OBSERVATION

TD Economics

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THE FEDERAL RESERVE'S CONUNDRUM:

RAISING RATES AMIDST CONFLICTING EXPECTATIONS

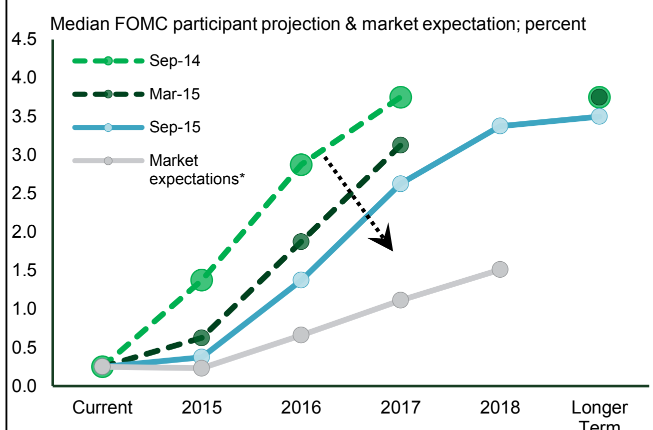
Highlights

- Minutes from the Federal Open Market Committee's (FOMC) September meeting show the balance of opinion among members coalescing on rate hikes this calendar year. As the minutes put it, "most participants continued to anticipate that, based on their assessment of current economic conditions and their outlook for economic activity, the labor market, and inflation, the conditions for policy firming had been met or would likely be met by the end of the year."
- Instead of heeding the Fed's call, market expectations for rate hikes have shown increasing sensitivity to individual data reports. Following last week's disappointing payrolls report for September, futures markets pushed the timing of the first rate hike to March of next year.
- The Fed's conundrum is in part due to its own communication strategy to emphasize the "data dependent" nature of policy decisions. In an effort to increase transparency, the Fed may have inadvertently trained market participants to place too high a focus on the month-to-month gyrations in economic data, rather than on the big picture – the medium-term outlook.
- Pulling the lens back can help reinstate a perspective on the economy's foundation, outlook and risks. A broad sweep of the data indicates the U.S. economic foundation has become sturdy enough to support a modest rise in rates, even with a backdrop of emerging market uncertainty.
- If the Fed wants to solve the expectations conundrum it will need to be more precise on its interpretation of the economic data in the context of its outlook. If it cannot, it risks either jolting financial markets or waiting too long for fear of doing so.

The Federal Reserve is in a bit of a pickle. The majority of FOMC participants have consistently signaled intent to raise rates earlier and by a greater extent than market participants have believed. So far, the market has been right and the Fed's projection within the "dot plot" has been repeatedly revised down (Chart 1). Last week's disappointing payrolls report saw market expectations lowered again, with the timing of the first rate hike pushed to March 2016 (from January). This would create quite a wide gap relative to the signal sent by the FOMC participants at their mid-September meeting and reiterated in minutes released on October 8, which overwhelmingly conveyed an expectation for a rate hike by the end of this year.

The problem for the Fed is that in an effort to increase transparency on monetary policy intentions, it may have inadvertently trained market participants to place too high a focus on the month-

CHART 1: FEDERAL FUNDS PROJECTIONS & EXPECTATIONS



*OIS curve, October 8, 2015. Source: Federal Reserve Board, Bloomberg.

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to-month gyrations in economic data, rather than remaining focused on the big picture – the medium-term outlook. Applying an old adage, the market has lost sight of the forest for the trees.

