DOLLARS & SENSE
TD Economics

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THE FED'S MESSAGE IS CLEAR: GET READY FOR HIGHER POLICY RATES

Highlights

- Economic data and hawkish commentary from Federal Reserve members have re-adjusted market expectations upwards for the fed funds rate. This progress in convincing previously-sceptical markets will, in turn, give the Fed the flexibility to follow through with an actual increase.
- The domestic economy warrants higher rates given that we are moving steadily closer to full employment and are seeing signs that trend inflation is moving back to target. As a result, the Fed has sufficient scope to raise rates as early as June. As long as rate hikes are gradual, real interest rates will remain negative and accommodative even as nominal rates move higher.
- A lot can happen in the weeks ahead, but the odds of a rate hike in either the June or July meeting are now close to 50/50. If a rate increase does not occur at either of these meetings, there will likely be sufficient positive data over the summer to convince the Fed that a September hike is necessary.

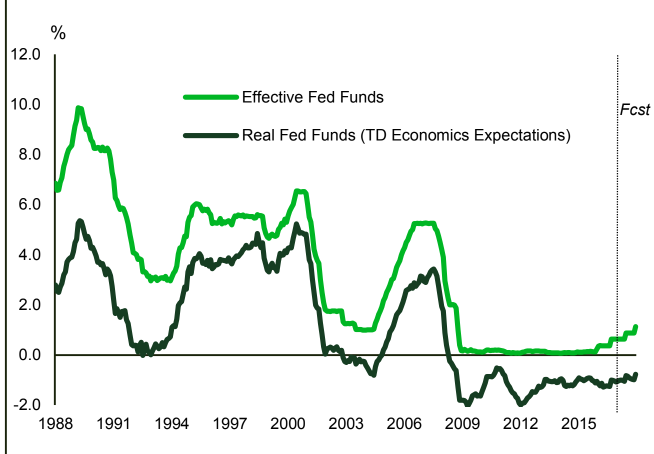
Following several months of rising optimism, an air of caution has returned to financial markets over the past few weeks. The turn in risk sentiment has been sparked in part by a shift in the tone and tenor of Federal Reserve communications. While past statements were heavy on the recognition of global risks, those made recently have put an emphasis on the resilience of the American economy and the case for moving policy rates higher in the coming months.

The recent flow of data has added fuel to the fire. Retail sales, industrial production, housing starts, and home sales have all turned up in recent releases, pointing to a strong start to the second quarter. At the same time, revisions to past data suggest that economic growth in the first quarter was not quite as weak as first thought and is likely to be revised higher, perhaps as much as double the original estimate (of just 0.5% annualized).

The Fed has been steadfast in its intention to continue to raise rates as long as the data remains supportive. The recently released minutes from the April policy decision (in which rates were left on hold) spent a considerable amount of time laying out the conditions for raising rates at the next meeting in June. Previous to the minutes, markets had priced in virtually zero likelihood of a rate increase for June. Within seconds of the release of the FOMC minutes, expectations for a June hike jumped to about one-third and Treasury yields moved higher.

The over-riding driver of investor doubt that the Fed would raise rates this summer is that the American economy cannot withstand even a very gradual pace of rate hikes. This is hard to

CHART 1: THE FED HAS ROOM TO HIKE



Source: TD Economics, FRB, BEA

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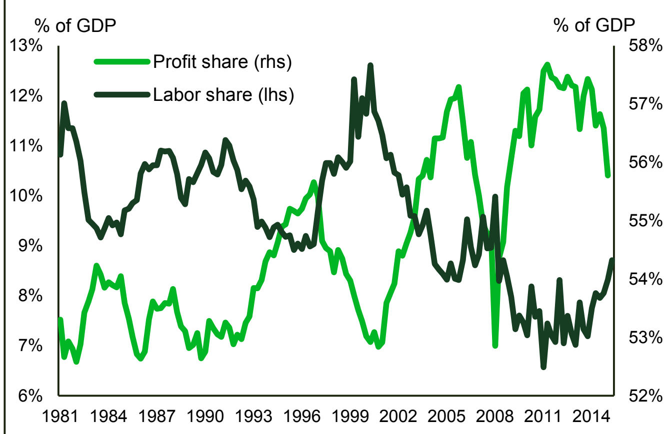
square with the evidence. Even with the rate hike in December, the real (inflation-adjusted) Fed Funds Target rate remains firmly negative. As inflation moves higher, the Fed can afford to raise rates without tipping into restrictive territory. Assuming, as Chair Yellen does, that the underlying "natural" real rate of interest (consistent with stable inflation) is zero, the Fed can raise nominal rates by another 150 bps before it gets to this point.

