

The Paradox of a Stronger Economy

Published on: 9 February, 2018 | Author: Investment Team

The recent market moves are driven by a repricing of liquidity and risk free rates that in turn drive a reassessment of the value of holding any investment.

The worldwide cost of capital is rising: benchmark US 10-year Treasury yields are currently 2.78%, up from a low of 1.4% in July 2017. The market looks likely to take 10-year yields around 3% in the near-term. For the first time in a long time, equity investors will have to face up to the fact that equities will be competing with a “risk-free” asset backed by the “Full faith and credit of the United States,” that offers an acceptable, albeit modest, return.

Stock markets are repricing somewhat aggressively as a result of this upward move but that said, no market participant could claim to be surprised that 10-year yields are rising. Up to a point, rising bond yields are a welcome symptom of a return to normality.

Consumer price inflation in the States is running at 2.1%, slightly above target but Core CPI which strips out volatile food and energy remains below the Federal Reserve target of 2%, printing at 1.8% at the last reading in mid-January. At the same time, wages are beginning to accelerate with the January report taking US wage growth up to 2.9% for the year – the highest point for almost a decade. Civilian unemployment has dropped to just 4.1% and payroll growth is running in excess of 200,000 per month, enough to absorb increases in the labour supply.

Following the series of rate rises commencing in early 2016, the Federal Funds rate stands at 1.41%, somewhat below Core inflation. There are only two occasions when the Fed Funds rate has been this low; June 1958 and the period from August 2008 to the present. Since 1958, the average spread of Fed Funds over Core CPI has been 1.3% which would put the Fed Funds rate at 3-3.5% assuming Core CPI remains at or around the 2% target. In practice, policy is unlikely to be this tight. The average Fed Funds rate in the post-war period has been almost exactly 5%. Importantly, it should be remembered that this period includes the oil price shock induced “Great Inflation” of the 1970s and 1980s.

The easy money days are largely over but still low “real” interest rates, modest inflation and wage growth should support the current expansion even in the face of a normalising bond market.

The risk is that the financial market impact of rising interest rates feeds back into the global economic picture, resulting in a falling appetite for investment and in turn a reduction in economic output. This effect is not evident at present however we continue to watch for signs that the economic picture has not been impacted by the recent market volatility spike. Until such a scenario unfolds, the relationship between bonds and equities remains key: bond yields are rising in anticipation of an improving economic outlook whilst equities have risen for the same reason.

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