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Tim Rocks
Chief Investment Officer
Timothy Rocks

A new era for the Fed

We appear to be on the cusp of a radical change in the approach to monetary policy in the US. The Federal Reserve (Fed) has recently abandoned plans for further rate rises, declared an early termination of quantitative tightening and announced a strategic review of its monetary policy framework.

The change reflects a persistent failure to hit its inflation target, and the ongoing slide in inflation expectations. The inevitable consequence is likely to be a substantial extension of the era of low rates.

The about-face could have significant implications for currencies, as the 30% jump in the US dollar since 2014 arguably mostly reflects the divergent path for US monetary policy. A fall in the US dollar is likely to place some upward pressure on the Australian dollar, which we are already forecasting to rise based on higher commodity prices and a resurgent Chinese economy. We are predicting an increase to US$0.75 over the next year.

A rise in the Australian dollar will have implications for equity portfolios and could prove to be a drag on returns from international equities if they are held on an unhedged basis. One way to address this is to increase the amount of hedging in portfolios.

Recommendations

The new approach to monetary policy by the Fed and the budding improvement in the Chinese economy represent major changes for a range of asset markets.

For bond markets, returns may be impacted by interest rates staying lower for substantially longer. This could continue the push for bond investors into private credit markets or bond proxies in equity markets.

For equity markets, investors should consider the following:

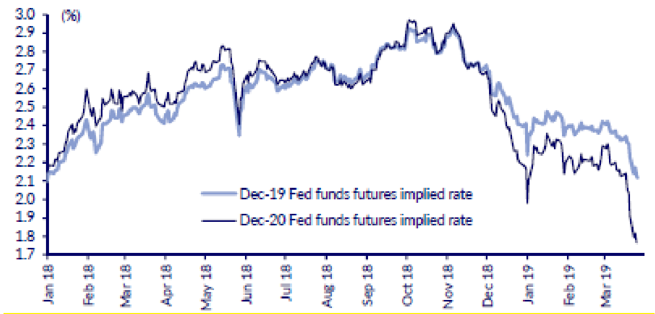
- Switching international holdings to funds or exchange traded funds (ETFs) that are currency hedged. This is particularly the case for US shares given the vulnerability of the US dollar. This is less necessary for emerging markets, where local currencies are likely to rise with better economic and equity prospects.
- Increasing exposure to emerging markets given the implications of an improving outlook for the Chinese market and others dependent on it.
- Maintaining exposure to interest rate sensitive sectors including REITs and infrastructure, given the prospects that bond yields will be lower for longer.

A new era for the Fed

It appears that we are on the cusp of a radical change in the approach to monetary policy in the US. This was flagged in January when the Fed abandoned its plans for further rate rises and it has since declared an early termination of quantitative tightening. But this appears to be only the beginning of a radical new approach which could have profound implications for economies, currencies and equity markets.

Interest rate markets have already reacted sharply. Expectations for the Fed rate in December 2020 have been slashed from 3% to 1.7% and there has been a commensurate decline in government bond yields around the world.

Figure 2
US Fed funds futures implied rates



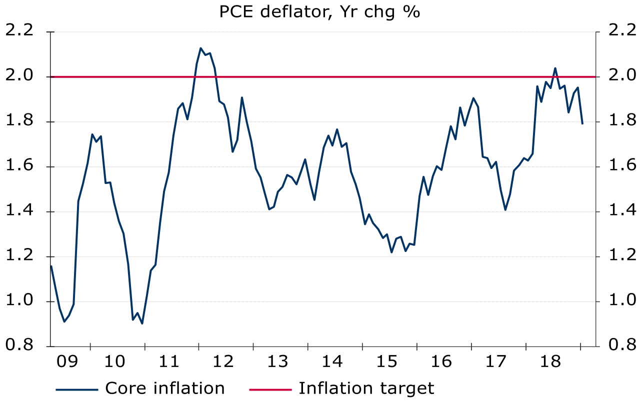
Source: Bloomberg

The Fed's strategic review

The Fed has revealed it is currently conducting a *strategic review of its monetary policy framework* that will take around one year. This has been motivated by persistent low inflation – whereby its preferred measure is the core Private Consumption Expenditure deflator that has spent 95% of the past decade under its 2% target.

