Investment Note

Manulife Asset Management

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Liftoff at long last: US Federal Reserve raises interest rates

It was a decision that was nearly a decade long in the making. Media outlets had countdowns for the Federal Open Market Committee (FOMC) meeting as if it were some kind of extreme sport to watch. After months of intense speculation, the Federal Reserve has finally raised interest rates by 25 basis points to a range between 0.25% and 0.50%. With the announcement, the US Federal Reserve has finally begun to normalise monetary policy. Manulife Asset Management's Chief Economist Megan Greene takes a look at the rationale behind the decision, some of the risks involved and why she still expects US interest rates to stay low for a very long time.

Break out the champagne! The US economy is finally strong enough for the US Federal Reserve (Fed) to start normalising monetary policy! Or is it? There are a number of reasons the Fed has finally decided to hike the Fed Funds rate for the first time in nine years[1] and some of them are even good ones. For those who thought that liftoff would mean no more Fed obsessing though, think again. Now that the Fed has started a rate hiking cycle, there are two major things to watch. First, there is a risk to the Fed's credibility if the New York Fed's Open Markets desk fails to successfully implement the rate hike and manage the Fed Funds rate higher. Second, the most important aspect of Janet Yellen's press conference following the FOMC meeting was her messaging on the rate path going forward. We think her emphasis on a gradual hiking cycle carries much more weight than the Fed dots, though the biggest risk to the US economy in 2016 remains a policy mistake by the Fed.

Hurry up please it's time

The phrase "hurry up please it's time" is uttered by a British bartender in TS Eliot's "The Wasteland" with increasing urgency as he tries to coerce his customers to go. Anyone watching the Fed over the past year could swear the English bartender was whispering the same phrase into the ears of the FOMC members. Looking at the economic data, there is one indicator that strongly suggests it was time for the Fed to begin its rate hiking cycle: unemployment has fallen to 5%[2], a low rate even by US standards. The nonfarm payrolls headline figure has been robust for the past two months in particular. Beyond this headline figure, though, there are some suggestions the Fed should have waited to hike. Wage growth, while strong in October, decelerated again in November to 0.2% month-on-month[3] in line with the sluggish pace we have seen over the past two years. The US economy continues to add a significant number of jobs every month, but the majority are still in low wage sectors. Without significant upward pressure on wages, upward pressure on inflation will remain elusive.

One only has to look at the inflation data to see this. The core consumer price index (excluding food and energy) firmed to 2% year-on-year in November, while headline CPI was 0.5% year-on-year[4]. The Fed's

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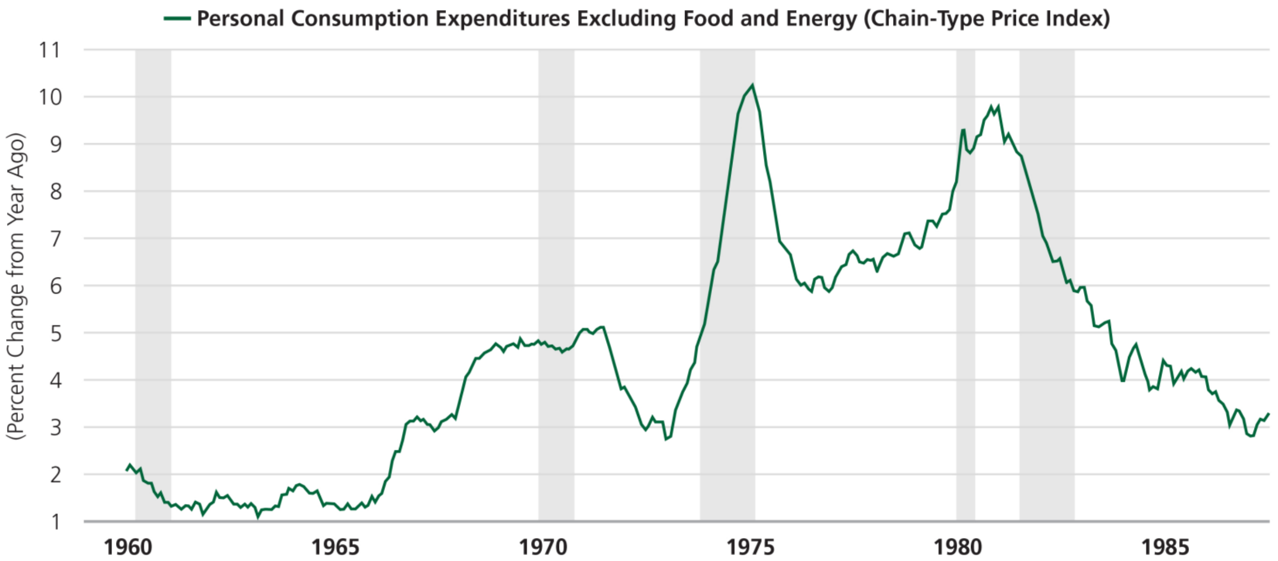
[1] Federal Reserve Bank of New York: Historical Changes of the Target Federal Funds & Discount Rates
[2] Bureau of Labor Statistics: The Employment Situation, 4 December 2015
[3] Bureau of Labor Statistics: Real Earnings, 15 December 2015
[4] Bureau of Labor Statistics: Consumer Price Index, 15 December 2015

