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As expected, the FOMC raised the Federal Funds Rate (FFR) by a further 0.25% points this week, taking the target range to 1.5% - 1.75%. This was Chair Powell's first meeting as head of the FOMC and the event passed largely without surprise. However, we thought that there were some notable standouts from the meeting and take this opportunity to provide an update on our thinking on fixed income markets and the positioning in our clients' portfolios.

'Powell Paradox'

The updated FOMC economic projections were not without a few surprises and oddities. The FOMC modestly revised up their outlook for GDP growth in 2018 and 2019, to 2.7% and 2.4% respectively. We note that this cumulative revision of +0.5% points remains materially below the US administration's stated belief that recent tax reform and spending pledges will raise growth to 3%. Alas, this remains an elusive outcome.

The expected path of unemployment was revised lower again, with most FOMC members now expecting unemployment to fall a further 0.5% points, towards 3.5% through 2019. These firmer economic projections appear to justify the committee's outlook for the path of the FFR – there is now increased conviction for a further 1.25% points rate increase over the next two years. Further, the balance of risks is now towards an even higher path of rate increases, above and beyond the current market implied path for the FFR.

Oddly, however, the inflation projection remained unchanged over the projection horizon. Given the stronger outlook for both economic and employment growth this suggests that the FOMC have revised their output gap estimate lower. That is, there remains still ample non-inflationary supply in labour markets. Which leads us to question the higher projection for the FFR given the benign inflationary projection? This, to us, is the 'Powell Paradox'. The FOMC now appear to wish to cool employment growth over the projection period, rather than to allow a modest inflation overshoot as compensation for years of undershooting.

Immaculate perfection

One answer to the puzzle of the higher projected path for the FFR is the FOMC's longer-run (beyond 2020) economic projections. These estimates for the unemployment rate and GDP growth are almost 1% point *above* and *below* near-term projections, respectively. That is, the FOMC expect material cooling in the economy to emerge in the period to 2020, with both growth and unemployment expected to be worse than is projected for this year. Yet, the FOMC expect the FFR to be around 1.25% points higher by 2020, and, conversely, project a further 0.5% point increase that year.

This suggests to us that the FOMC expect to engineer an immaculate 'soft-landing' in the US economy, once momentum from tax reform and spending cuts fades. This explains why the FOMC expect to be cutting the FFR, albeit modestly, by 2021. A higher FFR over the next few years appears motivated by a desire to quell possible financial excesses rather than expected inflationary outcomes (given the benign inflation projection). We are sceptical that the FOMC have the tools (or will have the luxury of time) to deliver such optimal economic control going into what would be the thirteenth year of economic expansion.

Portfolio outlook

We are increasingly bullish on the outlook for fixed income markets this year. Sovereign yields have risen materially since the onset of the global equity 'bull run' that began towards the end of 2016. Longer-dated yields in core interest rate markets now exhibit inflation premia not justified in an environment of global QE tapering and increasingly agitated central banks.

Whilst short-dated forward yields in the US should rise along with an increasing FFR, long-dated, core interest rates should continue to fall given the rather benign outlook for inflation and the mature global economic cycle. Indeed, we would say that global fixed income markets now look attractive relative to 'risk' markets.

Early in the year we turned positive on the outlook for long-dated yields and retain all of the core investment themes with which we began 2018. We continue to hold exposures to long-dated forwards in Germany, expecting inflation premia to fall across the Eurozone as the end of QE draws nearer. We believe that market expectations for interest rate increases from the Bank of Canada look too optimistic for 2018 and so are positioned for some tempering of market exuberance. Further, euphoria in equity markets in the early part of this year led to us adding a modest long in Japanese yen versus the US dollar. We believe that the return profile for yen is increasingly asymmetric, given the level of global yields and maturity of the financial market cycle.

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