Preparing for a US Rate Rise

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- **Fed chair Janet Yellen reinforces the case for a US interest rate rise**
- **Markets should be able to take a rate rise in their stride**
- **Emerging market assets preferred**
- **Dollar sees support particularly against the Yen**
- **Gold may see some profit taking**

The markets continue to enjoy signs that some of the more profound downside risks to the global economy are in abeyance. However, it also means we are getting closer to some modicum of monetary tightening probably through a rise in US interest rates very soon. Asset markets should be able to take any US interest rate rise in their stride, although with many assets looking fairly-valued judicious choices between assets will be important. **We prefer emerging equities over developed markets. Within developed markets, we have switched more money to Europe. In bond markets, we still prefer credit and emerging market debt over government bonds, and we remain long duration**.

Fed Chair Janet Yellen delivered more than what the markets had bargained for in her Jackson Hole speech last Friday. In the aftermath the US 10 year bond yield (1.63%) is at the highest level we have seen in a month and expectations for a Fed funds rate move have increased sharply. Whereas before the market priced the risk of a rate rise by the year-end as a 50-50 bet, that has now risen to 65%, and the risk of a rate rise in the next meeting on September 21st is up at 42% from 22% a week earlier.

Janet Yellen only made a brief comment on near-term developments in the US economy, but by and large she reiterated the position taken by the FOMC in the last meeting that the **downside risks to the US economy are much diminished**. Indeed, if there is a theme around the developed world at the moment is that there is less of a feel of pending disaster but more of a muddle through at still modest levels of growth.

An increase in interest rates at the September meeting is possible and probably more than the market discounts. Given the comments from Janet Yellen and subsequent comments from other voting members of the FOMC, it appears to be very much in their minds to increase rates. After all, some of the global risks that the Fed had worried about before – such as Brexit – have come and gone with only a slight impact on growth expectations. Also, commentators have criticised the Fed in the past for not seizing the moment to increase rates and subsequently probably regretting it.

How the asset markets deal with the interest rate rise will very much depend on how the committee contextualises the rate rise. We can expect some forward guidance as to the pace of further rate increases. Given the hesitancy of the committee to raise rates in recent years, we can assume that they will signal that further rate rises will remain data dependent. The bond market's initial reaction has been for a sell-off across the curve, although with less of an impact on bonds with a maturity of above ten years. The equity market took the rise in expectations of a rate rise in its stride.

The risks of a US rate rise are probably unlikely to break the back of the solid returns we continue to see from the global bond markets. However, the rising cost of leverage may reduce somewhat the potential capital chasing in the bond markets. The positive offset is that central banks such as the European Central Bank and the Bank of Japan are likely to maintain if not expand further their quantitative easing programs.

Our strategy remains to be biased towards credit markets with lower holdings of government bonds. US government bond yields are likely to remain biased lower than you would typically expect in a rising rate environment purely because of the ongoing demand for dollar paper from yield-seeking investors from Japan and Europe. Yield-seeking investors are likely to be supportive of credit markets, however, there will be the increasing challenge to these markets from the rising cost of leverage (higher libor rates).

Capital inflows to emerging-market-dedicated bond funds moderated in the past week, although continue to be at healthy levels. EM bond prices have rallied and are getting closer to fair value versus the broader bond markets. **We see further capital flows towards EM investment grade bonds, as pockets of opportunities still exist.** As summer-end approaches, GCC bond syndicate desks have started to conduct roadshows, beginning with Sharjah Islamic Bank issuance and the NBAD's green bond transaction. We expect a slew of issuance mainly driven by sovereign players, with some corporate issuers tapping the markets for their refinancing needs.

Janet Yellen's comments on longer term developments in monetary policy were comforting for longer-term assets such as equities. Drawing on research from the Federal Reserve published the previous weekend, Janet Yellen set out a number of things the Fed could do when the next recession hits the US market. Given that US interest rates are very low the Fed would probably have to rely quite heavily on quantitative easing. Hence quantitative easing where the central bank steps in and openly buy assets in the market is seen as an ongoing tool for central bank action. In essence interest rate changes are no longer the only mainstream tool of choice of central banks to revive a flagging economy.

Equities are likely to consolidate after recent gains with a likely seasonal bias to weakness. The S&P500 has struggled to break 2200 and needs a new story to push on. Global investors will also be mindful that on balance equities are down in September and this year marks the 30th anniversary of the 1987 crash!

We expect to see a rotation from the US to European equities. The S&P 500 is trading at 18x forward earnings, well above its long-term average, so the upside is limited. While other developed equity markets such as Europe have tracked the US higher, they have yet to see any significant support from institutional investors. We expect to see investors turn their attention to the Eurozone as the data flow continues to improve. Analysts keep on cutting their forecasts for Eurozone companies, but in a much more modest way than we have seen in the past. Indeed, given that economists are increasingly comfortable that Brexit has not generated a major lurch down in European growth, we expect upward revisions to corporate profits forecasts in due time.

European economic data releases remained upbeat last week. Industrial and consumer confidence for August were mostly resilient. Although the German IFO survey of industrial confidence fell back, the indicator of service sector confidence was better than expected.

We would recommend investors use any weakness to add to emerging markets. India continues to offer upside on account of its improvement in growth and political stability, though valuations are getting stretched. China offers lower valuations and an increasing market expectation that the government will step in with another round of fiscal spending. However, our preference is to buy a broad basket of countries by investing in the emerging market index. Emerging markets have underperformed developed markets by around 40% over the past four years.

The dollar got some kneejerk support from increased expectations of a rate rise. For the moment the Yen looks more vulnerable as the Bank of Japan is expected to come with a further round of quantitative easing when it announces changes to its policy framework in late September. By contrast, the ECB in the market's eyes may soft-peddle on further easing given the apparent ease with which the economy has dealt with Brexit.

After a good run, we expect gold to go a little quiet here. The prospect of an imminent US rate rise is typically a handicap to gold's price performance. Seasonally this is a time of the year when the price on balance shows a positive return, however, the metal has looked technically vulnerable trading close to $1315 support, below which it is on-risk of a move down to $1250. We would reiterate our positive long-term view of gold. For those investors who like to trade, there is an argument for trading out a small part of one's holding to buy it back lower down.

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