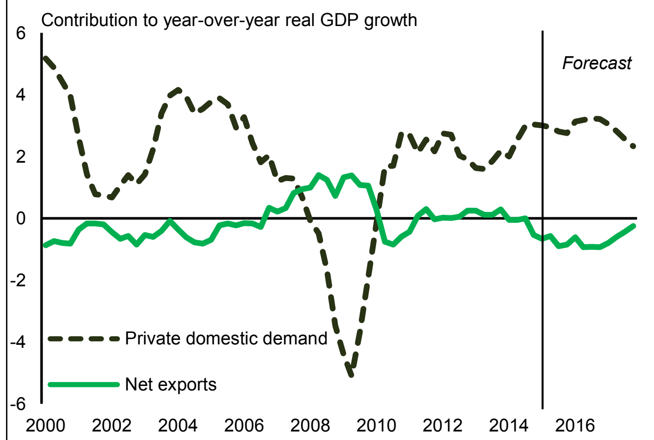
Whether it's the decision to exit quantitative easing in 2014 or the still-unknown first rate hike, the Fed has repeatedly cited some variation of the phrase that they are closely monitoring incoming information or that their decisions are "data dependent". This is not new, as the Fed has always endeavored to read the tea leaves. But, as Peter Olson and David Wessel astutely point out in a recent Brookings Institution blog post, the Fed's decision to emphasize the near-term evolution of data was motivated by a concern that financial market participants were growing complacent.[1] Specifically, they note that "in June [2014], some FOMC members expressed concern that '*low implied volatility in equity, currency, and fixed-income markets*' indicated that '*market participants were not factoring in sufficient uncertainty about the path of the economy and monetary policy*.' In short, Fed officials thought their forecasts about the future path of rates were being taken too seriously – more like commitments than predictions."

It now appears that in attempting to refocus the market from having too literal an interpretation of the Fed "dots", market participants have instead become myopic to near-term data releases. Hence the 12-15 basis point drop in 10-year Treasury yields during intra-day trading in response to a jobs report that produced 142k new positions.

Pulling the lens back can help reinstate a perspective on the economy's foundation, outlook and risks. The markets' cold feet on rate hikes became entrenched within concerns over the negative impact of the rising dollar, weakening global activity and increasing financial volatility. These risks are certainly valid and were also noted by the Fed when it chose to hold off on raising rates in September. However, the central question is whether these risks have materially evolved to alter Janet Yellen's statement before the House Committee in mid-July that "the economy can not only tolerate, but needs higher rates". The alternative hypothesis is that the U.S. economic foundation has become sturdy enough to support a modest rise in rates. A broad sweep of the data indicates that this is indeed the case.

Nonetheless, if the Fed wants to solve the expectations conundrum it will have to do a better job of communicating its interpretation of the economic data in light of its outlook. If it cannot, it risks either jolting financial markets or waiting too long for fear of doing so.

CHART 2: PRIVATE DOMESTIC DEMAND & NET EXPORTS



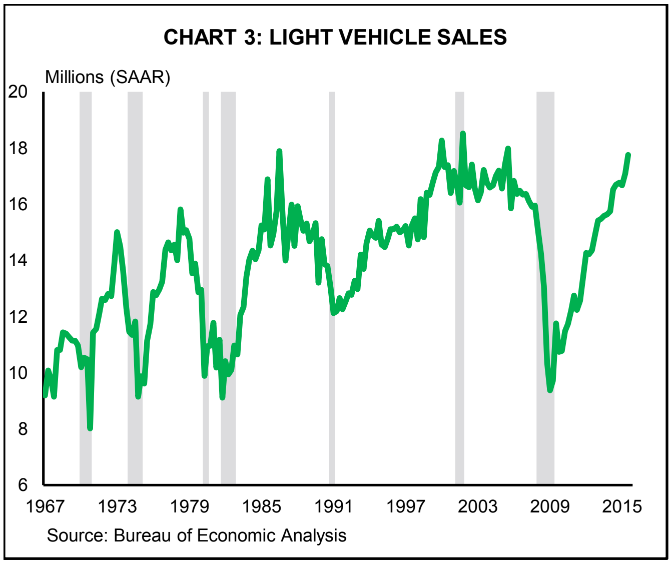
Source: Bureau of Economic Analysis. Forecast by TD Economics.

Growth in domestic demand suggests solid economic growth will continue

The market perception is correct that global influences and the high greenback are biting into near-term economic growth. Third quarter real GDP is tracking only 1.5% (annualized), about a percentage point less than what was expected just one month ago. However, this headline masks a strong undercurrent in domestic demand.

