Brief Market Commentary
September 16, 2015

This week's Federal Open Market Committee (FOMC) meeting has garnered significant attention while the financial media has become obsessed with the debate around whether or not the Fed will (finally) raise interest rates. To be sure, monetary policy uncertainty has contributed to recent market volatility and the Fed understandably finds itself in a difficult situation. Put simply—US labor market strength likely argues for higher interest rates, while the lack of inflation potentially warrants ongoing accommodation. Clearly, the Fed's commitment to a "data-dependent" policy is challenged when the data is mixed.

The potential for the first Fed rate hike since 2006 is certainly a newsworthy event. At this point, however, the outcome of this week's policy meeting seems to be a bit of a tossup. As the research firm Capital Economics points out, "there is obviously a pretty even split among the voting members of the FOMC, so there is no point in us pretending that we are confident in one outcome or another."[1] And while we recognize the broad importance of Fed decisions to investors and economic participants, we don't believe that making predictions of this kind is necessary to successful long-term investing.

We provide below some additional background information and share our perspective.

Near-Term FOMC September Decision

- The FOMC will hold its next regularly scheduled policy meeting on Wednesday and Thursday of this week. The Fed's statement announcing any changes to policy will be released at 2pm on Thursday, followed by Fed Chair Janet Yellen's press conference. In addition to the interest rate decision, the Fed will also release its latest economic projections.
- For months, Yellen and her colleagues have been signaling their intention of hiking rates. With this level of transparency in the communication strategy, a move late this year has been well-telegraphed. For example, minutes from the late July FOMC meeting stated that "most judged that the conditions for policy firming had not been achieved, but they noted that conditions were approaching that point".
- At the beginning of 2015, most economists thought the Fed would raise rates by midyear. After an economic slowdown in the first quarter, predictions for the first rate increase coalesced around September. However, expectations for a September rate increase have slid in recent weeks given turbulence in financial markets and worries about China's economic slowdown. Indeed, both the World Bank and International Monetary Fund have said the Fed should delay raising rates until the global economy is more stable.
- According to Capital Economics, under the circumstances, some form of a compromise outcome would not be surprising. "Either the Fed could raise rates by 25 basis points in September while also using the policy statement to rule out a second hike until next year. Or the Fed could leave rates at near-zero this month, but communicate in the accompanying statement that a rate hike was almost certainly coming at either the October or December FOMC meetings."[2]

Macro Backdrop and Monetary Policy Decisions

- As mentioned, the Fed's upcoming rate decision is complicated by the current macroeconomic backdrop. The latest jobs report, released on September 4th, showed unemployment falling to 5.1%—right in the middle of the Fed's estimate of so-called full employment. Yet inflation remains well below the Fed's 2% target—core PCE inflation (the Fed's preferred measure) has been trending lower over the past three years and currently stands at a four-year low of 1.2%. Weak wage growth also suggests that there is still slack in the labor market. Adding to the challenge, the Fed reckons that it takes 18 months for changes in rates to have their full impact. As a result, Janet Yellen has long emphasized that rates may rise before inflation is in sight.[3]

- In the seven years since the world's central banks responded to the financial crisis by slashing interest rates, more than a dozen banks in the advanced world have tried to raise them again—and all have been forced to retreat. This also looms as a threat as Federal Reserve officials contemplate raising interest rates for the first time in nearly a decade. Central banks in the Eurozone, Sweden, Israel, Canada, South Korea, Australia and beyond have tried to raise interest rates in recent years, only to reduce them again as their economies stumbled.[4]
- The sluggish nature of the post-financial crisis recovery and the high levels of debt that remain explain why it has been so difficult for central banks to return to a "normal" level of interest rates. In the past, many central banks were usually raising rates at the same time. But any country that tightens policy at the moment will stand out from the crowd. Foreign capital may drive its currency higher, as investors take advantage of more attractive yields—which will act as a further tightening of policy. US financial conditions have already tightened to some extent due to the stronger dollar and recent widening credit spreads.[5]

Longer-Term Considerations

- Our base case view has been that the Fed will begin raising interest rates sometime late this year, upping the fed funds rate to 0.25%. Given the US economic recovery and strength of the labor market, we believe the Fed is somewhat eager to move away from the crisis-oriented monetary policy of 0% short-term interest rates that came about from the 2008 Great Recession. Whether or not the first hike occurs in September or December is a bit of guessing game and somewhat inconsequential. In our view, the longer-term pace and magnitude of rate hikes matters most.
- With overall debt levels in developed economies still high, a big rise in borrowing costs would be a shock to debtors. So central banks have emphasized that any tightening in monetary policy would be slow and steady, and that the "normal" level for rates may be well below those prevailing before 2007.[6]
- Both short-term interest rates and longer-term bond yields are likely to rise over the long run, but we believe will remain low by historical standards and range-bound in the near-term. U.S. and global economic growth simply isn't strong enough to warrant materially higher interest rates and limited inflationary pressures currently exists. In addition, rising rates could potentially occur under a few different scenarios—better economic growth, rising inflation, or a loss of confidence—each of which likely has a different impact on financial markets.
- Central banks have historically erred on the side of raising rates too little too late. The result is that inflation starts to spiral out of control, eventually forcing a more aggressive tightening of policy than would originally have sufficed. However, according to BCA Research, the biggest current policy risk is that the Fed will find itself "ahead of the curve", having raised rates too quickly and by too much. One could argue that this is hardly a serious concern given that rates are currently at rock-bottom levels. However, rates have been zero for nearly seven years and inflation has yet to rear is head while economic growth had disappointed. This suggests that the economy has "needed" low rates.[7]
- According to research by Capital Economics, historically the US stock market has tended to fare quite well during previous Fed tightening cycles. In the last seven major tightening cycles since the early 1970s (defined as instances when the cumulative increase in the federal funds rate exceeded one percentage point), on average the S&P 500 rose by almost 9% in the eight months or so that preceded the first hike in each of these cycles. In addition, the S&P 500 also gained an average of around 11% in the 21 months after the first rate hike. Yet, none of these past seven cycles featured unconventional monetary stimulus, which has arguably given equity prices a big boost this time around—suggesting that market performance in the next cycle may be sub-par compared to historical average returns.

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[1] Paul Ashworth, Capital Economics, Fed Watch: Odds of a September Rate Hike are 50-50, September 9, 2015.
[2] Ibid.
[3] The Economist, The Fed: More Red lights Than Green, September 15, 2015.
[4] Harriet Torry and Jon Hilsenrath, Wall Street Journal, Lesson for Fed: Higher Interest Rates Haven't Been Sticking, September 13, 2015.
[5] The Economist, A Brief History of Rate Rises: Tightening Pains, September 12, 2015.
[6] The Economist, Buttonwood: With Great Power, September 5, 2015.
[7] BCA Research, Global Investment Strategy Weekly Report: Will The Fed Tell Investors to Take A Hike?, September 11, 2015.