

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

December 21, 2015

IN BRIEF

- With the Fed's initial rate hike in the rear view mirror, we refocus on the key debates that will shape U.S. monetary policy over the next 12-18 months.
- The path of inflation is difficult to predict but is not a total wildcard; core inflation is poised to slowly rise. Terminal policy rates have been falling and central bank balance sheet policies are becoming the new norm; both of these complicate the interpretation of yield curve dynamics.
- From the perspective of a multi-asset investor, we see the initial rate hike, combined with the Fed's commitment to gradualism, as an important anchor insofar as rising short-term rates will continue for the foreseeable future. In contrast, given the relative murkiness of medium-term factors affecting monetary policy and the long end of the yield curve, we remain leery about taking directional views on duration. We also caution against taking the flattening yield curve as evidence of an imminent end to the business cycle.

FED POLICY IN THE MEDIUM TERM: ANCHOR OR WEIGHT?

After markets, analysts and policymakers ruminated for the past two years about the specific timing of a U.S. rate hike, the Federal Reserve (Fed) finally moved. Attention is now poised to quickly pivot from short- to medium-term influences on monetary policy. For all the talk of "data dependency" in determining Federal Open Market Committee (FOMC) decisions, the logical implication of embarking on a purposefully gradual process, as the FOMC said it will follow, is that rate hikes will continue apace for the foreseeable future. The burden of proof for incoming data will increasingly be why not to hike, rather than why hike.

This simple logic provides a powerful medium-term anchor for an array of asset prices. For one, it underpins a process in which short-term bond yields grind higher as this long, gradual process unfolds and skeptical market participants are repeatedly proven wrong. Yesterday's doubters that the FOMC would raise rates are today's believers in "one-and-done" and other implausibly low paths for policy. They will be tomorrow's skeptics about the taper of reinvestment of maturing securities on the Fed's balance sheet. If we are correct that the U.S. economy will continue to hum along with relatively low recession risk, it will do so against the backdrop of rising short-term yields.

One direct implication: U.S. monetary policy will continue to provide support for dollar strength in the coming years, with a zenith in policy divergence between the Fed and other G4 central banks likely to occur sometime in 2016. As was forcefully demonstrated after the European Central Bank (ECB) meeting earlier this

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month, when markets sensed limits to the European QE program, any weakness in the dollar is likely to emanate from abroad.

Beyond these trends, which tend to tightly orbit central bank interest rate policy, implications of policy for equities and duration get a bit murkier. In our view, three questions will dominate debate over the next 12-18 months:

- When will core inflation return to 2%?
- What is the terminal policy rate?
- What's next for the Fed's balance sheet?

Inflation is not a bogeyman

The FOMC's confidence in some Phillips curve-type mechanism – i.e., one linking a tightening economy to a higher path of inflation – was on display at its December meeting and, in fact, was an integral part of the rationale to begin raising rates. However, such confidence often encounters deep-seated doubt about policymakers' understanding of the inflation process and their ability to forecast the corresponding medium-term path of policy.

Based on our own assessment, we expect that inflation will not be entirely unpredictable in the medium term. On the contrary, core inflation in developed markets tends to be highly inertial and much less prone to sudden swings than the unemployment rate (that is, the Phillips curve is very flat). That inertia—coupled with the Phillips curve's reasonably good track record at forecasting prices closely

linked to the labor market—suggests that inflation is a decent anchor for policymakers in the process of normalizing rates (**Exhibit 1**).

The terminal rate is falling

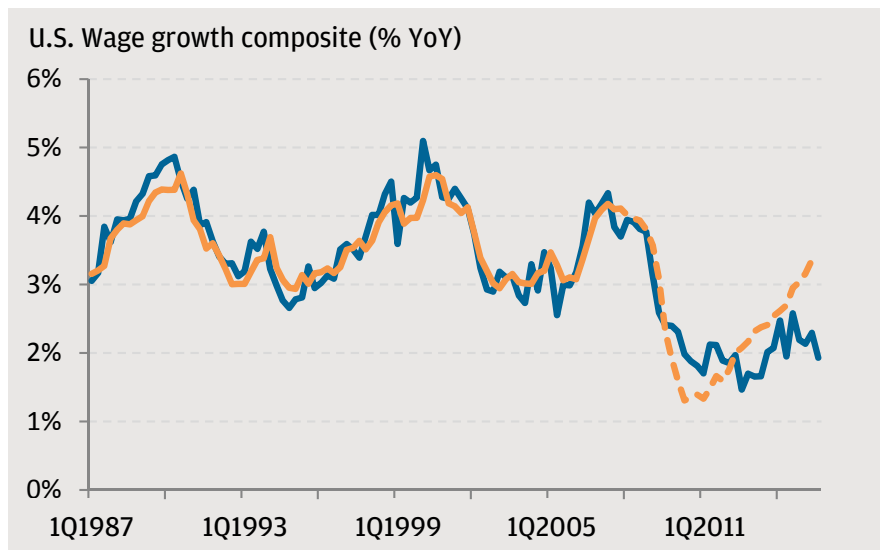
As rates migrate upward, the second question to ponder is where they end up. Where is the gradual path heading? The answer to this question is closely linked to the long-term economic performance of the U.S. economy; indeed, in simple theoretical growth models, the risk-free interest rate exactly equals the long-run economic growth rate.

What this means for the FOMC today is that the terminal fed funds rate is a moving target. The Committee has acknowledged as much in its quarterly Summary of Economic Projections, which has seen steady declines in estimates of both growth and the fed funds rate over the longer run. In 2012, the median participant's assessment of these variables was 2.5% and 4.4%, respectively. As of last week's FOMC meeting, they were, respectively, 2.0% and 3.5%.

