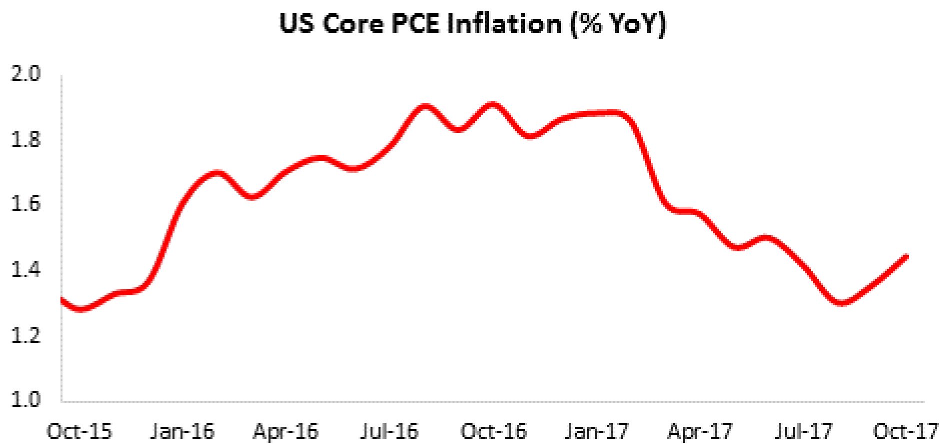
By Michael Kokalari, CFA
Chief Economist

The Fed Hikes Rates, and its 2018 US GDP Growth Forecast

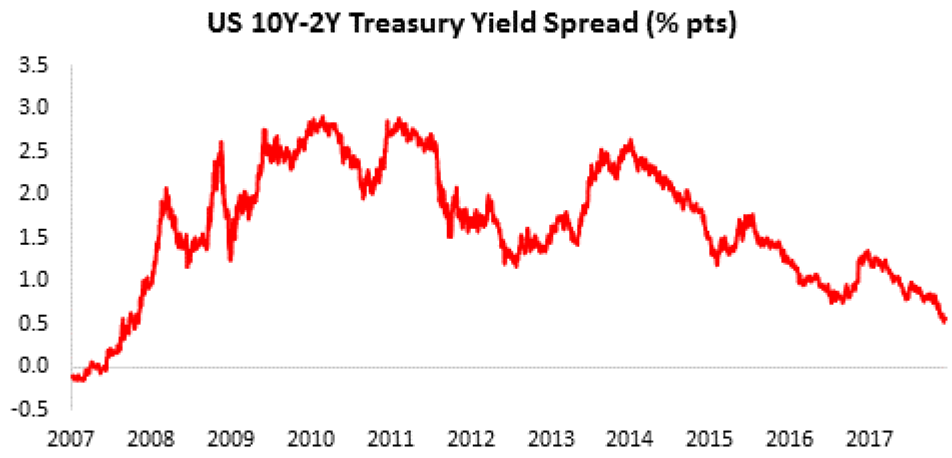
Earlier this week, the Federal Reserve hiked US policy interest rates by 25bps to 1.5%, which was widely expected, and the Fed also lifted its 2018, US GDP growth forecast from 2.1% to 2.5%, given that US GDP exceeded 3% in both Q2 and Q3.

However, Fed officials acknowledged that Core PCE inflation in the US continues to languish well below the Fed's 2% target. Core PCE inflation fell from 1.8% in early 2017 to just 1.4% at present, despite a drop in the unemployment rate to just 4.1%, which seems to indicate that the so-called "Phillips Curve", which predicts higher levels of inflation at low unemployment rates, is currently broken. Last Friday's employment report showed that US wage inflation is unchanged at just 2.5% yoy, while unit labour costs actually, *unexpectedly* fell in both Q2 and Q3.



Fed officials acknowledged this conundrum during a press conference at which this latest rate hike was announced, but Yellen and others also stated that the Fed does not expect core inflation to pick-up in the near term. That guidance is somewhat of a reversal of the statements coming from Janet Yellen and other Fed officials in recent months that low inflation is a "transitory phenomenon", which would soon abate, and that guidance also seems to contradict the above-mentioned upward revision of the 2018 GDP growth outlook somewhat.

Most economists now expect Core PCE inflation to remain below 2% next year, given a slowdown in US M2 growth from an 8% yoy pace in 2016 to just 3-4% at present. For that reason, the market expects just over one rate hike in 2018, vs the Fed's continued guidance for three hikes next year. But the single biggest divergence between the Fed's guidance for relatively robust growth next year, and the market's expectation is the continued flattening of the US Treasury yield curve to the lowest level in a decade.



This flattening US yield curve is the subject of much discussion among analysts, and was highlighted in a widely read Bloomberg article earlier this week, "*Inverted Yield Curve in 2018 Is Taking Over Wall Street Outlooks*". This topic is attracting a lot of attention because a *flattening* yield curve is a reliable sign of a slowing economy, while an *inverted* yield curve is a near certain sign of an imminent recession.

There are two theories about why a flattening / inverted yield curve is a definitive indicator of slowing economic growth. The first is that the flattening yield curve **causes** a slowdown in growth because banks lose their appetite to lend when the spread between the interest rates they can charge for mid-term and long-term loans drops below the rates they pay for (typically) short-term deposits. The other theory is that a flattening yield curve **signals** an approaching recession, which is presaged by weak demand for long-term investment capital and falling inflation expectations.

At first blush, the latter seems to be occurring because commercial loan growth by US banks slowed from a 16% pace in early 2016 to just 4% yoy at present. However, the lending standards of US banks loosened considerably this year, as evidenced by the Fed's surveys of loan officers and the record high proportion (circa 75%!) of "covenant light" loans currently being extended to businesses. That means banks are still keen to extend loans – even at the current spread between short-term and long-term interest rates – but that the demand for loans is weak. And that last point reinforces that "secular stagnation" is weighing on the US economy – which explains why US companies would rather buy back shares on the stock market then invest in expanding their core business operations.

What all of this means for Vietnam

A strengthening US economy would boost Vietnam's export growth to its largest export market (exports the US are up 10% this year, vs 15% to the EU and 50% to China). However, higher-than-expected USD interest rates would probably also boost the value of the Dollar - and a circa 10% fall in the USD this year has been one of primary drivers of the 30% YTD increase in EM stock markets (vs a 20% increase in the US and other developed markets). It's true that Vietnam has outperformed EM stock markets YTD, but the biggest driver of the VNI's meteoric increase this yet is the EM bull market, which in turn has largely been driven by the weak USD. If a strong growth revival leads to higher-than-expected increases in US interest rates, that would probably hurt Vietnam's stock market.

The good news is that the US economy is unlikely to strengthen by as much as the Fed expects next year. The signals given by the flattening yield curve are probably more reliable than the Fed's forecasts for a strengthening economy few reasons – one of which is that strong growth in Q2 and

Q3 were largely driven by inventory accumulation (without which, GDP growth would have been closer to 2%).

The biggest uncertainly is possibility that Trump's tax reform bill gets enacted, which would make it comparatively less appealing for US investors to put money in Vietnam (or anywhere outside the US). The likelihood of the tax reform bill passing fell yesterday when the Democrats won the Alabama senate seat special election – leaving the Republican Senate majority at just 51 seats (out of 100). If the tax bill were to pass, the Fed may raise rates quicker pace than the market expects, even though tax reform would probably not boost GDP growth meaningfully because it would only lead to more stock buybacks.