Pace of Fed tightening to surprise investors

- Capital Economics believe that monetary policy will tighten faster than investors expect over 2018, which will put upward pressure on ten-year Treasury yields.

- Global demand for Treasuries is unlikely to be as strong as during the last tightening cycle and won’t anchor yields this time round.

- Capital Economics expect ten-year Treasury yields to rise to 3.0 per cent by the end of 2018, compared with around 2.3 per cent today.

Despite the weakness of core inflation this year, the Federal Reserve has begun its balance sheet normalisation and a majority of Federal Open Market Committee members still intend to push ahead with one more interest rate hike this year. The Federal Reserve’s median projection points to an additional three rate hikes next year. In contrast, Capital Economics expect that the introduction of a fiscal stimulus by early next year and a more marked rebound in core inflation will force policymakers to be slightly more aggressive, culminating in four rate hikes in 2018.

At Capital Economics, our forecast is that the federal funds rate will rise to a peak of 2.50-2.75 per cent in the spring of 2019. This is more than investors are currently anticipating. The level of the rate that is currently implied in the Treasury markets is just over 2.0 per cent at that time.

This is important because it implies that the “risk-neutral” component of Treasury yields, which captures the expected path of the short-term interest rate during its lifetime, is likely to rise. This component has typically risen in the past when investors have underestimated the speed and scale of rate hikes over the next couple of years. Indeed, this was the case during the last major Federal Reserve tightening cycle in 2004-2006. Capital Economics believe that investors are making the same mistake again.

Of course, it is possible that other factors can prevent ten-year Treasury yields from rising. This happened during the last tightening cycle as the rise in interest rate expectations was offset by a fall in the “term premium”. This component captures the combined influence of all factors other than interest rates expectations. It collapsed amid a global savings glut and kept Treasury yields well-anchored. However, we aren’t convinced that will happen again. After all, the term premium is already very low, unlike at the outset of that cycle.

It is more likely that the term premium will rise slightly, adding to the upward pressure on the ten-year yield from a reassessment of the outlook for Federal Reserve policy. Although the persistence of low bond yields in much of the rest of the developed world is likely to keep the term premium unusually low, this probably won’t be enough to prevent it from rising as demand for Treasuries wanes.

First, foreign demand is unlikely to be as strong as it was. Foreigners own more Treasuries than any category of domestic investor. They have soaked up more than a third of the increase in the outstanding size of the market since the first quarter of 2009, which itself has doubled. This includes most of the...
holdings of non-financial corporate America. During the past six years, the biggest rise in foreigners’ holdings of Treasuries has been in Ireland. To a large extent, this reflects a surge in the amount held by the foreign subsidiaries of American multinational enterprises and results from the way in which these firms are taxed.

Additional tax is due when American corporates’ foreign earnings are repatriated to the United States or distributed to the company’s shareholders. The standard corporate tax rate in the United States is high by international standards. As a result, there is an incentive to generate earnings abroad and then retain them there indefinitely, either by investing in plant and machinery or in financial assets. Additional United States corporate income tax can be avoided if the foreign earnings are invested in American financial assets such as Treasuries. This source of demand for Treasuries could potentially ebb, however, if the Republicans’ proposed changes to the United States tax code reduce the incentive for multinational enterprises to generate earnings abroad.

Demand for Treasuries from other foreign investors could conceivably take up some of the slack. But this is not expected to be very strong by the standards of the past, despite persistently low bond yields abroad. First, China is unlikely to buy Treasuries on the same scale as in the mid-2000s. This is partly because of international political pressure not to engage in currency manipulation. Second, it is not believed that the demand from other economies in emerging Asia will be as strong as it once was, since they now have substantial reserves. Finally, our forecast that the oil price will remain fairly stable over the next year or so does not point to a big rise in the demand from oil exporters.

Second, investors in the United States itself may not have much appetite for Treasuries either, at least in the aggregate. Most notably, the Federal Reserve, which has been the second largest source of demand after foreign investors, has begun this month to trim the size of its holdings as part of a plan to shrink its balance sheet. Meanwhile, demand for Treasuries from private sector financial institutions in the United States, which had previously increased as a result of tougher requirements relating to their capital and liquidity, may also falter if the Republicans have some success in rolling back financial regulation.

Overall, it is Capital Economics’ view that demand for Treasuries during the next year or so is unlikely to be anywhere near as strong as it was when the Federal Reserve last raised interest rates in the mid-2000s. As a result, we doubt that yields will remain anchored in the way that they did during that period. The upshot is that we think that the term premium of ten-year Treasuries is also more likely to rise than to fall through the end of next year.

Capital Economics expect the ten-year Treasury yield will rise to 3.0 per cent next year (which compares to a level of around 2.3 per cent now) as the speed and scale of monetary tightening takes investors by surprise.