The determinants of long-run economic performance, in turn, will ultimately pin down whether policymakers are shooting for a 2% or 4% terminal fed funds rate. Certain factors, such as demographics and their effect on the labor market, are relatively slow-moving and easier to project into the distant future. Others (productivity growth, for example) are less well understood, which

EXHIBIT 1: A PHILLIPS CURVE FORECAST OF US WAGE INFLATION SINCE THE GREAT RECESSION

Phillips curve models (linking prices to inflation expectations and tightness in the labor market) did a reasonably good job at predicting the downturn in wages during the Great Recession and the subsequent slow rise. These types of results inspire confidence that the tightening U.S. labor market will nudge inflation back towards the Fed's 2% target.



Source: Bureau of Labor Statistics; J.P. Morgan Asset Management Multi-Asset Solutions; data up to 3Q 2015. For illustrative purposes only.

infuses a degree of imprecision in discussions of trend growth and the terminal rate.

Our own view is that trend growth is close to, if not slightly above, 2%, which pegs the terminal fed funds rate near 4%. We've fully discounted demographic drag but we are more tentative about marking down productivity growth closer to recent, disappointing levels (e.g., year-on-year growth in output per hour in the private sector has averaged 0.6% since 2010, compared to 2.1% over the past 20 years).

Growing influence of the Fed's balance sheet

It is often said that money cannot buy happiness but, also, that it's an experiment most folks prefer to try out for themselves. As the Fed's long experiment in QE has unfolded, it is difficult to argue that \$4.5 trillion of assets on the Fed's balance sheet has bought no happiness at all. While QE is by no means a perfect (or perfectly understood) policy, many studies have concluded that it was a critical contributor to the healing of financial markets after the global financial crisis, and that the various QE salvoes helped ease financial conditions.

Our conjecture, therefore, is that QE will remain an important part of policymakers' toolkit in upcoming business cycles. This view is reinforced by the argument that the FOMC will be forced to use some type of QE as it encounters the zero bound on nominal rates more frequently in the future. Indeed, had previous rate cutting cycles started at a fed funds rate of 3.5% - the Fed's current assessment of the terminal rate - 7 of 11 previous

cycles would have breached zero (**Exhibit 2**).

ASSET CLASS IMPLICATIONS

The ball is rolling and it will continue to roll. The first U.S. rate hike in nearly a decade has given way to a sustained period of rising short-term rates and moderate support for dollar strength. What will generate the most dissonance over the next 12-18 months are the medium-term drivers of monetary policy and their implications.

Notwithstanding a baseline expectation that longer-term yields drift upwards next year, we see scope for the yield curve to continue flattening as policy normalizes against the backdrop of factors weighing on duration. These factors include: (i) low inflation rising at a glacial pace, (ii) further downward repricing of the terminal rate, and (iii) a growing recognition that the Fed balance sheet will be larger in steady state. Active ECB bond buying also plays a part.

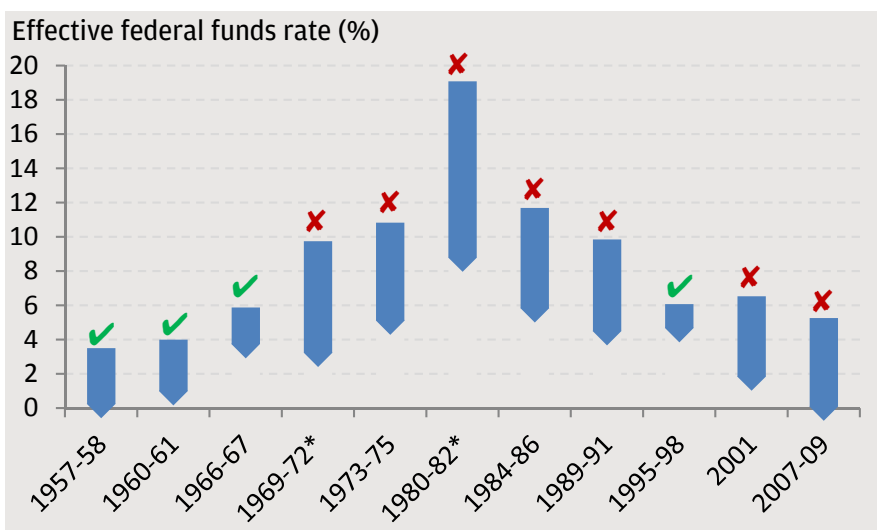
These dynamics remind us of the FOMC's conundrum in the mid-2000s, when rising short rates had little effect on long yields. And we note the possibility of a feedback effect for policy, in which accommodative financial conditions give cover for the FOMC to raise rates at a marginally faster rate.

If that does occur, perhaps the greatest risk is that the flattening yield curve sounds a premature alarm bell about U.S. growth prospects. We continue to see the U.S. economy as firmly in mid-cycle, and yield curve dynamics consistent with moderate equity returns.

EXHIBIT 2: EFFECTIVE FED FUNDS RATE AT THE BEGINNING AND END OF PREVIOUS RATE CUT CYCLES (%)

If previous rate cutting cycles had started at a 3.5% policy rate, 7 of 11 would have breached zero. Given the secular decline in policy rates, the use of QE and other alternative tools (and any associated distortions of the U.S. yield curve) will be more commonplace in the future.

Naturally, some big open questions remain about the mechanics and side effects of QE, which could temper policymakers' desire to deploy it outside of emergencies. But we doubt that the Fed's balance sheet in steady state will shrink back to pre-crisis levels.



Source: Federal Reserve, J.P. Morgan Asset Management Multi-Asset Solutions. For illustrative purposes only.

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