

The US economy, the Fed and interest rates

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Key points

- > With the US economy on the mend, the focus will likely soon shift to when the Fed will start to raise interest rates. This could cause some volatility in shares.
- > However, a Fed rate hike is probably still a year away at this stage and history tells us that it's only when rates reach onerous levels that they become a real threat to share markets and ultimately economic growth.
- > Rate hikes are further away in the Eurozone and Japan, which may still need further monetary easing.
- > Steady progress towards eventual rate hikes in the US will further relieve pressure on the \$A over time.

Introduction

A constant for investors over the last five years has been very easy global monetary conditions, with near zero interest rates and quantitative easing programs in the US, Europe and Japan. This has helped the global economic and share market recoveries since the GFC. But with the US economy on the mend the time will come when it will be appropriate to start unwinding the monetary stimulus. Already the Fed has been winding down its quantitative easing program. And with it likely to end later this year and the US economy picking up from a winter slumber, the next big issue for investors may well be when the Fed will start to raise interest rates.

This note looks at the key issues, taking a Q&A approach.

Why were interest rates cut to zero?

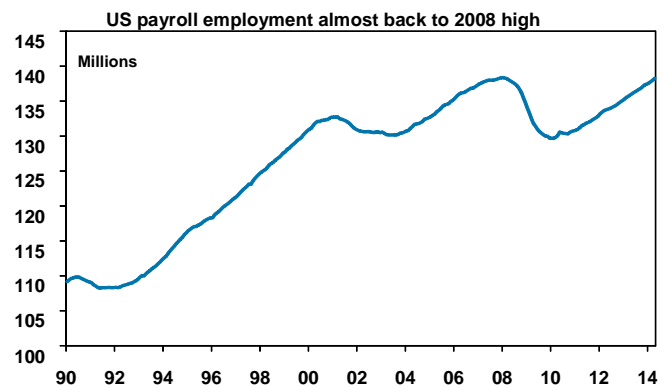
By way of background, it's first worth thinking about how we got here. Put simply it was just part of the cycle: growth weakened and so monetary conditions were eased. But of course the GFC related slump in the US and most developed countries was deeper than normal downturns with companies and households more focused on reducing debt. So once interest rates hit zero and it was apparent the recovery was still sub-par, the focus shifted to measures to boost the supply of money. This became known as quantitative easing (QE) and involved the Fed printing money and using this to buy government bonds and mortgage backed debt. It helps growth by reducing borrowing costs, injecting cash into the economy, forcing investors to take on more risks, and to the extent it drives shares higher, it helps build wealth that helps spending.

Is the US economy on the mend?

The short answer is yes. A range of indicators suggest that the headwinds to growth in the US have abated and the economy is now on a sounder footing:

- companies and businesses look to have stopped trying to reduce their debt;
- bank lending growth is trending higher;
- house prices have been recovering and housing construction has picked up;

- consumer spending has picked up;
- business investment looks stronger;
- business conditions indicators (often called PMIs) are running around levels consistent with solid growth; and
- the level of employment is nearly back to its early 2008 high and unemployment has fallen to 6.3%.



Source: Bloomberg, AMP Capital

In particular, a range of indicators for confidence, jobs, durable goods orders, etc, suggest that growth is picking up after a winter soft patch. Finally, while inflation remains very low at 1.5%, it appears to be bottoming.

When will QE end & what happens after that?

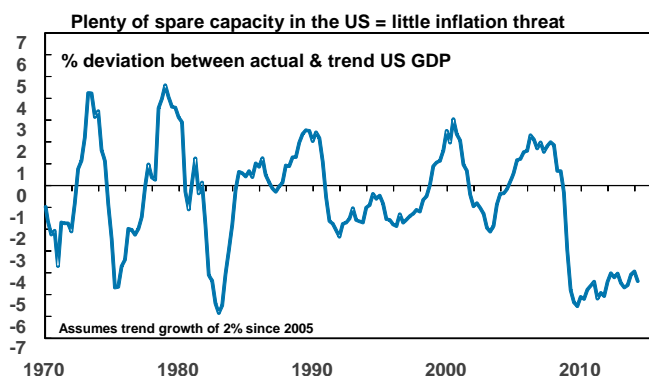
The continuing improvement in the US economy suggests that the Fed will keep tapering its QE program by \$US10bn a month at its six weekly meeting. QE3 started at \$US85bn a month in bond purchases in late 2012 and following the start of tapering in December last year has now been cut to \$US45bn a month. At the current rate it will have fallen to just \$US5bn in October and to zero at the December meeting. In other words it's on track to end late this year.

After QE has ended the next step would be for the Fed to actually start tightening monetary policy. This could come in the form of reversing its QE program (ie unwinding the bonds it holds) or raising interest rates or a combination of the two. Raising interest rates is simple, but unwinding its bond holding is a bit more complicated. It could do this by: not replacing the bonds as they mature – ie the Fed gets paid back just like any bond investor; or actively selling them back into the market. I suspect more of a reliance on the former as it's less disruptive but of course it may take 5 to 10 years.

How long before the Fed raises interest rates?

