CIBC Asset Management

Market Insight

March 2017

U.S. Fed raises interest rates again

Patrick O'Toole
Vice-President, Global Fixed Income

As market watchers expected, the U.S. Federal Reserve again upped its key interest rate by 0.25%. Portfolio Manager Patrick O'Toole shares his thoughts on the potential impact for investors.

It was almost a certainty that the U.S. Federal Reserve (Fed) would raise the fed funds rate another 0.25% at the March 15 meeting. Many pundits had agreed that the time was right, citing better-than-expected economic data as justification for the Fed to move. However, while surveys of consumers and businesses have moved sharply higher, hard data related to economic activity has been mediocre. Consumer spending in January only advanced 0.2% and was negative when accounting for inflation. Core durable goods orders (excludes the volatile defense and aircraft orders components) fell 0.4% in January versus expectations for a 0.5% advance. Pending home sales also posted a big miss, foretelling a slowdown in the pace of improvement in the housing market. Construction spending unexpectedly declined. Auto sales, while still high, are slowing modestly despite record incentives to boost sales. The result of disappointing data on real economic activity saw economists cutting their GDP forecasts for the current quarter to the mid-1% zone. So the Fed has fired the first salvo of the three that it has told investors to expect in 2017, yet it needs the more ebullient surveys to be backed up with better growth in the next couple of quarters to justify further volleys.

And here in Canada…

The Bank of Canada (BoC), however, is not expected to follow the Fed in raising its rate, given the ongoing struggles in our economy despite the recovery in oil prices. At a recent meeting, the BoC downplayed the recent strength in Canada's economy and the uptick in inflationary pressures. It focused instead on the challenges that the export sector faces along with "subdued growth in wages and hours worked". The BoC is well aware of the added risk of potential changes coming from the Trump Administration and the possibility that an improvement in exports could be delayed. The BoC is right to wait. Although fourth quarter GDP was much better than expected, it was largely the result of a drop in imports—that's not a signal of underlying strength in our economy. In fact, final domestic demand grew a paltry 0.4% quarter/quarter, and that's an annualized rate!

More rate increases to come this year?

Although we expected the Fed to raise rates this year, we only see two increases, given our forecast that economic growth will not meet consensus expectations. That should allow bond yields to remain in the range that has prevailed for the past few quarters and continue to see corporate bonds providing better returns than government bonds. As a result, we remain overweight investment-grade and high-yield corporate bonds in client portfolios.

The gameplan for investors

Investors should remain diversified. Many markets are responding to a rise in 'animal spirits' resulting from the anticipated reduction in regulations, and the potential for major spending on infrastructure and lower taxes in the U.S. However, the initial ebullience may fade as the harsh realities of governing result in delays and/or watered-down reforms from the Trump administration.