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Rising interest rates in the USA

Gerhard Winzer



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The sentiment of the financial market participants has deteriorated in the past months, with the losses across numerous asset classes in the year to date seemingly the driving factor. Now we have to ask ourselves: are we at the outset of a new trend, or is this just a case of increased volatility? The general decline in prices has gone in conspicuous tandem with the increase in three important financial market ratios:

- US Treasury yields
- the oil price, and
- the US dollar

Also, the movement affected mainly countries with high inflation and high current account deficit.

Increase of key-lending rates priced in by the market

The real neutral interest rate is estimated to amount to 0.45% in the USA (Laubach / Williams, Federal Reserve Bank of San Francisco. This is the interest rate that affects inflation neither in a dampening nor in a supporting fashion. By adding the inflation target of the Fed of 2%, we arrive at the nominal neutral interest rate of 2.45%. The Fed itself assumes a value of 2.9%, which it wants to reach by the end of 2019. A key-lending rate (i.e. Fed funds rate) of 2.7% is already priced in for the end of 2019. By comparison, the current Fed funds rate is within a target band of 1.50-1.75%. This means the majority of the expected rate hike is priced in. In terms of the important benchmark, the 10Y yield of the US Treasury bond, this means a stabilisation within a band of 3-3.25% (currently 3.07%; source: Bloomberg, as of 17 May 2018). This holds as long as inflation is not rising.

Mild inflation pressure

Generally speaking, the central bank can act cautiously as long as the underlying inflation remains low. The recently published inflation data have suggested only mild inflation pressure for many countries in the developed economies. In line with this scenario, many central banks have been signalling a wait-and-see stance in the past weeks, with the exception of the USA, where the increase in inflation is more profound. The inflation benchmark preferred by the US central bank (i.e. the core PCE deflator) was at 1.9% in March, i.e. close to the inflation target. Also, labour costs increased by 2.7% p.a. in Q1 (source: Bloomberg), up from 1.4% p.a. at the end of 2009. The core statement of the US Fed at the beginning of May was that the goals of full employment and 2% inflation had been reached and that the inflation target was symmetrical. This basically means that inflation rates of slightly above 2% will not accelerate the path of interest rate hikes. At 1.5%, average inflation has been below this target only slightly in the past ten years. However, an increase in US inflation could drive 10Y yields up further. At the moment, the so-called break-even point in the 10Y segment is already 2.19%, which means that the achievement of the inflation target by the Fed is already priced in.

Appreciation of the US dollar

The divergence of inflation and central bank signals between the USA and other countries is in line with the recent appreciation of the trade-weighted US dollar. At this point, the US dollar is back at its level of the end of 2017. While we continue to expect broadly-based economic growth and the mild normalisation of the monetary policy also in other important countries and regions (Eurozone, UK, Canada), we also stick to our scenario of the US dollar moving sideways this year after its depreciation in 2017.

Rising interest rates mainly have two effects:

- Deteriorating valuations of other asset classes
- Deteriorating credit quality due to higher credit costs

Increased valuations

Years of low interest rates have caused substantial inflows into asset classes with a higher promised yield. This in turn has led to generally falling yields, narrowing spreads, and rising valuation metrics. Generally, higher valuations go hand in hand with lower future returns and with a stronger degree of susceptibility to correction. Rising interest rates mean an increase in the attractiveness of (credit-) risk-free interest rates, i.e. US Treasury bonds. At the same time, the attractiveness of investment alternatives falls. For this situation to balance again, i.e. in order to achieve an increase in risk premiums (i.e. spreads) required, the prices of other asset classes come under pressure. If the basic assumption of a stabilising 10Y US yield holds and global economic growth remains strong and broadly based, equities will remain more attractive than government bonds (or in the USA, Treasury bonds).

Rising credit costs

Credit costs are rising. This is of course negative for companies and governments with high debt (in US dollar). If earnings growth and GDP growth remain strong, the increase in interest expense can be covered.

Growth: stabilisation in the current quarter

Real global economic growth has weakened in Q1 2018 vis-à-vis Q4 2017. This has triggered worries that sustainable weakening could ultimately result in recession. The indicators published in the past weeks, such as the purchasing managers' indices for April, suggest an economic stabilisation in the ongoing quarter. Our model estimates (the "nowcasts") also indicate continued, strong growth above potential that is broadly based, although growth rates are lower than in Q4.

Appreciation of the US dollar and key-lending rate hikes in the emerging markets

Rising US rates are particularly negative for countries with high external financing needs, i.e. a high current account deficit. It is no coincidence that especially Turkey and Argentina have recently come under pressure with current account deficits of above 5%.

Countries with such elevated financing needs in US dollar are faced with an increasing interest burden when the US dollar appreciates. Indeed, the emerging currencies have come under particular pressure by the US dollar. Generally, a weakening currency comes with positive and negative effects. Among the positive effects is the fact that it supports net exports in the medium term. At the negative end, the attractiveness of real and financial investments decreases from the perspective of foreign investors as long as the currency continues to weaken. When the depreciation is excessive, the pressure on the central bank rises to hike rates in support of the currency. Most recently, the Argentinean central bank has tried to stabilise its currency with drastic rate hikes – so far, successfully. If the falling exchange rate leads to inflation, the pressure to raise rates increases further. If successful, the restrictive monetary policy can stabilise the currency, but unemployment rises. If the currency cannot be stabilised, there is also the option of selling foreign exchange reserves. However, falling reserves are detrimental to the rating of a country. Even though typical features of emerging economies still exist, we have seen a structural improvement in many countries over the past years: low inflation (central banks with inflation targets), floating exchange rates (no US dollar peg), fewer external (current account deficit) and internal (high budget deficit) imbalances, higher share of local currency bonds (debt taken out in domestic currency).

Higher oil price due to US sanctions against Iran

The oil price has embarked on a rising trend. Generally speaking, demand growth is currently above supply growth. At the same time, inventories have fallen drastically. But the most important reason for the increased oil price is the fact that the US sanctions against Iran could lead to a decline in oil exports. The higher oil price eats into the purchase power in the oil-importing countries and thus presents a risk to growth.

We can see our base case scenario of a gradual normalisation of the interest rates confirmed. Real global economic growth remains strong – albeit slightly lower than in Q4 – and broadly based. At the same time, inflation is low and rising only gradually, with central banks cautiously reducing their expansive stance (N.B. the US Fed more swiftly so than the other central banks). This abandonment of the “Goldilocks” scenario induces elevated price fluctuations and the adjustment of spreads due to increasing US interest rates. In this base case scenario, we continue to prefer risky asset classes such as equities and US corporate bonds with low ratings (high-yield) and local currency bonds from emerging markets.

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Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.