AN OUTLOOK

SEVEN VII IM
Investment Management

LIFT-OFF

> "Be wary of the consensus view that higher US interest rates automatically mean higher bond yields and a stronger US Dollar"

Markets have been intensely focused on the Fed's decision to start increasing interest rates: we now have lift-off, with the Fed delivering what markets expected: a 25bp rate hike (the first in almost a decade!), emphasis on the "gradual" pace of future rate rises and encouragement both about the state of the economy today and about how long the expansion can continue. We have experienced high volatility as a prelude to the Fed's first move, but the successful implementation of a "dovish hike" (i.e. a small interest rate rise, accompanied by soothing language about the future path of interest rates) can support a quick recovery in sentiment if – as we expect – the sky does not fall in after a first Fed hike. So far, so good: market reaction has been very positive in the immediate aftermath. As the moment of lift-off passes, the focus will naturally shift to the trajectory of subsequent interest rate hikes versus what is already priced in: how many hikes, how quickly and to what peak level for the cycle? We share the broad market expectation that a first hike will be followed by a steady drip of reassurance that the economy is continuing to perform and that monetary policy remains very stimulative. It's worth remembering that the early stages of past Fed hiking cycles have tended to be good periods for equities, as optimism and earnings growth offset higher rates. We should be wary of the consensus view that higher US interest rates automatically mean higher bond yields and a stronger US Dollar: markets are efficient – they know rate hikes are coming and have priced assets in that expectation. Bond yields can rise, or the Dollar strengthen, if interest rates rise faster than expected – but a slower pace of hikes would still leave scope for consensus to be surprised: recent rises in US Treasury yields (and US inflation-linked bonds, or TIPS in particular) start to appear quite interesting.

Beyond the immediate hurdle of interest rate decisions, markets are also wrestling with the outlook for commodities. Commodity producers have been slow to reduce excess supply after a decade or two of heavy investment in capacity. This perceived overhang has further undermined prices, reopening debate about where a potential trading range for oil and other resources may settle. With crude oil prices over $46 at the start of November, one could foresee a less challenging picture for energy-related deflation, global trade data, and perhaps energy company profits and capital spending in the not too distant future, with year-on-year stabilisation in prices vs levels seen in Q1 2015. However, renewed weakness in oil prices (below $42 by the end of November and below $40 as we write in December) raises the possibility of more of what we saw in 2015: downward pressure on headline inflation, disappointing global trade data and cuts to energy companies' earnings expectations. The open question remains: will lower energy prices help to fan consumer demand? The world consumes around 90m barrels of oil per day: with oil prices over $60 a barrel lower today than in late 2014, the collapse in oil prices looks to have shifted almost $2tn from producers to consumers over that period. Consumer trends in developed markets seem reasonably strong, but with improving labour markets, rising wages, decent availability of credit and now this boost to disposable income from lower fuel costs, it's surprising that consumer demand is not yet stronger. That may yet come.

Commodities form part of our strategic asset allocation: we would expect to hold some allocation to commodities in normal circumstances. In fact, we have been holding zero weight for the past few years, and the decision to avoid buying back in appears a good one. We remain watchful, and continue to weigh opportunities in commodities as elsewhere, but stay on the sidelines for now. Equity markets will remain volatile – one consequence of a subdued global growth rate is that a minor scare on the growth outlook can result in a quite significant market panic – but offer value and reasonable upside as the economic cycle continues to develop. The change in the interest rate cycle, and the divergence between the US and Europe, will create opportunities in bonds too, for return generation as well as portfolio diversification.

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