



# Weekly Insight

## Are there grounds for the Fed to raise rates this summer?

The Federal Reserve interest rate cycle is back in focus, following the release of hawkish minutes of April's policy meeting and signs that US inflation is firming. The Fed minutes revealed that policymakers have not ruled out a rate hike this summer, noting that market pricing of Fed expectations was "unduly low."

### Data dependency will be put to the test

Policymakers are keeping alive the option of raising rates this summer and are likely hoping to realign market expectations. Since the Fed's dovish policy statement in March and further cautious comments by Chair Janet Yellen, financial markets have taken a complacent view of the Fed rate path. Broad expectations that the Fed would stay on hold for a prolonged period has helped the S&P 500 to largely hold on to gains since mid-February, has driven two-year treasury yields lower and maintained a softer US dollar trend this year.

The Fed has consistently emphasised that its policy decisions are 'data dependent'. This phrase has provided policymakers with defensive cover during times when the US economy has been tested by external forces. However, more recent economic releases are showing that US economic momentum is starting to gather pace in the second quarter, particularly domestic consumption. If this upward momentum can be sustained, the Fed will need to start following through on its words. Indeed, a failure to act in the event that the Fed stays on hold longer than the underlying data would suggest is likely to increase the risk of a policy error.

### Inflation: Moderate upside risks

The inflation outlook is key to the Fed rate path. We believe that inflation risks are moderately skewed to the upside, a view that we have held for some time. While headline inflation has been depressed by disinflationary energy effects, core inflation has shown greater resilience since October 2015, due to the strength of service inflation. Shelter comprises one third of the US CPI basket and this, together with medical care costs, has placed upward momentum on services inflation. Further evidence of rising services inflation can be seen in April's PMI services survey, where prices paid by suppliers rose for the first time in three months. Moreover, this year's rebound in energy prices coupled with some moderation in the strong US dollar trend could boost headline inflation over the medium term.

Another factor supporting the Fed rate tightening path is the US labour market: the one area of the economy that has shown consistent strength. Nonetheless, April's employment report showed signs that the current labour market recovery cycle is maturing, evidenced by slower jobs growth and a levelling in the unemployment rate, which has fallen meaningfully since 2010. Small business surveys also show that the rate of hiring is slowing. However, as the economy reaches 'full employment', wages pressures are likely to build. Average hourly earnings rose 2.5% in the last 12 months to April, signalling modest pressures. Interestingly, the Federal Reserve Bank of Atlanta's wage growth tracker, a measure we find more representative of underlying wage trends, shows that median wage growth increased 3.4% year-on-year in April 2016 and has been on a steady upward trajectory since October 2015.

### Mixed economic activity but some reassuring indicators

While we expect the inflation outlook to support a Fed tightening path, we have to acknowledge that policymakers' task has been complicated this year by disappointing economic activity. This has largely been due to the manufacturing sector, which continues to struggle amid high inventories, slower global growth, weak commodity prices and a strong US dollar.

Reassuringly, services activity is picking up, reducing concerns that manufacturing weakness could impact broader confidence. US consumption has not been as strong as we would have expected, with domestic sales slowing in the first quarter. However, April's stronger than expected retail sales report signals a potential shift in consumer behaviour, particularly with financial market volatility having subsided and evidence that wage growth is picking up. The housing sector also remains on a recovering trend, albeit growth has slowed in the last few months. Further positive data surprises are likely to increase the probability that the Fed acts in July, but no later than September. After that time, the Fed will most likely want to avoid implementing policy decisions during the US electoral cycle.

### How should we expect markets to perform?

Prospects of higher US interest rates should keep a wider rate differential versus other developed economies, which we would expect to support the US dollar in the near term. US treasury bond valuations remain expensive and we

maintain a short duration position. We expect that a shallow rate tightening cycle against the backdrop of modest growth and inflation should be relatively benign for corporate credit. However, we also recognise that the credit cycle has matured and investors will need to be selective in finding areas of the market offering compelling value. In this regard, we hold exposure to US high yield energy bonds, where the default outlook is starting to improve due to oil prices rebounding and a better energy supply/demand outlook towards the end of 2016/early 2017.

US equity valuations are looking stretched and corporate earnings growth remains under pressure. The US equity market has outperformed most other developed markets over the last 3-5 years. Given these factors, we have been lightening our exposure in favour of other equity markets, including Europe and Japan.

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**Risk Warnings:**

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