Fed at the wheel:
The destination matters more than the journey

Roger Aliaga-Diaz, PhD
Chief Economist, Americas
Vanguard Group

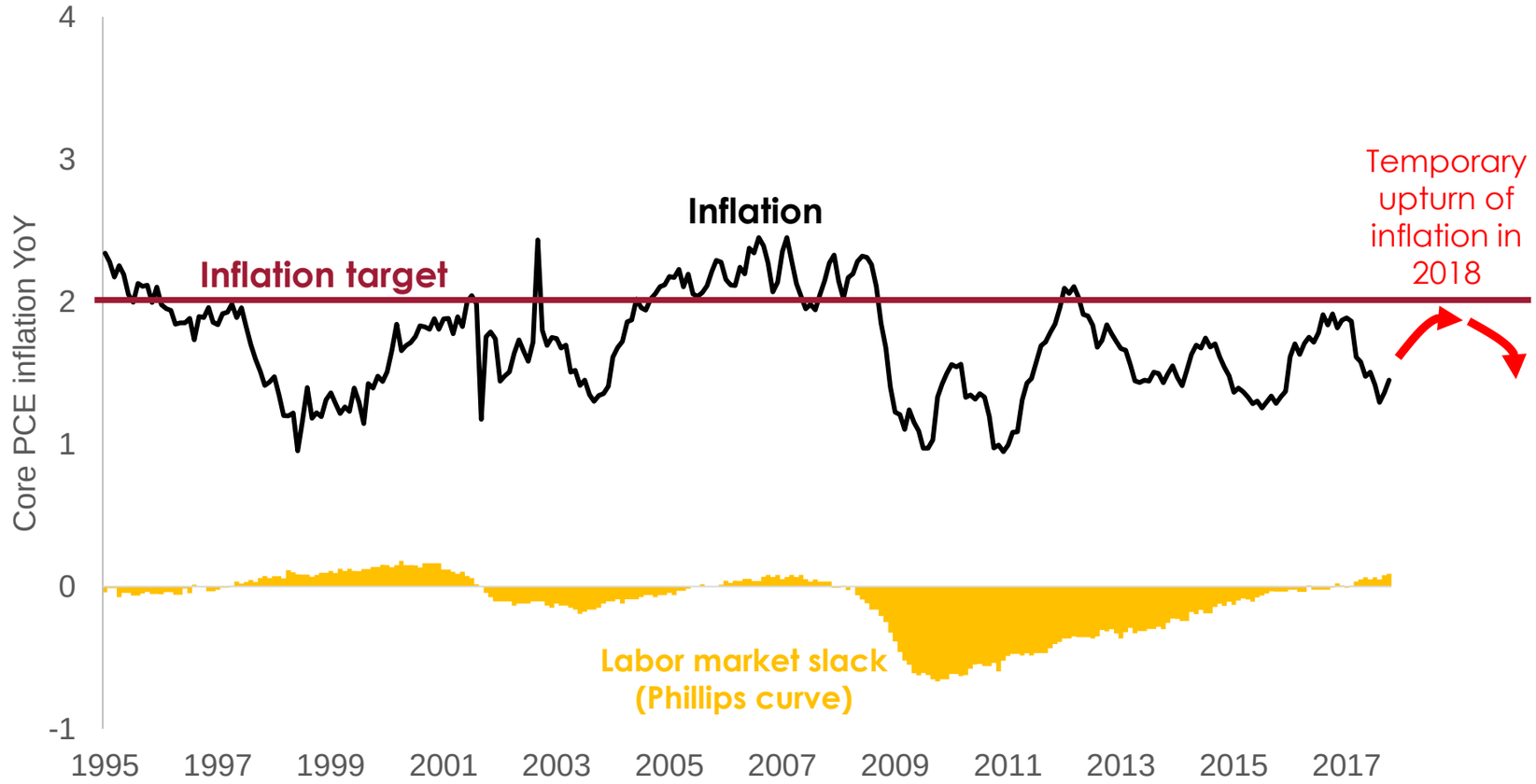
Financial Standard
Chief Economist Forum
February 2018

Vanguard

Agenda

- Federal Reserve pressing on with policy normalisation (without much inflation)
- Raise in long term interest rates should stick
- Policy mistake is a 2019 risk