US Core Inflation

PCE deflator, Yr chg %



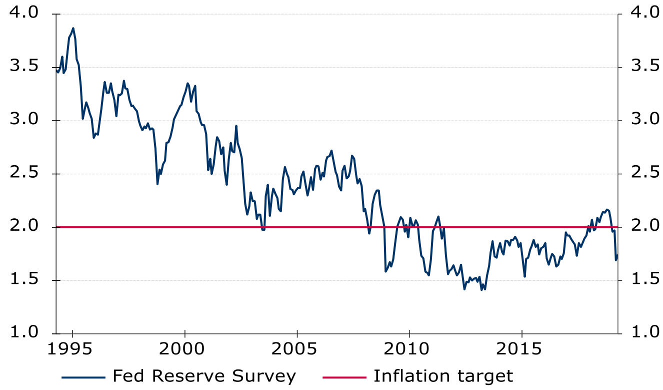
Source: Thomson Reuters Datastream, Evans & Partners

The persistent failure to hit its target after a decade of healthy growth and a tight labour market is a frustration. A substantial undershoot of the target is potentially just as dangerous as an overshoot. An undershoot reduces confidence in the Fed's credibility to hit its target and risks a collapse in inflation expectations similar to what has happened in Japan.

Inflation expectations have certainly been sliding. Surveys show that 10-year inflation expectations have fallen by around 0.8% over the past decade and are now at 1.7%. The Fed wants to take action to avoid any further falls that may lead to the Japanese scenario of structural deflation.

Expected US Inflation - next 10 years

%

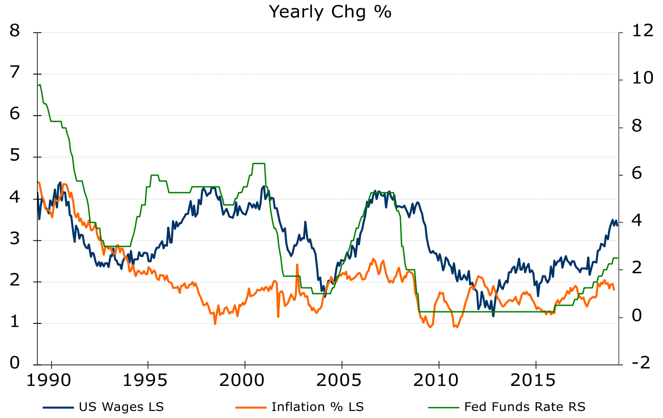


Source: Thomson Reuters Datastream, Evans & Partners

The strategic review will focus on whether the Fed's assumptions about the determinants of inflation are still valid. It has always set monetary policy on the assumption that higher wages cause higher consumer prices. The chart below shows that the Fed funds rate has charted the path dictated by wages. While the logic behind this assumption is self-evident, the chart also shows that the actual correlation between wages and prices has been close to zero over the past decade.

US inflation and the Fed

Yearly Chg %



Source: Thomson Reuters Datastream, Evans & Partners

Either the relationship between wages and prices in a modern economy is massively overstated, or there are other drivers of inflation that have made this link far less important. Those other drivers could be the substantially disinflationary pressures from e-commerce, technology disruption and the globalisation of labour and product markets.

The Fed might conclude that, based on the under-estimated importance of these other factors, it was a policy error to raise rates from 2015 simply because the labour market was tightening. Recent actions and rhetoric from the Fed suggests this will be a likely conclusion from the strategic review.

