WHY THE SECOND US RATE HIKE IS MORE IMPORTANT THAN THE FIRST

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The post-2008 investment cycle has been abnormal in that it has been underpinned by massive central bank liquidity and the weakest advanced economy recovery in history. During this time, nine major central banks have tried to tighten policy and nine been forced to abandon their desires. However, Matt Sherwood, Perpetual's Head of Investment Strategy, Multi Asset finds that the US is in a good position to arrest this trend, as much of the private balance sheet repair has been done, growth is gradually improving and the US economy is close to full employment. Most investors are concerned about US Fed policy causing a decline in share prices similar to what has been seen in six of the past seven US tightening cycles since 1974. With corporate cost savings seemingly exhausted, the longer-term US sharemarket outlook will be governed by the pace and the nature of the US tightening cycle and in this way the second rate hike is more important than the first.

KEY TAKEOUTS

- While no two US Fed rate hike cycles are identical, there have been seven tightening cycles in the US over the past 40 years. However, these have been part of a super-cycle where interest rates steadily declined with any rate peak lower than in the prior cycle. Increases in US interest rates have led to increased sharemarket volatility in six of the seven cycles, but only one has triggered an end to the equity bull market with six of seven cycles having recorded prices gains over +25% in the next three years, as earnings growth improved.
- Emerging markets are most exposed to US Fed rate hikes as they have raised trillions of US dollar denominated debt since 2009 and are now characterised by high and rising debt, out-dated growth models, chronic corporate deflation and structurally declining growth. Indeed, the emerging market's (ex-China) growth rate has declined below that of the advanced economies for the first time in 17 years and one of the few times in the past three decades. EM economies may be in better shape than was the case in the late 1990s, but leverage has risen notably which means that rising US interest rates and a rising US dollar will place increased stress on the region and suggests that a 2016 growth re-acceleration is highly unlikely.

INTRODUCTION

A Italian historian once said that '*there can be no task harder to take in hand, more perilous to conduct and more uncertain in its success than to take the lead in the introduction of a new order of things*' and investors and the US Fed may be feeling this way as all await the first rise in official US interest rates since 2006. The US recovery remains the weakest in history, but its sustainable and emergency policy settings are not appropriate with the US Fed now focused on storing some policy ammunition for the next crisis, whenever that may be.

MARKETS - COMFORTABLE WITH HIGHER US RATES

Despite heightened volatility when the tapering of the US Fed's QE program was first announced in 2013, and again when China was weakening in August this year, the markets seem to have adjusted to the notion that US rates will soon rise. With unemployment having halved to 5.0% over the past six years and inflation likely to rise as the impact of higher oil prices wash out of the annual calculation, a policy adjustment seems well justified. Over the past 40 years, seven US tightening cycles have taken place, but this has been in a super-cycle where interest rates steadily declined with tightening cycle peaks at a lower rate than that in the prior cycle. This is largely attributable to the Fed's success in maintaining a low inflationary environment and that they needed to provide more stimuli each cycle to arouse the marginal investor. That is, across the cycles there was a trend of lower highs and lower lows in the US Fed Funds Rate.

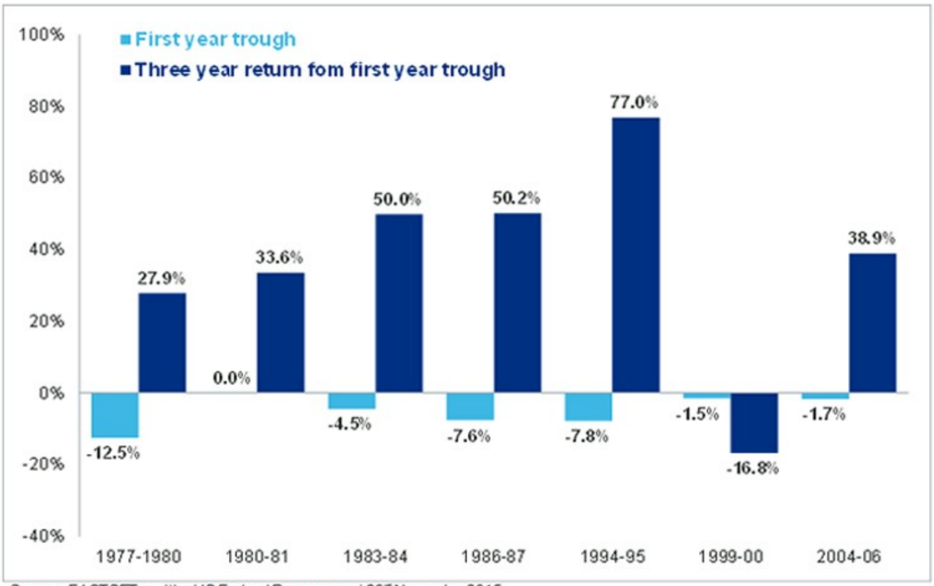
LESSONS FROM HISTORY

Increases in official US interest rates have led to increased sharemarket volatility with six of the past seven cycles recording a decline in the first year. However, very few of the rate hike cycle have triggered the end of the equity bull market with six of the seven cycles recording price gains over +25% or more in the subsequent three years (see Chart 1). These price gains reflect the fact that the US Fed raised interest rates because the economy was strengthening and this underpins a rise in earnings growth, which fuels higher dividends. That doesn't mean that market corrections won't happen as the 1999-00 and 2004-06 cycles preceded two of the largest US sharemarket declines in the past century, but those were not driven by restrictive US monetary policy, but by exogenous shocks such as the bursting of the dotcom boom and the GFC.