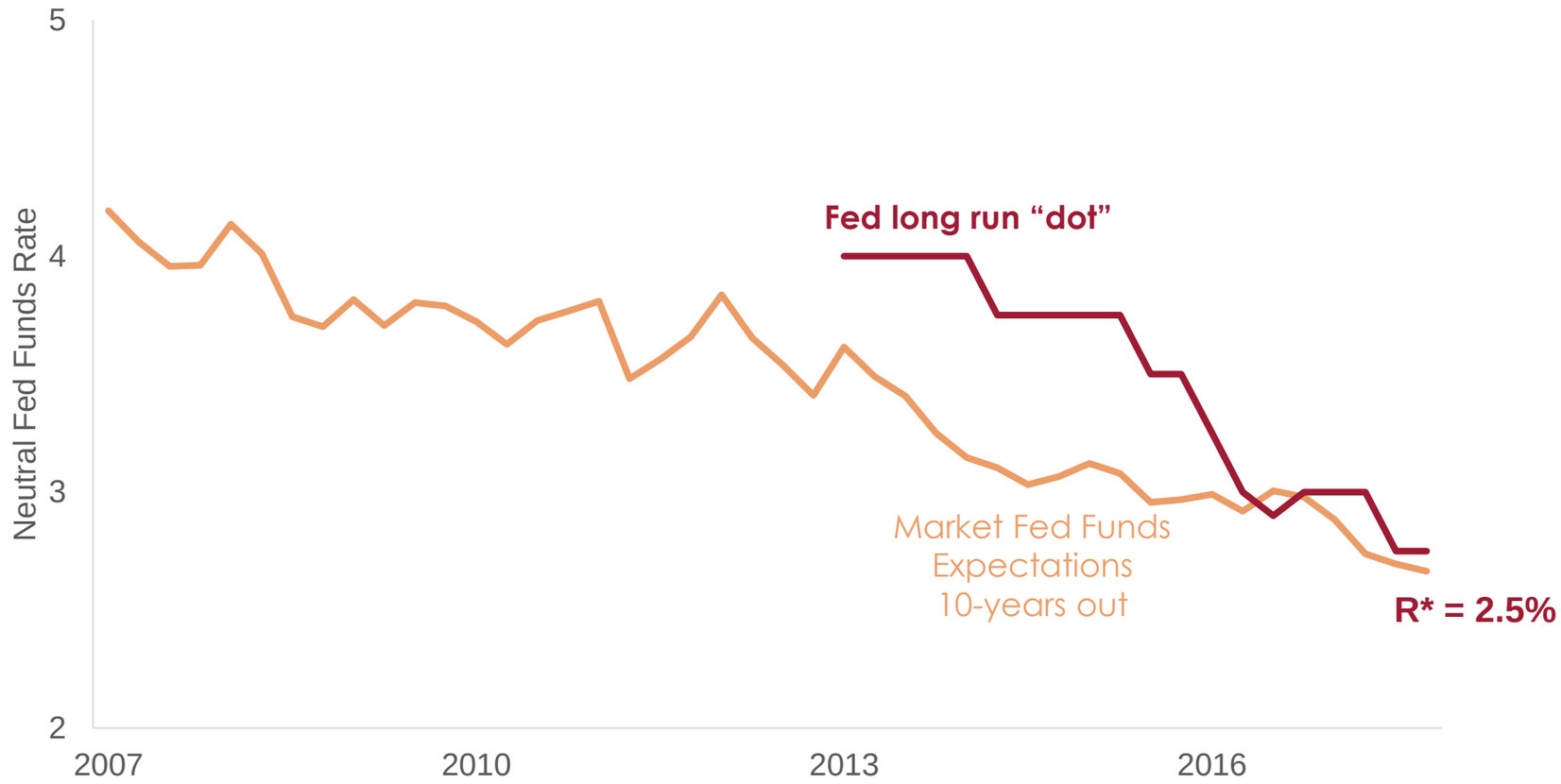
Missing inflation not a “mystery” … below target 80% of the time



Source: 2018 Vanguard Economic and Market Outlook: Rising risks to the status quo, Vanguard white paper, December 2017.