Rising wages support the Fed's model for inflation

A key argument for the Fed's inability to raise interest rates is that it is missing on its inflation target and rate hikes will ensure that it continues to do so. This view tends to cite global factors limiting inflation and skepticism over the relationship between inflation and economic slack. But, it also ignores the fact that the dollar's impact on inflation is limited (and fleeting) and that wage growth has already accelerated broadly in line with the tightening that has occurred in the labor market. This is a textbook example of late-cycle dynamics, where an economy is reaching capacity limits, and in turn, wage pressures firm. The combination of a closing output gap and wage pressures should combine to raise inflation – reinforcing the Fed's view (see our recent report here).

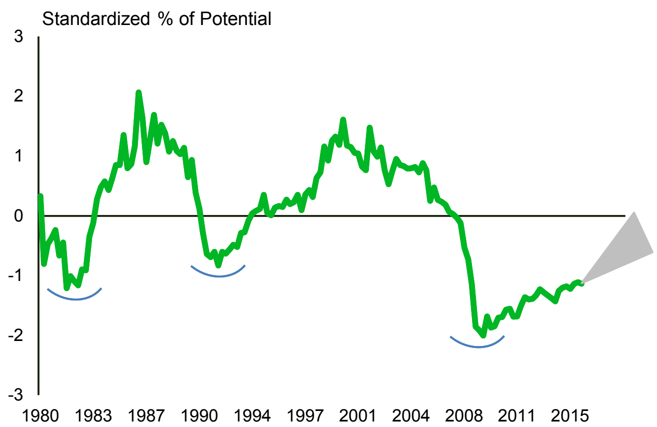
With low inflation, wages are also growing in real terms. That is, American workers are finally taking a greater share of the economic pie. This has been a long time coming. The labor share of income has fallen for over the past decade (Chart 2). The increasing share of income going to capital has disproportionately benefited the top-end of the income spectrum. This has likely slowed the recovery in consumer spending by concentrating income gains in households with the lowest propensity to consume. Wage gains that are more equally spread are more likely to give a boost to cyclical spending.

CHART 2: LABOR SHARE OF INCOME FINALLY SEEING SOME UPSIDE



Source: TD Economics, BEA

CHART 3: CYCLICAL SPENDING HAS ROOM TO GROW



Source: CBO, BEA. Calculations by TD Economics.

A bigger pie will allow for wage and profit growth

Of course, with interest rates and wages rising, profit margins will remain constrained. This has led to another fear with respect to higher policy rates – namely that declining corporate profits could derail the American economy. However, the recent decline in profits is not simply a margin story, but related to the slowdown in top line revenue growth. This is particularly true of firms exposed to the oil sector and global demand. The bottom line is that what corporations as well as consumers need is faster nominal GDP growth. As such, accelerated wage growth could be just the spark the American economy needs.

The bottom line

In adjusting the market's expectations for higher policy rates, the Fed has given itself maximum flexibility heading into its June meeting. The decision remains a close call, but if economic data continue to improve, global risk appetite stays firm, and market odds drift higher, the Fed would likely use the window to raise rates at either the June or July FOMC meeting. But if the Fed chooses to stay its hand in June, due to say uneven economic data or a renewed bout of global risk aversion, we agree with current market pricing that a rate hike by September is a very likely outcome. This reaffirms our view that the American economy can withstand slightly higher rates. Though the path will be slow, rates are going up because the American economy is on surer footing.