While US economic growth looks to be picking up, US interest rate hikes are still probably 12 months or so away:

- Growth is still far from booming.
- Spare capacity remains significant with a wide output gap, ie the difference between actual and potential GDP. See the next chart.



Source: Bloomberg, AMP Capital

- While the unemployment rate has fallen to 6.3%, the labour market is a long way from being back to normal. A slump in labour force participation has exaggerated the fall in the unemployment rate. While much of this is structural, some is cyclical and at some point will bounce back slowing the fall in unemployment. Labour force underutilisation, which includes unemployment and those who want to work longer, at 12.3% is well above its average of 8.8% when the Fed was last raising rates
- Wages growth is up from its 2009 low, but it remains very weak currently running at just 1.8% year on year.



Source: Thomson Reuters, AMP Capital

What about the impact on the share market?

Just like talk of tapering upset shares around the middle of last year, so too a move towards the first monetary tightening could cause a similar upset. However, beyond a short term upset, when the initial monetary tightening comes it is unlikely to be a huge problem for shares.

First, the historical experience tells us the start of a monetary tightening cycle is not necessarily bad for shares. The next table shows US shares around the first rate hikes in the past 8 Fed tightening cycles. The initial reaction after 3 months is mixed with shares up half the time and down half the time. But after 12 and 24 months a positive response dominates.

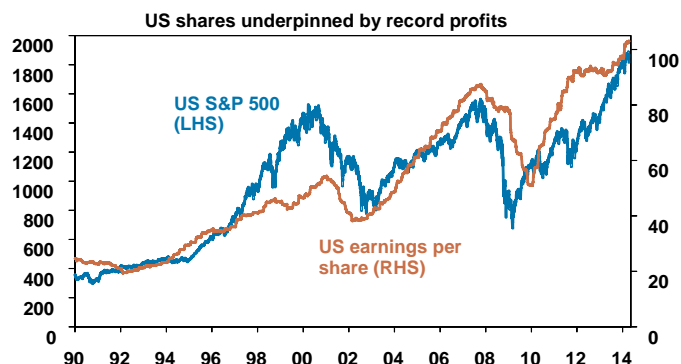
US shares after first Fed monetary tightening moves

| First rate hike | -3 mths | +3 mths | +6 mths | +12 mths | + 24 mths |
|-----------------|------------|------------|------------|------------|-------------|
| Oct 80 | 4.8 | 1.6 | 4.2 | -4.4 | 2.4 |
| Mar 84 | -3.5 | -3.8 | 4.3 | 13.5 | 22.5 |
| Nov 86 | -1.5 | 14.0 | 16.4 | -7.6 | 4.8 |
| Mar 88 | 4.8 | 5.6 | 5.0 | 13.9 | 14.6 |
| Feb 94 | 2.9 | -6.4 | -4.9 | -2.3 | 14.9 |
| Mar 97 | 2.2 | 16.9 | 25.1 | 45.5 | 30.3 |
| Jun 99 | 6.7 | -6.6 | 7.0 | 6.0 | -5.6 |
| Jun 04 | 1.3 | -2.3 | 6.2 | 4.4 | 5.5 |
| Average | 2.2 | 2.4 | 7.9 | 8.6 | 11.2 |

Source: Thomson Reuters, AMP Capital

The reason for this lies in the improvement in growth and profits that normally accompanies an initial monetary tightening. It's only later in the cycle when rates interest rise to onerous levels to quell inflation that it's a worry. At this point short term interest rates have invariably pushed above long term bond yields. Right now we are a long way from that.

Secondly, the rally in shares over the last five years is not just due to easy money. Easy money has helped, but the rally has been underpinned by record profit levels in the US.



Source: Bloomberg, AMP Capital

Finally, shares are likely to benefit from long term cash flows as the mountain of money that has gone into bond funds since 2008 continues to gradually reverse.

So while talk of Fed rate hikes and their eventual reality could cause a correction as bond yields rise, they are unlikely to be enough to cause a major share market slump.

What about other economies?

The global economy is far from a synchronised cycle regarding interest rates. While the US is gradually heading towards monetary tightening, the rest of the world is different:

- The Eurozone may still require further monetary easing as bank lending and inflation remains extremely low;
- Japan is in a similar situation with the April sales tax hike having disrupted growth and a stalling in the decline of the Yen threatening progress towards the Bank of Japan's inflation objective;
- Many parts of the emerging world have already been through a tightening cycle which has seen a cooling in growth and so could see an eventual monetary easing over the next 12-18 months.

In other words, global monetary conditions are likely to remain relatively easy for some time.

What about Australia?

For Australia, an eventual move towards monetary tightening in the US may come as a relief as it will help remove upwards pressure on the \$A, allowing it to fall towards \$US0.80 which we judge to be necessary to deal with Australia's relatively high cost base.

Concluding comments

With the US economy recovering from its winter slumber the next big issue for investors may well be when the Fed will start to raise interest rates. While this could contribute to a significant correction, even when US interest rates do start to rise we are a long way away from tight monetary conditions that will seriously threaten the cyclical rally in shares.

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