Investment Spotlight

ANZ Wealth Chief Investment Office

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US rate hikes – perception versus reality

When we think of US Fed interest rate hikes we tend to see them as a definitive way of tightening financial conditions to slow the economy, with knock-on impacts to the share market. However, reality is not quite that simple.

Background

At its March meeting, the US Federal Reserve (the Fed) increased the key federal funds rate (FFR) by 25 basis points (bps), bringing it to the 0.75%-1.00% range. According to the Federal Open Market Committee, "this increase was viewed as appropriate in light of the further progress … made toward the Committee's objectives of maximum employment and 2% inflation."

This move was largely in line with the market's expectations, though perhaps a little early. Most surprising was the central bank's dovish tone when delivering the news. The Fed continued to emphasise the gradual nature of its expected rate hikes as it looks for a level of 3% in three years' time. The Fed anticipates two more hikes in 2017.

Are conditions actually tightening?

While the FFR is 75 basis points higher than December 2015, does this mean that financial conditions are actually tightening?

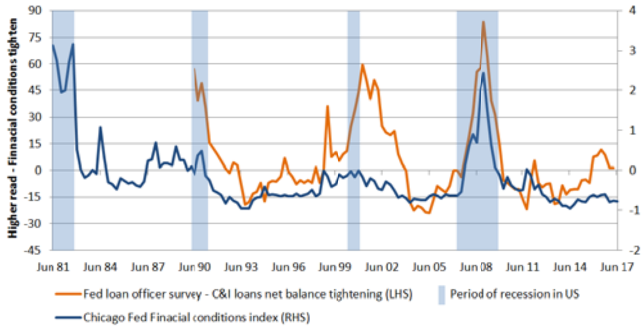
When we talk of financial conditions for the economy, this is about the cost and availability of finance. It's more than just the level of one particular interest rate and is naturally complex to measure as there are numerous ways for companies, households and governments to fund their spending.

Fortunately for the US, the Chicago Federal Reserve Bank has combined a range of financial variables such as the US yield curve (10 year minus 2 year), the US trade weighted currency index, credit spreads for corporate and mortgage debt, residential and commercial property price index and volatility measures for shares and bonds.

These factors are weighted to capture their relative importance to give us the National Financial Conditions Index (NCFI) (Chart 1). History shows that a level of 0 or higher is typically consistent with a period of recession. At its current level of (-0.8), it's consistent with continued strong economic growth. In fact since the Fed started tightening over 12 months ago, it suggests financial conditions have eased, not tightened (Chart 2).

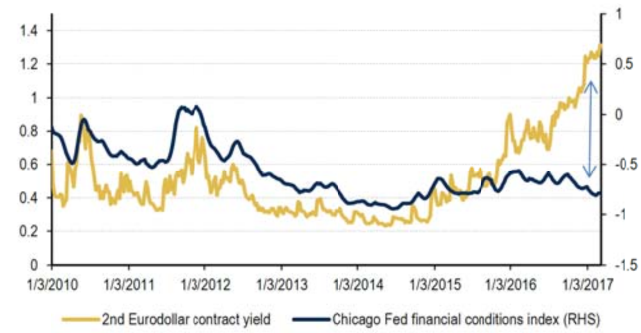
While financial conditions have eased, the Senior Loan Officer Opinion Survey on Bank Lending Practices (SOSLP) is somewhat tighter and broadly neutral in contrast to financial conditions, which have remained as accommodative as possible. This has happened before – see the 1990s and 2000s cycles. In both episodes, financial conditions eventually tightened in line with the SOSLP.

