Interest Rate Policy Conundrum

March 17, 2015

With the Federal Reserve (Fed) conducting their regularly scheduled FOMC meeting this Wednesday, we point out an interesting contrast between the current posture of the Fed which suggests they are leaning toward Fed Funds rate hikes versus prior post-crisis policy.

When the Fed lowered Federal Funds rate to zero percent in December 2008, various forms of Quantitative Easing (QE) were used to further ease monetary policy, decrease longer-term interest rates and stimulate the economy. Since 2008 there have been three separate instances of QE. Additionally, an action termed "Operation Twist" allowed the Fed to sell shorter term bonds they recently bought and use the proceeds to purchase longer term bonds. Economic activity reversed course with these actions.

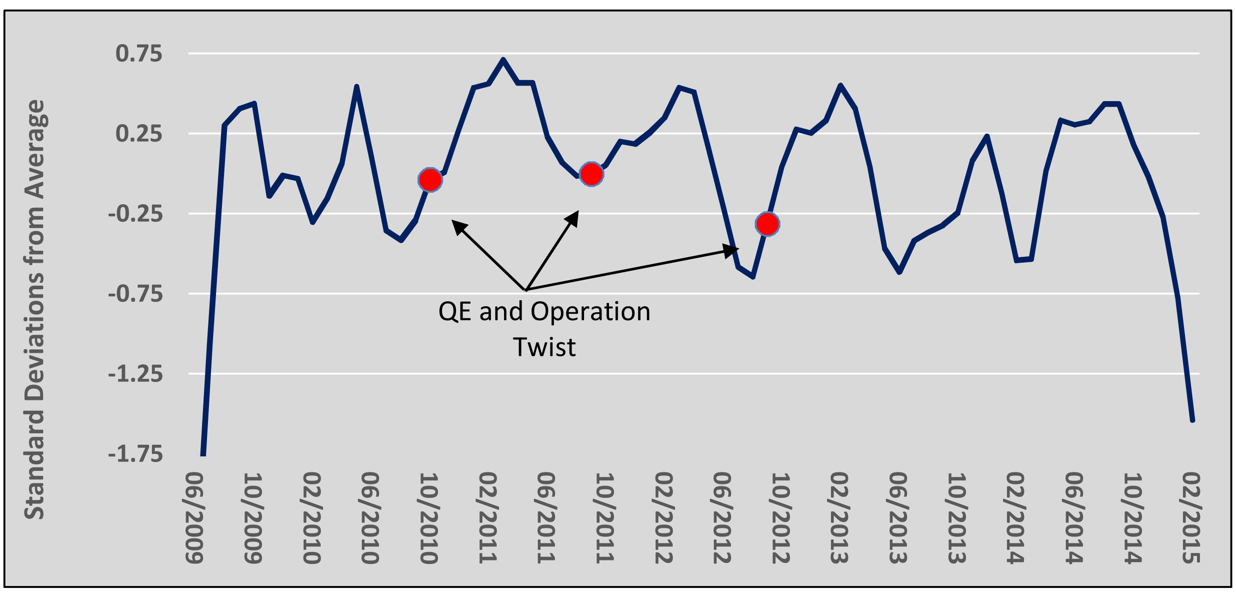
The first round of QE started in 2008 concurrent with the move to a zero interest rate policy to combat deep economic contraction and a severe banking crisis. The following two doses of QE and Operation Twist were done in efforts to reverse slowing economic data. Except for on-going asset purchases aimed at maintaining the current level of the Fed's balance sheet, QE3, the latest occurrence of QE, ended last October and was quickly followed by Fed discussions of potential interest rate increases. Based on various speeches by Federal Reserve Chairwoman Janet Yellen and her colleagues, many market participants believe the Fed could raise the Federal Funds rate as early as the June 17th meeting.

Talk of raising interest rates introduces a new Fed conundrum. Over the last few months, Federal Reserve Board members have maintained a less dovish tone which implies the eventuality of rate hikes despite economic data which has been slowing rapidly. The singular exception to weaker data has been the employment figures which have continued to improve. Based upon a composite of economic data readings, the prior policy stance would have called for more QE (or rate decreases if not zero bound) given the weak levels of economic data as well as the trends.

As we illustrate below, a case can be made that, excluding 2008, the economy is weaker now than prior to the announcement of the previous QE actions and Operation Twist. Further confounding the Fed stance is inflation, which as measured by CPI is running lower than at any time since 2009. Additionally the strong dollar and global deflationary trends point to lower inflation and possibly deflation in the coming months.

