

Dawn of the Fed

"When you come to a fork in the road, take it" Yogi Berra – Player / Manager, New York Yankees
So the big day has arrived (again) and we will later find out whether the US Federal Reserve is finally going to bite the bullet and raise interest rates. The bond market is priced for a 79% probability that they will raise interest rates by 0.25%, bringing it up to 0.5%. One gets the distinct feeling that, a bit like Santa, if Janet Yellen doesn't deliver for Christmas, there are going to be an awful lot of unhappy children.

But let's pretend for a moment that we already knew that the Fed was definitely 100% certain to raise. What would you, could you, practically do? Well, if you had a ton of money on deposit earning nought or a line of free credit, low dealing fees and the right set up, you might start by making the assumption that, in theory, higher rates means falling share prices, a stronger dollar and higher yields (meaning falling bond prices). You would need a lot of money, of course, because the opportunity already having been mostly priced in means there's little to go for in percentage terms. But you might at least reassure yourself that mathematics was on your side. So far, so good.

Unfortunately, markets are not always so compliant and logical. Firstly, there is the Chair of the Federal

Reserve Janet Yellen who, amongst other things, wants us to breathe a collective sigh of relief and go and buy shares. As the most important and influential person in global markets, her wishes cannot be easily dismissed. Indeed, despite a flip-flopping side show last year resulting in the taper tantrum in bond markets, she has cut a pretty steady figure and has successfully conveyed the message that yes, she is a dove, but a cautious one and will only raise rates when everything is right with the economy. In her own words, the US economy has "recovered substantially", wages are up, unemployment down and the threat from the Chinese economic slowdown appears to have subsided. So long as you turn a blind eye to stubbornly low inflation, everything looks wonderful, we can raise rates, nothing to see here, please move along.

This is the positive spin on a rate hike and we can expect some earnest and reassuring comments to allay any fears that the outcome could be any different. Unfortunately, there is a lot of fear out there.

We get the impression that there's not been a whole lot of fundamental investment going on in the last few weeks. Market volumes have been low creating fertile ground for volatility to pick up as short term trading in markets reacts to every twist and turn in news flow. Evidently, everyone is just waiting on the Fed.

Monday was a classic example. The fall in crude oil on the back of a forecast of a continued supply glut implies less inflation in the months ahead. As this compounds the mystery of the missing 2% inflation target, it raised the unwelcome increased possibility that the Fed could back out of a hike later today. There was a very volatile and confusing opening to Monday's Dow as a result. But, as night follows day, markets bounced back strongly yesterday. In trying to make sense of it all, it's improbable that the market fundamentally shifted its view 48 hours ahead of the Fed decision. Put bluntly, if everything had suddenly changed overnight and the markets had decided that the US economy really cannot handle a quarter point hike, then we are all in much more trouble than we think. More likely, in our view, is that the market is simply trading on technicals and low volume.

Nevertheless, we know that a fear has given rise to fund managers taking measures against a material loss in the wake of a rate hike because of this. Perhaps this is understandable because we sailed off the charts into unknown territory some time ago. But in balance with the positive spin on the economy which should see markets rise on the back of some kind of relief, there are a layers of stop losses and bets using derivatives, such as put options, which could potentially act as an effective "short" on stock markets. We are awake to the possibility that an indiscriminate sell off could trigger stop losses like a string of fire crackers until the market effectively runs out of marginal net sellers – possibly pushing down the major stock markets 10% or so. Unpleasant though this (we hasten to add unlikely) outcome may be, we would expect the well-diversified portfolios to outperform well and it would set up a quite remarkable buying opportunity, in our view. As we have said all year, we will act quickly if the opportunity outweighs the risk, a strategy that has delivered good performance across all mandates in 2015.

Even if we could be 100% certain that the Federal Reserve will raise later today, our answer to the question about what to do in the immediate aftermath is not immediately obvious because the mathematical, logical and technical assumptions could be entirely swept away by the positive interpretation of what a hike really means.

We are, and should be, much more interested in 2016 and 2017 when the argument will be all about the pace and frequency of further rises and, as always, company earnings growth and the economy generally. A straw poll around the investment team reveals a range of probabilities the Fed will raise and the average is significantly higher than 79%. But, however close we edge to 100% probability, we all agree that the various TAM portfolios are optimally set up exactly as we would like them to be on the day of a critical decision from the US central bank.

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