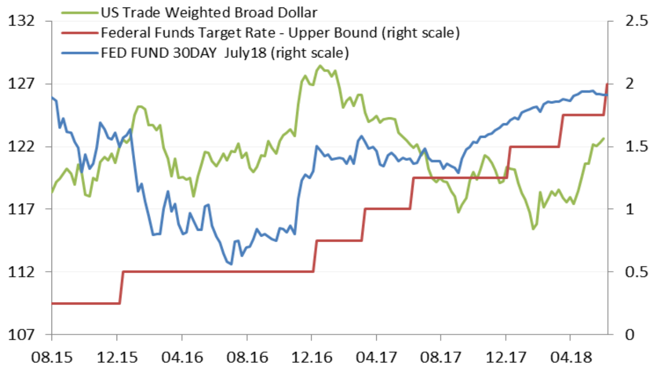


Sources: Bloomberg, BearBull Group

The increase in the number of expected hikes by the Fed in 2018 should not be overrated, however, since it is the result of an increase in the number of members from seven to eight in favour of two new 0.25% increases in H2 2018. This development may feel like a future tightening of monetary policy, but it will still depend on changes in economic conditions at the end of the year. The final hike in December is therefore far from certain. Moreover, the outlook for 2019 remains unchanged with three 0.25% rate increases. Central bank committee members will most likely feel more and more inclined in the next few months to consider that the upturn in US growth will warrant regular yet measured action on key rates. Still, they have not changed their forecast for the Fed Funds rate at 3.4% by the end of 2020.

The Fed will pay close attention to risks that could derail the current growth cycle. In this context, we believe that it will not react excessively to a possible acceleration of inflation for example if it were to happen, or to a temporary strengthening of economic growth. The estimated level of the Fed Funds rate (median progression) has thus increased to 2.375% for the end of 2018 and to 3.125% for the end of 2019.

Fed funds, key rates and trade weighted dollar



Sources: Bloomberg, BearBull Group

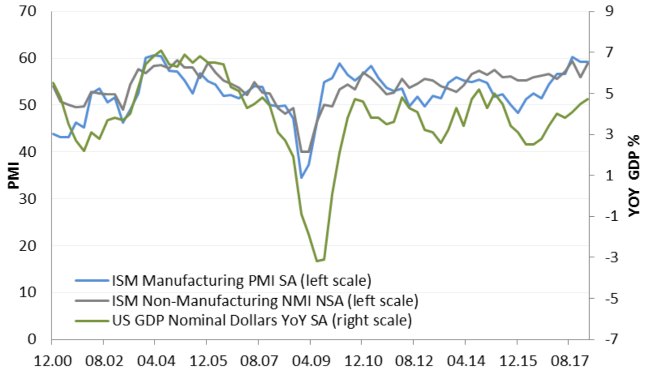
Serenity at the Fed and in the financial markets?

The US central bank has conveyed its assessment of the current economic situation and seems increasingly comfortable communicating its positive conclusions on the state of the US economy. The Fed is more confident than ever in the country's growth prospects and has once again raised its forecast for 2018 from 2.7% to 2.8%, although it has kept the outlook for 2019 at +2.4%. Growth in the US is now considered "robust" after having been deemed "moderate". The temporary drop in momentum in Q1 has been replaced by a much better outlook in Q2. With regards to the labour market, the Fed revised its projections based on better prospects for 2018. The key focus of its analysis remains labour market conditions, which continue to point to an increase in new jobs and a decrease in the rate of unemployment (3.8%). The institution's forecast for the latter is of 3.6% in 2018 and 3.5% in 2019. The Fed's outlook on inflation remains relatively unchanged. An increase beyond the set target of 2% (2.1%) seems likely in 2018 with no perceived risk of this target being exceeded quickly and significantly. The central bank is not claiming victory with regards to inflation, highlighting that inflationary expectations are relatively stable. To date, the bond market has shown no specific reaction to the announcement of this monetary policy measure. Ten-year rates barely reached 3% before stabilising slightly below this mark, as the rate hike failed to drive these rates closer to the high reached on 18 May 2018 at 3.12%. The situation is a little less stable for the US currency. The trade weighted US dollar index surged by close to +2% to return to his highest level since 29 May 2018. As for the US equity market, it remains in wait-and-see mode since the S&P 500 remained quiet this week at 2,785 points.

