UOB

Investment Insights

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Welcoming the New Fed Chair

On 5th February, Jerome Powell, a 65-year old ex-lawyer and investment banker, was officially sworn into office as the new Fed Chair. He took the reins of the most powerful central bank at a delicate time. While the unemployment rate in US is low and the economy is booming, the inflation has started to show signs of picking up. Meanwhile, Trump's tax cuts and infrastructure spending would add trillions to the budget deficit.

Amid these uncertainties, Powell has to guide the Fed to run the Balance Sheet Reduction (BSR) program and to hike rates. In this issue, we explore the Powell's background, provide our views on the Fed's policy direction and corresponding strategies.

Who is Powell?

Powell is a moderate Republican. Unlike his predecessors such as Yellen and Bernanke, Powell does not have an educational background in economics. He was a lawyer by training and started his career as lawyer and thereafter as investment banker. He then worked in the government for a few years and later in his career made his fortune as partner of a private equity fund.

What sets Powell apart from other Fed Chair candidates is his prior experience of working in the Federal Reserve. From 2012 to 2017, Powell served on the Federal Reserve Board of Governors. The experience gives him good understanding of the organization's culture and relatively complex reporting system.

In November last year, Powell was appointed by President Trump as the next Fed Chair and subsequently voted in by the Senate this January. Following the confirmation, Powell assumed office as Fed Chair in early February.

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His philosophies

Powell is viewed widely as a consensus builder and most observers regard his succession as continuation of the previous Fed Chair Yellen. According to a survey of 30 economists conducted by Bloomberg, Powell is slightly more of a dove and is expected to normalize the monetary policies at a gradual pace. The coming FOMC meeting in March will be Powell's first FOMC meeting as Fed Chair and he is widely expected to support a hike in interest rate. The outcome of the meeting would be a key signpost to deciphering the new Fed Chair's views on economy and monetary policy normalisation path.

Powell's views on financial regulations differ from Yellen. While Yellen urged lawmakers to be cautious about rolling back post-crisis tight financial policies, Powell is more open to easing some of these policies to reduce the regulatory burdens of the banks. During his testimony in November last year, Powell stated that he was willing to consider lowering regulatory requirements while preserving core reforms. His stance is more aligned with President Trump's plan to deregulate the banking industry.

Figure 1: Five Facts about Jerome Powell.

1. Powell is the first Fed Chair without a PhD in Economics since Paul Volcker (1979-1987).
2. He is likely to continue with the Fed's current approach of slowly raising interest rates.
3. Unlike Yellen, Powell is more likely to roll back some financial regulations implemented during the 2008 financial crisis.
4. Powell is the wealthiest Fed Chair since 1948. His net worth is reportedly as high as US$55 million.
5. President Obama appointed Powell as Fed governor in 2012. Over the past 5 years, he voted in favor of every Fed policy decision.

Source: Fortune, 03 February 2018

Implications for investors

Although Powell has assumed the position of the new Fed Chair, we do not expect him to deviate significantly from the policy trajectory defined during Yellen's leadership. Hence our base case for the Fed's rate hike remains at 3 times this year, but we do not write off the possibility of a fourth rate hike this year if data continues to surprise on the upside.

Given that fundamentals remain solid, we do not expect continued rate hikes to trigger a bear market. Therefore, we continue to prefer equities, focusing on relative valuations and growth prospects when identifying opportunities. Within the fixed income space, EMD local currency still offers value and buffers against higher rates. Investors who are under-allocated to risk assets could consider taking the opportunity to add some risk assets to their portfolios.

3 Hikes with Risk of One More

UST 10y yield is expected to hit 2.9% by the end of 2018 and our economist team maintains projections for 3 rate hikes in March, June and December (with possibility of adding one more hike).

Although stronger inflation expectations could result in a more aggressive Fed in terms of policy normalisation, the Fed would be cautious given that the BSR program is still running in the background. Though its effects were mild in 2017, the BSR program is likely to gain further traction in 2018 as cuts to investment continue. Trimming the Fed balance sheet under the BSR program has similar effects to hiking rates, so it is probable that the FOMC will take into consideration the additional impacts from the BSR program when deciding the trajectory of the rate hikes.

With UST 10 yield hovering around 2.85% to 2.95%, a large part of the repricing is likely to be done. In the short term, UST 10y yield could grind closer to 3%, but any moves beyond that would require significant upside surprise from inflation and employment data.