Private domestic demand – spending by households and businesses – is on pace to grow by over 4.0% (annualized) in the third quarter, similar to the outturn in the second quarter blockbuster GDP report. There are two meaningful interpretations here. First, domestic demand strength has demonstrated persistence. Over the past two years, it has grown by an average pace of 3.5%, and the more recent data is showing acceleration. Second, the strong growth in the current quarter is a good predictor of future economic growth. According to analysis by the Council of Economic Advisers, among GDP components, private domestic demand growth in the current quarter is the best predictor of GDP growth the following quarter.[2] This is in contrast to indictors that have dominated the market's focus lately, mainly exports/manufacturing and inventories (two factors that will weigh on near-term growth). Both are highly volatile and have virtually no ability to explain future economic growth.

There is good reason to expect this strength in domestic demand to continue. The benefit of lower energy prices has only begun to diffuse through the economy and has been offset to-date by the decline in capital spending in the oil



and gas sector. For consumers, the saving at the gas pumps amounts to a 0.7 percentage point lift to after-tax income growth (or roughly $800 extra dollars in the pocketbook). Initially households appear to have saved some of the windfall, but after peaking at 5.2% in the first quarter, the personal saving rate has since fallen to 4.6%. In the third quarter, the spending impetus came through loud and clear with auto sales rising to 18.1 million, their highest level in over a decade.

Businesses are also likely to use energy savings to increase investment and hiring. Savings on the business side are likely to add a further 0.2 percentage points to economic growth. While initially this was masked by the direct decline in investment in the oil sector, there is evidence that this transition is occurring. As an example, lower energy prices have driven a boon in chemical manufacturing structures investment. As a result, real investment in manufacturing structures has risen 63% over the past year – its fastest rate on record going back over fifty years. While the lofty dollar will counteract some of this benefit on investment, its impact will dissipate over time as activity shifts toward domestic-oriented sectors.

A final but important point is that even with real GDP-growth of just 1.5% in the third quarter, it is still on track to meet the Fed's own projections on an annual basis. Achieving the Fed's median projection of 2.1% for 2015 will require fourth quarter growth of just 2.2%. Given the strength in domestic demand and the continued boost to domestic purchasing power from low energy prices and a strong dollar, this is more than achievable.

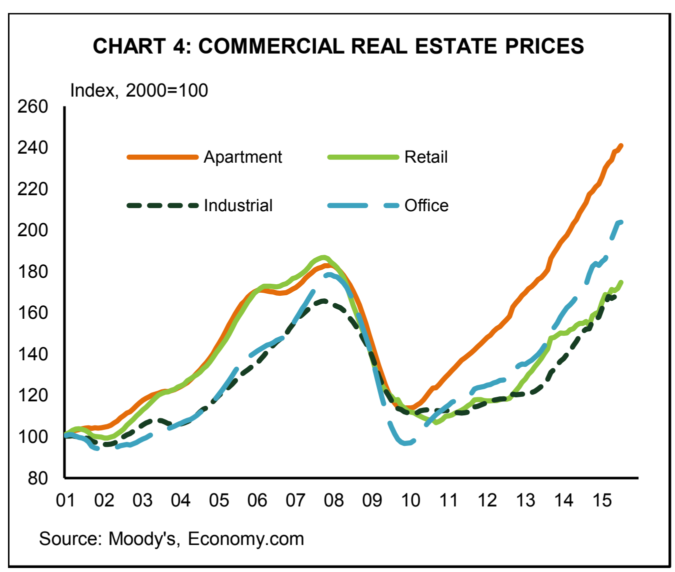
Two percent is the new three percent

An aspect that often gets overlooked is that the rate of growth the economy can sustain is on a permanently slower path than it has been historically. So far the focus has been on the demand side of the equation, but the Fed is also aware that due to supply constraints, the speed limit for economic growth has slowed.

This is perhaps most poignant in terms of monthly job growth. Market watchers have become accustomed to job creation exceeding 200k a month, and indeed over the past five years it has. However, as the population ages, the underlying trend of job growth will slow along with it. We estimate that once slack in the labor market is absorbed, the rate of job growth necessary to keep the unemployment rate steady is just 80k jobs a month. Put in this context, the 142k jobs created in September represents an economy that is operating with more than enough juice to sustain a non-zero policy rate.

