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POINTS OF VIEW

ECONOMIC UPDATE

As expected, in December the US Fed increased its Fed funds rate (FFR) by 0.25% to between 0.5% and 0.75%. This was the first and only increase in 2016 and just the second in 10 years.

The surprise was in the so-called "dot plot", which shows the Federal Open Market Committee's (FOMC) median FFR expectations. The upward shift in the "dots" shows the FOMC now sees three rate increases in 2017, up from two previously. It continues to expect three hikes per year in 2018 and 2019, with the median rate projections for the end of 2017, 2018 and 2019 of 1.4%, 2.1% and 2.9%, respectively. The longer-run rate projection was raised from 2.9% to 3.0%.

In both the statement and press conference that accompanied the rate change the FOMC projected a more hawkish tone, a consequence of the continuing tightening in the labour market and the rising trend in inflation. It might be remembered that in December 2015, the FOMC suggested there would be four rate increases in 2016. Eventually it only pulled the trigger just once, largely as a result of adverse external factors and a strong US dollar that negatively impacted corporate earnings. So, the obvious question for 2017 is whether this time the Fed will do what it says.

Potentially, external events and renewed strength in the dollar could again derail the Fed's plan, but the requirement to move towards policy normalisation, albeit at a very slow pace, looks greater in 2017 than in 2016. Removing one possible impediment to policy tightening, analysts are factoring in better corporate earnings growth in 2017 and 2018, helped by President Trump's proposed tax reductions and wider fiscal stimulus, which together should more than offset the negative impact of a strong US dollar. This is in stark contrast to the situation in 2016 when earnings expectations were revised down sharply due to the "double whammy" of a stronger US dollar and weaker oil prices. More generally, sentiment in the corporate, consumer and homebuilding sectors has surged to multi-year highs since the election, suggesting that the economy is now on a much stronger footing than a year ago.

Alongside faster growth, headline inflation will likely rise above 2% thanks to the recovery in energy prices and a pickup in wage growth (the latter reflecting an increasingly tight labour market). Again, this will contrast with the situation in 2016 when, for much of the year, Consumer Price Index inflation hovered around the 1% mark.

Markets are now pricing in the next US interest rate hike for June 2017. If the current economic momentum is sustained and wage growth accelerates, the Fed could well tighten again earlier than markets are currently expecting. Nonetheless, the pace and extent of Fed action will remain heavily influenced by both the trend in the dollar and the incoming administration's fiscal actions.

It will be important to gauge how monetary tightening by the Fed influences the mood in other central banks. The UK's growth and inflation profile is similar to that of the US. While this may put pressure on the Bank of England to raise rates, it is likely to use Brexit uncertainty as the excuse to keep policy on hold, unless inflation overshoots significantly. Meanwhile, Mr Draghi's recent rhetoric suggests that the European Central Bank will remain accommodative, although pressure for a change of course may emerge from Germany later in the year. The Bank of Japan is also likely to maintain its distance from the Fed's tougher stance, given continuing dull growth. Moreover, with 10-year government bond yields already above 0%, there are likely to be more questions with regard to the efficacy of its policy of "yield-curve control".

FOMC "dot plot" of median Fed funds rate expectation

Source: Federal Reserve.

First published on 13th January 2017 by Janet Mui, Global Economist at Cazenove Capital Management.

US GRAND SLAM IN MARKET EUPHORIA

A euphoric stock market reaction to Trump's new fiscal policies and a classic 'santa rally' has driven all four of the main US stock market indices to record highs!

The oldest, the Dow Jones Industrial Average, tracks the average prices of just 30 "blue chip" companies, the S&P 500, the most commonly cited US index, tracks the returns from the 500 largest .US-listed companies (although weighting by size means that the very largest companies have the greatest influence on reported returns), the Russell 2000 tracks returns of smaller companies (the 1000th to 3000th biggest US companies), while the Nasdaq index is more focused on technology stocks – as can be seen by its extreme spike in the late 1990s. Given all have reached record highs for year end, it's worth pondering why US equity investors are so uniformly optimistic?

For years now, stock markets have relied on central banks and the combined power of ultra-low interest rates, quantitative easing and forward guidance to 'save' a sluggish global economy which is overly burdened by debt and mired in political discord.

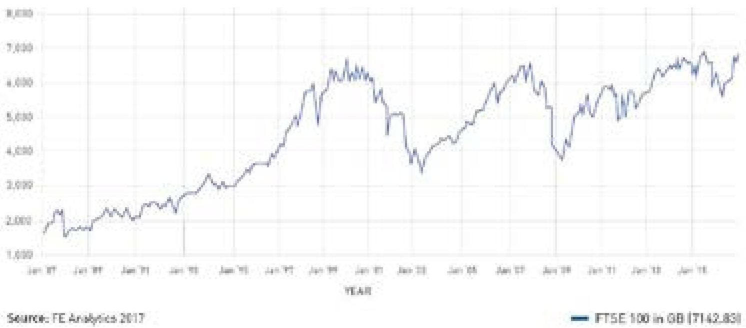
Almost overnight however, the baton has passed to governments, as concerns increase over the effectiveness and inequality of monetary policy and politicians have responded with a wave of fiscal stimulus to boost economic growth and lower unemployment. Whilst it's undeniable that there are clear efficiency gains from improving infrastructure which has long been underfunded, the benefits of supporting sectors in structural decline (such as coal and manufacturing) are less clear, especially when it will only further increase debt.

Contrary to the UK, US investors have responded by switching out of predominantly large cap technology stocks (trading at historic premiums), and moving into smaller, more cyclical companies within sectors such as financials, industrials, biotech and energy, which they're betting will be insulated from the rising Dollar and should benefit from the pickup in activity.

Equity markets have clearly decided to treat this new approach as a positive, powering to new highs. Unsurprisingly, debt markets have taken the opposite view and have been weakening since the summer. The question therefore, is how sustainable is this change in investor sentiment and will these new fiscal stimulus measures actually have an impact on the real economy? Only time will tell, but it is interesting to observe these changes as such trends can take many years to play out and can have a significant impact on asset values.

These trends also have the potential to influence other equity markets, as the FTSE 100 reached record highs on the back of strong manufacturing PMI data and general positive sentiment.

FTSE 100 Hits Record High



As we move into 2017, with heightened levels of political risk and elevated equity level valuations, it appears ever more important to ensure your portfolios are well diversified to mitigate any external shocks or change in sentiment which may follow.

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