Inevitable deceleration in growth

We pointed out that it would probably be difficult for the US economy to maintain growth above +3% in early 2018. Q3 2017 (+3.2%) remains a benchmark that may yet be reached once more in Q2. A few months ago, we also pointed out that we would likely see a drop in GDP growth. However, after the rather unimpressive result in Q1, our forecast is once again a little more optimistic. Now in its tenth year, this economic cycle is one of the longest in contemporary history, although it still does not show any of the usual features of an end of cycle. Indeed, the desired wage pressure still has not been observed, and inflation is barely reaching the 2% target set by the Fed, thereby reducing probabilities of any significant increase in key rates and long-term rates. As Q2 is coming to a close, we note that probabilities of a growth rate greater than +3% are once again high. US consumers are well and truly present, largely driving increased momentum in a context increasingly favourable to growth in personal income and purchasing power. The outlook has also improved markedly for investment, and tax policies will likely start having some effect, probably temporary, but which will support accelerating economic growth. Therefore, the next quarters could well be the strongest in the current cycle with a result close to +3.4% at the end of June already. Leading indicators actually point towards an increase in economic activity in 2018, and US consumers will likely be encouraged by a flow of positive economic news and an increasingly favourable situation in the labour market.

GDP and PMI



Sources: Bloomberg, BearBull Group

May's manufacturing PMI (56.4) was at its highest since 2014 with the services PMI presenting a similar picture (56.8). The composite PMI thus logically also reached a peak in the period (56.6). The ISM non-manufacturing index reached a decade high of 59.5 in January before stabilising in May at its highest level in the decade at 58.6. The ISM manufacturing index followed the same trend, reaching 58.7. Current momentum will likely remain robust in Q3, supported by factors already in play, unless the risks of a trade war, which re-emerged because of the introduction of import duties in the US, affect the economic context.

Reassessing the risks of a trade war

The risks to US growth are now more political than ever and relate to the consequences of the unilateral measures taken by President Trump in terms of tariffs and import taxes. The introduction of taxes on aluminium and steel imports will undoubtedly be followed by an increase in import tariffs on other goods, including motor vehicles for example.

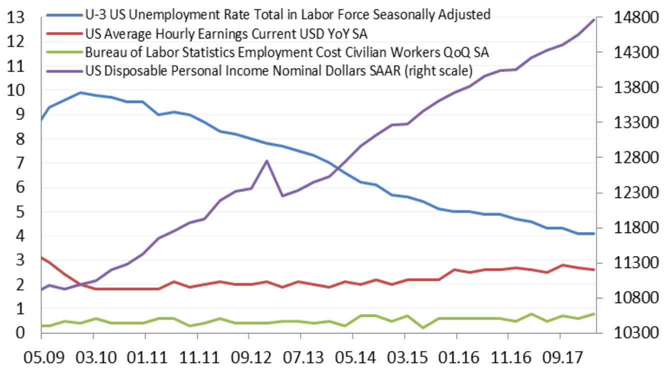
The spectre of a possible global trade war is back thanks to Donald Trump's protectionist stance. The US' economic partners have reacted in unison, insisting that they will not have measures imposed that are contrary to the commercial treaties and international agreements that were signed. Moreover, it should be noted that the decisions taken by the US President are far from foolproof in legal and constitutional terms. Indeed, as it was pointed out by the House Financial Services Committee Chairman (Republican) in front of Congress, "I don't believe the Honda Accord is a threat to US national security". This is indeed a vital argument since President Trump has justified his decision to introduce tariffs on the fact that the low prices of imported steel and aluminium are a threat to national interests. An estimate of the effects of these customs barriers suggests that the creation of 92,000 jobs could be offset by the destruction of 250,000 other jobs.

US imports of European steel and aluminium only represent 0.5% of imported goods, i.e. barely $2 billion out of $256 billion. The impact on Germany or China's GDP is estimated at about 0.04 basis points. We believe it is still early to assume the US President will commit to total trade war, which would probably not have the desired effects.

Increases in wages, inflation and interest rates

The consumer price index (CPI YoY) reached +2.8% in May while the core index settled at +2.2%. Inflation seems to have accelerated also for producer prices, confirming the Fed's expectations. The PPI for final demand is also at its lowest since 2011. Momentum is still restrained but remains above the Fed's target. Expected YoY inflation has increased greatly, reaching +2.9% in May. In the longer term, the 5- to 10-year expected inflation forecast is also higher than current inflation at +2.6%.