Position for Higher Rates

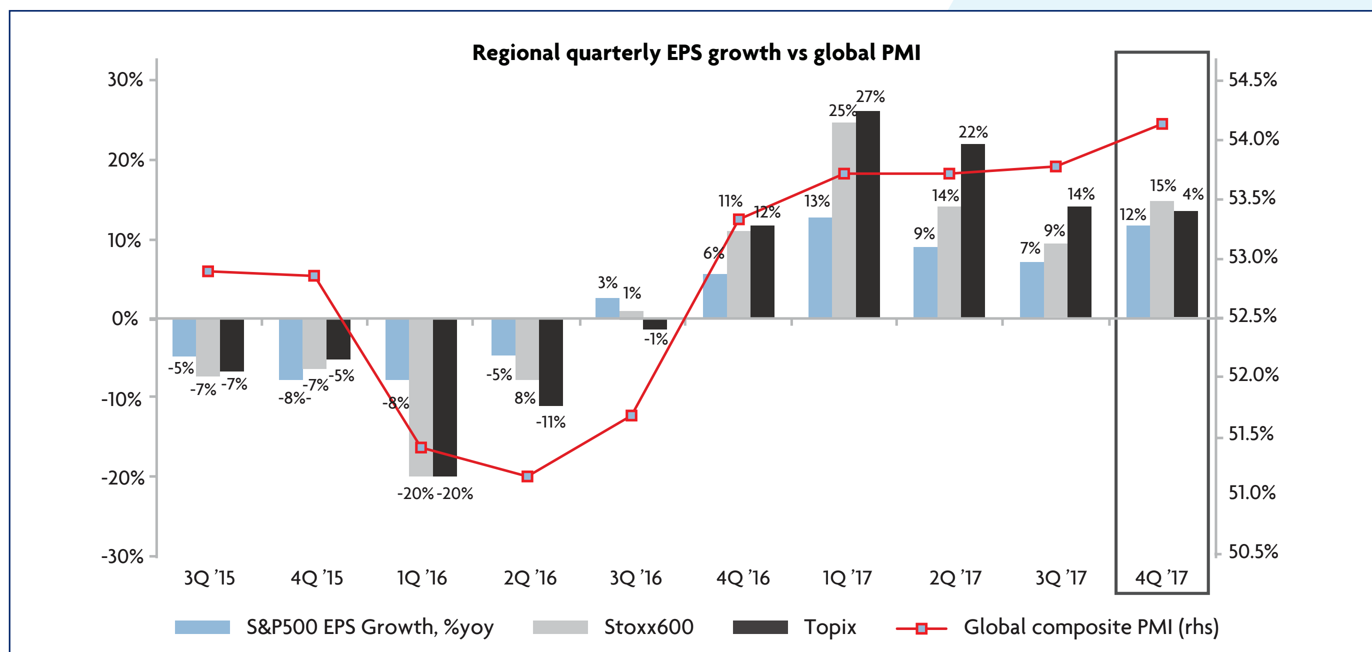
Within equities, prefer financials and ex-US opportunities.

Equities can perform in a rising rate environment as long as earnings growth remains supported. We reiterate that the current pullback largely occurred on technical grounds, instead of fundamental weakness.

As shown in Figure 2, the global composite PMI is robust and have recovered from lows in 2016. Meanwhile, earnings growth also rebounded and maintained at healthy levels across key regions in US, Europe and Japan.

In terms of sectors, we continue to favour financials, especially banks. The lenders tend to benefit from rise in short-term rates as they are able to increase their interest margins. Across regions, we hold a preference for ex-US opportunities like Europe, Japan and EM. These regions present more reasonable valuations versus the US markets and hence provide better buffer for higher rates.

Figure 2: Global PMI and earnings growth are strong.



Source: J.P. Morgan, 5 February 2018

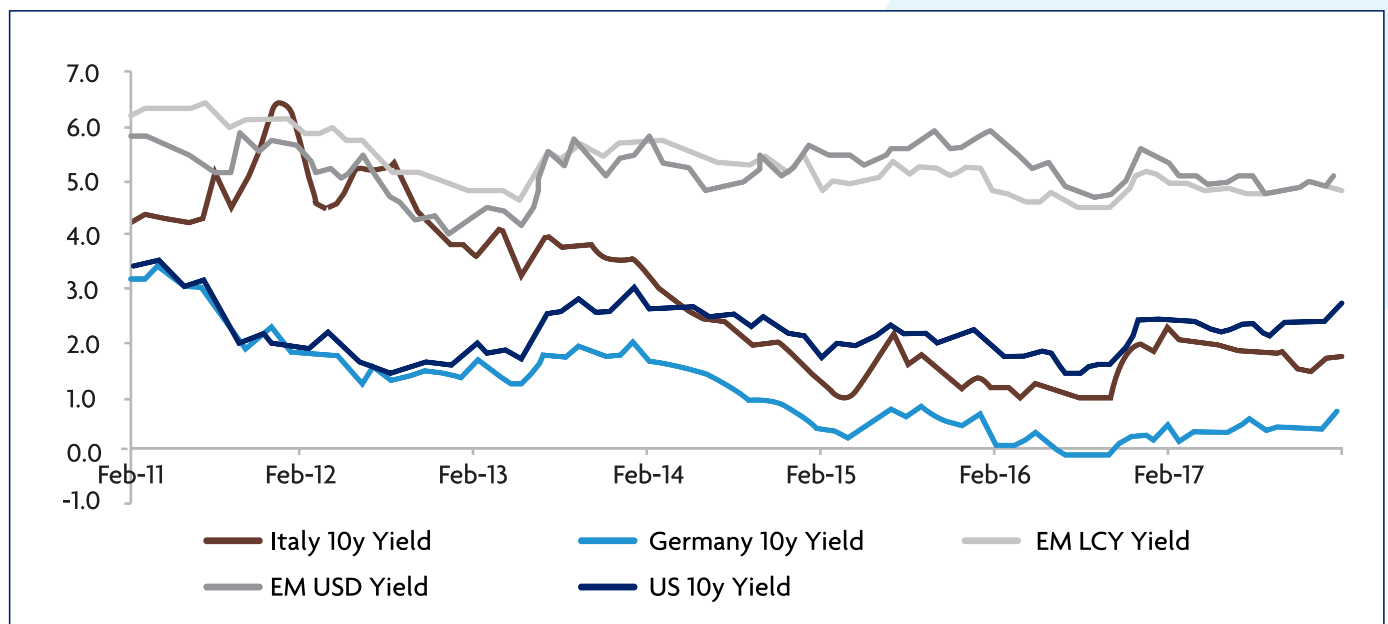
Within fixed income, focus on EMD local currency

