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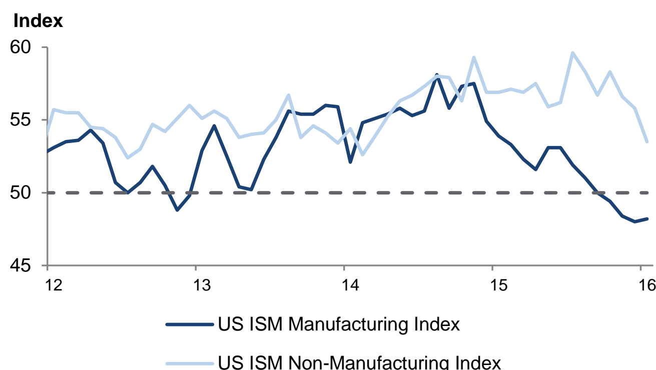
Yellen speech puts Fed tightening path in focus

- Fed Chair Janet Yellen acknowledged that financial conditions and recent market turmoil could weigh on the outlook if they were to persist. However she also highlighted reasons why growth could also surprise to the upside. Similarly, although she pointed out the labour market has continued to make good progress, some slack still exists.
- While the Fed Chair recognized there has been notably weakness in inflation expectations, these were downplayed. Undeniably the economy is only expected to warrant gradual rate rises, most likely, in our opinion, to be 2-3 this year as the outlook becomes more stable.
- The market reaction was muted given the broadly unsurprising nature of her comments. The S&P 500 was up 0.6% and UST yields were little changed, while the DXY drifted marginally higher.
- We prefer to be underweight government bonds and instead maintain a preference for risk assets such as equities, high yield credit and EM debt, within the context of a well-diversified multi-asset portfolio, from a strategic and long-term perspective.

The facts

Wednesday afternoon saw Fed Chair Janet Yellen deliver her semi-annual Monetary Policy Report testimony to the House Financial Services Committee, and she will repeat the testimony before the Senate Banking Committee on Thursday. Considering the recent financial market turmoil, this was one of the most highly anticipated pieces of Fedspeak for months especially following signs of a slowdown in the strongly performing services sector (Figure 1).

Figure 1: Yellen's speech was eagerly anticipated given the recent deterioration of US services sector data



Source: Bloomberg, as at February 2016

Ahead of the speech therefore, investors were looking for Yellen to eliminate some uncertainty about Fed policy by acknowledging that recent global market financial volatility and wider external risks amid signs of a domestic slowdown and tighter financial conditions would moderate the pace of tightening. At the same time, however, expectations were that Yellen would be reluctant to seem too dovish given continued strength in the US jobs market. Although the latest US employment report was mixed and showed that nonfarm payrolls rose 151,000 in January (versus consensus of 190,000), average hourly earnings were encouraging and rose 0.5% on the month (2.5% yoy) whilst the unemployment rate fell to 4.9% in January – a new cyclical low and in line with the Fed's own forecasts of full employment.

The prepared remarks for the semi-annual testimony confirmed the Fed is in a wait and see mode. Yellen particularly focused on downside risks and more specifically on financial conditions that have recently become less supportive of economic growth. If these developments persist they "could weigh on the outlook for economic activity". She also mentioned external risks (centred on China and EM more generally) which has increased volatility in global financial markets, but she does not believe there has been a sharp slowdown in Chinese growth.

Yellen acknowledged the recent progress seen on labour market conditions in 2015 and early 2016, but noted that growth slowed down in the last quarter of the year. She nevertheless maintained a relatively optimistic view on domestic final demand and thus near term economic prospects with low energy prices and the associated solid growth in real disposable key supports.

On inflation, Yellen still attributed the low levels of inflation to the recent decline in energy prices with mostly unchanged expectations: the Committee expects inflation to remain low. Interestingly she downplayed the recent decline in inflation expectations metrics still thinking that they have remained "reasonably stable".

Finally, after justifying the decision of the hike in December, Yellen once again reiterated the fact that the Fed Funds rate will increase only gradually and is not on a pre-set course. She was keen to highlight that even with gradual increases in the federal funds rate, monetary policy will remain accommodative with the Fed Funds target below the neutral nominal Fed Funds' rate and the continuation of the reinvestment policy is unlikely to halt until monetary tightening is "well under way".

Market reaction

The overall market reaction of Yellen's testimony could be described as muted given the broadly unsurprising nature of her comments. At time of writing (3pm GMT), the S&P 500 is up 0.6%, with the market showing evident comfort from the

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Fed's ''gradual'' adjustment to monetary policy. US 2-year and 10-year Treasury yields were little changed. The USD rose slightly, with the broad based dollar index (DXY) gaining 0.3%. The four gainers were AUD (+0.3%), CHF (+0.5%), CAD (+0.3%), BRL (+0.2%) while EUR (-0.7%), GBP (-0.1%), JPY (-0.4%) fell. Over in Europe, the Euro Stoxx 50 is up 2.6% and all the other major European bourses are also up, however this move was supported by a rebound in banking stocks following a recent large sell off in the sector. Meanwhile, most peripheral European government bonds edged higher (yields fell) and core European bonds were little changed.

Investment implications

Yellen's testimony was broadly in line with our expectations and presented a balanced view of the challenges facing the Fed. Positively, Yellen highlighted the recent progress seen in the labour market whilst maintaining a relatively optimistic view on near term economic prospects, led by stronger domestic demand. However, her focus on the downside risks to the US growth outlook, combined with recent softness in US data as well as global financial market volatility, compels us to hold a less bullish view on the pace of further rate hikes in the coming year. We now believe that the prospect for four rate hikes as expected by the Fed in the December meeting "dot plot" is unlikely, and would expect two to three rates hikes for the year ahead. Furthermore, it is important to point out that while the market is pricing in a zero probability of a March rate hike, the FOMC members themselves have repeatedly referred to it as a "live" meeting, driven by continued labour market strength, particularly the encouraging rise in average hourly earnings.

By reassuring investors that the pace of rate hikes will remain data dependent and "*gradual*" whilst monetary policy "*accommodative*" could boost risk appetite sorely lacking in recent weeks. Given the more gradual path of policy tightening than previously expected, the US economy should continue to perform well in 2016 led by a buoyant services sector. Furthermore, any persistent weakening in the USD should provide the manufacturing sector a much needed shot in the arm. We maintain our neutral outlook for US equities, and continue to highlight that recent profit momentum has slowed at the same time as US wage inflation appears to be rising, so we still hold this position albeit with a negative bias. A weaker USD also has important implications for the battered commodities sector, and with signs of stabilisation in the Chinese manufacturing sector this could also support sentiment.

We also believe the recent sharp fall in US treasury yields is pricing in an overly pessimistic outlook for the US economy, even if the risks of a slowdown have risen (our econometric model indicates a minimal probability of recession in the next six months). With yields at this level, we prefer to be underweight government bonds and instead maintain a preference for risk assets such as equities, high yield credit and EM debt, within the context of a well-diversified multi-asset portfolio, from a strategic and long-term perspective.

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