Weekly Digest
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Investec
Wealth & Investment

The weekly insight into world stock markets

The Importance of This Week's Fed Meeting to Markets

We live in strange times. Last week, the German government borrowed money from investors for 10 years with a coupon of 0.25% and an issue price of €104.76 per €100 of debt, in effect providing a borrowing rate of -0.24% i.e. investors chose to pay the German government to lend it money. Moreover, this is not a new phenomenon. Currently, Barclays estimates that the market value of bonds trading with a negative yield has doubled since last autumn to $12 trillion dollars. Countries offering negative yields include Germany, Switzerland, the Netherlands, Denmark and Japan. In times when the outlook for growth is uncertain, interest rates are low or negative, inflation is tepid and politics is threatening a generation of increased globalisation, investors are more concerned with the return of capital rather than the return on capital.

There is little doubt that the developed world's interest rate policies of the past ten years have had a profound impact on investment markets. Government and corporate bond yields have fallen materially and real assets such as equity, property, classic cars, fine wines, fine art and much more have experienced strong financial performance despite economic growth rates that have been disappointing by historic standards. It is interesting to note that 2018 was a year of increased volatility as the US interest rate setting committee, the Federal Open Market Committee (the "Fed"), consistently increased the US base rate and withdrew quantitative easing, leading to two significant drawdowns in global equity markets (in quarters one and four).

And so to the Fed meeting this week (with an announcement on Wednesday evening) and its importance to markets. In terms of background, the US has been raising interest rates from essentially 0% to the current range of 2.25%-2.5% since December 2015. By many metrics, the US economy appears to be late in its economic cycle and rising US interest rates are warranted. Signs of the late economic position include an unemployment rate at its lowest level since the late 1960s (3.6%) and US wages increasing at close to the fastest level since the financial crisis (3.1%). However, the Fed, under its relatively new chairman Jay Powell, pivoted its position at the start of this year. In December 2018, the famous US "dot plots" (the Fed's signal of individual members' views on future interest rates) were pointing to two more interest rate rises in 2019 and one last one in 2020. Since Powell's pivot in January, the market has moved from pricing in potential rate rises to discounting a strong possibility of two to three interest rate cuts in 2019.

What has changed so much that has led to this dramatic change in future expected US interest rate policy? First, the inauguration of Donald Trump as President in early 2017 saw a positive combination of tax cuts, extra spending and a general spirit of deregulation buoy the US economy. That means that in the short-term, it is not possible to provide a further boost to the US economy without further borrowing and the current growth rate compares unfavourably with better times in 2017/18. Second, escalating trade wars between the US and other global powers have heightened concerns about a looming global economic downturn. The Fed has been left to guess the extent to which the stand-off between the US and China - and Mr Trump's other aggressive trade policies towards places such as Mexico and (potentially) Europe - will impact the global economy. On top of this, the US President has been very critical of the Fed's rate tightening policy, opining only last Monday that "they (the Fed) had made a big mistake. They raised rates far too fast".

So what is likely to happen? Most economists are now expecting the Fed to retain its policy of a base rate range of 2.25% to 2.5%, though it could modify its language in its statement to highlight the risks from trade wars and weaker data, providing a future path to lower rates. Certainly, an interest rate cut in June or a half point cut in July could be interpreted by markets as the Fed knowing more about the likely weaker outlook, which could lead to a negative shock to the prices of risk assets. Fortunately, last Friday saw the release of US retail sales data, which at +0.5% month-on-month in May soothed some fears over the near term outlook for the US economy.

The impact on investment markets has been predictable this year (following the change in tone from the Fed). Despite the weaker economic environment, all assets have been boosted by the outlook for lower interest rates and the potential for more QE. Many equity markets are showing up to double digit returns while bond returns are positive across the curve. However, this Goldilocks environment (with growth and inflation not too hot or too cold) is not predicated on a further slowdown in the world economy, which does not appear to be priced into global equity markets.

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Head of Fixed Income

FTSE 100 Weekly Winners

Evraz	10.0%
Anglo American	6.9%
Antofagasta	6.7%
DS Smith	6.5%
Just Eat	6.3%
Rio Tinto	5.6%
Halma	5.2%

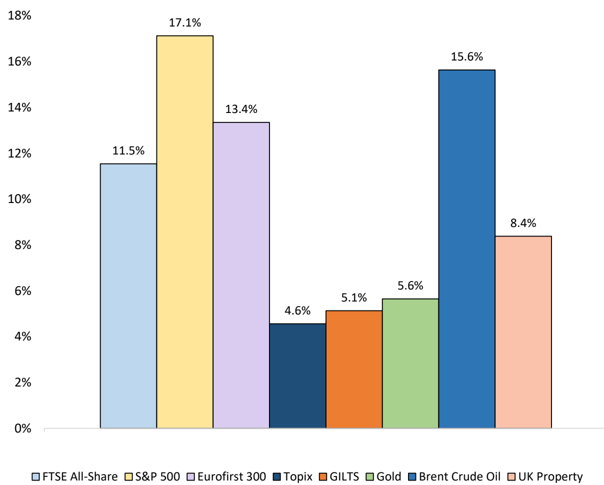
Source: FactSet

FTSE 100 Weekly Losers

Persimmon	-4.7%
Imperial Brands	-4.7%
Centrica	-4.5%
British American Tobacco	-4.3%
Hargreaves Lansdown	-3.6%
Next	-3.5%
ITV	-3.0%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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