Doves fly above hawks: Investment implications

The decision from the US Federal Reserve (Fed) to keep the benchmark federal funds rate unchanged has upended previous market projections for a resumption of interest rate hikes.

Here are the key messages from the meeting:

- Benchmark federal funds rate kept at a range of 2.25-2.50%
- The dot plot graph showed expectations for Fed hikes in 2019 are at zero, a change from the 1 to 2 hike forecast range in December 2018
- US growth forecasts turned weaker than expected as 2019 figures are downgraded to 1.9-2.2% from 2.3-2.5%
- Quantitative tapering will begin in May and end by September 2019, a timeline brought forward from the end of 2019

Our quick take:

- Language from the central bank is remarkably dovish
- Inflation is unlikely to trigger a Fed hike as numbers are subdued, though numbers may face upward pressure from rising US wage growth.
- Low inflation expectations will keep the long end of the US Treasury yield curve down
- 10-year US Treasury yields will be kept between 2.5% to 2.8%, and unlikely to deviate too far from the long run neutral rate of 2.75%

In the Fed we trust

Central bank monetary policy has been thrust back into the limelight owing to a reverse of events. While the previous year saw market volatility with solid economic fundamentals, the investment outlook this year has turned brighter despite slower growth and a weaker international environment. The Fed is on a trajectory change from 2018, where it hiked rates regardless of market and global economic uncertainty. Chairman Jerome Powell is now dishing out measures that were on investor wish lists, that is monetary policy intervention to financial market volatility and economic slowdown outside of the US. This “Powell put” is likely positive for risk assets, giving the emerging markets higher chances of a rally moving forward.

Low interest rate addiction

The Fed is not alone in turning dovish on its outlook away from aggressive tightening. Major central banks have shifted increasingly accommodative for 2019 amid a downgrade to global growth data from 2018. Earlier in March, the European Central Bank (ECB) cited worsening economic conditions and lowering inflation forecasts as reason for keeping interest rates steady. In addition, a lingering backdrop of Brexit uncertainties may mean even lower chances of a policy shift toward a hawkish stance.

Echoing the outlook was the Bank of Japan (BoJ) keeping its monetary stimulus program unchanged alongside export weakness. Other Asian central banks have largely stayed pat on interest rates and the possibility of rate cuts are back on the table with low inflation hovering across the region.

The key issue for central banks is the question of policy moving more dovish and whether interest rates can ever normalise, particularly if economic data stays in the doldrums. This then raises the possibility of central banks utilising more tactical monetary policy frameworks such as yield curve controls (from the BoJ) and targeted longer-term refinancing operations (TLTROs) in the case of the ECB continuing to preserve lending conditions. These scenarios would be bullish for risk assets and can't be dismissed as growth and inflation targets stay lacklustre.

House view

Overall, the market has shifted to a dovish tilt where fixed income returns look more attractive and we prefer income strategies focusing on rates, credit, high yield and dividend yield. Hence, our stance on equities is reduced to neutral from an overweight position (last quarter) with the allocation shifting to neutralising fixed income from underweight (last quarter).

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