preferred inflation gauge, the personal consumption expenditures index (PCE) stood at 0.2% in October though[5] (year-on-year). Core PCE was higher at 1.3%, but this remains far below the Fed's 2% target.



Source: Federal Reserve Bank of St. Louis; data from Bureau of Economic Analysis

While the Fed continues to tighten monetary policy, the European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PBoC) are all expected to ease monetary policy further. This monetary policy divergence is likely to result in a further strengthening of the US dollar relative to most other major currencies. Inflation is already stubbornly low, but as the dollar strengthens further the US will increasingly import deflationary pressures.

The Fed is not only keen to hike rates off the back of strict economic indicators. There is built-in bias for the Fed – and other central banks – to want to normalise monetary policy. This is partly because while interest rates remain at the zero lower bound, traditional monetary policy tools are less effective, an argument that has been summarised in a paper[6] by the Chicago Fed. While negative rates have been effectively implemented in Europe, this seems less likely to be the case in the US because it would threaten the mutual funds industry. The Fed could therefore raise rates to address signs of financial or economic overheating in the US, but it does not have room to lower rates in the event of a slowdown. I have always found the argument that the Fed should hike rates in order to be able to lower them later somewhat spurious. Surely it would be a greater threat to the Fed's credibility if it has to reverse course than if it had waited a bit longer to hike rates.

Another reason the Fed has a natural bias towards tightening is because the Fed is keen to maintain its independence. This was outlined in great detail in a speech entitled Central Bank Independence[7] by vice chairman of the Fed Stanley Fischer on 4 November. In his speech, Fischer highlights that "the power to set the short-term interest rate or the money supply is a formidable one. Well exercised, that power can support the stability of both prices and output; poorly exercised, it can create economic havoc. Any institution to which such responsibility has been delegated must be held accountable for carrying out its mission effectively and efficiently…Accountability of the central bank helps deal with the potential conflict between the benefits of shielding the central bank from political pressures and the fact that unelected officials…are determining policies critical to the country's economy." In other words, central banks have the power to significantly impact economies, and therefore should be free from political influence.

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[5] Bureau of Economic Analysis: Personal Income And Outlays, 25 November 2015
[6] Risk Management for Monetary Policy Near the Zero Lower Bound, Evans et al, March, 2015
[7] Speech by Fed Vice Chair Stanley Fischer: Central Bank Independence, 4 November 2015

When central banks are engaging in conventional monetary policy, the impact of their policies is ambiguous since most of us are both borrowers and savers. When the Fed engages in extraordinary monetary policies such as quantitative easing and maintaining rates at the zero lower bound, the implications for an economy are more controversial. These policies tend to benefit investors who hold assets such as equities, which see their valuations rise off the back of extraordinarily easy monetary policy. This means that the wealthy tend to get wealthier in the face of extraordinarily easy monetary policy and inequality rises. The Fed does not want to be in the spotlight and accused of causing or exacerbating social or economic imbalances. Central bankers by their very nature do not want to be rock stars. They therefore are eager to begin normalising monetary policy so they can get out of the spotlight and ensure they are free from any kind of influence from politicians, the media or society at large. This is outlined in a piece written by Professor Erik Jones at John Hopkins SAIS[8]: "There is an underlying political controversy around central banking that creates an incentive for central bankers to move more quickly in raising interest rates than economic conditions might warrant. This controversy takes place any time central bankers approach the frontier between 'conventional' and 'unconventional' monetary policy; it gets stronger and more intense once they crossover and start using unconventional monetary policy instruments; and it lasts until central bankers find a way to return to normal."

Liftoff at last: Now what?

Now that the Fed has announced a rate hike, the immediate test will be for the Fed's New York Open Markets desk to implement that hike. Normally, this is a non-issue: when the Fed announces a rate hike, the markets fall in line and interest rates rise towards the Fed's target automatically off the back of expectations that they will. While key money market rates have obediently risen as the Fed has signposted a December rate hike over the past month, the New York Fed's Open Markets desk may have trouble actually bringing the Fed Funds rate in line with the Fed's target.