In a recent speech, Chairman Powell hinted at these conclusions. He implied that the Fed will be more willing to keep monetary settings very easy and would even be willing to permit the inflation rate to stay above 2% for an extended period in a deliberate attempt to raise inflation expectations. This is what he refers to as "makeup strategies" in the quote below:

> *"My FOMC colleagues and I believe that we have a responsibility to the American people to consider policies that might promote significantly better economic outcomes. Makeup strategies are probably the most prominent idea and deserve serious attention. They are largely untried, however, and we have reason to question how they would perform in practice. Before they could be successfully implemented, there would have to be widespread societal understanding and acceptance--as I suggested, a high bar for any fundamental change. In this review, we seek to start a discussion about makeup strategies and other policies that might broadly benefit the American people."*
>
> Jerome Powell, Chairman of the Federal Reserve, March 8, 2019 at a speech titled "Monetary Policy: Normalization and the Road Ahead".

Political pressure for easier policy

At the same time as the Fed is undertaking this academic debate, politicians on both sides of the electoral divide in the US are calling for easier monetary policy for their own purposes:

- Trump is now demanding lower rates as a way to boost the economy heading into the 2020 election campaign. Given the ground that the Fed has already given, and that Trump is now trying to stack the Fed board with sympathetic nominees, he could succeed.
- High profile democratic politicians are calling for an even more radical approach. The *Green New Deal,* as espoused by progressive politicians in the US such as Bernie Sanders and Alexandria Ocasio-Cortez, argues for using the printing press to fund new social programs and a massive program of investments in clean-energy jobs and infrastructure. This proposal hides behind the "modern monetary theory" idea that a country able to issue debt in its own currency cannot go broke. The dangerous extension of this argument is that governments can continue to spend up to the point that inflation is triggered and based on recent evidence on inflation in the US, this could allow significant scope for further expansion.

While we would hope that sanity prevails and a massive program of unfunded government spending does not occur, there does appear to be enough groundswell to support a substantial extension of the low interest rate era. Adopting the "don't fight the Fed mantra", this means that the US economy and US markets will be supported for at least the next couple of years and the prospects for a recession in 2020 or 2021 will be significantly reduced.

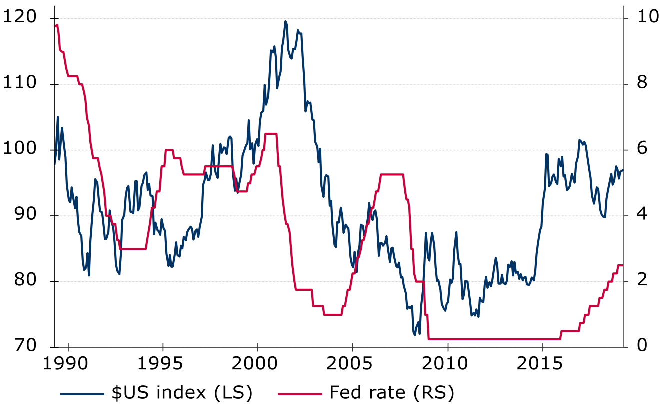
We will focus on some of the implications for currencies in the rest of this note and will continue addressing the broader implications of this change in subsequent notes.

A peak in the big dollar?

A significant change in the Fed's approach could have significant implications for the US dollar. The US dollar jumped around 30% when investors started anticipating higher rates from the Fed from late 2014. This set the US apart from the rest of the world, particularly Europe and Japan. The US dollar has broadly maintained that level since.

$US and the Fed rate

Index and %

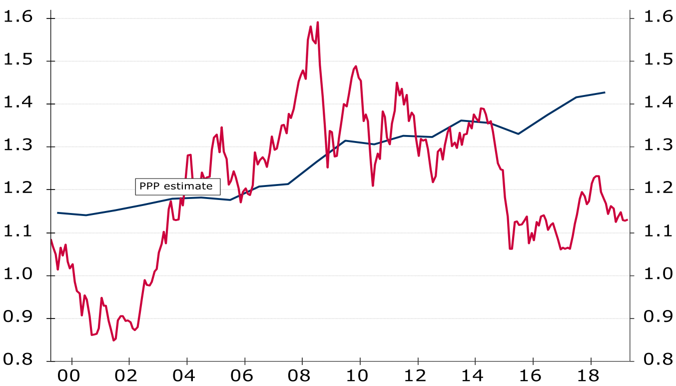


Source: Thomson Reuters Datastream, Evans & Partners

It is surprising that the US dollar has not weakened in response to the change in the US interest rate outlook that has already occurred. This probably reflects lingering concerns about the short-term global outlook.

