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GLOBAL IDEAS

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Global market insights

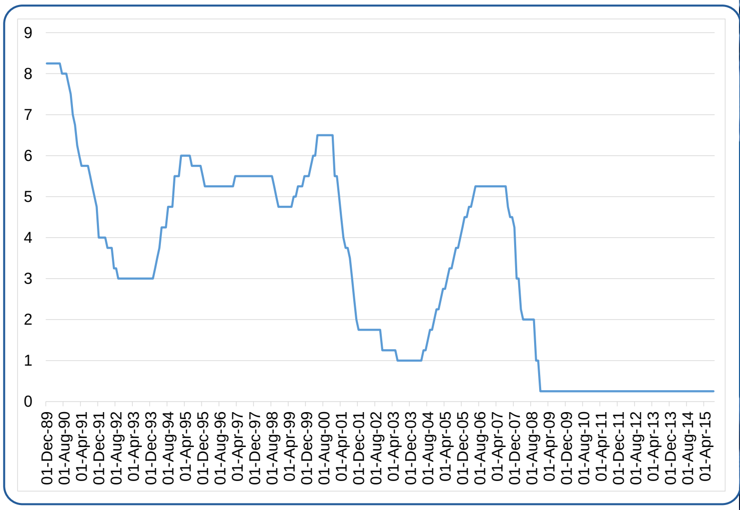
In our global market insights section, we look at important macroeconomic indicators and market events globally as well as their impact on markets.

"Let me issue and control a nation's money and I care not who writes the laws." - Mayer Amschel Rothschild (1744-1812), founder of the House of Rothschild.

The US Federal Open Market Committee (**FOMC) is meeting this week (16 and 17 Septembe**r) when, amongst other items on the agenda, **they will set the target federal funds rate**. The FOMC generally meet eight times each year (though only four meetings are required by law). Usually the chair of the FOMC (which is currently Janet Yellen) addresses the media every other meeting, with this week's meeting set to be followed by one of those press conferences.

The market has been paying a lot of attention to when the FOMC will next hike rates. **The last time the committee hiked rates was nearly 10 years ago in mid-2006** – since then it has either been cutting or holding rates. **The current upper bound for the federal funds rate is set at 0.25% and it has been there since December 2008 (during which time the lower bound has been 0%).**

Fed funds rate, %:



Source: Bloomberg, Anchor Capital

It's fair to say that, as a result of the global status of the US dollar, the fed funds rate is effectively the base rate for the global economy and, as such, most financial asset prices are impacted by it. **The fed funds rate can affect the flow of money – when it is very low, as it is now, it tempts investors into other assets like emerging market (EM) bonds or high yield (low-rated) corporate debt where investors can earn relatively more attractive yields and *vice versa*.**

So, there are **a couple of major fears associated with the current hiking cycle**:

- First, as the yield on largely risk-free US government assets becomes more attractive, other **asset classes that have benefitted from the search for better yields could experience a sell off, making it difficult for over-leveraged countries and companies to find people to lend to them at reasonable rates and, as such, putting these entities under stress**.

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Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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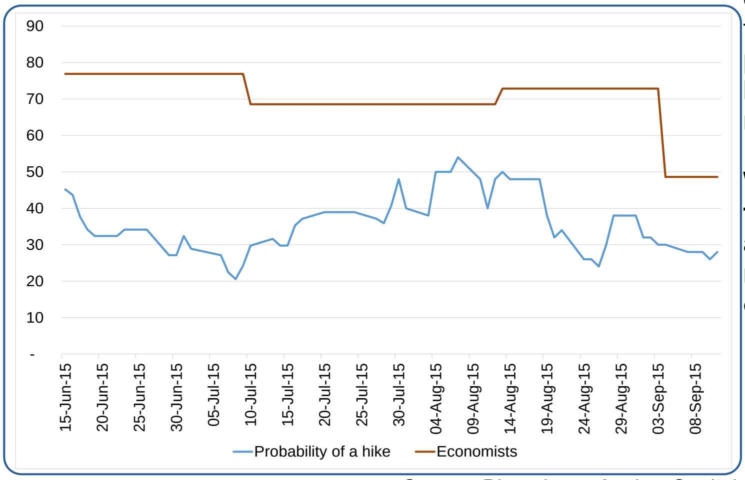
- Second, the FOMC use monetary policy, like fed rate hikes and quantitative easing ([QE] basically printing more money), to regulate the economy and to prevent it from overheating or freezing up. Since the Global Financial Crisis (GFC) the FOMC has used everything in its power to prevent the US economy from completely freezing up and heading into an extended depression. As a result of this, it has largely used up all its 'dry powder' – the lower bound of the target fed funds rate is already 0% and it has been at that level for 7 years and the Fed has printed about $4.5trn since the GFC. Currently, the FOMC need to basically start restocking their 'dry powder' reserves as it is now 7 years since the last economic crisis, and these crises tend to come with reasonable frequency. So, the FOMC basically need to start hiking rates, so that they can cut rates if (or when) we hit the next crisis. The issue here is that it's not clear whether the economy (particularly the global economy) is strong enough to cope with the added pressure of rate hikes, so if the FOMC hikes too early and that kicks off a crisis, the Fed has no dry powder to do anything about it. This effectively means that **when it's not clear that there's an abundance of nuts, when should the FOMC 'squirrels' start gathering nuts for the winter – early enough to have plenty to get through the winter, but not so early that they forego the sustenance they need to get them through the summer!**

