CAPITAL GROUP®

Market Update
Interest rates

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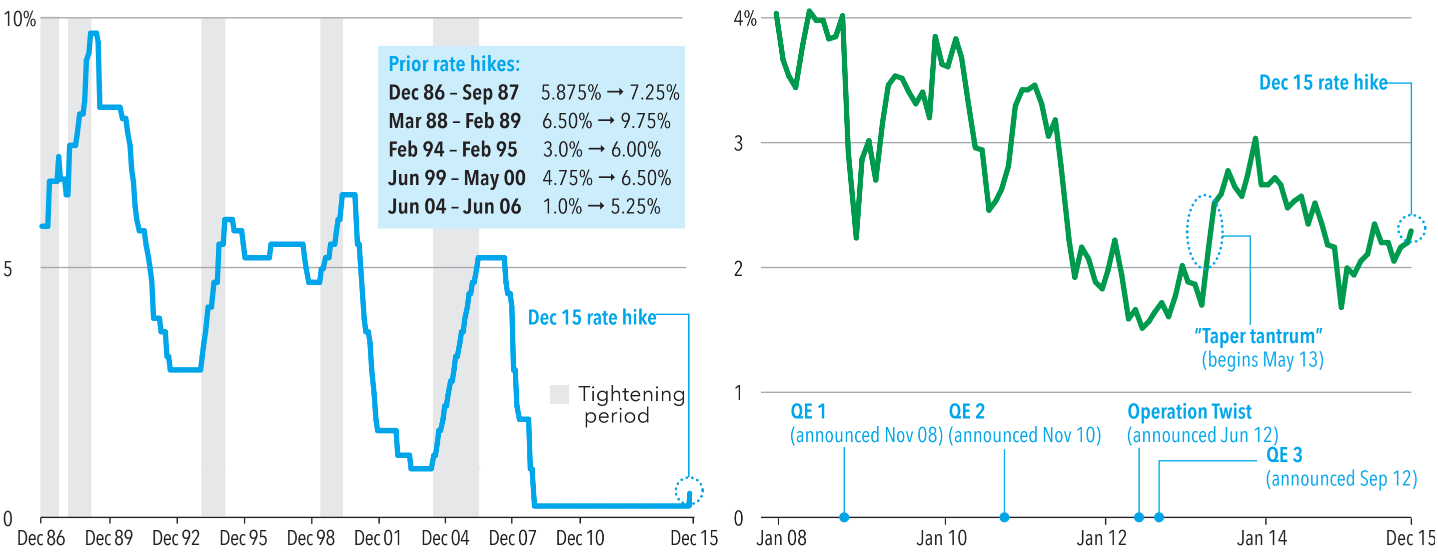
Fed rate decision: liftoff at last, but no cause for panic.

Summary

- The Federal Reserve (Fed) has increased interest rates, as it appears confident about the US labour market recovery, domestic inflation expectations and gradual economic recovery outside the US.
- While the Fed has not laid out its precise path for normalisation, it has stressed a careful approach to increasing rates, which may imply that this tightening cycle will be slower than past ones.
- Although some areas of the bond market may lag in a rising rate environment, the income investors earn from bonds should benefit from higher yields going forward.
- The impact on equities is more mixed, with some sectors benefiting as the economy continues to strengthen and others facing a headwind from higher financing costs.

The Fed has raised rates for the first time in nearly a decade

Fed funds rate | **10-year US Treasury yields**



All data through 16 December 2015. Prior hikes shown exclude single rate hike in March 1997.
Sources: Capital Group, FactSet

How did we get here?

The last US interest rate hike was in June 2006 – the culmination of a two-year period during which the federal funds target rate was raised from 1% to 5.25%. Then, in September 2007 – amid rising market volatility and a housing market correction – central bank policy began to head in the opposite direction.

Over the next 15 months, the Fed progressively lowered rates in a bid to counter the sharp deterioration in economic and market conditions prompted by the Global Financial Crisis. In November 2008, the Fed announced its first quantitative easing bond-buying programme (QE 1), and a month later it lowered the benchmark interest rate to virtually zero. Further bond-buying programmes were unveiled over the next five years, the third of which (QE 3) ended in October 2014.

For the first time in nearly a decade, the Fed on Wednesday 16 December 2015 lifted short-term interest rates, signalling that it believes the US economy is strong enough to absorb higher interest rates, with employment continuing to recover, inflation expectations grounded and the global economy and markets showing some stability.

The market largely anticipated the 25-basis-point increase in the federal funds target rate from near zero to between 0.25% and 0.50%, with futures contracts implying more than an 80% chance of a hike. The rate had hovered at its lower bound since December 2008, when the Fed cut it to that point to help calm investors at the height of the financial crisis.

"This was one of the few times in the past year or more where the Fed's communication was very well judged. They wanted this not to be a big market-moving event, and it really wasn't," says fixed income portfolio manager Wesley Phoa. "The decision received a positive response from the equity market afterwards, but there was no big drama around it." The S&P 500 Index rose by about 0.8% between the Fed announcement and market close, while 10-year Treasury yields were essentially flat on the news.

Although the Fed sometimes tightens monetary policy to pour cold water on an overheating economy, this time around its action could instead be interpreted as a sign of confidence. "As Fed Chair Janet Yellen explained, the US is on a path to sustainable improvement, and job market prospects should be good," explains Phoa. "It's appropriate to tighten right now, because the economy is reasonably close to its potential productive capacity. The fact that they're moving now sends a positive message."

The Fed's patience is likely to continue

Although the move was a significant step for the central bank, Fed officials made clear that they remain very cautious. That is evident by the Fed's projections, which show rates may increase by only 1 percentage point annually in 2016 and 2017. "It was a dovish hike," says fixed income portfolio manager David Hoag. "In the statement and the press conference, they used the word 'gradual' many, many times. So I think that continues to be the theme."

Even though the Federal Open Market Committee has finally begun raising rates, policymakers could take years to reach their long-term rate target. The nation's unemployment rate was 5.0% in November, a level that many economists consider full employment. However, broader indicators suggest that the labour market recovery isn't complete. Workforce participation is at just 62.5%, for example, and remains the lowest in more than 35 years. Wage growth has also been disappointing in recent years.

Although the Fed believes that inflation expectations are on target, actual year-over-year inflation has been nearly flat throughout 2015 due in large part to low energy prices. And while some overseas economies have experienced a difficult year and are even loosening monetary policy, the Fed sees the global picture as stable enough to absorb slightly higher rates in the US.

The Fed's commitment to move slowly can be clearly seen through its economists' latest projections, particularly those for median interest rates in 2017 and 2018, which are slightly lower than what was expressed after their September meeting. Yellen also pledged that the Fed would be careful not to raise rates too quickly. "The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate," she said in the press conference that followed Wednesday's announcement.

The central bank is expected to continue to increase rates in 2016, even if implemented at a modest pace. That said, Phoa pointed out that we should remain mindful that the Fed could reverse course if domestic growth or foreign turmoil darkens its outlook. If inflation increases faster than anticipated, US monetary policymakers could also speed things up.

Investors should not panic

Investors have been anticipating this move for some time, and it was largely priced into the market before the hike actually occurred. While higher rates mean lower bond prices in the short term, over time reinvestment can provide higher yields. Active managers, in particular, have the tools and insights to help tackle higher rates and the associated volatility. On the equity side, the impact is not as clear-cut. Some sectors, like banking, may benefit. Others may not fare as well, whether those in a more interest-rate sensitive business or companies facing more expensive financing, like airlines.