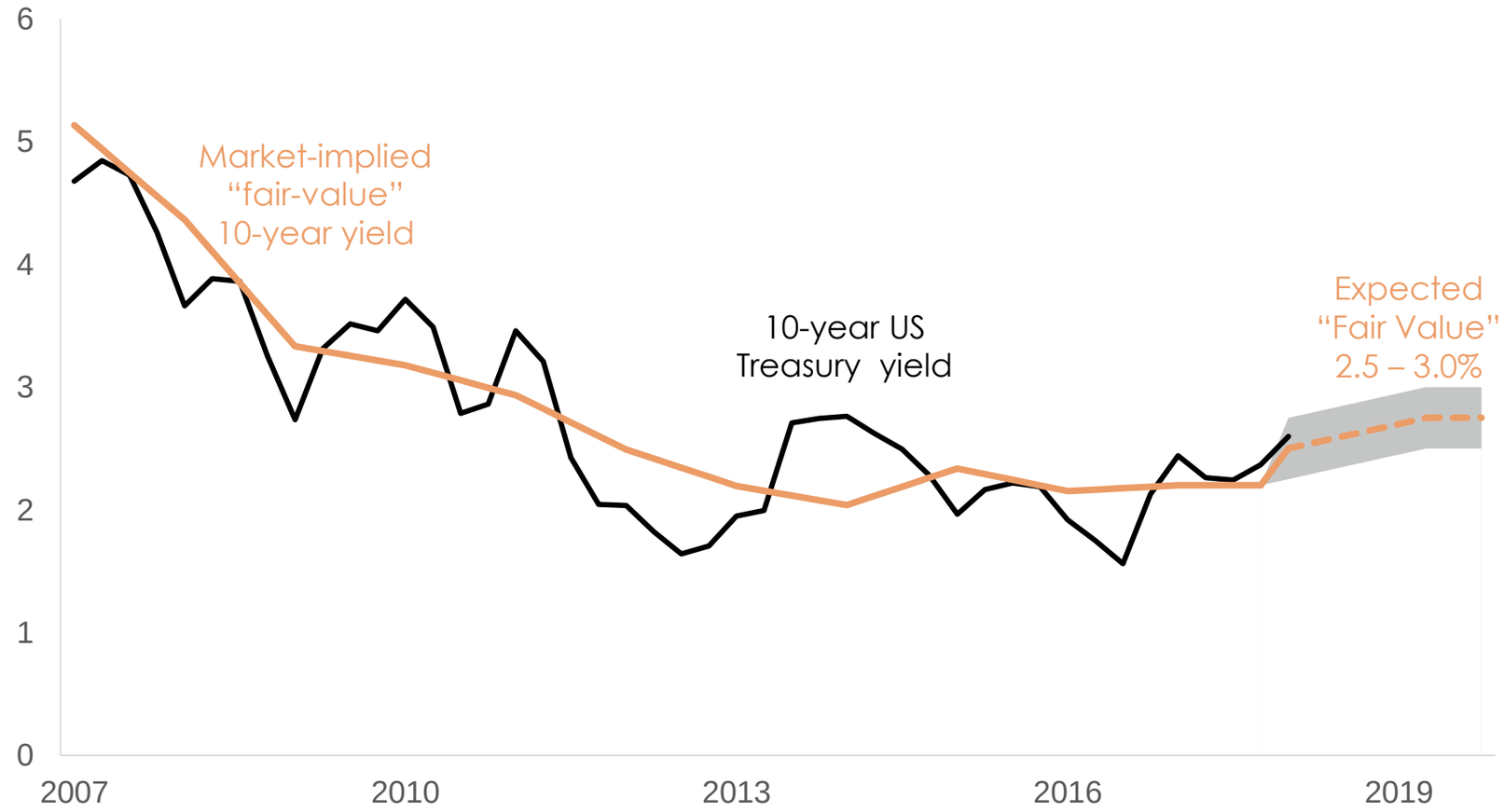
The destination matters more than the journey

