Wednesday 11 March 2015

Prepare for turbulence

The official short-term interest rate as set by the US Federal Reserve has been a range between zero and 0.25 percent since December 2008.

The Fed's chair, Janet Yellen, told a congressional committee last month that this rate would, on current expectations, be the subject of central bank tightening later this year.

Following Yellen's appearance in Washington her Federal Reserve colleagues fanned out across the United States bearing the message that official interest rates which are the most potent weapon in the Fed's monetary arsenal were going to be raised later this year.

This marketing blitz was aimed at soothing any apprehension that the change in policy would be anything other than incremental, smooth and seamless.

Back in 1994, the Fed precipitated a financial crisis when it unexpectedly raised interest rates that had been set at the favourable level of three per cent to ease the US economy through the collapse of the nation's savings and loan system.

Compounding the pain involved in that surprise tightening was the Fed's decision to move the rate by a king size 75 basis points in one go.

The Fed was, as they say, behind the curve and had to regain control of policy.

This proved to be a disruptive episode with global dimensions as emerging economies had become quite active in the international bond market.

The crisis in 1994 left a legacy of damaged corporations that were ill prepared for the Asian contagion of 1997-8.

Globally, there were a number of high profile bankruptcies; the most prominent was Orange County, one of the most prestigious and expensive counties in California.

Lessons not forgotten

The lesson of '94 was not forgotten nor fully understood in May 2013 when the then chairman of the Fed, Ben Bernanke, gave a heads up to a congressional committee hearing that the Federal Reserve expected to begin tapering its quantitative easing program later in the year.

Financial markets were much more connected than had been the case in 1994. In addition there had been over the previous decade a quantum leap in global debt exposure across corporate, household and public sectors.

The Bank of International Settlements in its post mortem of what has become known as the "taper tantrum" stated: - "The policy announcements occurred after a prolonged period of exceptional monetary accommodation in advanced economies just as the economic outlook was turning positive.

"They caught markets by surprise, reminding them that negative term premia cannot last indefinitely."

The BIS report says that a key driver of the rise in bond yields and in equity markets of both advanced and emerging economies was the uncertainty about the future stance of monetary policy.

Escalating geopolitical tensions and the dependence of emerging economies on fickle foreign capital reinforced these economic headwinds.

While economic conditions in the United States have improved significantly since May 2013 the same cannot be said of major economies such as Europe and China.

The case for going early

Last week a positive labour market report in the US sparked off significant retreats by equity and bond markets around the globe.

The widely accepted explanation for this market behaviour is that the strong growth in employment could actually encourage the Fed to bring forward the interest rate change from the previously favoured September to June.

However, Yellen has said in the past that she wants to see inflation convincingly headed in the mid term to 2 per cent before moving on interest rates.

But, that was in the days before the dive in crude oil prices. Remove the impact of the oil factor and the 2 two per cent inflation target – in the mid term as cited by Yellen – looks credible.

The case for going early, that is in June, is persuasive.

If the US economy continues its present trajectory of recovery then the '94 factor will come into play.

The Fed can afford to tolerate a somewhat higher level of inflation than Yellen's 2 per cent. That's not a worry.

What it cannot afford to do is fall behind the curve in a way that it did back in '94 when it threw a 75 basis point rock in front of a recovering economy.

There will be headwinds to recovery. What's very different this time is that the extensive use of unconventional monetary policy means that those winds will not all gust from the traditional macro-economic directions.

Instead, as a number of prominent commentators have noted the distortions and legacies of unconventional monetary policies ranging from negative interest rates through currency wars to bloated central bank balance sheets have to be addressed.

David Rosenberg from Toronto's Gluskin Sheff research has pointed out that the combined balance sheets of the Bank of England, Bank of Japan, and the Federal Reserve - the three central banks that have engaged in quantitative easing so far with the European Central Bank entering the fray this week with a trillion dollar plus kitty – have purchased $5 trillion worth of bonds. These entities, he says, have done so for purely non-economic reasons.

Dangerously simplistic

Harvard's Kenneth Rogoff, believes popular explanations for the fundamental disconnect between the new highs reached by global equity indices and the new depths plumbed by real interest rates worldwide are dangerously simplistic.

He says: "Surely heightened public concern about the risk of future economic catastrophe in the wake of the financial crisis is still playing an important role, reinforced by lingering fragility and rising instability in emerging markets."

Nouriel Roubini from New York University warns that if the advanced countries were to suffer from secular stagnation, a world with negative interest rates both short –and long-term bonds could become the new normal.

Mohamed El-Erian, chair of President Obama's Global Development Council sees a tug of war between Europe and the U.S over interest and exchange rates.

He says: "We will be learning quite a bit from them about what negative nominal interest rates do to a capitalist construct that assumes participants should be compensated for taking risks.

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Last week the Fed released minutes going back to 2009 of its Open Market Committee.

One quote from Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond struck me as apposite to the present.

He said: “This discussion has been fascinating against the backdrop of our not having a clear sense exactly why and how expanding our balance sheet affects the world. I think we’re really groping in the dark here. I think we need to recognise that.”

Thoughts from Max Walsh - Deputy Chairman of Dixon Advisory

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