INTEREST RATE & FOREIGN EXCHANGE RATE OUTLOOK

		Spot Rate	2015				2016				2017			
		May-25	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		0.50	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.25
3-mth T-Bill Rate		0.32	0.03	0.01	0.00	0.16	0.21	0.30	0.55	0.55	0.55	0.80	0.80	1.05
2-yr Govt. Bond Yield		0.92	0.56	0.64	0.64	1.06	0.73	0.80	0.95	1.15	1.20	1.35	1.40	1.60
5-yr Govt. Bond Yield		1.40	1.37	1.63	1.37	1.76	1.21	1.35	1.45	1.65	1.70	1.80	1.85	2.00
10-yr Govt. Bond Yield		1.87	1.94	2.35	2.06	2.27	1.78	1.90	1.95	2.10	2.15	2.25	2.30	2.40
30-yr Govt. Bond Yield		2.66	2.54	3.11	2.87	3.01	2.61	2.70	2.75	2.85	2.90	3.00	3.05	3.10
10-yr-2-yr Govt Spread		0.95	1.38	1.71	1.42	1.21	1.05	1.10	1.00	0.95	0.95	0.90	0.90	0.80
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.56	6.20	6.20	6.36	6.48	6.45	6.60	6.78	6.88	6.96	7.04	7.12	7.18
Japanese yen	JPY per USD	110	120	122	120	120	112	113	113	115	118	120	121	122
Euro	USD per EUR	1.12	1.07	1.12	1.12	1.09	1.14	1.10	1.07	1.09	1.12	1.10	1.14	1.14
U.K. pound	USD per GBP	1.47	1.49	1.57	1.51	1.48	1.44	1.39	1.43	1.47	1.53	1.55	1.56	1.58
Swiss franc	CHF per USD	0.99	0.97	0.94	0.98	1.00	0.96	1.00	1.02	1.02	1.00	1.03	1.00	1.01
Canadian dollar	CAD per USD	1.30	1.27	1.25	1.34	1.38	1.30	1.33	1.35	1.32	1.33	1.33	1.32	1.32
Australian dollar	USD per AUD	0.72	0.76	0.77	0.70	0.73	0.77	0.73	0.72	0.70	0.71	0.72	0.74	0.75
NZ dollar	USD per NZD	0.67	0.75	0.68	0.64	0.68	0.69	0.67	0.66	0.64	0.62	0.62	0.63	0.64
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.12	1.07	1.12	1.12	1.09	1.14	1.10	1.07	1.09	1.12	1.10	1.14	1.14
Japanese yen	JPY per EUR	123	129	136	134	131	128	124	121	125	132	132	138	139
U.K. pound	GBP per EUR	0.76	0.72	0.71	0.74	0.74	0.79	0.79	0.75	0.74	0.73	0.71	0.73	0.72
Swiss franc	CHF per EUR	1.11	1.04	1.04	1.09	1.09	1.09	1.10	1.09	1.11	1.12	1.13	1.14	1.15
Canadian dollar	CAD per EUR	1.45	1.36	1.39	1.50	1.50	1.48	1.46	1.45	1.44	1.49	1.46	1.51	1.51
Australian dollar	AUD per EUR	1.55	1.41	1.45	1.59	1.49	1.48	1.51	1.49	1.56	1.58	1.53	1.54	1.52
NZ dollar	NZD per EUR	1.66	1.44	1.65	1.75	1.59	1.65	1.64	1.62	1.70	1.81	1.77	1.81	1.78
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	110	120	122	120	120	112	113	113	115	118	120	121	122
Euro	JPY per EUR	123	129	136	134	131	128	124	121	125	132	132	138	139
U.K. pound	JPY per GBP	162	178	192	181	177	162	157	161	169	181	186	189	193
Swiss franc	JPY per CHF	111.2	123.5	130.6	122.6	120.1	117.3	112.8	111.0	112.9	118.0	116.8	121.0	120.9
Canadian dollar	JPY per CAD	84.6	94.6	97.9	89.4	86.9	86.7	85.0	83.7	87.1	88.7	90.2	91.7	92.4
Australian dollar	JPY per AUD	79.3	91.5	94.1	84.1	87.6	86.3	82.5	81.4	80.5	83.8	86.4	89.5	91.5
NZ dollar	JPY per NZD	74.3	89.8	82.8	76.6	82.3	77.9	75.7	74.6	73.6	73.2	74.4	76.2	78.1

F: Forecast by TD Economics, May 2016; Forecasts are end-of-period; Source: Federal Reserve, Bloomberg.

GLOBAL STOCK MARKETS

	Price May-25	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	2,091	-0.0	1.5	2,128	1,829
DAX	10,205	-1.6	4.1	11,771	8,753
FTSE 100	6,263	-0.8	-4.6	7,041	5,537
Nikkei	16,757	-4.6	-4.0	20,868	14,953
MSCI AC World Index*	397	-2.4	-4.8	438	353

*Weighted equity index including both developing and emerging markets.
Source: Bloomberg

