HEALTH WEALTH CAREER

PREPARING FOR FED LIFT-OFF

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BACKGROUND

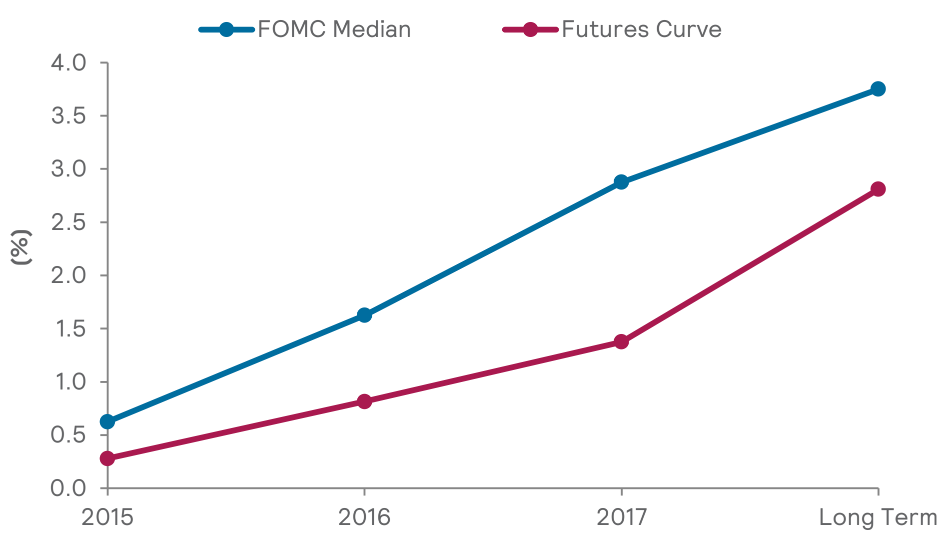
Since the financial crisis, central banks around the world have supplied extraordinary monetary stimulus to the global economy through record low interest rates and quantitative easing ("QE"). The most influential central bank, the US Federal Reserve ("the Fed"), has maintained its target rate at close to zero since December 2008 and increased the size of its balance sheet by around $3.5trn. The Fed seems likely to take its first tentative step towards "normalisation" at some point in the next few months, although the recent turmoil in markets might keep them on hold until 2016.

While speculation rages around the timing of the first hike, we think it is more important to think about the potential implications of normalisation for the economy and markets, regardless of precisely when the first rate rise happens.

WHAT IS THE MARKET PREDICTING?

Going into each of the past few calendar years, some market commentators have forecast that the Fed would raise its lending rate that year and 2015 was no different. The Chair of the Fed, Janet Yellen, recently supported the expectation of a rate rise during 2015, noting in July that, "If the economy evolves as we expect, economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target." And while central bankers have emphasised that any tightening would be very gradual, market pricing currently implies a more gradual path of rate rises than forecasts from the Federal Open Market Committee ("FOMC"). For example, the chart below illustrates that while the Fed is forecasting a federal funds rate of around 3% in 2017, the market is expecting a rate of around 2%.

U.S. Short-term Rates: Fed's Projection vs. Market Expectation

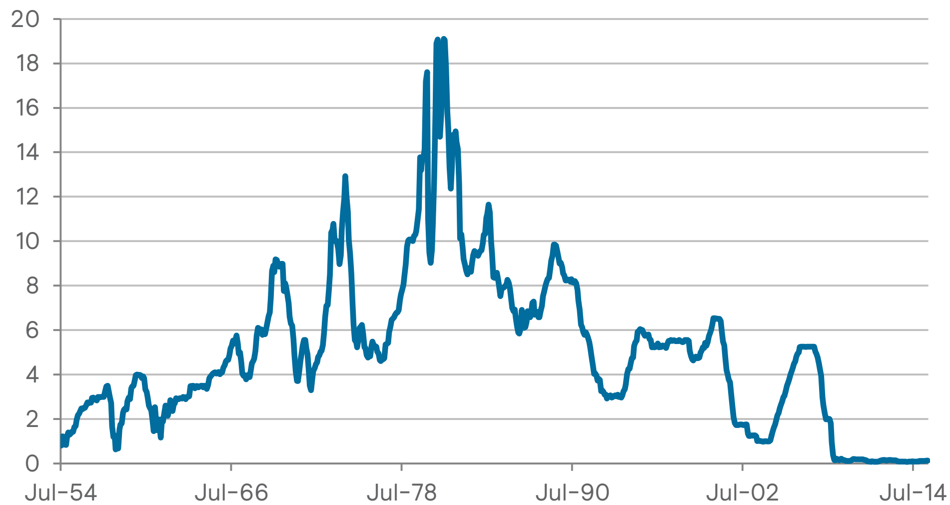


Source: Bloomberg, Thomson Reuters Datastream

WHAT HAVE PREVIOUS TIGHTENING CYCLES LOOKED LIKE IN PRACTICE?

