Market Insight

Fed Takes Action

As widely expected, the Federal Reserve announced a 25 basis point hike in the federal funds rate following the December gathering of its policy-making Federal Open Market Committee (FOMC), bringing the target to 0.25–0.5%. In the statement accompanying the central bank's unanimous decision, the Fed cited considerable improvement in labor market conditions and a reasonable confidence that inflation will approach its 2% objective over the medium term. It also noted that its monetary policy stance remains "accommodative" despite the increase.

The FOMC announcement was more or less in keeping with market expectations; as of this morning the futures market was pricing in an 80% likelihood of a federal funds rate hike at this meeting, while 97% of business and academic economists surveyed last week by the *Wall Street Journal* forecast a hike. Rhetoric from Fed governors in the weeks that followed the October meeting — at which the Fed held steady, as widely anticipated, but took a less accommodative stance in its statement — seemed designed to soften up the market for December action barring any renewed tumult to derail the "data dependent" central bank; this includes Chair Janet Yellen, who described a December rate raise as a "live possibility" on more than one occasion. The hiking drumbeat grew even louder after the release of strong jobs reports for October and November brought the unemployment rate to 5%, even as many other economic and global indicators grew sluggish.

With an initial increase out of the way, attention will turn to the trajectory of the rate hike cycle and its terminal level. Messaging from today's statement suggested the central bank remains generally dovish on these points. Rate projections from Fed officials — the "dot plot" — fell slightly from the last time they were published in September, with the median expectation suggesting a fed funds rate of 1.3% by the end of 2016, 2.6% at the end of 2017 and 3.2% at the end of 2018. Over the longer run, the FOMC foresees a rate of 3.4%. This caution is driven by still-modest forecasts for key metrics. The central bank slightly upgraded its expectation for 2016 economic growth, to 2.4% from 2.3% previously, but left its 2017 forecast unchanged at 2.2%. Meanwhile, Fed officials do not expect inflation to reach the central bank's 2% objective until 2018; core PCE, the Fed's preferred inflation metric, grew only 1.3% in October from a year earlier.

Notably, the Fed's decision to begin raising short-term interest rates comes at a time when other major central banks — notably, in Europe, China and Japan — continue to provide massive amounts of support to their economies and are biased more toward further accommodation than anything else. The European Central Bank in early December announced the extension of its €60 billion per month quantitative easing program by six months until at least March 2017 and reduced its deposit rate further into negative territory, a restrained effort that left many observers hoping the ECB was merely keeping some powder dry. The People's Bank of China continues to tweak its policy mix as it reorients its economy toward a more consumption-based model while trying to avoid a hard landing; in its latest foray, the PBoC in October cut lending and deposit rates as well as the reserve requirements for banks — just days after China reported its worst GDP print since the global financial crisis. Meanwhile, pressure is building on Bank of Japan — which currently purchases about ¥80 trillion of domestic assets per year, mostly government bonds — to take action in the face of waning inflation expectations, sluggish domestic consumption and faltering external demand. The disruptions that potentially may emerge from this divergence in central bank policies is something that will demand close attention from the Fed.

With the financial crisis in full swing, the Fed cut its target federal funds rates to near zero in December 2008 in an attempt to stoke lending to consumers and businesses and revive the economy. This was the last of a series of rate cuts that took the target rate from 5.25% to 0–0.25% in a mere 16 months. Rock-bottom interest rates were accompanied by massive asset purchases — aka quantitative easing — that added more than $3.5 trillion to the central bank's balance sheet before the last bond was bought in October 2014.

We asked the leaders of our four investment platforms for their thoughts on the Fed's announcement.

Equity

Though the Fed finally has introduced the first fed funds increase in nearly ten years, the same risks and opportunities persist in the equity markets. Global growth remains uncertain, and domestically we're concerned about corporate earnings growth. Earnings — likely to hit another all-time high in 2015 — have been driven in large part by rigorous expense management and the utilization of corporate finance measures like stock buybacks, and are vulnerable without better support from top-line revenue growth. Meanwhile, those stocks that have been able to generate top-line growth have grown crowded, leaving them susceptible to wild swings in investor sentiment should their metrics disappoint. Our equity strategies are built through rigorous bottom-up research combined with disciplined portfolio construction, which we believe allows us to perform well in a variety of market environments.

Fixed Income

The 25 basis point increase in short-term rates announced today was a foregone conclusion for markets, and the cautious tone the Fed has communicated about the arc of the tightening cycle allows the central bank

significant flexibility moving forward. The "gradual" pace referenced in the FOMC statement can be construed as slightly more dovish than the "balanced approach" mentioned in September and the "measured" pace used in prior tightening cycles. And with good reason: Economic growth has never been as weak at the beginning of a hiking cycle as it is at present, and leading indicators point to listless core inflation. Worth noting was the Fed's citing of "actual" as well as expected progress toward its inflation goal, which again underscores the cautious approach the Fed likely will take in addressing future policy rate changes.

Following the Fed's announcement, interest rates reacted only modestly; near the market close, the two year had moved a little more than 2 basis points to 1% and the ten year 2 basis points to 2.29%. The Fed's forecast for growth and inflation remained moderate, as does the trajectory of additional rate hikes as indicated by the dot plot of FOMC participant forecasts. We expect the U.S. yield curve will continue flattening as bond markets remain less convinced than the Fed of the need to begin tightening or to remove accommodation. We believe long-term inflation will come in lower and real interest rate expectations will decline as the bond market increasingly treats the low potential growth rate of the economy as a permanent condition.

As far as currency impact goes, we do not expect the hike will benefit the U.S. dollar going forward, and we favor the euro versus the dollar. The latest ECB stimulus package was restrained and served as a message that a deterioration in economic growth will be needed before Europe will truly open up the stimulus floodgates. At the same time we see the Fed either under-delivering on future tightening actions or subsequent rate hikes being priced by the market as inappropriate, either of which would suppress longer-term interest rates. Historically, the dollar has depreciated following the start of every hiking cycle; circumstances suggest this tradition will continue.

Multi-Asset Strategies and Solutions

Given the market volatility registered ahead of the December FOMC meeting, the Fed is sure to carefully gauge global market responses to its 25 basis point hike. After an announcement in line with market expectations, the question turns to how the Fed will communicate its intentions going forward. The Fed likely will remain "data dependent" as well as sensitive to the reactions of the global economy and financial markets.

Looking ahead we expect that the Fed will operate with care, hiking once per quarter until a real rate of 1% is achieved. That would suggest a federal funds rate of about 1.25% a year from now; despite the Fed's comments to that effect, however, futures markets put a 64% probability of the target rate being 1% or lower by December 2016. The process of pricing in higher rates and the attendant reading of data tea leaves is likely to generate some headwinds to risk assets where realistically none should exist. Combined with the uncertainty around ECB/BoJ liquidity generation, the Fed's move is likely to keep pressure on commodities, the dollar and global growth, which will impact emerging market equities and other risk assets, especially in the coming months.

Senior Loans

However small the hike, the Fed's decision to finally lift rates finally removes some uncertainty from the market and certainly will be a positive catalyst for demand in the loan asset class. Though with the LIBOR floors of most loans still approximately 75 basis points greater than current short-term rates, we likely won't see a dramatic shift in the current of demand until the gap between actual rates and floors begins to recede more noticeably. On the other hand, institutional investors likely will be unmoved by today's statement, having for some time been positive on the asset class (via both collateralized loan obligations and other non-CLO institutional accounts and funds) and the low volatility and risk-adjusted returns that loans currently provide.

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