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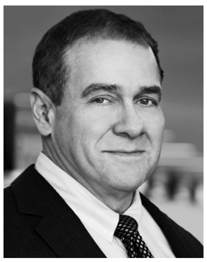
# Global CIO Outlook
# The Next Step for the Fed Could Be a Hike

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Some believe we may have seen the Federal Reserve's (Fed) last rate hike in this cycle, and that the next step from here will be a cut in rates as the economy loses momentum going into the first half of next year. I believe that view is plainly wrong. With economic data picking up and a likely bounce back that will extend into the second quarter, employment and price data are likely to remain strong especially as wage gains and energy prices continue to rise.

In the United States, the real economy is doing just fine and overseas we are seeing signs of rebound. China is firmly on track with both strong monetary and fiscal stimulus now in place. Given their close trading ties, Japan will likely benefit from China stimulus.

Europe is more troubling, but the European Central Bank has returned to a dovish stance, German manufacturing should stabilize in the coming months now that challenges in the auto sector seem to be largely behind them, and the water level in the Rhine has returned to levels where shipping is no longer inhibited. Additionally, the more than one million migrants that were admitted as refugees since 2015 are gradually becoming eligible for employment. This increase in the labor pool will raise output potential and will contribute to growth in the coming years.

Italy is still a mess and will remain a long-term challenge, but policymakers are firmly committed to buying time by kicking the can of much-needed structural reforms down the road. The same can be said of Britain, which has yet to resolve how or even if it will leave the European Union. All this adds up to continued growth which will ultimately lead the Fed to increase rates again. The only questions are when and can anything derail this scenario.

Before considering further hikes the Fed will wait to see second quarter data, which will arrive in the third quarter. Most likely it would want to be certain that the second quarter bounce back is real, so that would delay any hike until the fourth quarter at the earliest.

Of course, markets will not wait for action by the Fed and will start to reprice in anticipation of possible future hikes. Currently, the bond market is priced for an ease. Ultimately, the market will take that back and more by the fourth quarter, which will lead to a steepening in the yield curve in coming months.

The risk to this scenario could be a potential financial accident. Given how rapidly markets have repriced from the fourth quarter and the large spike and subsequent decline in volatility, the possibility exists that problems lurk in the shadow banking system which have yet to come to light. Another risk lurks in the emerging markets where recent stress on Argentine debt could cascade into other markets. With hedge funds currently holding record short positions in the VIX, a sudden surge in volatility could lead to a precipitous decline in equities. Given instability created by stretched asset valuations and a long period of low interest rates and the resulting malinvestment, fragilities throughout global financial markets make the environment ripe with potential landmines which could explode at any time.

A study of financial history reveals a strikingly similar precedent for this scenario. In 1998, about one year after the Asian financial crisis began, markets awoke to risks buried in a hedge fund called Long-Term Capital Management. Once these risks were exposed, policymakers responded rapidly to reduce rates and stabilize the financial markets. This caused a steepening in the yield curve and increased premia on risky assets like emerging market debt and high-yield and corporate bonds.

The consequences of such a scenario could be similar to 1999 and 2000, when the Fed, after cutting rates, remained on hold for over seven months and fueled the revival of animal spirits that resulted from the unanticipated ease in monetary policy.

In the wake of the Asian financial crisis, risk assets renewed their rise. Internet stocks entered bubble territory, as did telecom and finance stocks, which were thought to benefit from the growth of the Internet. The easy availability of credit further exacerbated corporate malfeasance and ultimately resulted in numerous defaults for investment grade bonds. Once it became apparent that inflation expectations had recovered, the Fed resumed rate increases.

While a rate cut may not be our base case scenario, this is a very real risk should the Fed find itself forced to ease as a result of some financial crisis.

I often remind people that economic expansions do not die of old age. Instead central banks are forced to extinguish them when price pressures rise above acceptable levels. This is a sentiment echoed by Ben Bernanke earlier this year.

We have not yet reached the point where the Fed will need to slow the expansion, but given the low risk premia offered by financial assets, whether stocks or bonds, I see little opportunity and sufficient risk to remain prudent.

There are times return of capital takes precedence over return on capital. Now is one of those times.

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