Although a rising rate environment is negative for fixed income in general, certain asset class may still be able to generate positive return. We like EMD local currency on the basis of attractive yield pickup, which provide the much-needed buffer as rates grind higher. Some local central banks, like Russia, may have room to cut rates due to subdued local inflation.

Near-term consolidation provides potential entry point

In the near term, we expect markets to continue consolidating following the recent sell-off. Scepticism about the markets' strength and concerns about rate hike could linger. Market participants may also need some time to get used to Powell as the Fed Chair. However, we do not expect continued rate hikes to spark the beginning of a bear market, as long as they are done gradually. Clients who are under-allocated to risk assets could take advantage of the correction to add some risk assets to their portfolios.

Figure 3: EMD local currency yields remain stable and attractive levels post 2011 "Taper Tantrum".



Source: Bloomberg, 22 February 2018

Market Outlook and Strategies ▶▶

Macro	
Global Growth	**Global economic activities continue to firm up**. Global growth forecast for 2018 is revised up to 3.9% from 3.7%. EMs lead the improvement in growth, while the outlooks for DMs remain mostly stable.
Monetary Policy	Central banks continue to normalise monetary policy. **Fed leads with rate hikes and BSR**. ECB has started tapering. BOJ is likely to remain accommodative, but its stance could shift.
Inflation & Rates	**Inflationary pressure stay subdued but is expected to trend higher**. Expect 3 hikes from the Fed in 2018 with higher probability of one more hike, as US wage growth and inflation data beat expectations.

Risks	
Inflation Overshoot	Yields have repriced but **tight labour markets and stable commodity prices** could feed further into wage growth and inflation. Spikes in yields could affect risk assets negatively.
China Hard Landing	Chinese government is likely to continue to strike a balance between stability and deleveraging. **But overly aggressive policies could raise default rates and hard landing concerns**.
Geopolitical & Political	**Tensions remain heightened** in North Korea and the Middle East. **A number of elections** are scheduled to be held in the US, Europe and some emerging economies in 2018.

Strategies

Tactical Strategy		Key Proposition	Key Risks
Reflation and rotation in DM	**US financials equities**	• Attractive discount versus broad US market and benefits from a reflationary environment.	• If the Fed turns out to be more dovish and hike rates less than market expected, performances of could be hurt.
	European equities	• Attractive discount versus US and tailwinds from improving economic activities.	• Strong Euro could negatively impact exporters, but the impacts are mitigated by improving domestic demand. Some political risks remain.
	Japanese equities	• Attractive discount versus other DM equities and local sentiments have recovered. Potential policy tailwinds under Abe's rule.	• A change in BOJ's monetary stance could cause Yen to strengthen. However, BOJ should remain largely dovish.
Tap into EM growth	**EM equities** *Incl. EM allocation and Asian equities*	• Offer more appealing valuations and potential tailwind from structural reforms. Stable commodity prices could provide support to earnings.	• Unexpected USD strength could be headwind, but we expect USD to stay range-bound.
	EMD LCY	• Higher yields versus other fixed income assets and benefit from improving fundamentals in EMs.	• Unexpected USD strength could be headwind, but we expect USD to stay range-bound.
Structural opportunities	**Quality equities**	• Tend to experience less drawdowns during sell-offs and outperform broad equity markets over longer investment cycles.	• Hefty valuations could increase probability of short-term corrections. However, global recession risks remain low.
	Global healthcare equities	• Attractive valuations and earnings likely to improve on higher innovative drug approvals and strong M&A activities.	• Policy uncertainties could continue to weigh on sentiments, but meaningful structural reform of drug pricing is unlikely in the foreseeable future.
Yield Enhancer	**Short duration high yield bonds**	• Lower sensitivity to interest rates and attractive yields versus Treasuries.	• Default risks could rise if economic conditions worsen, but current outlook remains stable.

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