COMMODITY PRICE OUTLOOK	Price	52-Week	52-Week	2015				2016				2017			
	May-25	High	Low	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	49	61	26	49	58	46	42	34	44	48	50	52	52	55	55
Natural Gas ($US/MMBtu)	1.77	2.95	1.49	2.87	2.78	2.75	2.10	1.97	2.00	2.35	2.50	2.90	3.10	3.40	3.60
Gold ($US/troy oz.)	1225	1293	1051	1218	1191	1124	1104	1182	1245	1225	1200	1195	1185	1175	1175
Silver (US$/troy oz.)	16.3	17.8	13.7	16.74	16.44	14.92	14.78	14.93	16.50	16.00	15.50	15.25	15.00	14.85	14.74
Copper (cents/lb)	210	276	196	264	275	238	222	212	216	222	226	228	230	230	232
Nickel (US$/lb)	3.81	6.17	3.45	6.51	5.94	4.78	4.27	3.86	3.97	4.20	4.45	4.75	5.00	6.00	6.25
Aluminum (Cents/lb)	71	81	65	82	79	72	68	69	70	72	72	74	74	76	76
Wheat ($US/bu)*	5.91	7.95	5.58	7.45	7.34	6.39	6.36	5.89	6.10	6.25	6.15	6.25	6.25	6.50	6.75

F: Forecast by TD Economics, May 2016; Forecasts are period averages; Source: Bloomberg, USDA (Haver). *As at May 24, 2016.

INTERNATIONAL INTEREST RATE OUTLOOK	Spot Rate	2015				2016				2017			
	May-25	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Australia													
Cash Target Rate	1.75	2.25	2.00	2.00	2.00	2.00	1.75	1.50	1.50	1.50	1.75	2.00	2.25
3-mth T-Bill Rate	1.74	1.97	1.96	2.01	2.02	2.04	2.00	1.75	1.75	1.75	2.00	2.25	2.50
3-yr Govt. Bond Yield	1.61	1.72	2.04	1.84	2.02	1.90	1.60	1.45	1.60	1.75	2.25	2.50	2.65
5-yr Govt. Bond Yield	1.82	1.87	2.27	2.12	2.24	2.09	1.80	1.65	1.80	1.90	2.35	2.60	2.75
10-yr Govt. Bond Yield	2.31	2.33	3.01	2.62	2.88	2.49	2.35	2.25	2.40	2.45	2.85	3.00	3.05
10-yr-3-yr Govt Spread	0.70	0.61	0.97	0.78	0.86	0.59	0.75	0.80	0.80	0.70	0.60	0.50	0.40
Germany													
ECB Deposit Rate	-0.40	-0.20	-0.20	-0.20	-0.30	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
3-mth T-Bill Rate	-0.61	-0.31	-0.30	-0.36	-0.54	-0.59	-0.60	-0.60	-0.60	-0.60	-0.60	-0.50	-0.50
2-yr Govt. Bond Yield	-0.51	-0.26	-0.24	-0.27	-0.35	-0.49	-0.50	-0.40	-0.30	-0.20	-0.10	-0.05	0.00
5-yr Govt. Bond Yield	-0.37	-0.11	0.16	-0.04	-0.05	-0.33	-0.30	-0.10	0.00	0.20	0.30	0.60	0.80
10-yr Govt. Bond Yield	0.15	0.17	0.81	0.54	0.63	0.15	0.30	0.40	0.50	0.70	0.95	1.05	1.25
30-yr Govt. Bond Yield	1.05	0.61	1.57	1.33	1.49	0.84	1.10	1.20	1.30	1.45	1.60	2.00	2.20
10-yr-2-yr Govt Spread	0.67	0.43	1.05	0.81	0.98	0.64	0.80	0.80	0.80	0.90	1.05	1.10	1.25
United Kingdom													
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
3-mth T-Bill Rate	0.51	0.50	0.53	0.55	0.55	0.51	0.50	0.60	0.90	1.05	1.15	1.25	1.40
2-yr Govt. Bond Yield	0.48	0.39	0.61	0.56	0.65	0.44	0.55	0.75	1.05	1.15	1.35	1.40	1.55
5-yr Govt. Bond Yield	0.93	1.16	1.58	1.18	1.35	0.84	0.90	1.20	1.40	1.50	1.70	1.80	2.00
10-yr Govt. Bond Yield	1.46	1.54	2.11	1.74	1.96	1.42	1.50	1.70	1.90	2.00	2.10	2.20	2.30
30-yr Govt. Bond Yield	2.30	2.28	2.81	2.44	2.67	2.29	2.40	2.60	2.70	2.80	2.85	2.90	2.95
10-yr-2-yr Govt Spread	0.98	1.15	1.50	1.18	1.31	0.98	0.95	0.95	0.85	0.85	0.75	0.80	0.75

F: Forecast by TD Securities, May 2016; Forecasts are end-of-period; Source: Bloomberg