Uncertainty around a shift in policy direction is often reflected in heightened market volatility. The implications of a rate rise in the US, as the world's largest economy and with the US dollar as the world's primary reserve currency, are far-reaching and will have some impact on most global asset classes. While there is potential for volatility to increase at the time of the first rate hike (reminiscent of the "taper tantrum" in 2013), of greater long term importance will be the pace of further rate hikes, the ultimate terminal level of interest rates and the impact on the economy.

Federal Funds Rate (%)

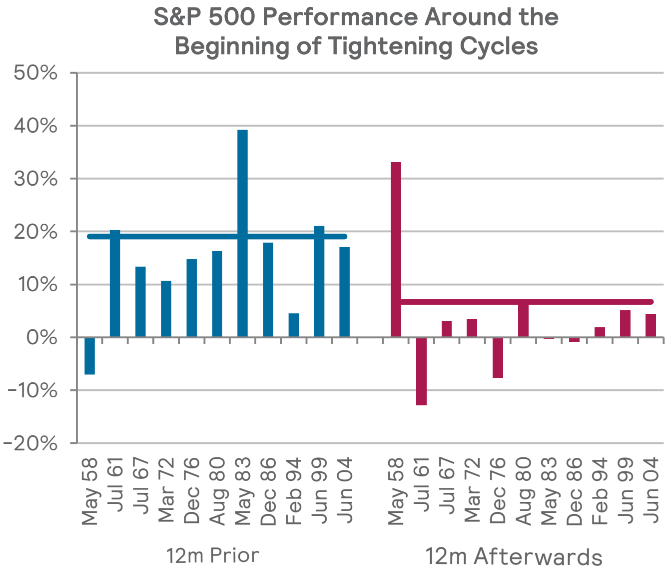


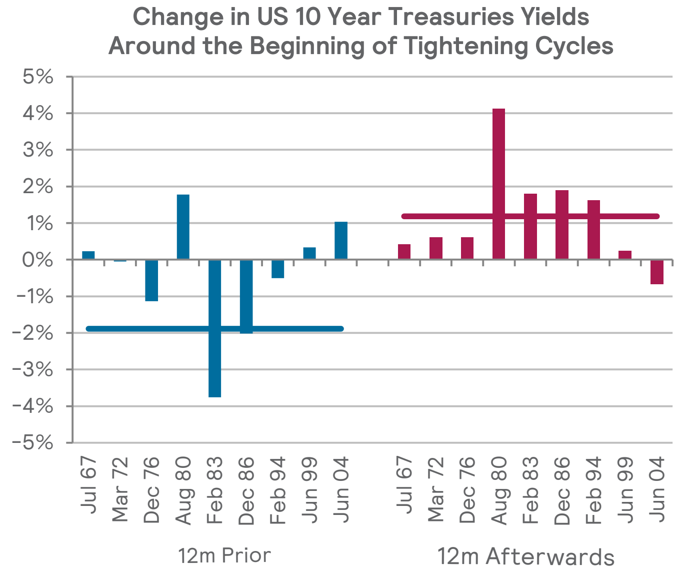
Source: Datastream

The chart above, illustrates the US Federal Funds Rate over the past fifty years with a number of interest rate-hiking cycles evident over that period. Though the impact of the interest rate rises on equity and bond markets is difficult to separate from the myriad of other variables affecting markets at a given point in time, these tightening cycles may provide some insight into the potential effects of rate rises in the current environment.

The effect of the interest rate-hiking cycles on US government bond yields and US equity markets is shown in the charts below.

Interest Rate-hiking Cycle Analysis





Source: Bloomberg. Left chart shows change in the S&P 500 price index as total return data is not available throughout the period. The change in the US 10 Year Treasury yield is not shown around the 1958 and 1961 rate hikes due to the availability of data.