Our view, however, is that a realigning of the interest rate stance of the US with the rest of the world should result in a realigning of currencies. As the global outlook improves, led by a rejuvenated China, we expect this to occur. The US dollar is now 10-30% overvalued relative to purchasing-power parity against the major currencies, some of which could now be reversed. The next chart shows that the US dollar is around 30% overvalued relative to the Euro.

Euro vs $US and PPP estimate



Source: Thomson Reuters Datastream, Evans & Partners

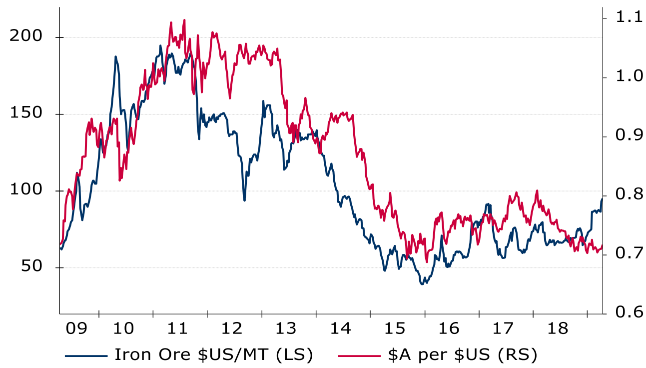
Upside for the little dollar?

A fall in the US dollar is likely to place some upward pressure on the Australian dollar. We are forecasting a rise to US$0.75 over the next year, based on a fall in the US dollar and a number of other drivers including:

- Commodity prices have jumped in recent months and diverged from the Australian dollar. The iron ore price in particular has surged mostly due to supply issues, but the Australian dollar has not followed. An iron ore price of US$80-90/t has historically been consistent with an Australian dollar around US$0.80. A broader range of commodity prices, including copper and coal, have also been resilient recently.

Iron ore and $A

$US



Source: Thomson Reuters Datastream, Evans & Partners

- We expect Chinese stimulus to boost commodity demand in 2019, which could create further upward pressure on prices and the Australian dollar. The end of the deleveraging campaign, tax cuts and stimulus are starting to have a significant impact on the Chinese economy, which we expect to be sustained through 2019.

China manufacturing PMI measures

Index, 50 = no change

Source: Thomson Reuters Datastream, Evans & Partners

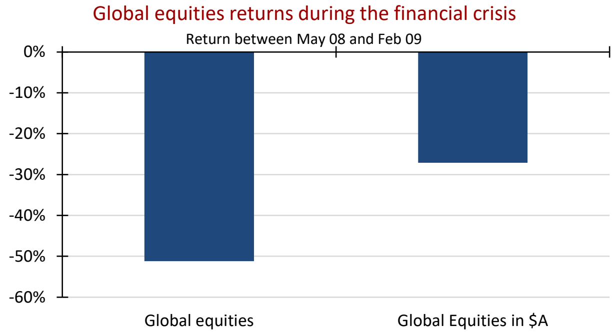
The upside from commodity prices needs to be balanced against risk to the downside for Australian interest rates. However, we would note that markets are already now priced for rate cuts by the Reserve Bank and interest rate differentials have not been a major driver of the Australian dollar in recent years. Relative interest rates have not played a major role recently because the actual differential has been small over that period (there is only 1% difference in the official rates at the moment).

Time for some more hedging

After an extended period of Australian dollar falls since 2011, investors need to prepare for a period of Australian dollar strength. In particular, a rise in the Australian dollar will have implications for equity portfolios and could be a drag on returns from international equities if they are held on an unhedged basis. One way to address this is to reconsider the amount of hedging in portfolios.

