The US Federal Reserve raises interest rates – good news as the US comes off life support

17 DECEMBER 2015
EDITION 42

Key points

> After much delay and much warning the Fed has finally raised the Fed Funds rate from a range of 0-0.25% to 0.25-0.5%. The move signals confidence in the ongoing recovery in the US economy after the GFC.

> Given ongoing deflationary risks and slow global growth future Fed hikes are likely to be cautious and gradual.

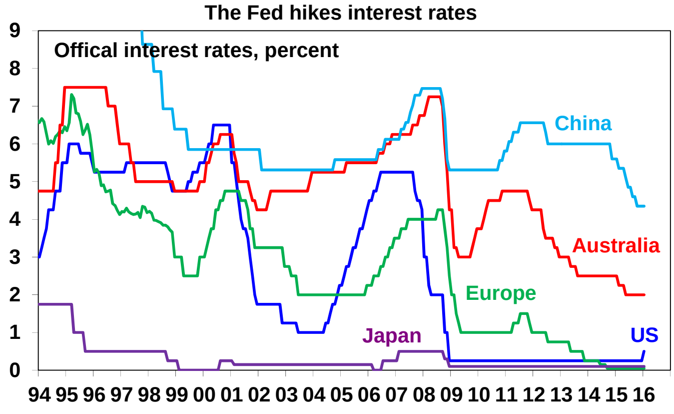
> With the Fed decision out of the way, global shares are likely to resume their rising trend but with US shares as a relative underperformer.

> Bond yields are likely to remain low which should be positive for real assets.

> Rising US interest rates will help maintain downwards pressure on the value of the $A through 2016.

Introduction

In the most anticipated and hotly debated interest rate decision ever the US Federal Reserve has opted to raise its Federal Funds target interest rate from a range of 0-0.25%, where it's been for the last seven years, to the range of 0.25-0.5%.



Source: Bloomberg, AMP Capital

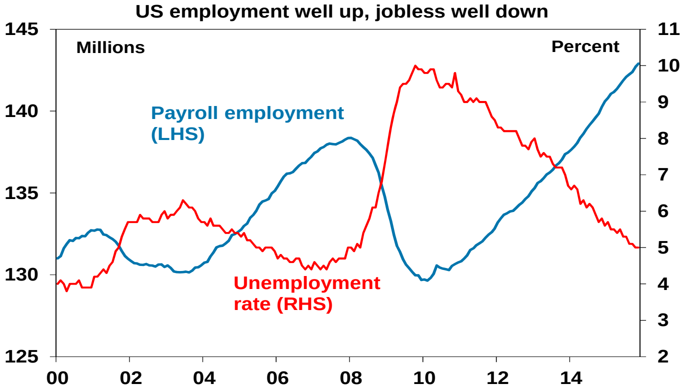
The move is hardly a surprise. The Fed has been talking about a rate hike ever since ending quantitative easing over a year ago. After being delayed in June and September, due to a combination of soft US data and financial market turmoil, the Fed has given ample warning recently of a December hike provided there were no unanticipated shocks and that economic data is consistent with further labour market improvement and confidence that inflation would rise. In the absence of any major shocks and with US economic data mostly favourable, the US money markets had effectively moved to price in the tightening.

More importantly the move should be seen as a "dovish hike" in that while the Fed has hiked the commentary around it was relatively dovish with the Fed indicating that it expects future increases in the Fed Funds rate to be "gradual" and dependent upon further "actual and expected progress towards" its inflation goal of 2%. Federal Reserve officials also lowered their median expectation for the Fed Funds rate (known as the "dot plot") for end 2017 from 2.625% to 2.375%.

At its core the Fed's move is positive as it signals that the US economy is strong enough to be further taken of the life support that has been in place since the global financial crisis (GFC). Against this though it's understandable for investors to be wary as they have become used to zero interest rates for so long.

Why the hike?

The reasons for the hike are simple. The extraordinary monetary easing since the GFC (zero interest rates and three rounds of quantitative easing) have done their job in seeing off the risk of a depression and returning US growth to reasonable levels. Jobs are now well up on pre GFC levels, unemployment is down to 5%, confidence is up, the housing sector has recovered and business is investing. And since inflation normally turns up with a lag after the jobs market has improved the Fed feels there is a strong argument to get going now.



Source: Bloomberg, AMP Capital

What does it mean for investment markets?

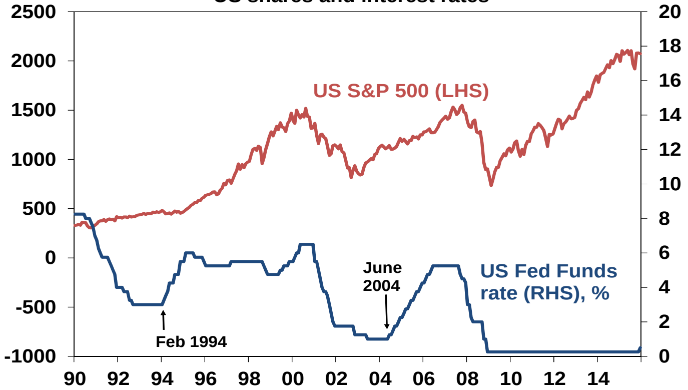
There are several reasons not to be too concerned about the Fed's shift to a tightening cycle:

- First, and perhaps most importantly the rate hike is a sign that the world's biggest economy is getting back to normal after the havoc of the GFC. This is a good news.
- Second, US economic downturns/recessions have historically only come three years after the first Fed rate hike in a tightening cycle. In fact, recession did not come for seven years after the February 1994 first hike and for three and a half years after the June 2004 first hike. This is because the first rate hike only takes monetary policy from very easy to a bit less easy and it's only when monetary

policy becomes tight after numerous rate hikes that the economy gets hit. This is often signalled by long term bond yields falling below short term interest rates. And we are a long way from that.

