THE BARK IS WORSE THAN THE BITE

Market expectations around a near-term rise in the federal funds rate started to increase in the wake of the release of the minutes from the Federal Reserve’s Federal Open Market Committee (FOMC) April meeting. The minutes were viewed as hawkish as they said most FOMC participants judged that if the growth, labor market and inflation data continued to improve then “it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June.” Just last week, Fed Chair Janet Yellen indicated that if the economy and labor markets continue to strengthen, as the Fed anticipates, then such a move would probably be appropriate “in the coming months.” Market reaction so far has been relatively measured, however – and today’s disappointing jobs report has taken wind out of the Fed’s sails. Over the last two months, the probability of a July hike rose from 33% to as high as 55% – before falling right back down to 30% as markets digested the small number of jobs added to the economy in May. We reiterate our expectation of only one rate hike over the next twelve months.

As shown in Exhibit 1, asset markets behave well when the Fed doesn’t surprise and raises rates in a predictable manner. Asset price volatility is much greater when the increases are sudden, and less discounted by the markets. This cycle, we think the “bark” about the potential for rate hikes will be worse than the “bite” of the actual rise in interest rates. This should be supportive of asset markets as monetary policy remains overly accommodative despite the modest uptick in tightening rhetoric.

EXHIBIT 1: SLOW AND STEADY WINS THE RACE

Source: Northern Trust, Bloomberg.

The Fed’s steady approach to rate hikes in 2004/2005 led to stable market returns, while the “heavy handed” approach in 1994/1995 led to much greater volatility. This cycle will not see the magnitude of rate increases of either of those cycles, as the Fed had difficulty in raising rates the first time this cycle and the timing of the second hike is also complicated. The next meeting, which takes place from June 14-15, occurs just a week before the U.K. referendum on remaining in the European
Union (EU). While the bookmaking odds have moved noticeably toward the U.K. remaining in the EU, these same sources were not very accurate in their predictions ahead of the recent U.K. election. For the Fed to be committed to its risk-averse policy stance, it seems unlikely that it would surprise the markets a week ahead of such a major event. This then puts into play the July meeting, which runs from July 26-27. While some analysts have said that the lack of a corresponding press conference makes the Fed unlikely to move at this meeting, it seems simple enough to call a press conference if they have decided the time is right for a hike. The September 20-21 meeting would seem to fit into Yellen’s “coming months” timeframe, but could prove to be too close to the U.S. Presidential election.

We think the much more important question surrounds the eventual pace of the tightening cycle, and how much the markets have discounted the move in advance. We expect the Fed to only raise rates once over the next year, well below the Fed’s hopes. One reason the markets are hesitant to assign a higher rate trajectory is the history of the last five years. In Exhibit 2, we show the evolution of expectations around Fed policy since 2011 by graphing the Fed funds futures contracts as of May 31 of each year. In 2013, futures markets expected the federal funds rate to hit 1% by February 2016, in contrast to the actual rate of 0.375%. In 2014, the markets expected the federal funds rate to exceed 1.75% by April 2017 – while today the rate is expected to be less than one-half of that.

EXHIBIT 2: FADEING EXPECTATIONS

The message from Exhibit 2: consistently lower interest rate expectations persist as the global economic recovery has failed to accelerate and disinflationary trends have remained in force. Importantly, we don’t see the trends of the last five years reversing over the next five. The most important drivers of interest rates are growth and inflation, with an uncertain impact from technical factors like quantitative easing. In 2013, we expected global growth to average 3.3% over the next five years, and we cut that to just 2.6% in our 2015 forecast (our 2016 forecast will be published in July). Likewise, our inflation forecast fell a full percentage point from 3.8% in 2013 to 2.8% in 2015.
Turning to asset class performance, risk assets have typically fared well in the 12 months that straddle the second hike in a period of policy tightening. While the stock market has historically seen an increase in volatility around rate hikes, it tends to resume its upward trajectory as investors become comfortable that the Fed hasn’t gone too far and risked putting the economy into recession. Over the course of the full tightening cycle, earnings growth is the key contributor to stock returns as valuations have tended to compress. As we wrote in our August 2014 commentary, “What to Expect When You’re Expecting – A Rate Hike,” price-to-earnings multiples have fallen on average by nearly 5% across the last five rate cycles. Earnings have increased at an annual rate of 19% over the cycles – reflecting the continued growth in the economy. As shown in Exhibit 3, developed ex-U.S. and emerging market equities have outperformed U.S. equities during the 12-month period straddling the second rate hike, reflecting the different monetary policy cycles. We don’t expect these differentials to repeat this cycle as the magnitude of monetary policy change will be much reduced as compared to historical cycles. High yield returns have been generally positive through tightening cycles as the improving economy has historically helped improve credit quality and therefore reduce spreads.

