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Interest rate lift-off – Stay cool

Peter Szopo

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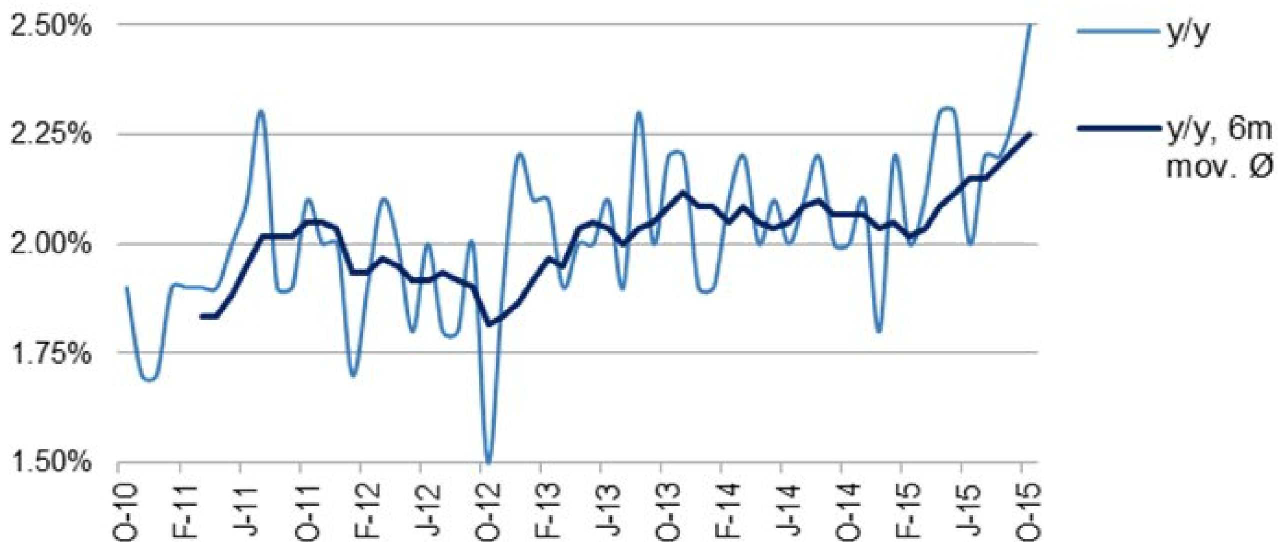
Following last week's surprisingly strong employment report, the odds that the US Federal Bank will start raising its policy rate at the next FOMC-meeting in December jumped to almost 70%. Of course, 70% is still short of 100%, but most observers believe that something terrible must happen in the next four weeks to make the Fed reconsider, particularly in light of President Yellen's statement in September that the FOMC's thinking suggests a "call for a funds rate increase later this year".

While the case for starting the lift-off remains a close call as Kenneth Rogoff pointed out, it has strengthened in recent weeks as US economic data have turned more positive relative to expectations, according to Citi's economic surprise index. Most importantly, the improvement in the job market is continuing. The US economy has been adding, on average, 200,000 jobs in the non-farm sector each month in 2015.

The unemployment rate dropped to 5% and there are signs that the Phillips-curve is doing its job, finally. Average hourly earnings are now growing at an annual rate well above 2%. This may still not be exactly the "whites of inflation's eyes", which Paul Krugman wants to see before any rate hike, but it is a sign that deflation risks are receding.

US: Avg. hourly earnings



Source: Bloomberg; Erste Asset Management

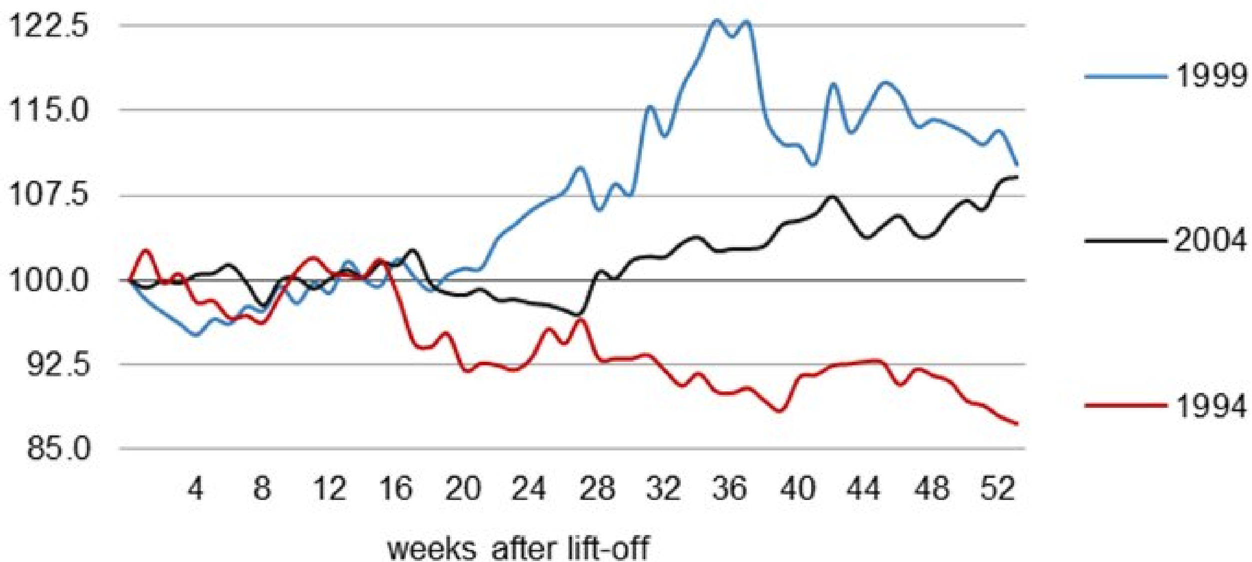
The possible fallout from a December lift-off has been a big issue in the financial press and the international blogosphere, as well as in the minds of the policy makers themselves. However, it is far from obvious that an increase of the Fed Funds Rate by 25 basis points – and nothing else is realistic – in December would have serious repercussions: As mentioned before, there has probably never been a monetary measure that was publicly discussed in more depth than the Fed's next interest rate move. The surprise effect should be very benign.