The Fed has traditionally controlled the Fed Funds rate by moving reserves into and out of the banking system. In expanding its balance sheet extraordinarily during the first, second and third rounds of quantitative easing (QE1, QE2 and QE3), the Fed has created an unprecedented amount of excess reserves that now must be sopped up in order for the Fed Funds rate to rise to within the Fed's new target.

As a result, the Fed will have to manage the Fed Funds rate indirectly by influencing the price of money in the system. One way the Fed plans to do this is by increasing the interest on excess reserves from banks to 0.5% (from 0.25%). The other way is by increasing the reverse repurchase (or "repo") rate for non-banks to park money at the Fed to 0.25%. This creates a 25 basis points corridor within which the Fed Funds rate should trade.

This plan should work unless investors aim to park more money at the Fed than the Fed is willing to borrow. This could happen in particular if, with higher rates, money market mutual funds are able to attract more investor cash by offering higher rates themselves and then lending that cash on to the Fed via the reverse repo facility. If this occurs, the Fed Funds rate will fall below the target range. If the Fed cannot effectively manage the Fed Funds rate, then its credibility will be severely undermined. Since last September, the Fed has maintained a cap on transactions of $300 billion per day[9]. This cap has been removed.

Path going forward

Assuming the Fed manages to implement this rate hike, the most important question is what the path for interest rates looks like going forward. In the press conference following the FOMC meeting, Janet Yellen was careful to highlight that rates would increase gradually and that future rate hikes, like this one, will be data dependent.

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[8] Erik Jones: Central Bankers Seeking Normal, 13 September 2015
[9] New York Fed: Statement to revise the terms of overnight reverse repurchase agreement operational exercise, 17 September 2014

One clue for what the Fed Funds rate might look like going forward can be found in the dot plots from the FOMC members, which suggest four 25bp hikes in 2016. For the past few years, these dot plots have been much more hawkish than what was ultimately played out in monetary policy. That is one reason to take the latest dot plots with a grain of salt. Another clue for the Fed Funds rate going forward can be found in the markets. Leading up to the December rate hike, market pricing for federal funds futures suggested that the Fed will hike rates by 25bps twice next year.

Our baseline case is right in between these two estimates, with three 25bp hikes by the Fed in 2016. Beyond 2016, history suggests that the terminal rate for the federal funds rate in a tightening cycle is roughly equal to the yield on 10-year US Treasuries at the start of the cycle. With the yield on the 10-year generally bouncing between 2.00% and 2.25% over the past few months[10], we believe that would be a reasonable expectation for where the federal funds rate ends up. Still, we only expect to see this at the end of our five-year forecast period.

Fed's got the whole world in its hands

While we expect the Fed to proceed very gradually in this rate hiking cycle, the greatest risk to our US economic growth forecast is that the Fed gets overeager and hikes too much too quickly. According to some analysts, inflation has been stubbornly suppressed by transitory factors including lower oil prices, healthcare costs and an appreciating US dollar. If oil prices stabilise, healthcare costs are no longer held down by one-off events (such as the Affordable Care Act or the expiration of a boost to Medicaid provider rates) and the US dollar stops appreciating; we could – in theory – see a boost to PCE. If the Fed reacts to this boost in PCE with aggressive rate hikes, the US recovery could be truncated. Given that the US is the single engine in this global recovery among developed markets, the fallout would be felt globally. Ultimately, the Fed would end up having to reverse course and cut rates back down to zero, thereby undermining its own credibility.

Assuming a major policy mistake by the Fed can be avoided, it is worth considering what will happen to long-term rates as short-term rates increase gradually. One possibility is that long-term rates will creep up very slowly and we will see a bear flattening of the yield curve. Traditionally 10-year treasury yields have averaged around 4%, broken down roughly into 200bps of inflation and 200bps of return for investors. We do not expect the Fed to achieve its inflation target of 2% until 2020. On top of that, with so many negatively yielding sovereign bonds (particularly in Europe and Japan), investors will no longer demand 200bps of return. We do not think 10-year treasury yields will reach 4% until the end of our five year forecast period.

Another possibility is that long-term yields will drop now that the Fed has begun the rate hiking cycle. According to this argument, investors have been steering clear of US treasuries because of the uncertainty surrounding the timing of liftoff in the US. Now that the Fed has removed that uncertainty, investors desperately seeking a safe haven – of which there are very few – will pile into US treasuries, pushing prices up and yields down.

Whether long-term yields rise slowly or drop now that the Fed Funds rate is rising, one thing is certain: interest rates will remain low for a very long time, even in the one country that is tightening monetary policy.

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[10] Bloomberg data, as of 15 December