EXHIBIT 3: GENERALLY POSITIVE RETURNS AS RATES RISE

As shown in Exhibit 3, equities have done quite well during the time of the second Fed rate hike in previous cycles – but what exposures do other risk assets have to interest rates? To answer this, we looked at the exposure these other risk assets have to equity movements and interest rate movements (and included high yield again for good measure). Equity exposure is formally referred to as market factor exposure – measuring the return generated above and beyond the risk-free rate by investing in equities. All risk assets – even high yield – have meaningful exposure to the market factor. Interest rate exposure is formally known as term factor exposure – measuring the excess return achieved by investing in fixed income securities out the yield curve (i.e. taking on duration risk).
The higher the term exposure in Exhibit 4, the greater sensitivity the asset class has to interest rates; all else equal, falling interest rates are good for these asset classes while rising interest rates are bad (in both cases, as compared to what is already priced into the markets). As we have highlighted before, high yield has very little exposure to the term factor – despite the fact it consists of fixed income securities (as noted above, higher interest rates are generally met by falling credit spreads). Natural resources have little (actually slightly negative) exposure to the term factor, while the slight exposure dividend-paying stocks have is overwhelmed by their exposure to the market factor. Global real estate and global listed infrastructure do have meaningful exposure to the term factor – in addition to the market factor – and this exposure is taken into account when we analyze the prospects for these “hybrid” asset classes. So if our “lower for longer” view on interest rates is correct, global real estate and global listed infrastructure will be relative beneficiaries. If we are wrong and rates do move up more significantly than the market currently expects, high yield, natural resources and U.S. dividend-paying stocks will do relatively better.

**EXHIBIT 4: VARIED SENSITIVITIES**

**SELECT RISK ASSET EXPOSURES TO TERM & MARKET FACTORS**

<table>
<thead>
<tr>
<th>Term exposure</th>
<th>Market exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Yield</td>
<td>0.07</td>
</tr>
<tr>
<td>Natural Resources</td>
<td>0.37</td>
</tr>
<tr>
<td>Global Real Estate</td>
<td>0.93</td>
</tr>
<tr>
<td>Global Listed Infrastructure</td>
<td>0.48</td>
</tr>
<tr>
<td>U.S. Dividend Payers</td>
<td>0.09</td>
</tr>
<tr>
<td>Global Real Estate</td>
<td>0.79</td>
</tr>
<tr>
<td>Global Listed Infrastructure</td>
<td>0.72</td>
</tr>
</tbody>
</table>


The impact of rising rates on fixed income returns continues to be a source of confusion for some investors. We believe many investors have an exaggerated sense of risk to their bond portfolios from the potential of rising rates. To forecast future expected rates of return, one needs to take into account what is already priced into the bond market. For instance, using the current forward curves (left hand panel of Exhibit 5) we see that a two-year bond currently yielding 0.91% is really a collection of a one-year bonds yielding 0.68% and a one-year bond in one year yielding 1.16%. In other words, the market expects one-year rates to go up 0.48% over the next year – and, should this occur, our original two-year bond will maintain its price level, despite the upward shift in rates. This exercise gets more involved as we look at bonds further out the yield curve – and even more involved when we consider forecasting returns for bond indexes, which have multiple bonds being issued and maturing over any given time frame – but the key point is that future rate expectations are a key driver of expected returns. Higher rates can definitely cause negative price movements to occur, but those increases in rates must outpace built-in expectations.
EXHIBIT 5: YIELD CURVE CUSHION


As noted earlier, and seen in Exhibit 2, the markets have been reining in their Fed policy trajectory over the past few years. Reduced expectations for future expected interest rates have reduced the steepness of the yield curve. This can be seen in the right side of Exhibit 5, which shows the yield curve – currently, and at the start of other rate hike campaigns – broken out by the spread between the three-month and two-year, two-year and 10-year, and 10-year and 30-year. The bigger the spread, the bigger the “cushion” built into the markets for rate increases. Currently, some “cushion” is still there but has been shrinking – in part due to reduced expectations for Fed rate hikes in coming years. But, even with the shrinking cushion, our expectation for a more modest rate hike trajectory than is currently priced in results in positive fixed income returns over the next five years.

CONCLUSION

Investor focus has returned to the Fed with the increased probability of a rate hike in coming months. We wouldn’t get too distracted by this debate. Even if the Fed chooses to raise rates in July or September, we expect the pace of rate increases in coming years to be very restrained. The Fed is keenly aware of downside risks as well as negative interest rate policies from the European Central Bank and the Bank of Japan. We think this caps the magnitude of potential Fed rate hikes, as unexpected dollar strength would tighten U.S. financial conditions and do the job of additional rate hikes. In addition, global growth momentum continues to disappoint – pushing other central banks into further easing actions. The history of recent interest rate cycles in the U.S. is that financial markets perform well in the early to mid-part of the cycle, as long as the Fed doesn’t negatively surprise investors. We think that remains the playbook for this cycle – so don’t be too worried about Fed policy suffocating investor risk appetite.

Special thanks to Dan Ballantine, Investment Analyst, and Tom O’Shea, Investment Analyst, for data research.
* **Exhibit 4 Sources**: High Yield – Barclays Capital High Yield Index; Natural Resources – Morningstar Upstream Natural Resources Index; Global Real Estate – FTSE EPRA/NAREIT Global Real Estate Index; Global Listed Infrastructure – S&P Global Infrastructure Index; U.S. Dividend Payers – Top Quintile of dividend payers in the Russell 3000 Index

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No bank guarantee | May lose value | NOT FDIC INSURED

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