

Fed Strategy Ahead of Trump Presidency: Raise Rates

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The Fed has taken a more incremental approach to implementing rate increases.

As expected, the Federal Open Market Committee (FOMC) raised the target Fed Funds rate by 25 basis points (bps). The December rate increase represents the sole rate increase for 2016, following the December 2015 move, and the second increase since 2006. What surprised markets is that the FOMC projected three rather than two rate hikes of 0.25% in 2017. In her press conference, Chair Janet Yellen emphasized, however, that this represented a modest change that was driven by improving employment data, as indicated by a lower unemployment rate, higher realized and expected inflation, and as Yellen conceded, the consideration by certain FOMC members of potential changes in fiscal policy under a Trump administration.

What may be more interesting is that the FOMC economic projections did not reflect any significant changes from their September levels, other than the one additional rate hike in 2017. The projections were largely unchanged despite the dramatic post-Trump election rally in equity markets, and sharp increases in Treasury yields, inflation expectations and the US dollar. The Fed's GDP forecast rose only 0.1% in 2017 and in 2019, to 2.1% and 1.9%, respectively, and they made no changes to either headline or core inflation projections for the next three years. The dot plot (showing the rate predictions of the FOMC members) indicated an increase in rate hikes in 2017 from two to three, but the number of hikes remained the same in subsequent years. The terminal Fed Funds rate was very modestly higher, at 3.0%, compared to 2.9%. All told, as Yellen emphasized in her press conference, "considerable uncertainty" surrounds the effects of Trump's policies on the economy.

Improving Economic Outlook

While the Fed will not change its forecast until it sees the impact of Trump's policies, there is a high likelihood that Trump's policies will deliver stronger economic growth, accompanied by higher inflation and, potentially, higher deficits. Trump may be able to effect significant positive economic change supported by his pro-business Cabinet, through lower taxes, less regulation and higher spending on infrastructure and defense. Some form of these proposals are likely to pass with Republican majorities in both houses of Congress.

Lower income and corporate taxes may add \$3 trillion to \$6 trillion in stimulus to the economy over 10 years. Trump has proposed \$1 trillion of infrastructure spending over the same period. The energy industry, which accounted for a significant portion of business fixed investment as well as employment growth in the five years up to 2014, may derive significant benefit from lower regulation, particularly in this period of OPEC and non-OPEC production cuts. In addition, the energy industry may benefit from the involvement of three proposed members of the administration with deep roots in the industry—Rex Tillerson as Secretary of State, Scott Pruitt as head of the EPA and Rick Perry, heading the Department of Energy. US growth may benefit not only from Trump's pro-growth policies, but from the improving global growth outlook. Global economic growth, as evidenced by increasing global PMIs, is on a modest upswing,

supported by higher commodities prices, monetary stimulus and stronger domestic demand.

The benefits of Trump's policies, however, may be realized more in 2018 than in 2017. Trump has already indicated that his top priorities in his first 100 days—the Supreme Court, Obamacare, and immigration—are *not* related to economic growth. Any income tax cuts may be phased in gradually, as they were for the Bush tax cuts. The proposed Treasury secretary, Steven Mnuchin, has gone on record saying that the wealthy will receive no net benefit from lower taxes, as he will also reduce deductions. Trump may also face more resistance from the Republican-majority Congress should he propose such cuts be financed through deficit spending. While infrastructure spending should benefit the economy, the timing and ultimate impact remain to be seen—private/public programs have not been successful in the past, and infrastructure spending typically has long lead times.

Will Trade Policy Hurt The Economy?

Beyond these pro-growth programs, the real wild card of a Trump administration continues to be his stance on trade. Trump won the election with a promise to keep jobs in the US; to the extent these goals are realized through protectionism, these policies would hurt US economic growth. His proposed commerce secretary, Wilbur Ross, has been an advocate of tariffs, yet his proposed secretary of state, Rex Tillerson, supports free trade. The most recent corporate tax reform proposals include a “border-adjustment” mechanism, in which corporations pay tax on imports, but no tax on exports. This approach represents a different way to implement tariffs, and penalizes companies that have developed integrated global supply chains and/or moved production offshore.

The US economy is now benefiting from the highest consumer confidence since the financial crisis, an improving global economic backdrop, and increasing commodity prices. With Trump's proposed pro-growth economic policies and his pro-business Cabinet, we believe the potential for higher growth and inflation is strong.

We continue to be positioned for rising interest rates and inflation in the wake of a stronger economy. We prefer credit markets over US Treasuries. Corporations may benefit from lower taxes, less regulation and higher growth. Within corporates, we favor financials and energy. Financials have less event-risk of share buybacks or increased dividends, and should benefit from rising interest rates. Energy firms may benefit from higher energy prices in the wake of OPEC cuts. Long-duration TIPS are attractive, in our view, given that breakevens (a measure of TIPS prices vs. Treasuries factoring expected inflation) embedded in TIPS are too low. Inflation expectations may continue to rise, reflecting higher spending, accompanied by potentially higher US debt levels. Higher yields, better relative economic growth and diverging monetary policies may continue to favor the US dollar; we have become more cautious on non-dollar exposures.

Within equities, we believe cyclicals may continue to outperform staples, as they should benefit from improving economic growth. Domestically-oriented firms should benefit relative to multinationals. We also favor technology and financials. Technology may benefit from the shift to mobile and cloud computing, while financials should benefit from rising rates. We are cautious on more interest rate-sensitive sectors such as REITS and utilities.

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