The risks of zero rates are beginning to outweigh the benefits

After several years of rebuilding a solid economic foundation, the Fed's decision around rates must also balance the risks of leaving rates at zero versus beginning to nudge them higher. Indeed, this is exactly the point that Chair Yellen made in her last major speech on monetary policy following the Fed's September rate decision. She noted that delaying the start of interest rate normalization for too long risks "having to tighten policy relatively abruptly to keep the economy from significantly overshooting." Moreover, "continuing to hold short-term interest rates near zero…



could encourage excessive leverage and other forms of inappropriate risk-taking that might undermine financial stability."

There is little doubt that the interest rate sensitive sectors of the economy are responding to the low rate environment. Perhaps most noticeably, commercial real estate prices have risen 90% since the trough in 2010 and are 13% above the pre-recession peak. Apartment prices have more than doubled (+111% since trough) and are 32% above their pre-recession peak. Keeping rates at zero while interest-rate sensitive sectors are expanding robustly puts additional wind in the sales of asset prices, which raises the risk of a reversal later on. This would especially be the case if rates have to be increased faster in place of an earlier, more gradual pace.

Moreover, zero interest rates embed their own vulnerability in the economy. Increased regulatory requirements have already raised liquidity concerns within financial markets, particularly for safe assets. Maintaining rates at zero can have unintended consequences of reducing liquidity in the very markets that it is intended to support. The Fed's own research on the impact of zero interest rates in 2008 noted that "reducing the federal funds rate to zero or nearly zero likely would degrade the functioning of certain financial markets and cause difficulties for some money market mutual funds."[3,4] With just a slightly higher level of interest rates, money market funds will operate more efficiently and these liquidity risks will diminish.

Bottom line

We can state the case, but without further clarity from the Fed, financial markets are unlikely to change their myopic lens. This may serve to reinforce the expectation that the Fed is following market expectations, rather than leading. If the Fed wants to stand behind the notion that the economic foundation of the U.S. economy is ready to support a slight uptick in rates this year, it will need to reset expectations on how it is interpreting its economic guideposts. The Fed has moved away from thresholds for unemployment, but it will have to be more precise about what constitutes "some further improvement in the labor market," especially when it keeps lowering its long-run projection for the unemployment rate.

If the Fed is not able to convince markets to move their expectation for interest rates closer to its own rather than the other way around, then it will either have to jolt markets when it finally does raise rates, or risk the very things that Chair Yellen has stated she would like to avoid. As Yellen has noted, monetary policy works with a lag, so the Fed cannot wait until it has achieved its goals to begin raising rates. As long as domestic demand holds firm, the American economy is ready for higher interest rates.

ENDNOTES

1 Olson, Peter, and David Wessel. 'What The Fed Really Means When It Says Interest Rate Raises Are Data Dependent'. *Up Front - Brookings Institution* September 10, 2015. http://www.brookings.edu/blogs/up-front/posts/2015/09/10-fed-interest-rates-data-dependent-olson-wessel

2 Furman, Jason. 'Second Estimate Of GDP For The Fourth Quarter Of 2014'. *White House Blog* February 27, 2015. https://www.whitehouse.gov/blog/2015/02/27/second-estimate-gdp-fourth-quarter-2014#pdfp

3 Madigan, Brian, Steve Meyer, and Dave Reifscheider. *Notes On Issues Related To The Zero Lower Bound On Nominal Interest Rates*. FOMC Secretariat December 12, 2008. Accessed from http://blogs.piie.com/realtime/files/2014/04/FOMC-200812memos-FOIA.pdf

4 With the gross return on short-term debt approaching the zero lower bound, the net return after fees that some money market funds are offering have pushed tangentially to zero, as well. With so little incentive to hold cash in these funds, there has been zero growth in assets under management for the industry since the financial crisis began. After assets fell by $1.2 trillion between 2009 and 2012, the industry has recovered just one-tenth of that loss (~$120 billion). Money market funds are a critical funding source for many businesses and key players in short-term debt markets – the disruption to normal operations due to zero interest rates could be both limiting the amount of credit to the economy and reducing liquidity in certain markets because these funds cannot offer anything above a negligible positive return.