Asia Insight

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Prospect of a U.S. Fed Hike and its Effect on Asian Assets

How close are we to a U.S. Federal Reserve (Fed) rate hike? How would a hike affect Asian securities? These are the questions we explore in this two-part series of *Asia Insight*.

A cohesive framework for understanding what drives a rate hike is useful for us not because it allows us to trade around such an event, but because the analysis lends insight into how best to position portfolios over the long run. In this issue, we use a model of the U.S. federal funds rate to consider the timing and pre-conditions for an eventual rate hike. Part II of our series provides frameworks for anticipating the possible effects of a rate hike on Asian securities.

In my view, the Fed will likely avoid the type of policy error made by the Riksbank, Sweden's central bank, which raised rates in 2010 despite inflation that was below the 2% target, a worsening European economy and the objections of its own monetary policy expert who had deep knowledge of Japan's 25-year fight with deflation.

The Riksbank prefers to act based on economic projections, as opposed to the prevailing state of the economy. The Swedish rate hike was a reaction to anticipated inflation, which in hindsight, was unlikely to have occurred even with a zero rate policy. The Riksbank had to reverse quickly in 2011 when it re-entered a rate cut cycle. However, the cuts did not come fast enough, and the Swedish economy has suffered deflation over the past two years.

In February 2015, the inflation hawks had to take the bitter, desperate pill of negative policy rates, in addition to announcing a bond-buying quantitative easing program, similar to those already implemented by the U.S., European and Japanese central banks.

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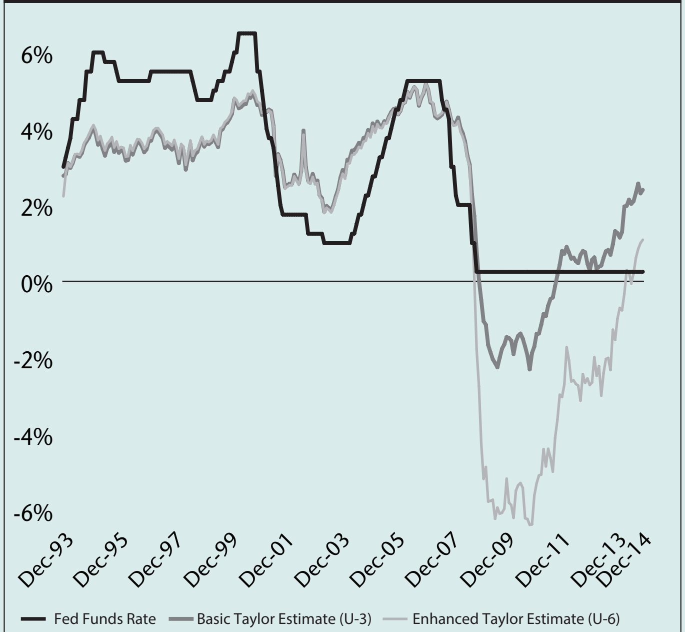
The U.S. federal funds target rate has been at the zero lower bound since December 2008. Some market participants believe the zero interest rate policy (ZIRP) should have been lifted long ago. Others believe that low inflation and weak labor markets continue to support the ZIRP.

Let's consider why ZIRP has been in force for six years, and use that analysis to inform an educated guess on both the timing and effects of a hike as it reverberates through the rest of the yield curve.

The Federal Reserve has a dual mandate to maintain stable price levels and full employment (i.e. the non-accelerating inflation rate of unemployment). The two goals can be at odds with each other. The Taylor Rule, named after Stanford professor John Taylor, formalizes this tradeoff as it relates to the equilibrium federal funds rate. The rule compares prevailing inflation to a target inflation rate and prevailing unemployment to the "full employment" level. It offers a structured, prescriptive opinion on where the federal funds rate should be.

TAYLOR RULE ESTIMATES OF FED FUNDS VS. ACTUAL
Dec. 1993–Dec. 2014



Sources: U.S. Bureau of Labor Statistics, Federal Reserve, MICM

"The U.S. Federal Reserve is wary of the type of policy error recently made by Sweden's central bank."

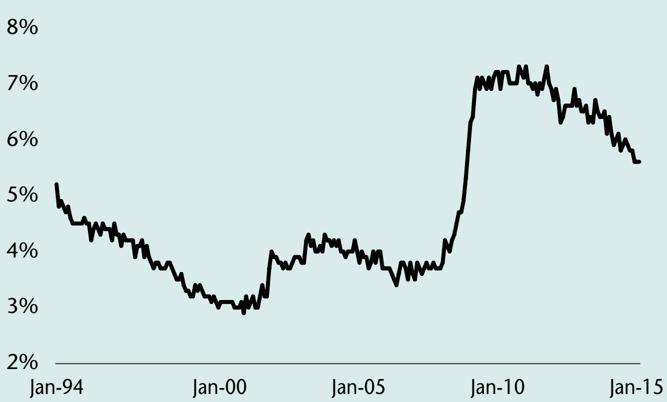
The basic Taylor Rule, using U-3 unemployment, justifies ZIRP before the cross-over point occurred on November 2011. U-3 is the headline unemployment figure. It counts as unemployed only those who are 100% unemployed and actively looking for work.