Expected long run level for the Fed Funds rate



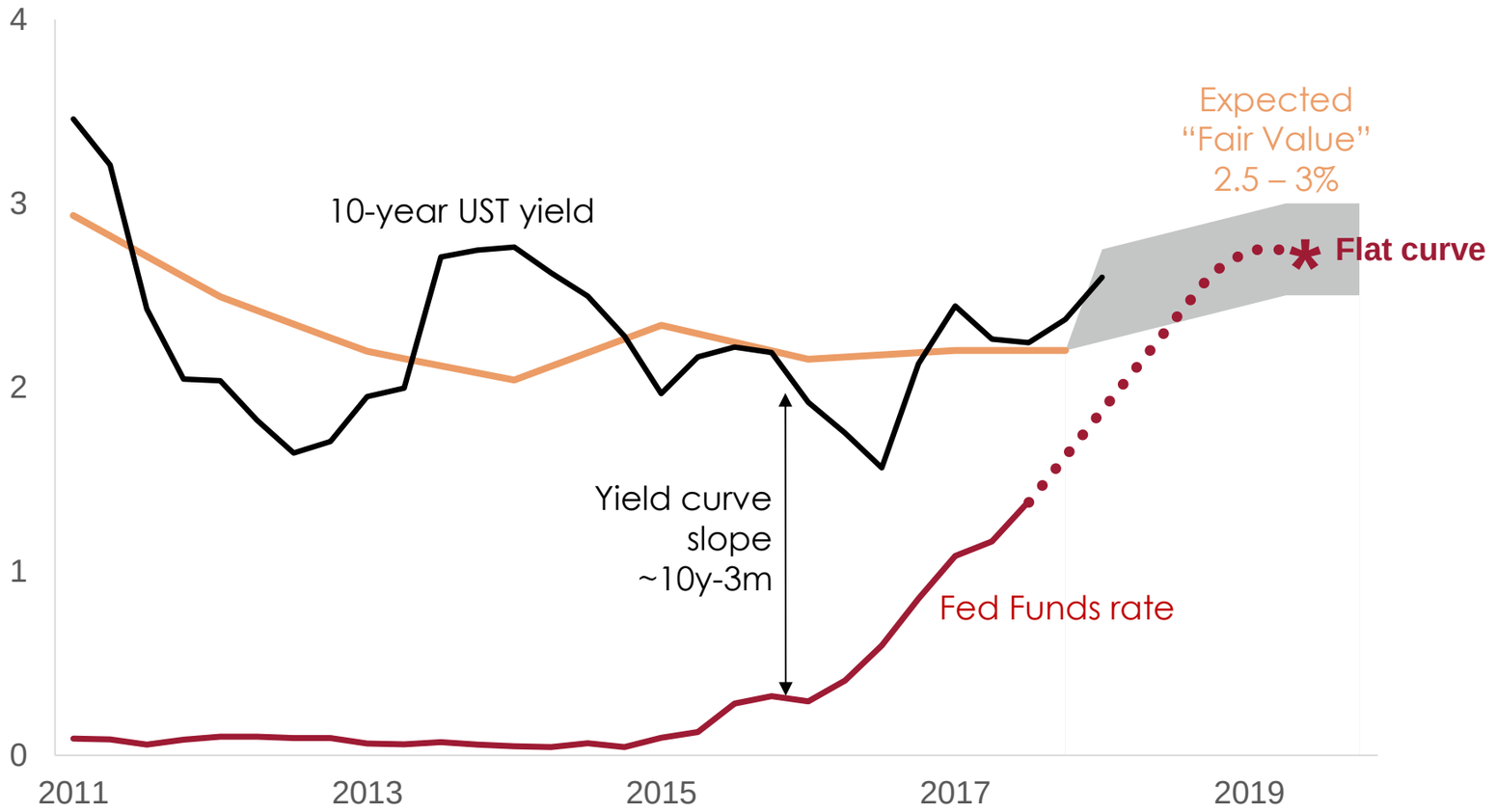
Sources: Federal Reserve, Survey of Professional Forecasters and FOMC Summary of Economic Projections

10-year US Treasury yield is “fairly” valued



Sources: Vanguard estimations based on Federal Reserve Board H15 Release CMT yields and Survey of Professional Forecasters.

Collision course 2019?



Sources: Vanguard estimations based on Federal Reserve Board H15 Release CMT yields and Survey of Professional Forecasters.