INVESTORS SHOULD NOT FEAR THE US FED

While no two Fed rate rising interest rate cycles, or set of economic conditions are identical, valuations at the start of any tightening cycle are notable determinants of future investment returns and 2016 will start with valuations more stretched than has traditionally been the case over the past four decades. Importantly, central banks tend to push up rates when the economy is growing rapidly and inflationary pressures are rising, both of which in isolation are constructive for earnings and equities. But in the current cycle, the US Fed's preferred inflation gauge (the core PCE) is sustained at very low levels and economic growth remains soft with the current expansion being the weakest in history (total growth of +14.2% in the past six years relative to an average of +35.6% over the past 20 business cycles dating back to 1874).

CHART 1: US SHARES VERSUS RISING US RATES



Source: FACTSET andthe US Federal Reserve as at 23rd November 2015.

Accordingly, investors should not fear US Fed rate hikes, but caution is warranted as the Fed's unprecedented policy response to the Great Recession may have created special challenges that markets have not seen before. The US Fed will not intentionally endanger the recovery and will continue to have the words '*cautious*', '*patient*' and '*gradual*' in its market guidance to calm investors. In this way, the rate hike start date doesn't matter – it is the pace and nature of the tightening cycle which will determine the market's reaction. As such, the date of the second rate hike is more important than the first.

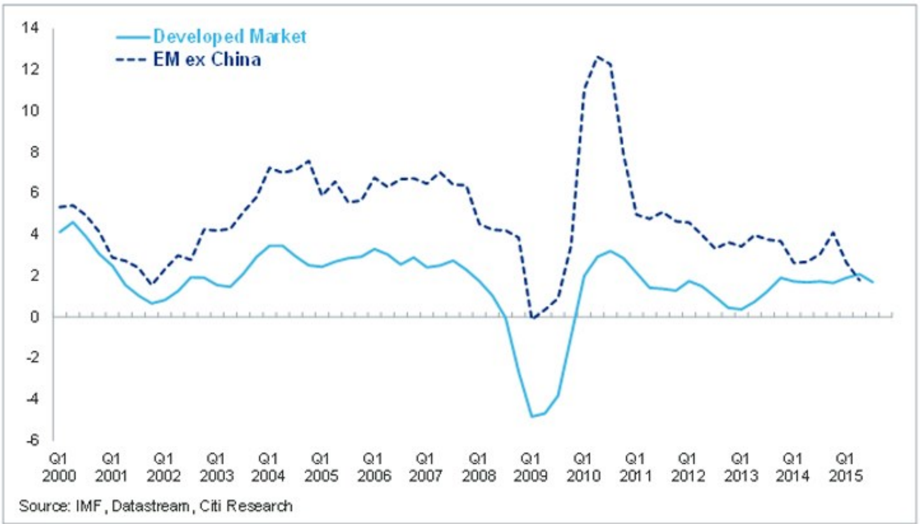
... BECAUSE THE US FED WON'T BE AGGRESSIVE

On that front, the sluggish nature of the current expansion in both advanced economies and their emerging peers since 2008, combined with less favourable demographics and the high levels of debt that remain, explains why it has been so difficult for central banks to normalise policy in the first seven years of the recovery. On the positive side, the vast majority of the global economy will be living in monetary conditions where financial conditions are either stable or easing further. Indeed, any country that tightens policy in 2016 will stand out from the crowd and capital inflows should drive currencies higher, as investors reallocate capital to investments which offer higher risk-adjusted yields. This will reinforce a tightening of US financial conditions as a higher exchange rate reduces the price of imports, and so adds to deflationary pressures. Consequently, when this tightening cycle begins, it is likely to be less aggressive than in the past.

EMERGING MARKETS ARE THE KEY RISK POINT

The one group which is most exposed to changes in US Fed policy is the emerging markets. This collective region has massively increased its leverage over the past seven years, with a large amount of US Dollar denominated debt being raised. However, the capital raised has funded investment in industry capacity in excess of growth in global demand, which culminates in a region with more debt, chronic corporate deflation and structurally declining growth, given their outdated commodity-based growth models. With the support from China's credit boom and the commodity-related investment boom now fading, annual growth in the emerging markets (ex-China) is now at +1.8%, which is below that of the advanced economies for the first time in 17 years (see Chart 2) and there is only modest growth upside for 2016 (+2.4%).

CHART 2: EM GROWTH IS LESS THAN DM GROWTH



Accordingly, the highly reliable boost that the global economy derived from emerging market industrialisation over the past two decades has become a drag and comes at a time when advanced economy growth is still modest with considerably less policy ammunition. More importantly, the EM has a much larger share of the global economy now (52% on a PPP basis) relative to 15 years ago (38%). EM economies may be in better shape than was the case in the late 1990s, but leverage has risen which means that rising US interest rates and a rising US dollar will place increased stress on the region and suggests that a 2016 growth re-acceleration is highly unlikely.

IMPLICATIONS FOR INVESTORS

It seems that markets have adjusted to the concept of official US interest rates being above zero. While one hike or indeed six of them would still leave rates at accommodative levels, there is a dangerous sense of complacency entering markets once again. Last week's reaction in regional sharemarkets where typical reflation trades such as energy, materials and financials outperformed suggests faith that the US Fed can adjust policy without impinging the US economy, commodities, oil or the broader global economy. While markets seem content for rates to rise it is the pace and nature of the tightening cycle that really matters, with the second rate hike probably more important than the first. The key to the market reaction over the medium term is valuations and the economic outlook. I still think the US is in the midst of its longest economic cycle ever, so recession by 2018 is not a base case, which reduces downside risk, but valuations are high which also limits upside potential. Overall, US shares are likely to outperform US bonds but underperform their international peers, where reflationary policies remain in place and will be added to in coming months.