Deutsche Asset
& Wealth Management

CIO Flash
The Fed: A good start to what could be a bumpy ride
Dec 17, 2015

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The U.S. Federal Reserve (Fed) delivers

- The Fed has finally increased the range of the federal funds rate by 25 basis points, from 0.25 to 0.5%. The decision was unanimous. This is in line with our and the overall market expectations.
- There were few surprises in the accompanying statement. According to the Fed, the labor market and the economy are in a reasonably good shape, and the risks are now "balanced", as opposed to "nearly balanced" in October.
- The Fed stressed that future decisions will depend on incoming data. It will maintain its policy of reinvesting proceeds from maturing bonds. Therefore, any concerns on balance sheet shrinkage will be put on the backburner for now.
- The rate increase was accompanied by several technical measures. The daily USD 300bn cap on reverse repo operations has been temporarily lifted and all treasuries held by the Fed will be potentially available for the repo program. The FOMC would without a doubt be prepared to use other tools to ensure the new regime will work smoothly in practice.

A slow, but uneven rate path ahead

- With the first hike out of the way, investor focus is now shifting towards the second hike.
- Potentially another rate hike could happen at any of the next meetings of the Federal Open Market Committee (FOMC). Although we think that an accommodative stance is most likely, uncertainty will be greater than it has been in a long time.
- The Fed's dot "plot", charting the target rates of FOMC participants going forward, is broadly consistent with a slow moving Fed. Of course, some dots (i.e. those of the Fed leadership) carry more weight than others. Overall, the FOMC's projections remain well above what markets are pricing in. Clearly, FOMC members expect the market to do most of the work of closing the expectations gap, rather than meeting it halfway.
- We expect to see two more rate hikes in 2016 and no balance-sheet shrinkage until after the first few rate hikes have taken place.

Market implications

- Mild initial market reactions underline how well the Fed has managed and met expectations. We see no reason to change our longer-term views.
- For U.S. Treasuries, we stick to our rates forecasts: 2-year at 1.50%, 10-year at 2.40% and 30-year at 3.10%, as of December 2016.
- Longer term, we see the dollar strengthening, despite the limited initial impact.
- We remain constructive on equities given the relatively benign economic environment in the US, Eurozone and Japan. Within the US, we would note that financials have historically outperformed as central bank interest rates start rising.
- By and large, it is positive to see the Fed delivering. Still, we believe, investors will have to learn to live with greater uncertainty about the path of monetary policy. Hang on for a potentially bumpy ride.

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Deutsche AWM expectations 2015. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved; Deutsche AWM Investment GmbH, CIO Office; Deutsche Bank AG; As of Dec 17, 2015

Glossary

Explanation of terms

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Bunds are issued by Germany's federal government, most frequently with a maturity of 10 years, and are the German equivalent of U.S. Treasury bonds.

Each **dot** represents where an FOMC member sees the federal funds rate at the end of each year.

The **federal funds rate** is the interest rate at which banks actively trade balances held at the Federal Reserve.

The **Federal Open Market Committee (FOMC)** is a committee that oversees the open-market operations of the U.S. Federal Reserve.

The **Federal Reserve System**, which serves as the U.S. central bank, was established in 1913, consisting of the Federal Reserve Board with seven members headquartered in Washington, D.C., and twelve Reserve Banks located in major cities throughout the United States.

Reverse repo operation describes the purchase of securities with the agreement to sell them at a higher price at a specific future date.

Monetary policy focuses on controlling the supply of money with the ulterior motives of price stability, reducing unemployment, boosting growth etc. (depending on the central bank's mandate).

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years), and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The United States dollar (**USD**) is the official currency of the United States and its overseas territories.

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