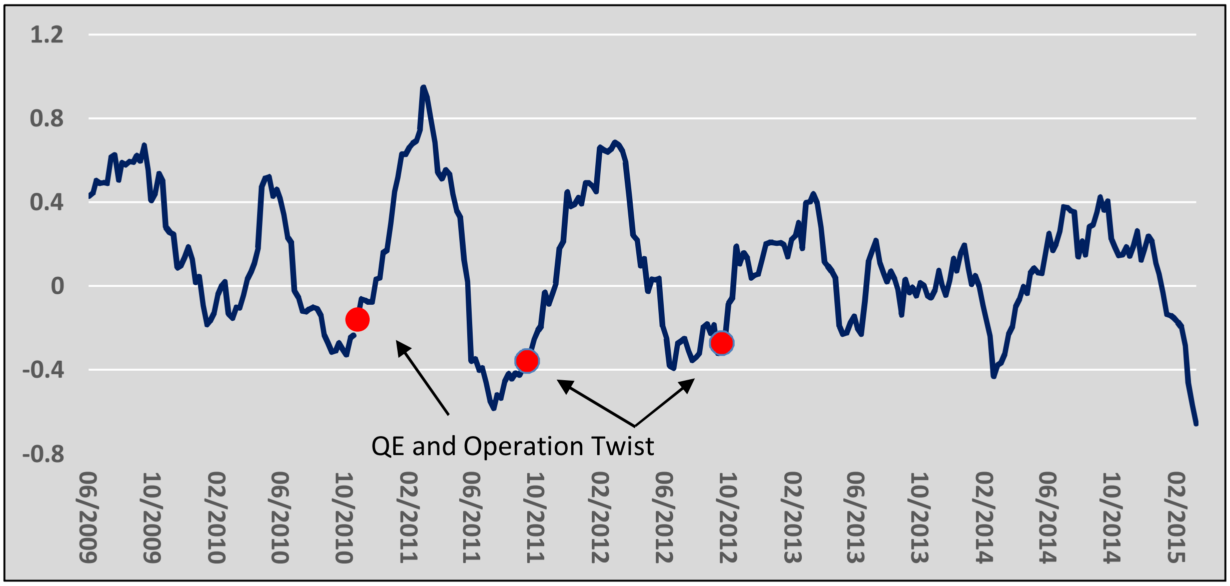
Graph 1, below aggregates eight key economic statistics and compares the most recent three month period to the average of the prior six months. This gauges the relative strength of data trends over the last nine months. Graph 2, the Bloomberg Economic Surprise Index, measures current economic data releases, like our trend model, but instead compares them to Wall Street economists' expectations and not prior data. The combination of graphs 1 and 2 confirm that economic data has slowed both sharply and unexpectedly. Finally, graph 3 charts CPI as compared to the Fed's self-mandated 2% inflation target.

Graph 1 – 720 Global Economic Data Trend



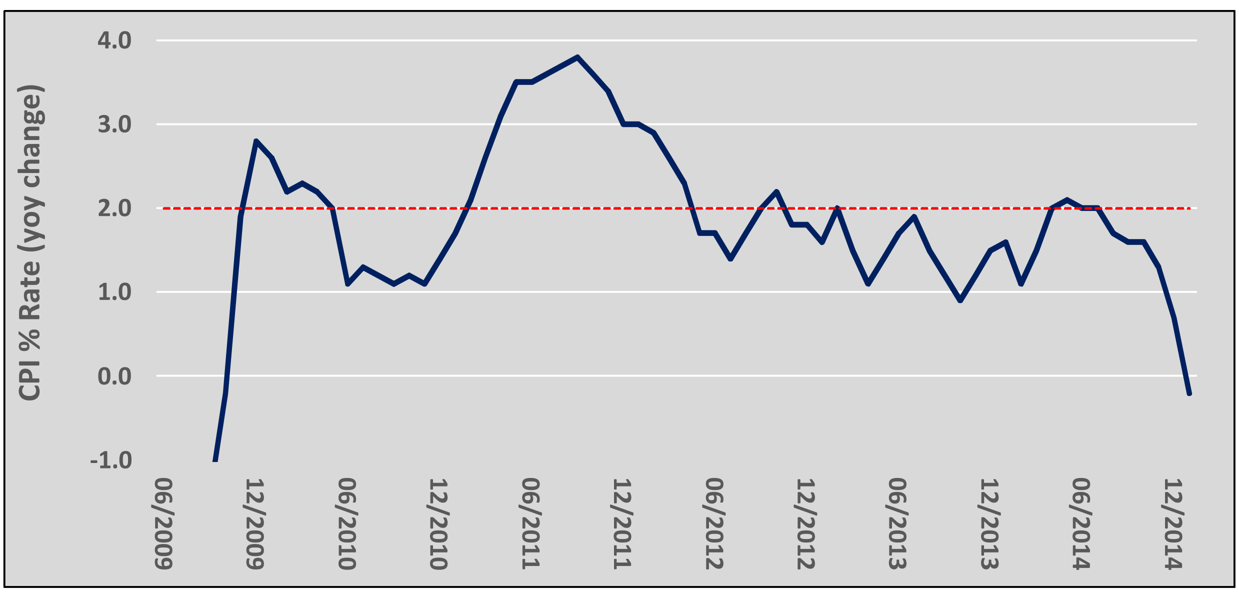
The following economic data was used for this graph: ISM, CPI, Industrial Production, Housing Starts, PCE, Durable Goods, Employment, and Retail Sales. Data Courtesy of the Federal Reserve Bank of St. Louis (FRED).

Graph 2 – Bloomberg Economic Surprise Index



Data Courtesy of Bloomberg

Graph 3 – CPI and 2% Inflation Target



Data Courtesy of the Federal Reserve Bank of St. Louis (FRED).

The Fed’s current language and posture are significant departures from monetary policy since the financial crisis. The soaring dollar and declining bond yields seem to be pricing in this new dynamic. Equities and other risk markets on the other hand do not reflect any noticeable concern. If Fed policy continues to shift toward rate hikes we expect market volatility to dramatically increase and equity markets and other risk assets to experience meaningful corrections. Current equity market valuations are at or near record extremes by several measures and well above fair value by most. Over the last 6 years, equity prices have been driven not by fundamental economic data but on an explicit promise and variety of actions from the Fed to support asset prices. To the extent this promise truly is coming to an end in its current form, it likely implies radical changes for asset prices and market behavior and warrants caution.
