

Fed ushers in a brave new world

- Unanimous decision to raise rates from zero to 0.25-0.5% range
- Our asset allocation preference remains for riskier assets
- Bond markets react favorably as new rate regime is priced in

Investors have woken up to a brave new world as the US Federal Reserve raised its interest rate for the first time in almost a decade.

The central bank on 16 December raised its core Federal Funds lending rate by a quarter of a percentage point to 0.25-0.5%, ending the era of historically low interest rates following the financial crisis. The Fed has not changed its key rate since December 2008, when it was cut to the unprecedented level of 0-0.25%, and has not raised it since June 2006, when it went up 0.25% to 5.25% before progressively coming down.

Markets took it all in the stride, with US stocks in the S&P 500 gaining 1% after the announcement and the dollar rising slightly against the euro, while the benchmark US 10-year bond yield was unchanged.

In a statement that met all market expectations, the fact that it was a unanimous decision by the 12-person rate-setting Federal Open Market Committee chaired by Janet Yellen was highly indicative, says Chief Economist Léon Cornelissen. At previous meetings, some members have wavered, believing that the US economy was not strong enough to support a hike.

“The Fed has exactly acted in line with expectations, and a unanimous decision was a bit artificial; a hike was inevitable in the light of earlier statements,” he says. “Having talked endlessly about an imminent move, the Fed felt bound to keep its word. Recent market volatility did not keep them back, as they don’t want to create the impression of being too sensitive to short-term market moves.”



Léon Cornelissen

US data allowed move

Cornelissen says consistently positive economic data allowed the Fed to finally pull the trigger. “Thanks to steady, reasonable growth, the unemployment rate had come down to 5%,” he says. “Headline inflation in November that was 0.5% year-on-year remains far below the Fed target, but the economically more relevant core of 2.0% was spot on target. However, the Personal Consumption Expenditure (PCE) price index, the Fed’s preferred inflation measure, showed a headline rate of 0.2% and a core rate of only 1.3% in October, making a hike much less urgent.”

‘And so the million-dollar question is: when will be the next move?’

“Labor market developments are positive, but wage growth is still a bit timid. And the Fed has a tradition of over-estimating inflation; the plunge in the oil price doesn’t help with its forecasts. Nevertheless, as a forward-looking institution following medium-term policies (at least on paper), the Fed has considered a first preemptive strike as perfectly defensible, although the case for this was not totally clear cut.”

“And so the million-dollar question is: when will be the next move? The Fed certainly won’t follow the ‘one meeting, one rate move’ path – it will remain ‘data-dependent’. A familiar pattern that remains basically unchanged is that its median interest rate projections suggest a more rapid pace of rate rises than is being currently predicted by financial markets rates. The Fed suggests rates could rise by another 100 basis points in 2016. We only see room for two quarter-point rate hikes in 2016, and the next one will probably be on 15 June.”

“The Fed will comfortably stay behind the curve: it will prefer to err on the side of caution. Every other central bank of a developed market that has raised rates since the end of the Great Recession has been forced to backtrack. We expect (and hope) this will now not be the case. ”

Overweight on riskier assets

For asset allocation, the decision bodes well for riskier assets due to the positive signals that the rate rise sends, says Lukas Daalder, Chief Investment Officer for Robeco Investment Solutions, which runs a multi-asset fund.

“We have just witnessed what could be called the best-flagged-first-rate-hike-cycle on record, with financial markets generally reacting with a sigh of relief,” Daalder says. “The rate hike was seen as a confirmation that the US economy is strong enough to live with higher rates, while at the same time there is no reason to worry about high inflation or growth running out of hand.”



Lukas Daalder

“This best-of-all-worlds message went down well with the stock market, which rallied following the rate decision. Neither the fixed income markets, nor the currency markets, were much impressed by the change, which is of course the direct result of the fact that this was a much-anticipated move. The rate hike also offered some relief to the high yield market, which managed to end higher for the second day running.”

“Looking beyond the decision, Yellen succeeded in delivering the message that we should not be expecting a strong upward-sloping rate hike cycle. The markets are currently pricing in a 40% chance of the next rate hike occurring at the March meeting, virtually unchanged from Tuesday. Much will depend on the data published in the months ahead to determine the timing of the next move.”

“All in all, this decision has not led to a marked shift in markets, nor has it produced fresh insights on the development of the US economy. As such, we are sticking to our risk-on tactical asset allocation stance, with an overweight position in risky assets and an underweight position in bonds and cash.

‘We are sticking to our risk-on tactical asset allocation stance’

Bond markets react favorably

Fixed income and currency markets which are most in the firing line for any rate rise have responded positively, says Kommer van Trigt, portfolio manager of the Robeco Global Total Return Bond fund, which has positioned itself to deal with the hike.

“In bond markets the most notable reaction was a flattening of the yield curve, with the spread between 5- and 30-year interest rates declining to the lowest level since April. The front end of the yield curve probably responded to the ‘dot plot’ in which the FOMC members show their expectations for interest rates over the next years. This plot remained more or less unchanged, while many had expected a revision downwards.”



Kommer van Trigt

“The Robeco Global Total Return Bond fund was positioned for a further flattening of the US yield curve. The interest rate exposure that the fund holds in US Treasury bonds is concentrated in the long end. This part of the curve performed well. The market reaction strengthens our view that in a low-growth, low-inflation world, there remains value in long-dated US Treasuries.”

“Credit markets also showed a constructive reaction on the Fed announcement. Spreads tightened slightly. The fund maintains its preference for European credit markets; especially subordinated financials offer value. For US credit markets, most notably high yield corporate bonds, our exposure is light. Also our involvement in emerging debt markets is being kept low in the light of the meager growth outlook and deteriorating credit quality in most emerging economies.”

'We were positioned for a further flattening of the US yield curve'

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