So why hasn't the Fed hiked rates yet? After all, January 2015's U-3 unemployment was 5.7%, which is not too far from most estimates of labor market equilibrium.[1]

The problem with U-3 unemployment is that it does not include discouraged workers who have stopped looking for work or part-time workers looking for full-time work. The U-6 unemployment figure captures those pools of discontent. As of January 2015, U-6 unemployment stands at 11.3%. The Taylor Rule with this more expansive definition of unemployment implies that the fall of 2014 was the first time the Fed should have considered raising rates.

Fed Chairwoman Janet Yellen carefully minds the gap between U-6 and U-3. It has been a staple observation in her public discourse. The gap has been declining but not quickly enough to make anyone worry that the economy is overheating. Moreover, the absolute level of the gap remains historically high, suggesting that it may be more prudent to keep monetary policy loose, rather than run the risk of halting the labor market recovery.

U-6 UNEMPLOYMENT MINUS U-3 UNEMPLOYMENT
Dec. 1993–Jan. 2015



Source: U.S. Bureau of Labor Statistics

In the February 2015 Senate Banking Committee hearing, Yellen lowered the probability of a near-term rate hike by saying, "… the labor force participation rate is lower than most estimates of its trend, and wage growth remains sluggish, suggesting that some cyclical weakness persists."[2]

This last observation should be of interest to the inflation hawks among us. The most reliable indicator of labor market slack is wage inflation, and the Fed sees no danger here. The U.S. economy seems poised for a non-inflationary glide toward full employment.

In the post-Volcker[3] era, the Fed has shown a bias toward full employment over price stability. This makes sense because while inflation is a small pain, widely dispersed, unemployment is intense pain, localized to individuals. The current slack in the labor market is concerning to the Fed whereas both the level and trend of inflation are innocuous. Furthermore, plummeting oil prices create a deflationary positive supply shock, giving the Fed a higher margin of error against the possibility of running an overly loose policy.

The Fed's overwhelming desire to avoid the "third rail" of deflation is well-established by now. Since 2008, price changes have flirted enough with deflation to remove any immediate worry about inflation. "Inflationistas" have truly been waiting for Godot. The latest annualized price change for Core Personal Consumption Expenditures (PCE), excluding food and energy, was 1.3% in December 2014. Headline PCE was a mere 0.8%. In 69 of 72 months since 2008, inflation has fallen below the target 2% rate.

1 John C. Williams, Update of "What Is the New Normal Unemployment Rate?" (Federal Reserve Bank of San Francisco, 10 February 2015).

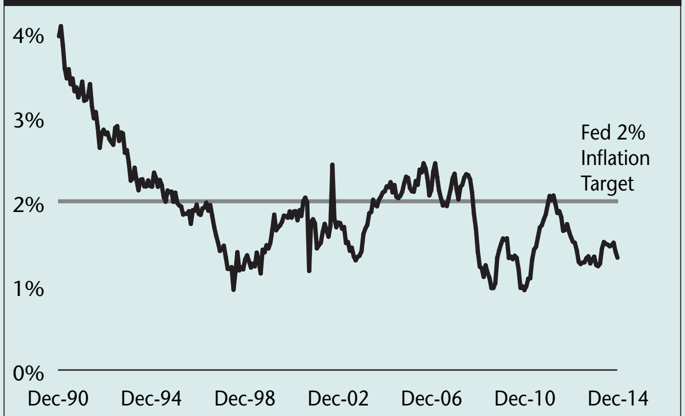
2 http://www.federalreserve.gov/newsevents/testimony/yellen20150224a.htm

3 Volcker: Paul Volcker, Chairman U.S. Federal Reserve, 1979–1987.

> "The Federal Reserve has a dual mandate to maintain stable price levels and full employment. But the two goals can be at odds with each other."

CORE PERSONAL CONSUMPTION EXPENDITURES (PCE) PRICE INDEX

Dec. 1990–Dec. 2014



Source: U.S. Bureau of Economic Analysis

With the current mild inflation backdrop, the Fed is more likely to wait to see the bloodshot eyes of a labor bull market before they raise rates. The gap between U-6 and U-3 unemployment is still wide, and it would be surprising if the Fed acted before the gap closed to at least 5%. A second possible pre-condition is that inflation be maintained at or above 2% for a sustained period.

Contrary to popular opinion, hiking rates in this environment to head off predicted inflation is not necessarily forward thinking, moderate or conservative. It can be a risky and aggressive move as the Riksbank's experience in 2010 showed. When inflation is low and the economy is weak, raising the policy rate in anticipation of higher inflation may stoke deflationary pressures that are quite difficult to unwind.

Barring any large macroeconomic disruption, such as war in Ukraine or a Greece departure from the euro, chances are higher in 2015 that the Fed will feel more comfortable with a hike in rates. This does not mean that a rate hike is assured, however. Accurately measuring the level and trend of slack in the economy is difficult. Even after the data is established, reasonable minds may still disagree on the interpretation and outlook.

In the next issue of *Asia Insight*, we examine how a rate hike could affect Asian securities.

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