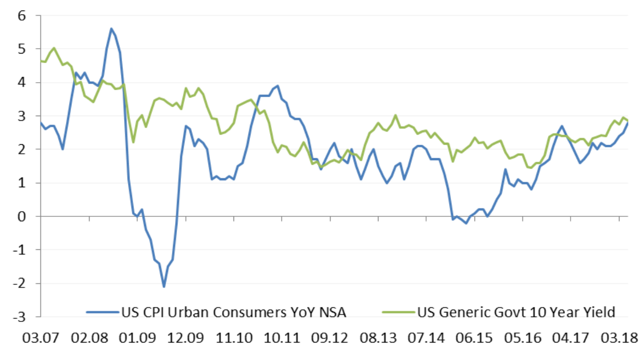
Unemployment, earnings, labour cost, income



Sources: Bloomberg, BearBull Group

An acceleration of this trend depends on an increase in wages, which is taking some time to materialise despite a labour market close to full employment and an unemployment rate of 3.8%. However, the upturn in inflation will strengthen due to wage pressures and price increases, which will intervene to preserve business margins.

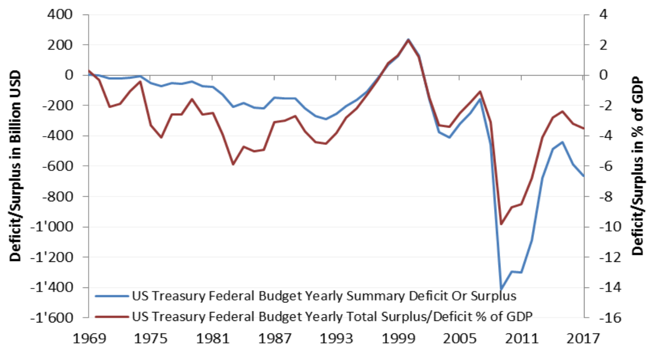
Inflation and 10-year US government bonds



Sources: Bloomberg, BearBull Group

After a few quarters of stabilisation, US long-term rates were the first to take off. Our 3% growth forecast for long-term rates has materialised. Nevertheless, although we still believe that long-term rates should ultimately exceed this level, it is likely that in the short term, volatility in the equity markets will drive a temporary stabilisation phase.

US government budget deficit



Sources: Bloomberg, BearBull Group

Dollar finally on the rise

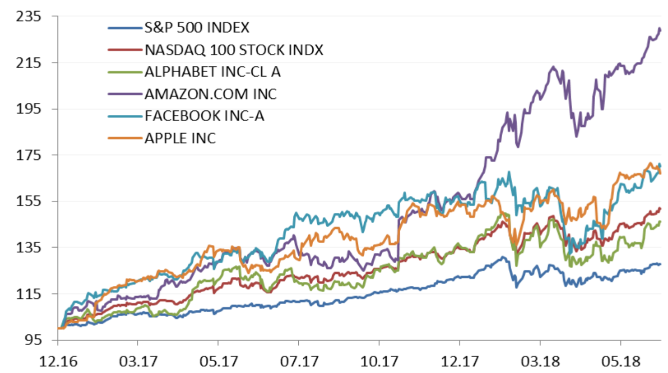
A few months ago, we predicted that superior US economic momentum would likely support an interest rate spread in favour of the dollar – a trend that now looks like it is strengthening. In this context, the perceived weakness of the dollar seems unjustified. The adjustment of the valuation of the dollar is ongoing.

The trade weighted dollar has regained the ground lost between November 2017 and February 2018. Our positive forecast is materialising with an exchange rate against the franc that is once again close to parity.

Contraction in margins a threat to the S&P 500

The price correction in February-March was expected and triggered new repositioning opportunities thanks to more attractive valuation levels. Risks remain after the rebound in May and June of seeing insufficient profit growth to justify once again higher valuation levels, which are approaching the levels that prevailed before the price correction. The earnings growth of multinational corporates could indeed suffer due to pressure on margins.

S&P 500, Nasdaq and GAFA



Sources: Bloomberg, BearBull Group

In the last few years, the rise in stock prices has mainly been driven by a phase of strong multiple growth, logical in a context of falling interest rates. The cycle of rising interest rates could therefore lead to adjustments and a PE contraction phase. It is likely indeed that, whatever the developments in corporate profits, the increase in interest rates will put an end to this ten-year expansion phase.

After the rebound of US stocks in the last few weeks, we once again recommend a degree of caution.

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