So while there can be share market wobbles around the first Fed rate hike after major easing cycles – just as we have seen this year – sustained problems usually only set in when monetary policy has become tight. This can be seen in the next chart. Shares had wobbles when interest rates first started to move up in February 1994 (US shares had a 9% correction at the time) in June 2004 (US shares had a 8% correction at the time) but thereafter they resumed their rising trend and a bear market did not set in till 2000 and 2007 after multiple hikes and with recessions looming.

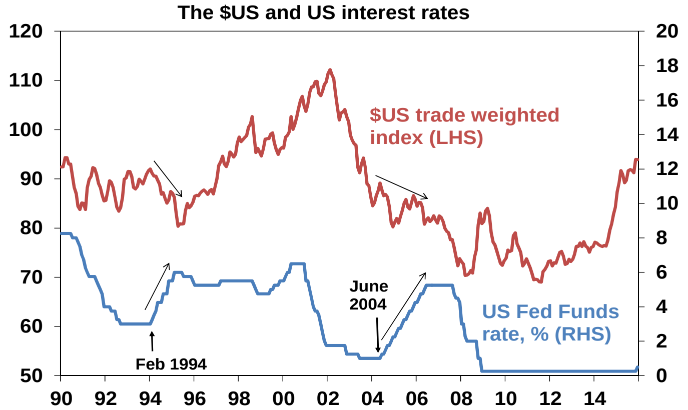
US shares and interest rates



Source: Bloomberg, AMP Capital

- Third, other major countries – Europe, Japan, China and Australia – are still easing or are at least a long way from monetary tightening. So global monetary conditions will remain very easy which is positive for growth assets.
- Fourth, while US shares are expensive on some measures after having outperformed since the GFC other share markets are relatively cheap. This is not 2000 or 2007.
- Fifth, fears around an ever surging US dollar reaping havoc on US multinationals, commodity prices and emerging countries (via potential debt servicing problems) are overdone. For one thing despite widespread views to the contrary the relationship between US interest and the US dollar looked at on a trade weighted basis is rather messy.

The $US and US interest rates



Source: Bloomberg, AMP Capital

The $US actually fell through the Fed rate hike cycles of 1994-95 and 2004-06. In fact, the 20% rise in the value of the $US over the last two years could turn out to be a case of "buy on the rumour/sell on the fact", to the extent it's anticipated the Fed. What's more the Fed is not oblivious to the $US as its gain over the last year is akin to around 150 basis points of US interest rate hikes in terms of bearing down on growth and inflation so it's been doing the Fed's job for it. So the rising $US will likely constrain the Fed, which in turn will limit upside in the $US itself.

- Finally, and related to this, the Fed is likely to be gradual. The experience this year with further global growth disappointment, falling commodity prices and falling/low inflation highlights that deflation remains a greater risk than inflation. As a result Fed rate hikes are likely to be very gradual and closer to market expectations for the Fed Funds rate to rise to 1.1% by the end of 2016 and 1.6% by end 2017 than the Fed's median "dot plot" expectations for 1.375% by end 2016 and 2.375% by end 2017. This means that easy US monetary policy will likely be with us for some time. Combined with still ultra easy/easing monetary policy in other major countries, this suggests that bond yields are likely to remain low with any rise being very gradual.

In summary, with the Fed's decision out of the way and future rate hikes likely to be gradual:

- Shares are likely to resume their rising trend but with US shares being a relative underperformer. I find it hard to get bullish on emerging market shares generally but that has more to do with their own structural problems than the Fed.
- Real assets like commercial property and infrastructure are likely to benefit from ongoing low bond yields and the search for yield.
- Bonds are likely to offer constrained returns reflecting low yields, but a sharp sell-off is unlikely in the absence of a much more aggressive Fed.

Risks

While past experience suggest little reason to be too concerned by the first US rate hike, there are a few risks. In particular: the Fed is still underachieving on its inflation objective; global growth is still fragile and if the Fed's rate hike does put more pressure on the value of the $US, the Fed may have made life more difficult for emerging countries; the combination of lower energy prices and higher US interest rates has led to an intensification of stress in the US credit market, as highlighted by some mutual funds that invest in junk bonds freezing redemptions (something certainly worth keeping an eye on).

There is long list of countries that have raised interest rates since the GFC – including Europe and Australia – only to cut them again. Japan had a similar experience in the 2000s. So there is always a risk the Fed may have made a similar mistake.

But the Fed does have the flexibility to keep its Fed Funds rate at the low end of its new range which would mean hardly any effective interest rate increase anyway. More importantly, most of these considerations simply reinforce the argument for the Fed to be cautious and gradual in raising interest rates. Its commentary – and common sense – suggest it will be.

Impact on Australia

To the extent that the Fed's interest rate hike signals a stronger US economy its good news for Australia. It doesn't signal that higher Australian interest rates are on the way though. Australian rates often follow the big swings in US rates, but in recent times they have diverged. With the Australian economy on a weaker trajectory relative to its potential than the US economy, the RBA will not be following the Fed into a rate hike. In fact, the odds remain that the RBA will have to cut again as the mining boom continues to unwind, the contribution to growth from housing starts to peak next year and inflation remains low.

The main relevance of the US rate hike is what it means for the $A. With the Fed undertaking a dovish rate hike there is a risk that a further fall in the $A will be further delayed. But as the Fed undertakes more albeit gradual rate hikes next year, the RBA retains an easing bias and commodity prices remain weak the trend in the $A is likely to remain down with it heading to around $US0.60 sometime in the next 12 months.

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