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The Fed, US rates & what it means for investors

EDITION 30 – 18 SEPTEMBER 2014

Key points

> With quantitative easing set to end next month, the Fed is on track to start raising interest rates next year, most likely in the June quarter. The anticipation and then reality of this could cause some volatility in shares.

> However, once it gets underway Fed tightening is likely to be gradual and history tells us that it's only when rates reach onerous levels that they become a real threat to share markets and ultimately economic growth.

> Progress towards eventual rate hikes in the US will put further downwards pressure on the $A, which we see falling to around $US0.80.

Introduction

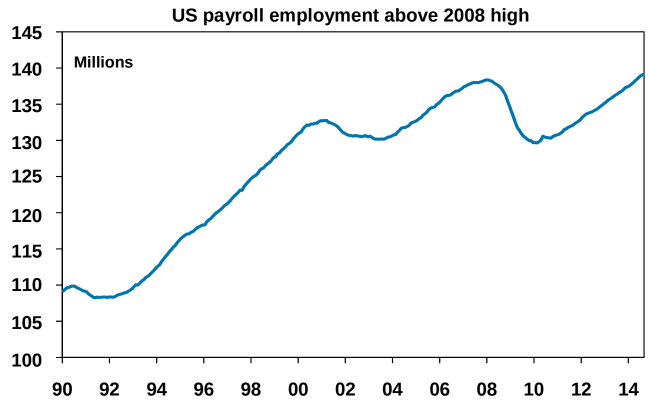
The impending end of the US Federal Reserve's quantitative easing (QE) program and when it will start to raise interest rates are looming large for investors. Very easy global monetary conditions, led by the Fed, have been a constant for the last six years helping the global recovery since the GFC. But with the US economy on the mend the Fed is edging towards returning monetary policy to more "normal" conditions and this was evident in the Fed's September meeting. After gradually tapering its QE program all year it's on track to end next month and attention is now shifting to the first interest rate hike. What will this mean for the US and global economy and for investment markets? This note takes a Q&A approach to the main issues.

How did we get here?

It's worth putting things in context and recalling how we got to this period of extraordinary easy monetary conditions. At its simplest it was just part of the cycle: growth weakened and so monetary conditions were eased. But the GFC related slump was deeper than normal leaving households and businesses far more cautious. So once interest rates hit zero and it was apparent the recovery was still sub-par, the focus shifted to measures to boost the supply of money. This became known as quantitative easing and involved the Fed printing money and using this to buy government bonds and mortgage backed debt. It helped growth by cutting borrowing costs, injecting cash into the economy, forcing investors to take on more risks, and to the extent it drives shares higher, it helped build wealth that helped spending.

Has ultra-easy US money worked?

The short answer is yes. A range of indicators suggest the US economy is now on a sounder footing: bank lending is strengthening; the housing construction recovery is continuing; consumer spending growth is reasonable; business investment looks stronger; business conditions indicators are strong; employment is back above its early 2008 high and unemployment has fallen to 6.1%. In particular, after a contraction in GDP in the March quarter, US growth bounced back strongly in the June quarter and solid growth looks to be continuing in the current quarter.



Source: Bloomberg, AMP Capital

How will the Fed tighten?

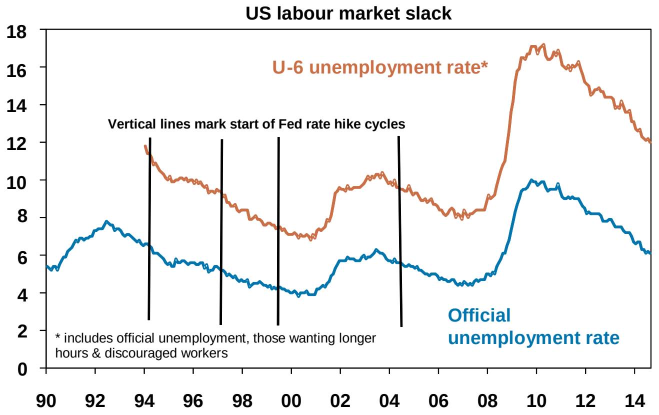
Reflecting the success of extraordinary monetary easing its little wonder the Fed is edging towards starting to return monetary conditions to "normal". In the past doing this was easy as the Fed would just start raising interest rates. Now it's more complicated. The first step was the tapering of its QE program. QE3 started at $US85bn a month in bond purchases in 2012 and following the start of tapering in December last year has now been cut to $US15bn a month. It's now on track to end at the Fed's late October meeting.

The second will be to actually tighten. This will come in the form of raising interest rates and reversing its QE program (ie unwinding the bonds it holds). Raising interest rates is simple, but unwinding its bond holding is a bit more complicated. At this stage it looks like it will primarily aim to do this by not replacing bonds as they mature.

How long till the first hike & what's "normal"?

For some time the Fed has said that it expects a "considerable time" between the end of QE and the first rate hike. This has been taken to mean around six months or more and so if QE ends in October this means the first hike will occur around the June quarter next year. While the Fed is still retaining the "considerable time" language its clear from Fed Chair Yellen's comments that the timing of the first rate hike is conditional on how the economy is performing. Our best guess though remains that the first hike will come in the June quarter. While the economy is on the mend, there remain several reasons why the Fed is not in a great hurry:

- Growth is still far from booming and the difference between actual and potential GDP is around 4%.
- Labour force underutilisation, which includes unemployment and those wanting to work longer, at 12% is well above the 9.4% average that applied when the Fed started raising rates in 1994, 1997, 1999 and 2004.
- Wages growth remains very weak at just 2.1% year on year, which is where it's been for the last four years now.
- Inflation on the Fed's preferred measures is just 1.5%.
- Finally, global economic conditions are still subdued including in Europe and the emerging world and this is a dampener on demand for US exports.



