

The Fed’s Rationale for Raising Rates

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SUMMARY

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As recently as a week and a half ago, we were comfortable with our prediction that the Federal Reserve would wait until the middle of the year to take the next step in normalizing U.S. monetary policy. There seemed to be no immediate prospect of an increase, and the Fed has been exceptionally cautious over the past few years.

But since the beginning of March, a remarkably well-orchestrated string of Fed speakers has made it clear that there will be an interest rate increase on March 15. Because it occurred during a slow period in the economic calendar, this change of tone was not based on new data. So what prompted the increased urgency?

In our view, there are two main reasons. First, asset prices have risen into territory that might cause concerns about financial stability. And secondly, the Fed was deterred from acting several times last year because of international uncertainties. Today, we are in a period of relative calm, but upcoming events in Europe threaten to disrupt the peace. The central bank seems to want to take advantage of this window of opportunity.

Here is our take on the likely content of next week’s conversations.

Economic Growth	
Reasons to Be Hawkish	Reasons to be Dovish
Incoming data from the Institute for Supply Management and small business surveys and consumer sentiment are bullish and denote expectations of continued business momentum. Equity prices are scaling new highs and improving the net worth of households, which is a positive influence on consumer spending.	Real gross domestic product (GDP) grew at trend pace in the fourth quarter (1.9%), implying a lack of inflationary pressure in the economy. Projections of economic growth in the first quarter of this year are progressing at a similar pace. The U.S. economy is not at risk of overheating.

Much of today’s discussion surrounding business activity centers on “animal spirits.” Economic actors seem to be upbeat about the quarters ahead; if they act on this impression, it can become self-fulfilling.

History suggests, however, that confidence readings do not always presage movements in broad economic trends. And if the sources of optimism are ultimately not realized, spirits might sink. Our forecast for growth of around 2% after adjusting inflation, which matches the Fed’s most recent projections, does not create a sense of urgency for monetary policy.

Fiscal Policy	
Reasons to Be Hawkish	Reasons to be Dovish
The current administration's plans to lower both personal and corporate income taxes and increase infrastructure spending will lift overall spending in the economy when it is nearly at full employment. These actions carry the potential to create inflationary pressures.	The scale and timing of any fiscal stimulus are in question. New outlays and tax relief will be limited by budget constraints. The country's debt is projected to climb rapidly without these measures under current law, and there is stiff opposition to allowing the debt to escalate further.

Progress on the administration's economic agenda has been slow. For procedural reasons, attention has turned first to reform or repeal of the Affordable Care Act (ACA). This has proven to be far more complicated than some had thought; few Republicans want to sustain much of the current system, but none want to be responsible for dismissing 20 million Americans from the insurance rolls. An alternative to the ACA was finally proposed this week, but has not yet met with broad support.

Getting reforms in place may become even more challenging. Deficit hawks will not want to see the budget deficit expand much, if at all. But paying for proposed tax cuts and infrastructure spending cannot be achieved merely with reductions in discretionary federal spending. (There isn't much left to cut, see [here](#).) The "border tax" has the potential to raise a lot of revenue, but also create a lot of economic disruption.

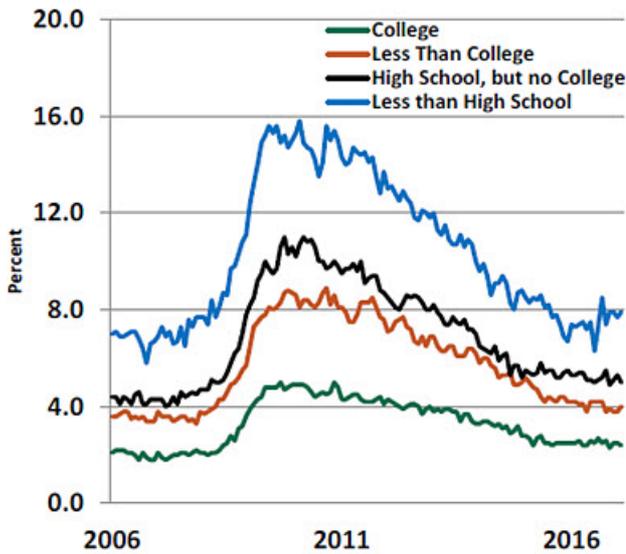
Reality may force delays in passing pro-growth legislation and diminish its size. The up-side risk to U.S. economic growth and inflation may not be as large as some might think.