Takeaways

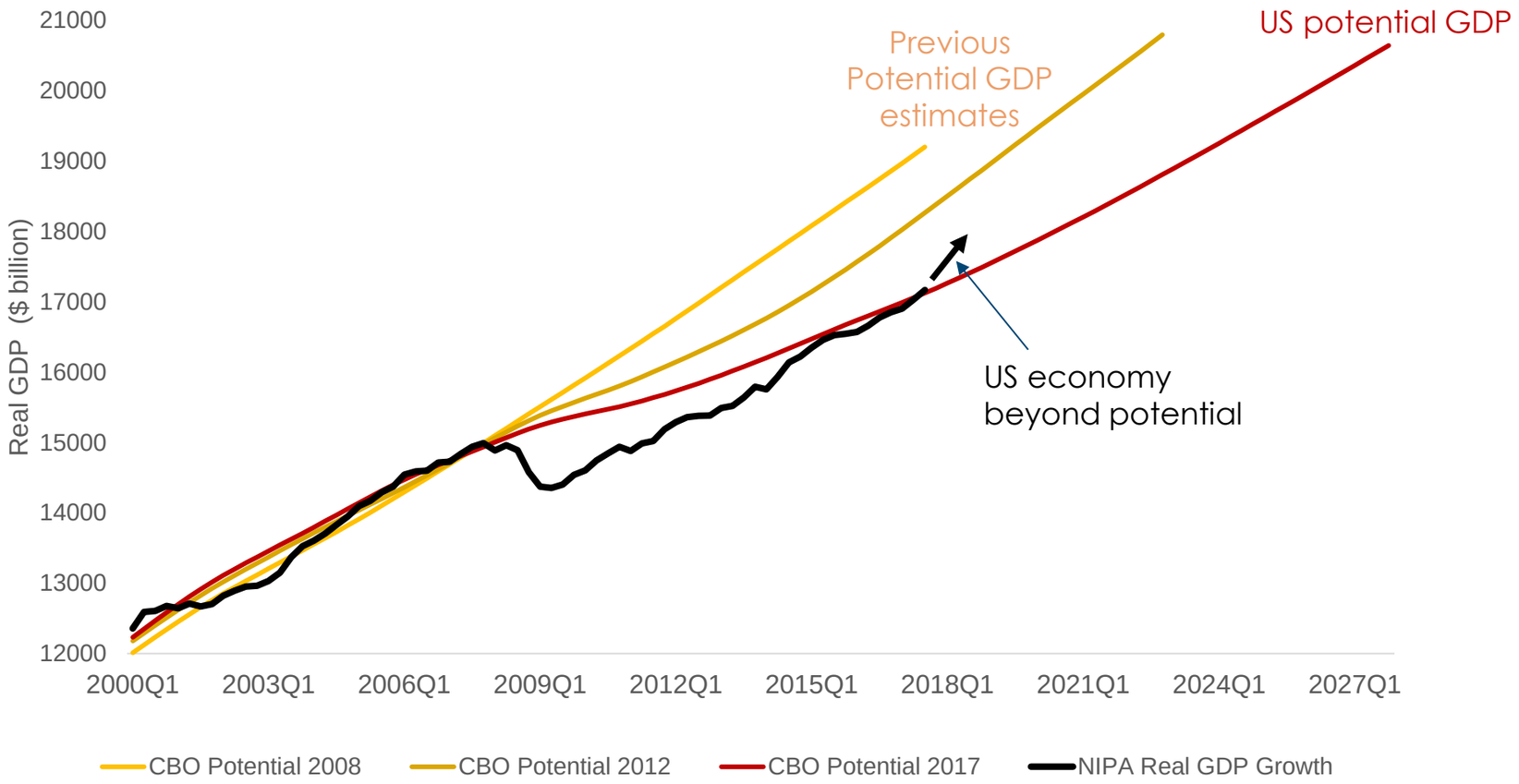
- A small expected pick up in inflation will embolden the Fed on its normalisation plans.
- Market's expectation of the terminal Fed funds rate is key to long term bond valuations.
- Fed's margin for error is thin: four hikes away from the end of the rate cycle. Six rate hikes planned by the Fed could be too far.
- **Investment thoughts:**
  - *Inflation risk remains moderate*
  - *Credit risk more prominent than duration risk*
  - *Elevated equity risk both in terms of valuations and economic cycle*

Vanguard®

Appendix

US economy going beyond potential

US GDP and estimates of potential GDP



Source: Vanguard calculations using data from Congressional Budget Office and Bureau of Economic Activity

Important information

Vanguard Investments Australia Ltd (ABN 72 072 881 086 / AFS Licence 227263) is the product issuer. We have not taken your circumstances into account when preparing this presentation so it may not be applicable to your circumstances. You should consider your circumstances and our Product Disclosure Statements (“PDSs”) before making any investment decision. You can access our PDSs at vanguard.com.au or by calling 1300 655 102. Past performance is not an indication of future performance. This presentation was prepared in good faith and we accept no liability for any errors or omissions.

© 2018 Vanguard Investments Australia Ltd. All rights reserved