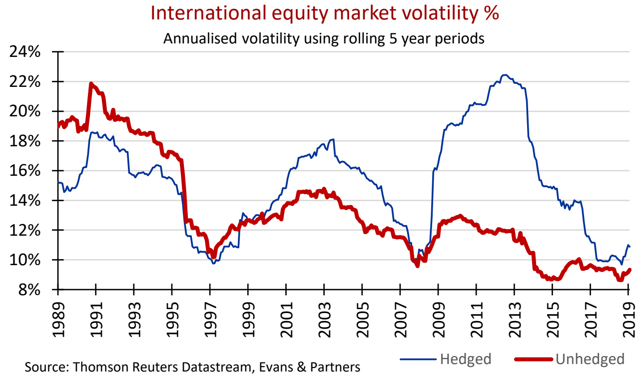
As discussed in *Asset Allocation: Our Approach* (22 February 2019) we recommend that international equities be held mostly on an unhedged basis for a range of reasons:

1. Unhedged equities provide protection in times of market stress because the Australian dollar tends to fall during periods of market stress, cushioning the fall in global equities during crises. In the global financial crisis (GFC) the fall in the Australian dollar resulted in unhedged equities outperforming by nearly 20%. In the nine major bear markets since 1983, the Australian dollar fell in eight of those, and by an average of 10%.



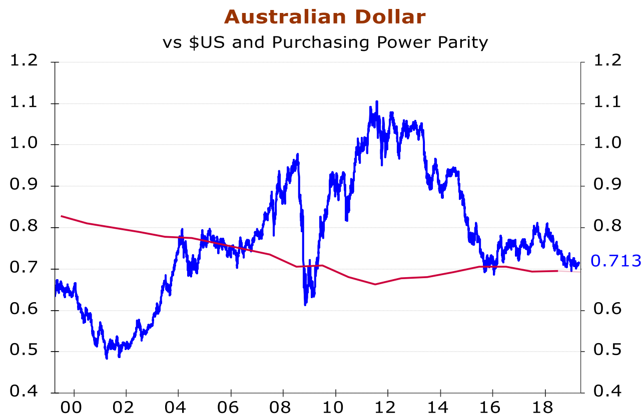
Source: Thomson Reuters Datastream, Evans & Partners

2. Unhedged equities tend to be less volatile than hedged equities for similar reasons. The chart below shows that the volatility of unhedged equities has averaged around 11% over the past decade, compared with around 15% for hedged equities.



Source: Thomson Reuters Datastream, Evans & Partners

3. The Australian dollar has been trading above fair value based on measures of purchasing power parity and, as it has fallen, unhedged equities have performed better. Fair value based on this measure is around USS0.70, so the valuation case for a falling Australian dollar over the medium term is no longer as compelling.



Source: Thomson Reuters Datastream, Evans & Partners

Note, however, that does not mean that the most appropriate hedging rate is zero. The most appropriate hedging rate is always a balance. Currencies are volatile and currency positions should not be so large that movements in the Australian dollar overwhelm movements in the underlying assets. As a result we generally recommend hedging equivalent to 25-30% of international positions in a portfolio.

In our view, this low level of hedging was appropriate when the Australian dollar was overvalued and there were good prospects for a steady fall in the Australian dollar. To his credit, my predecessor Mike Hawkins was a strong advocate for increasing exposure to unhedged international equities.

However, in my view we are now in a different position, given the prospects for a rise in the Australian dollar over the next year or so. A 5-10% rise in the currency could wipe out much of the returns from international equities. It therefore still makes sense to keep some equity positions unhedged because the first and second arguments presented above are still valid. But now that the valuation argument has been largely removed and the cyclical risk is to the upside in my view, investors should look to increase hedging up towards 40-50% of international portfolio positions.

This is most easily achieved by switching from unhedged to hedged versions of ETFs or managed funds where they are available.

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