Labor Markets	
Reasons to Be Hawkish	Reasons to be Dovish
The unemployment rate is within the range the Fed considers to be full employment. Monetary policy cannot solve the lingering pockets of joblessness, which might better be addressed by educational and social policy.	Wage pressure has been slow to gather despite progress on the hiring front. Current readings of employment compensation are far below the level seen at a similar stage in the previous business cycle.

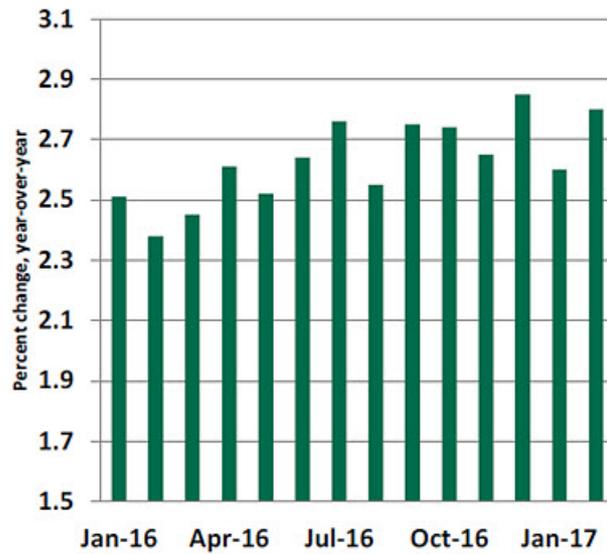
The February employment report showed widespread gains in hiring, with both goods and service sectors accounting for the overall increase. The 3-month average of payrolls at 209,000 is more than adequate to hold the jobless rate steady. Although hourly earnings regained strength, employment compensation is mostly stable and awaiting additional acceleration at the late stage of the expansion.

The unemployment rate dipped to 4.7% despite an increase in the labor force, a noteworthy development. Broadly speaking, the Fed's full employment mandate has been met.

Unemployment Rate by Educational Attainment



Hourly Earnings



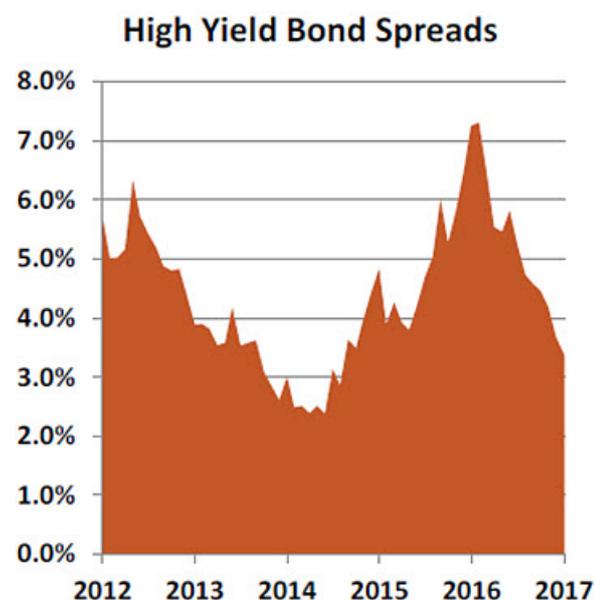
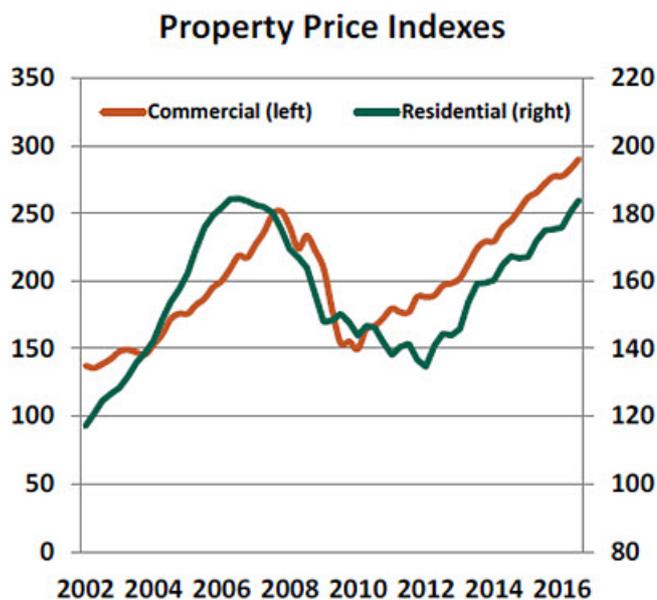
Source: Haver Analytics