Chart 1: Financial Conditions & the Economy



Source: Bloomberg, ANZ Wealth

Chart 2: Currently - high rates, easier conditions



Source: Bank of America Merrill Lynch

This isn't the first time it's happened

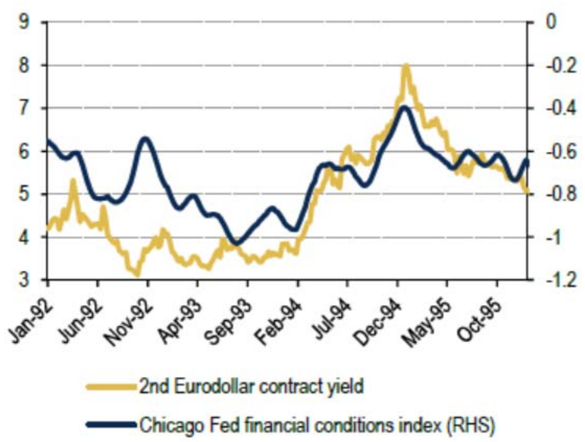
Last decade we saw a similar situation when higher short-term interest rates didn't follow through to tighter financial conditions (Chart 3). Looking back at the period between 2004-2007, New York Fed President William C. Dudley argues "the Fed wasn't really effective in tightening conditions, so (it) didn't really achieve its objective". He also went on to say "this was probably a period where the Fed should have done a bit more" (Source: Bank of America Merrill Lynch).

So, although the Fed was steadily raising rates, it still wasn't tightening overall financial conditions. How can this be the case? Significantly, the Fed's gradual tightening was well telegraphed, and it gave no sign it was interested in really slowing down the economy. Therefore markets reacted positively.

This was evident in the tightening spread between high yield (ie high risk) and low risk government bond yields. The market's perception of a falling risk environment resulted in credit being made readily available. Credit conditions didn't tighten until 2008 as signs of a bursting US house price bubble became evident and risk began to be priced in again.

Financial conditions being too easy for too long led to what we now know as the Global Financial Crisis (GFC).

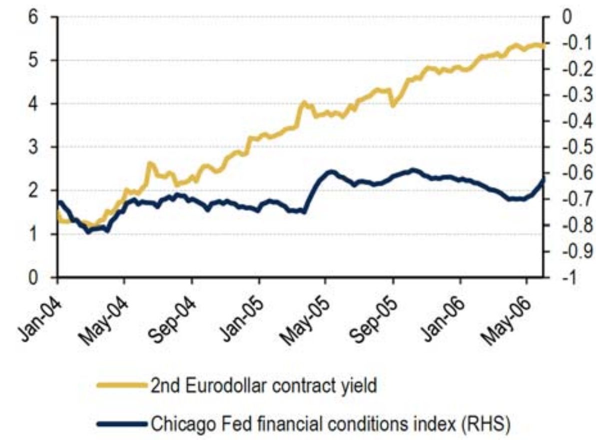
Chart 3: the 1994 hiking cycle



Source: Bank of America Merrill Lynch

This episode, however, stands in contrast to the 1990s cycle when financial conditions did tighten due to a Fed rate hike cycle. While the US economy did end up in recession, it was relatively mild, with unemployment rising by only around 250bps versus the 600bps of the 1980s recessions. This suggests it's better to take the 'medicine' early (ie tighter interest rates) rather than delay it – a case of being cruel to be kind.

Chart 4: 2000s – when conditions tightened



Source: Bank of America Merrill Lynch

Will the Fed tightening we see now be enough to prevent the current cycle ending in tears? First of all, it's still early days. In the past, the Fed has been compared to the one who removes the punch bowl just as the party is getting started. In late March of this year, Dudley noted during a speech at the University of South Florida Sarasota-Manatee, "I don't think we are removing the punch bowl yet. We're just adding a bit more fruit juice".

The Fed's slow reaction this time reflects low inflation and wages growth in the US, Europe and Japan, along with modest growth in debt outside of the government sector. The deflationary and deleveraging forces of the GFC live on, but there are signs these are fading.

The simple message is if the Fed needs to tighten financial conditions there is still quite a bit of work to do.

In conclusion

The US is undoubtedly sitting in a place we'd normally characterise as late in the business cycle, but it continues to have very accommodative financial conditions. Efforts by the Fed so far in raising rates have (if anything) seen financial conditions ease. These moves have encouraged the market to believe the business cycle can be extended, supporting both share and debt markets.

For the moment, the Fed feels it can take its time due to the hangover of the GFC's deflationary and deleveraging headwinds. We don't expect this to change any time soon. So, with the economic cycle extended, we continue to prefer shares over bond markets at present. We're on the lookout for signs the Fed may need to slow growth due to above-target and rising inflationary pressures. Tighter financial conditions eventually lead to a weaker economy and share market, but for the moment this seems to be a risk well into the future.

Mark Rider, Chief Investment Officer

Mark leads ANZ Wealth's Chief Investment Office. He is responsible for delivering the overarching investment strategy, including asset allocation, investment themes, product selection and monitoring, investment compliance, risk and analytics for all client investment offerings.