The charts above illustrate that in relation to previous tightening cycles, equity markets performed better in advance of interest rate hikes than following them, and the same was the case for bond markets. This reaction is highly dependent on economic and market conditions at the time of the rate rise, however, so we would caution against drawing firm conclusions based purely on the historical data.

Given that asset prices already reflect the market's expectations for interest rate rises, the biggest market impact would arise from unexpected action by the Fed, as was the case when the Fed raised rates more quickly than expected in 1994 (leading to a substantial bond market sell-off). The chart on the first page showed significant disparity between the Fed's and the market's expectations for tightening, which suggests there is potential for an element of surprise in this tightening cycle. However, with the Fed being more transparent around its intentions in recent years, we might expect more of the move to be priced in ahead of the first rate hike taking place. Indeed, US equity market performance has been weak in 2015, especially after the August sell-off.

All-else-equal, if the Fed proceeds in raising rates more quickly than the market anticipates, this is likely to have a negative impact on asset prices, while slower than expected rate rises would likely have a positive impact (though clearly there is an element of circularity in the sense that Fed decisions will be driven to some extent by economic conditions and the market reaction to their policies).

WHY MIGHT THIS TIME BE DIFFERENT?

As already mentioned, previous tightening cycles are unlikely to be an accurate predictor of the impact of future rate rises, given that a broad range of macroeconomic and market-specific factors will also drive market movements. In particular, in the current environment, the Fed (and other major central banks) have implemented QE on an unprecedented scale in response to the most severe economic downturn since the Great Depression, while yields have been at record low levels.

The pace of rate rises is likely to be slower than in prior cycles.

The severity of the global financial crisis and the fragility of the economic recovery also suggests that the pace of rate rises is likely to be slower than in prior cycles. Indeed, Janet Yellen has been at pains to stress that the Fed intends to raise interest rates gradually, saying in March 2015 “If conditions do evolve in the manner that most of my FOMC colleagues and I anticipate, I would expect the level of the federal funds rate to be normalised only gradually, reflecting the gradual diminution of headwinds from the financial crisis and the balance of risks I have enumerated of moving either too slowly or too quickly.” However, it is also not inconceivable that the Fed might raise interest rates more rapidly than many expect.

Non-US monetary policy is also likely to impact on the Fed’s decision making. Monetary policy is likely to remain accommodative in the Eurozone and Japan for the foreseeable future, which may constrain the Fed’s ability to raise interest rates due to potential appreciation of the US dollar.

WHAT DOES THIS MEAN FOR INVESTORS?

While it is far from clear how events will unfold over the coming months, there are a number of investment implications and actions that we think are worth consideration.

- **Be prepared for market volatility.** Government bond markets have a reasonably strong correlation with one another, so if US yields rise, there may be a knock on impact on other government bond markets, potentially providing short-term opportunities for investors looking to increase their bond holdings for liability hedging purposes. This supports the case for trigger-based approaches to enable a more dynamic response to changing market conditions.

- **Flexible manager strategies may be best-placed to take advantage of tactical opportunities.** Many institutional investors struggle to respond sufficiently quickly to short-term market movements, as opportunities can arise and disappear very quickly. Investment managers with flexible mandates that are willing and able to respond dynamically to changing market conditions may be able to take advantage of any market dislocations.

- **Consider sensitivity to interest rate rises.** Aside from asset classes with a well-established sensitivity to interest rates (e.g. bonds), other asset classes may also fall in value in a rising yield environment (e.g. equities, through the impact of a higher discount rate and higher interest rates dampening consumer spending). There may also be important sector and stock-level effects that active long-only or long-short equity strategies may be able to capture.

- **Review collateral adequacy.** Many investors with leveraged liability-driven investment (“LDI”) mandates received cash paid out from their portfolios in early 2015 following the significant fall in yields during 2014. In the event of yields rising faster than expected, the reverse may happen with investors being required to post additional collateral. Investors should regularly stress-test their collateral position and have a clear understanding of how any collateral calls would be funded, recognising that a rise in gilt yields and a fall in equity values could happen simultaneously.

- **Review risk exposures.** Investors could undertake scenario analysis and stress testing to help determine their exposure to rising interest rates, and the potential impact of various downside scenarios to assess whether it might be desirable to put in place any protection against particularly painful outcomes. As always, investors should ensure that the risks being taken in their portfolio are commensurate with their risk tolerance and specific circumstances.

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