Inflation	
Reasons to Be Hawkish	Reasons to be Dovish
<p>Actual inflation numbers are close to the Fed's 2.0% price stability mandate, reflecting higher prices for more than just energy items. Inflation expectations are hovering around 2.0%.</p> <p>Proposed trade restrictions such as tariffs will increase import prices and bear on overall price readings.</p>	<p>The year-to-year change in the personal consumption expenditure price index (1.9%) and the core price gauge (1.7%) are approaching the Fed's inflation target, but these do not present serious price pressures. The dollar's strength will hold down import prices and in turn trim headline price data.</p>

The Fed needs to be forward looking as policy changes affect economic activity and inflation with a lag. The price stability target is within reach. Delaying monetary policy tightening would require more aggressive hikes in the policy rate that will eventually be harmful to economic growth. Given that both the full employment and price stability mandates are nearly satisfied and the implicit financial stability goal is in place, the Fed's credibility will suffer if it fails to take action against inflation now.

Financial Stability	
Reasons to Be Hawkish	Reasons to be Dovish
<p>Asset prices in a range of markets have exceeded all-time highs. Values relative to fundamentals (price to earnings multiples for stocks, cap rates for real estate, etc.) are rich. Low interest rates may be leading investors to reach for yield in an unhealthy manner.</p>	<p>All indications are that the level of leverage underneath asset prices is far below what it was prior to the financial crisis. While this is no guarantee that there won't be a market correction, it does provide assurance that such a correction likely won't be systemic.</p>

Record equity indices have certainly attracted a lot of attention, but that isn't where the story ends. Commercial and residential property has also done exceptionally well; perhaps too much so. The Fed has issued a string of warnings about real estate, which it may choose to reinforce by making financing more expensive.

