Intelligent Investing

KINNELL & CO

Christmas Grinch or Crying Wolf?

This morning the Federal Reserve hiked interest rates by the expected 0.25% to a new range of 0.50-0.75% for the overnight Federal Funds rate. As is their custom the Fed as it is known released a quarterly 'dot plot' which serves to highlight the 17 member's different views of the likely future path of interest rates. The markets tend to focus on the median projection of the 17 members and this morning's 'dot plot' indicates there will be three more rate hikes in 2017 with more in 2018 and 2019 with the Fed Funds rate around 3.0% by late 2019. This is important because US interest rates are the most important on the planet for financial market and equity valuations and if this morning's 'dot plot' is to be believed the future path of US interest rates would likely place a headwind on today's equity market valuations. The Fed releases their 'dot plot' with the seemingly altruistic objective of offering the financial markets transparency into their current thinking (the RBNZ do something similar with their 90-day bank bill projection). But how useful is it and should we trust it as any sort of guide to the future? Let's review some recent history.

We all remember the painful period of the Global Financial Crisis which hit the economy and financial markets hard from 2007-2009 and saw the Fed cut interest rates aggressively in response. The Fed began cutting in 2007 and quickened the pace in 2008 as everything went south followed by quantitative easing. A painfully slow healing process began in the economy and fast forwarding a few years the QE program was wound down and the talk turned to normalising interest rates. In December 2014 the Fed held rates steady at the 0.0-0.25% range they'd been in since Christmas 2008 but released a 'dot plot' showing three rate hikes were likely for 2015 and by this Christmas rates could be around 2.5%. What we got was one quarter-point hike 12 months later. Similarly, at that December 2015 Fed meeting where they hiked a quarter point for the first hike in seven long years the accompanying 'dot plot' showed that four rate hikes were likely in 2016. What have we got to show for 2016? Again, one quarter point rate hike for Christmas to edge the Fed Funds rate up to its current 0.50-0.75% range. But have no fear this morning's 'dot plot' has three rate hikes baked in for 2017 and a steady path towards 'normal' interest rate levels around 3.0% by Christmas 2019.

Now, the median of Fed member's views might be right this time but forgive me for being a little sceptical. The post GFC global economic recovery has been the most anaemic in decades despite huge amounts of central bank stimulus (low rates & repeated injections of QE). Today there are many developed countries carrying very high levels of debt, be it government and/or private debt, and it does not feel like a world that can cope with rates moving higher at the speed the Fed keeps predicting. Accepting that opinions are like noses (everybody has one) I think we'll be lucky to get two rate hikes in each of the next two years and by 2019 we might be edging towards 2.0%, not the 3.0% the Fed's current 'dot plot' predicts. This matters because today's equity market valuations discount expected future cash flows. But given none of us know what the future holds it also highlights the importance of building a portfolio of stocks that holds companies that benefit from low interest rates, and companies that benefit from higher interest rates to mitigate your investment risk.

Wishing you a very Merry Christmas & many happy returns for 2017!

MICHAEL KINNELL
021 711 375
michael@kinnellandco.co.nz

Shoreline Business Centre
8/54 Molesworth Street
New Plymouth 4310