Second: The link between policy and market rates is weak, with the sign depending on the circumstances. Based on previous examples (1994, 1999, 2004), the rate lift-off will mainly affect the short end of the yield curve, while the impact on long-term rates – which are more relevant for the real sector – and on interest rates outside the US will probably be limited. In any case, we will most likely see some curve flattening following after the Fed's move.

Third: The performance of equity markets during previous periods of rising rates does not suggest that rate lift-offs are followed by lasting bear markets.

For example, in 1999 and 2004, both US and European stock indices – after minor losses in the first months immediately after the event – posted significant gains during the twelve months following the Fed's first rate move. It is also noteworthy, that there is no strong pattern regarding the relative performance of US and European equities after US rates were starting to move upwards.

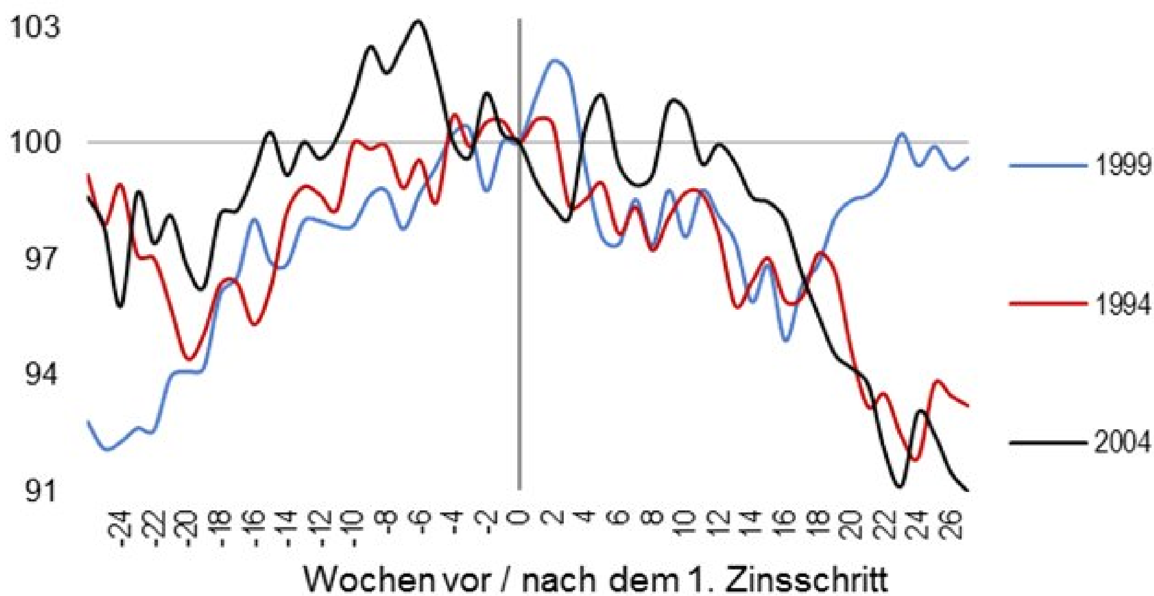
Euro Stoxx 600, S&P 500 - relative*



*Source: Bloomberg; Erste Asset Management. *) Local currency*

Fourth: From a US perspective, one of the main fears is that the possible rate hike will lead to further dollar strengthening, which in turn may threaten US economic growth. In addition, emerging economies with high foreign debt may suffer. However, the chart below shows that in the previous three cases of rate lift-offs this has not happened.

USD Spot Index



Quelle: Bloomberg; Erste Asset Management

In fact, the US currency started strengthening 4-6 months before the rate hike and softened after the fact. Of course, this time it may be different considering that major central banks outside the US maintain or consider even extending a policy of monetary easing. That said, the USD spot index (Bloomberg: DXY) already gained 25% since mid-2014 and the real trade-weighted dollar index is at its highest level since 2005. The dollar's further upside, therefore, might be limited (although it is worth remembering that exchange rates are notorious for overshooting).

No reason to get scared

The main message from looking at previous experiences is that the response of financial markets to the lift-off in December will likely be less dramatic than widely expected. More important than the timing of the first move itself will be which signals the Fed will be sending out with regard to the path of interest rates during 2016 and beyond. President Yellen already stated

that the ‘normalization’ – a term requiring a separate discussion – will be take longer and will be less steep than during previous periods when rates were hiked. Currently the market expects a very moderate increase in the Fed Funds Rate until the end of 2016 (to around 1%). Any indications that the Fed would move more aggressively would be taken negatively (as long as the growth outlook remains broadly unchanged),whereas any signals that rates will not be raised at all in the foreseeable future will probably confirm expectations that the world is moving towards deflation.

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