US interest rates: The Fed stays put

The Federal Open Market Committee (FOMC) voted to keep the Federal Funds rates unchanged last week, maintaining its target range of between 0 and 0.25%[1]. The decision put an end, for now at least, to weeks of speculation. Manulife Asset Management's chief economist Megan Greene examines the reasons behind the decision, and its implications.

Rarely has so much ink been spilled on absolutely no change as in the immediate aftermath of a US Federal Reserve (Fed) rate hold. As with all central bank meetings, the real meat was in the press conference afterwards. Chairwoman Janet Yellen cited a number of reasons for the Fed keeping the Fed Funds rate where it is. The thing is, these reasons are unlikely to change in the next few months. I have long been in the "December" camp for when the Fed will hike rates, but this FOMC meeting made it clear that all of the risks are to the later side.

Why hold?

Yellen highlighted some key reasons for why the FOMC decided almost unanimously to keep rates on hold. She discussed in some detail the remaining slack in the labour market that is not captured in the unemployment rate but is exhibited in low labour force participation and a high number of part-time workers. She also – for the first time – focused on external global concerns.

As I have said before, the slack in the labour market has very slowly improved over the past few years, but there are indications that it still has a way to go[2]. This is clearly seen in the data reflecting wage growth, of which there hasn't been much. This is driven in part by a global glut of labour, so this trend is unlikely to shift any time soon.

As for external global concerns, Yellen specifically mentioned lower commodity prices and soft exports, which seemed to be in direct reference to China. From this perspective, China is unlikely to have rebalanced its economy, liberalised its currency and stabilised its equity markets over the next few months. Similarly, other central banks are likely to continue their monetary easing as investors look towards the next potential liftoff date for the Fed, and so the US dollar is likely to remain strong.

New liftoff?

The next potential date for a Fed rate hike is in October, but it is extremely unlikely the Fed will lift off then. There is no press conference scheduled to accompany the October meeting, and while the Fed could scramble one at the last minute, it would be fairly obvious to investors what was coming.

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[1] FOMC Statement, September 17 http://www.federalreserve.gov/newsevents/press/monetary/20150917a.htm
[2] WSJ: US Jobless Claims Fall http://www.wsj.com/articles/u-s-jobless-claims-fall-by-11-000-last-week-1442493095

That leaves 16 December as the next meeting at which the Fed is likely to hike rates. I have long argued that the Fed would hike in December because baked into the Fed's forward guidance was the clear message that rates would start normalising this year. I still consider this to be most likely, but there are a number of risks that make me think the Fed might wait until next year to hike rates.

First, none of the risks that Yellen highlighted in her press conference will have dissipated by December. For that reason, I have always thought that the Fed SHOULD wait to hike rates until next year. Second, there is the issue of market liquidity at year-end.

It is hard to know how the Fed feels about tightening monetary policy at year-end. There is some precedent for it, most recently when the Fed started tapering its asset purchases. But this time really is different. When the Fed hikes rates, the New York Fed's markets desk has to be active in the markets actually pushing short-term rates up. Because of the extraordinary easing measures the Fed has implemented in the past, this will require sopping up unprecedented amounts of reserves. Furthermore, there are more players in the market now than last time the Fed hiked rates in a December, which was in 2005[3] – namely, there are more algorithms and fewer traditional big banks participating (the latter because of new regulations). The Fed may therefore want to push liftoff into next year to avoid having it coincide with year-end and a month in which there is typically a dearth of liquidity and a lot of volatility at the best of times.

If the Fed pushes off a rate hike to 2016, it may well have to do so until the second quarter of 2016. The US has tried to address some of the seasonally adjustment issues it has long had with first quarter GDP data, but has a ways to go on this. We can therefore expect first quarter data to look pretty sluggish next year before recovering. The Fed is unlikely to hike rates with potentially grim GDP data coming out.

Déjà vu

With the Fed having kept rates on hold, the frenzy over when liftoff will occur – and accompanying market volatility – will happen all over again in the run up to the December meeting. As has always been the case, the exact timing for a rate hike will ultimately be less important than the path for rates thereafter. Yellen's press conference last Thursday surprised most of us for its dovishness, and I think we can continue to expect the Fed to move very slowly and cautiously as it looks to normalise rates.

[3] Federal Reserve Press Release http://www.federalreserve.gov/boarddocs/Press/monetary/2005/20051213/default.htm