It's fair to say that outside of concerns around a global growth scare, which China might create if their economy implodes (China produces about one-third of the growth in the global economy), the other major concern this year is around the FOMC rate decisions. Fears around the FOMC's decisions have introduced a lot of extra volatility into global markets.

There are a couple of ways to judge the market's view on when the FOMC will hike: the 1st is following the pricing of the fed funds futures, from which you can imply a probability (this market is highly liquid and you can get up-to-the-minute probabilities) and the other is looking at economist consensus forecasts (these surveys generally update their predictions monthly):

<u>Economist forecasts vs market expectations, %:</u>



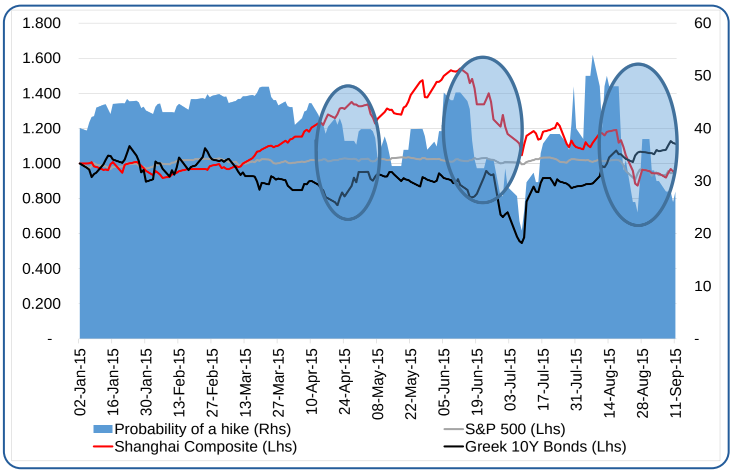
Source: Bloomberg, Anchor Capital

Economists now believe that there's a 50/50 chance of a rate hike this week, while market participants think there is about a 28% chance of a hike.

A couple of interesting things can be ascertained from this chart:

1. Generally, over time, economists are more bullish on when the rate hike will come (maybe market participants are more conservative because they have real money on the line?).
2. After the latest market correction, even these economists have dramatically adjusted their view on when the hike will happen.

<u>What's affecting the probability of an FOMC rate hike:</u>



Source: Bloomberg, Anchor Capital

If you look at the market **over the course of 2015, market participants have rarely placed more than a 50% probability on the rate hike coming by the end of this week's meeting. Each time there's a crisis, the probability quickly adjusts. In May, the Greek crisis brought the probability of a hike down by ~10%, while in June the sell-off in Chinese equity markets dropped the probability by ~30%. This latest equity market correction has now halved the probability to around 25%.**

We have always been of the opinion that the rate hike will happen later rather than sooner and we believe there's a slim chance of anything happening this week. It's much less likely that the FOMC will hike in October since, with no scheduled press conference after the meeting, if they do hike, they won't have the opportunity to dish out a soothing message to the market afterwards.

We suspect that we'll have a bit of a relief rally following the decision (or rather lack thereof) later this week and, assuming no other major global catastrophes, a period of relative calm followed by more volatility as anxiety rises on the outcome of a December hike.

Peter Little

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