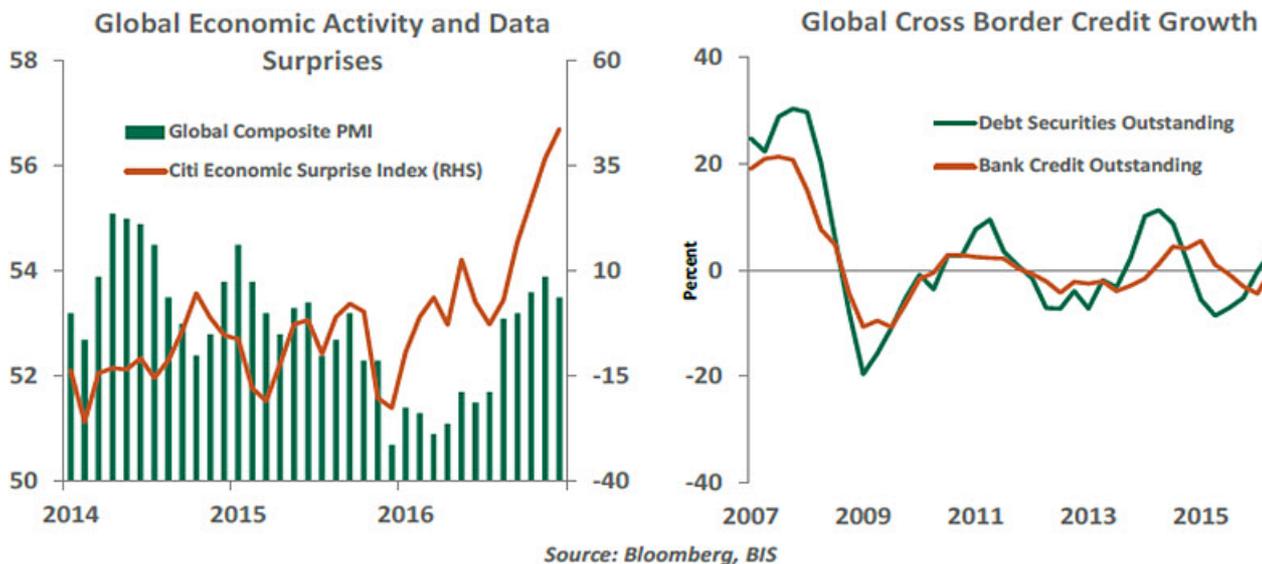


Source: Bloomberg

Further, compensation for credit risk in the market has fallen dramatically; spreads on high-yield debt are below their levels of three years ago, just prior to the bust in oil prices. (Many high-yield debt issuers came from the energy sector, which encountered challenges that caused it to correct severely.) Measures of market volatility are low, belying the myriad of risks present in the outlook. The Fed may find value in cooling things off just a bit.

International Factors	
Reasons to Be Hawkish	Reasons to be Dovish
<p>International cues have turned positive. Economic recovery in Europe is gathering momentum, with better-than expected growth and inflation numbers. Brexit's economic impact would take time to realize, and even then could be largely localized. This positivity is reflected in the broad bases and consistent improvement in purchasing managers indices.</p>	<p>Many emerging markets remain sensitive to reversal in capital flows due to substantial foreign currency debt and/or large external financing needs. Furthermore, a tightening of dollar liquidity conditions could leave the global financial system vulnerable to a meltdown if the tail risk scenario in any of the European elections or Brexit negotiations is realized.</p>

Recent economic data coming out of developed markets gives reason to be optimistic about the future. It could be argued that soft data — such as economic sentiment or consumer confidence — might be getting ahead of the hard data, but the data has been certainly surprising on the upside. The European recovery has even prompted talks of an earlier than expected monetary policy normalization from the European Central Bank. Across the Channel, growth in the U.K. has held surprisingly well in the aftermath of the referendum, forcing upward revisions of forecasts. It is now clear that the economic damage from U.K.'s divorce from the EU would be spread over a long period and even then it would be largely localized.



Of course, some emerging markets remain sensitive to shifts in global capital flows and could see external debt servicing costs rise (via both rising interest rates and stronger dollar). International credit growth is already tepid and higher funding costs could prove to be a headwind to growth. Furthermore, the global financial system is vulnerable to low-probability but high-risk political events in Europe and could do without tighter liquidity conditions. However, it is important not to overstate these vulnerabilities. On balance, the global economy is strong enough to withstand a more hawkish Fed.

Summary

Some have suggested there is urgency within the central bank to move the tightening process along before the White House appoints new governors to the Federal Reserve Board. This suggestion contends that with the federal debt likely to expand in the years ahead, the administration might favor candidates who would hold interest rates down. But we do not give much credence to this view, especially since many Republicans have been arguing for higher interest rates.

Speculation has already turned to what the Fed might do after March. Of the predicted three rate increases in 2017, we tentatively forecast the remaining two to occur in September and December out of consideration for potential mid-year international volatility. Of course, the Fed will provide a glimpse at its future intentions through the summary of economic projections that will follow the upcoming meeting.

We'll have coverage of the Fed's decision next Wednesday afternoon.

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