Source: Bloomberg, AMP Capital

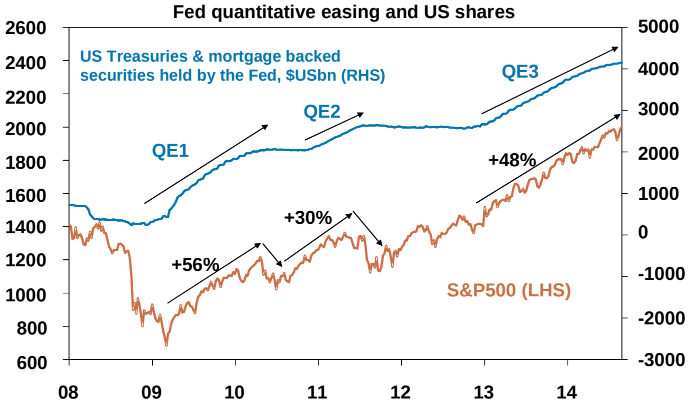
Reflecting this, the Fed can afford to take its time and when it does start to hike next year the process is likely to be gradual. In the past the "normal" or neutral level for the Fed Funds rate was thought to be around 4.5%, but Fed officials now put it at around 3.75% reflecting a more constrained growth environment due to more cautious attitudes towards debt and slowing labour force growth. So the Fed Funds rate may not rise that much above 3.75% in the upcoming tightening cycle, but it will take several years to get there.

What about the impact on the US economy?

Just remember that the Fed is only edging towards rate hikes because the US economy is stronger and so it can now start to be taken off life support. After the efforts of the last few years the last thing the Fed wants to do is to knock the economy back down again. Historically, it is only when interest rates rise above neutral and above the level of long term bond yields (which are now 2.6%) that the US economy starts to slow. At present we are still a long way from that.

What about the impact of the end of QE?

The more immediate issue is the end of QE next month. A concern for investors is that when QE1 ended in March 2010 and when QE2 ended in June 2011 they were associated with 15 to 20% share market falls. See the next chart.



Source: Bloomberg, AMP Capital

However, while the ending of QE3 may add to volatility it's very different to the abrupt and arbitrary ending of QE1 and QE2. Back then the US economy was much weaker and global confidence was hit by the Eurozone crisis. Now the US economy is on a sounder footing.

What about the impact of rate hikes?

Shares – just as talk of tapering upset shares around the middle of last year (with a 5-10% correction), so too talk and then the initial reality of rising US interest rates could cause a similar upset. However, the historical experience tells us that the start of a monetary tightening cycle is not necessarily bad for shares. The next table shows US shares around past Fed tightening cycles. The initial reaction after three months is mixed with shares up half the time and down half the time. But after 12 and 24 months a positive response dominates. The reason is because in the early phases of a tightening cycle higher interest rates reflect better economic and profit growth. It's only as rates rise to onerous levels to quell inflation that it becomes a problem. But that's a fair way off.

US shares after first Fed monetary tightening moves

First rate hike	-3 mths	+3 mths	+6 mths	+12 mths	+ 24 mths
Oct 80	4.8	1.6	4.2	-4.4	2.4
Mar 84	-3.5	-3.8	4.3	13.5	22.5
Nov 86	-1.5	14.0	16.4	-7.6	4.8
Mar 88	4.8	5.6	5.0	13.9	14.6
Feb 94	2.9	-6.4	-4.9	-2.3	14.9
Mar 97	2.2	16.9	25.1	45.5	30.3
Jun 99	6.7	-6.6	7.0	6.0	-5.6
Jun 04	1.3	-2.3	6.2	4.4	5.5
Average	**2.2**	**2.4**	**7.9**	**8.6**	**11.2**

Source: Thomson Reuters, AMP Capital

It's also worth noting that the rally in shares over the last five years is not just due to easy money. It has helped, but the rally has been underpinned by record profit levels in the US.

Bonds – the commencement of a monetary tightening cycle in the US is expected to put upwards pressure on US and hence global bond yields in response to uncertainty as to how high rates will ultimately go and as to how quickly the Fed will reduce its bond holdings. A 1994 style bond crash is a risk, but unlikely as the US/global economy is not as strong as back then. What's more the monetary tightening will not be synchronised with Europe, Japan and China possibly easing further. As such the back up in bond yields is likely to be gradual and the broad environment will remain one of low interest rates and bond yields for some time yet.

US dollar – the combination of anticipated then actual tightening of US monetary policy at a time of easy/easing monetary policy in many other parts of the world will likely put further upwards pressure on the value of the US dollar.

Emerging market assets – tightening US monetary conditions could weigh on some emerging countries that are dependent on foreign capital inflows. It remains a time to be selective when investing in emerging market shares.

What about the impact on Australia?

The gradual move towards US monetary tightening has taken pressure off the $A allowing it to resume its downtrend which is likely to take it down to $US0.80 over the next year or two. This is necessary to deal with Australia's high cost base and weakening export prices. While the Australian share market could underperform as the $A heads down as foreigners stay away, ultimately it will provide a huge boost as it helps trade exposed sectors become more competitive and boosts the value of foreign sourced earnings. Roughly speaking each 10% fall in the $A adds about 3% to earnings.

Concluding comments

With the US economy on a sounder footing, the Fed is getting closer to a tightening cycle. While this could contribute to short term share market volatility, the tightening is likely to be gradual given the constrained global economic recovery & we are a long way from tight monetary conditions that will seriously threaten the cyclical rally in shares.

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