ARTORIUS WEALTH

INVESTMENT OUTLOOK

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MANCHESTER ● **LONDON** ● **ZURICH**

Biblical times?

Given the holiday season, the Biblical time horizon of 7 years holds a wonderful irony when assessing US monetary policy. Seven years since the US Federal Reserve last cut rates in 2008, they have now increased them. Whilst we're not predicting feast, famine, a plague of locusts or even seven years of rate increases, that the interest rate backdrop is changing is important for investors.

The FOMC raised the funds rate to 0.25-0.50%, on 16th December, as widely expected. The post-meeting statement signalled a baseline of further funds rate increases, but expressed caution about potential inflation developments. The Summary of Economic Projections showed an unchanged median forecasted funds rate for end-2016; median projections for 2017-18 declined moderately.

Main points

Whilst the projections allude to further rate hikes in 2016, the Fed emphasised the need to monitor inflation, which remains below target. In particular, the statement said: "In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the Federal Funds rate"—stressing the "gradual" message that was repeated in many public comments by Fed officials.

In the Summary of Economic Projections participants made few changes to their forecasts for the economy and monetary policy. Fed officials raised their projections for GDP growth moderately for 2016 and lowered their projections for the unemployment rate. However, they also reduced the projection for core PCE inflation to 1.6% for end-2016, down from 1.7%. The median projection for the funds rate at the end of 2016 was unchanged at 1.375%; the median funds rate projection for the longer run was also unchanged at 3.5%. Projections for 2017-18 were slightly lower.

The gap between what the market expects interest rates to be at the end of 2016 and what the FOMC expect remains wide. This remains a risk to markets with either the FOMC or the bond market needing to rethink the path of interest rates.

Equity markets responded positively following the interest rate decision suggesting relief over the 'gradual' pace of rate increases, although the FOMC is predicting the same end point for rates at the end of 2016 as they did post the September meeting.

Rate decision makers change in 2016

The interest rate increase in the US reflects the belief of policymakers that the US economy is strong enough to withstand the monetary tightening. We aren't so certain - headwinds such as the strong dollar and worsening credit market conditions appear to be slowing the already subdued pace of economic and profits growth.

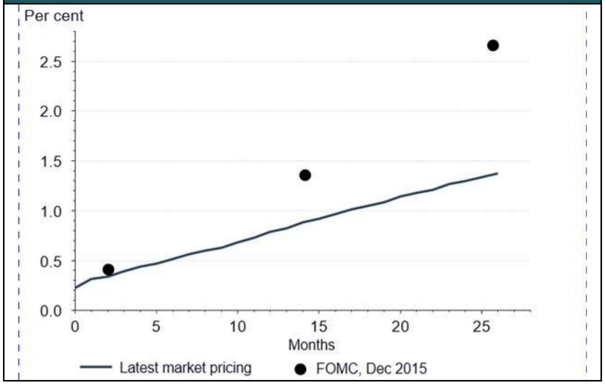
Other changes are afoot as well. The Federal Reserve conducts policy democratically, but rotates the voting membership between the various regional Federal Reserve Presidents that lead the 12 Federal regions in the US. More often than not the change in voting structure passes investors by, but between 2015 and 2016, we believe it is worth noting that the voting membership is set to become more hawkish, in contrast with the dovish membership prevalent in 2015. Hawks are those policymakers that seek to be more aggressive in policy to control inflation.

Richmond Fed President Lacker is the most hawkish voting member on the FOMC presently, in our view, and will no longer vote in 2016. However, three other known hawks (Bullard, George, and Mester) will vote in 2016.

Meanwhile, Boston Fed President Rosengren (a dove) will become a voting member in 2016. Rosengren is slightly less dovish than Chicago Fed President Evans (who will rotate off the FOMC). Atlanta and San Francisco Fed Presidents Lockhart and Williams, whom we consider to be centrists with dovish leanings, also rotate off the FOMC.

On a net basis, the composition of FOMC becomes more hawkish in 2016 versus 2015, which leads us to conclude that the 'natural' bias for the Federal Reserve in 2016 is to tighten more than if the 2015 membership were still voting.

Federal Reserve expects a higher level of interest rates than discounted by markets



Source: Artorius Wealth, Thomson Reuters

This detail matters as investors currently expect a more moderate pace of interest rate increases than suggested by the Federal Reserve. The market discounts that the Fed Funds rate will be at around 85bp by December 2016. The Federal Reserve own projections suggest that the policymakers expect rates to be 1.375% by December 2016. Rates rising by more than the market discounts implies that the US bond and equity market will have to adjust to the more hawkish backdrop, which supports our cautious stance towards US equities.

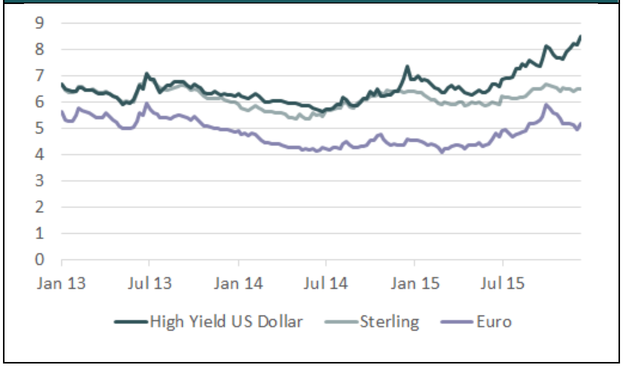
Another US problem.

US high yield bond markets are used by companies of lower credit quality as a source of finance. Lower quality investments should provide investors with a higher level of return to compensate for the degree of risk. Between 2010 and 2015, the degree of extra return from high yield bonds over government bonds (the spread) fell as investors required less return.

Typically, bond returns tend to mirror each other across the developed markets, with currency risk being a key driver of returns delivered to the investor. But this has not been the case in the high yield bond market in 2015.

In 2015, US high yield bonds have returned -2.7% as yields have risen by 151 basis points, from 6.97% to 8.48%, as measured by the Merrill Lynch High Yield bond index. Investors in Euro or sterling high yield bond markets have received a positive return of 2.5% and 5.8% respectively, even though yields in these markets have risen slightly.

Rising yields: a problem for high yield investors in the US but not elsewhere



Source: Artorius Wealth, Thomson Reuters

This reflects the sector bias within the US high yield bond market. At the end of 2014, 15% of all U.S. junk bonds were related to shale oil drilling compared to just 4% a decade ago. The high yield energy bond universe has lost 20% in 2015, as oil prices have fallen. This has triggered a reassessment of investments into the energy sector. This in turn should impact the scale of US oil production through 2016.

Portfolio positions and Christmas greetings.

Caution at Christmas in portfolios, across all asset classes, is recommended. We remain underweight US equities, as we think that the disconnect between monetary policymakers and market expectations are extreme. May we wish you a joyful and peaceful Christmas period, and a prosperous New Year.

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Our Contact Details

ARTORIUS WEALTH LONDON

Level 1, Devonshire House,

1 Mayfair Place, Mayfair,

London W1J 8AJ

+44 (0) 203 205 7140

ARTORIUS WEALTH MANCHESTER

2nd Floor, The Boardwalk,

21 Little Peter Street

Manchester M15 4PS

+44 (0)161 711 0730

ARTORIUS WEALTH ZURICH

Schlüsselgasse 3,

8001 Zurich,

Switzerland

+41 (0) 44 542 8338