*This diary has been written in conjunction with Capital Economics.*
Strategy

The Margetts Investment Committee believe that a particularly bullish case has been presented above, which hinges on Trump’s stimulus package, tax policy changes and regulation reforms being pushed through Congress. We feel that there is potential for these initiatives to be altered and whilst we agree that rate rises are likely to continue at the Fed, we do not currently expect that there will be four rate rises by the end of 2018.

With a backdrop of historically low developed interest rates and continuing Quantitative Easing in Europe and Japan, Central Banks are likely to err on the side of caution to avoid tightening too quickly, reversing the progress being made towards rising core inflation and wage growth.

Despite the fact that we expect a cautious approach from the Fed and forward spot rates are likely to remain low, we believe that the yield curve will steepen as investors start to price in higher future inflation. We feel that this will be prominent at the long and very long end of the curve.

We agree that consumer and business confidence is improving in line with unemployment data, but we are yet to see wage growth reflect this, and this is an indicator that we are currently following closely. The Margetts Investment Committee are confident that rising wages will become prevalent in the near term and things such as the tax changes referenced by the Republican Party, if pushed through Congress will help to push assets trapped in treasuries down to the real economy.

However, we continue to believe that, even if the Fed pursues a more cautious approach than outlined above and is ‘behind the curve’, it is difficult to make a good investment case for bonds (particularly long dated). The divergence in performance between bonds and equities has widened in favour of equities, and we believe that this is a symptom of investors gradually rotating out of bonds and into equities as expectations slowly change. To reflect this theme, we continue to hold shorter dated bonds, which have a relatively lower sensitivity to interest rate rises.

To conclude, the Margetts team favour equities which we feel will continue to benefit from growing consumer confidence and offer better value relative to other asset classes, such as bonds. Where bonds are held, our shorter dated preference will work well alongside equities regardless of a fast or relatively slower paced rate rise trajectory from the Fed.
**Fund Comments**

**Providence**

### Asset Allocation

The above chart, as of 06/10/2017, demonstrates the fund’s current asset allocation. When comparing our current allocation and tactical target for the UK this week we felt that our current position more accurately represents our view of the UK economy and the committee therefore decided to adjust the tactical target to match the current position, rather than place deals to bring the position in line with the previous target.

The UK tactical target has been increased by 1% (from 42% to 43%) and the cash allocation reduced by 1% (down to 7.5%) accordingly. The team has a positive view on the UK economy and we hope to see additional returns by increasing the portfolio’s exposure to this area. The overall equity weighting for Providence is now 55%, up from 54%.

### Fund Selection

The Royal London Global Index Linked fund has underperformed the other bond funds in the portfolio this week. This is in line with our expectations as the other bond funds were able to benefit from Sterling depreciation, while the Royal London Global Index Linked strategy is hedged to Sterling and so did not capture this benefit. The committee has no fund concerns at present.
**Asset Allocation:** The above chart, as of 06/10/2017, demonstrates the fund’s current asset allocation. As outlined in the strategy, we currently favour equities and decided this week to increase our overall equity target from 77.5% to 78%. The US equity tactical target was raised by 0.5% (from 11.5% to 12%) to achieve this, and cash reduced by 0.5% down to 3.5%.

The US target was raised as it was the most underweight sector relative to the IA Mixed Investment 40 - 85% sector. The decision was made not to place any deals to reflect these new targets, as our current positioning is close to these targets already.

**Fund Selection:** There are no changes to fund selection this week. The Fidelity Institutional South East Asia fund has performed well over the last 12 weeks, while the Rathbone Income fund has performed strongly over 2 weeks.
**Asset Allocation:** The above chart, as of 06/10/2017, shows that the North American allocation is slightly overweight. We are making small sells to bring the position closer to its target, and are investing the proceeds into the UK and Asia Pacific, which have small underweights. We are continuing to move out of the hedged share class and into the unhedged share class of the Schroder Tokyo fund as outlined in previous diaries.

**Fund Selection:** BlackRock Continental European has shown strong performance over 4 weeks. The Threadneedle UK Growth and Income fund has underperformed the sector over the short term, however the team remain comfortable with the fund selection in the portfolio.
Asset Allocation: The above chart, as of 06/10/2017, demonstrates that most of the fund’s allocations are within the bands outlined and are close to their targets. We are rebalancing the UK weighting slightly by making a small sell, and leaving the proceeds in cash to bring the cash weighting closer to its tactical target.

Fund Selection: The Fidelity Emerging Markets and IP Emerging Markets funds have performed well over the short term, this is likely to be due to their allocations to Chinese Technology companies, which have performed strongly. There are no changes to fund selection being considered at present.
Important Information

Please note that the contents are based on the author’s opinion and are not intended as investment advice. This information is aimed at professional advisers and should not be relied upon by any other persons.

Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

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