Data Snapshot

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Bank of Melbourne

What Goes Down Must Come Up?

- **The Federal Reserve has kept the Federal Funds rate at a target of between 0 and 0.25% for an unprecedented period of time. Moreover, the Fed has also undergone unconventional measures to provide additional stimulus. Given the extraordinary amount of stimulus currently in the economy, the path for returning to "normal" policy settings is more uncertain than in earlier periods of policy normalisation.**

- **If the US economy evolves as expected, and the Fed indeed, raises its benchmark interest rate, mid-next year, it would be the first rate hike by the Federal Reserve in almost eight years.**

- **As the time for the Fed to begin raising rates draws closer and actually tightens policy, the risk of a further adjustment within financial markets will increase. We expect that this will result in a trend increase in bond yields and long-term interest rates across the globe. The US dollar is also expected to strengthen further.**

- **As in past tightening episodes, as US bond yields head higher, the risk increases that Australian bond yields will also lift as they move closely with yields in the US.**

Low interest rates across the globe have been a key characteristic of the post-GFC landscape. It largely reflects the policy decisions of central banks in many countries of the developed world as they attempt to provide support to their economies. However, it also reflects the extent of the shock the GFC had on the global economy. Below par global demand and low inflation has meant that interest rates have been low for an extended period of time. Cheaper borrowing and very low returns on "safe" investments such as bank deposits and government bonds has translated into large gains in share markets and other asset markets including residential housing across the world.

It is helpful to think of interest rates as separated into two categories – short-term and long-term. Short-term rates are generally set by central banks like the Reserve Bank of Australia (RBA) and the US Federal Reserve (The Fed). They tend to have most influence on rates such as the bank bill swap rate and standard variable mortgage rates (in Australia).

Long-term rates are the domain of government and corporate bond markets and influence fixed-term rates. In recent years, the Federal Reserve has also directly affected yields in bond markets through its quantitative easing program or QE. Asset purchases by other central banks such as the European Central Bank (ECB) and the Bank of Japan (BoJ) have also kept global bond yields down.

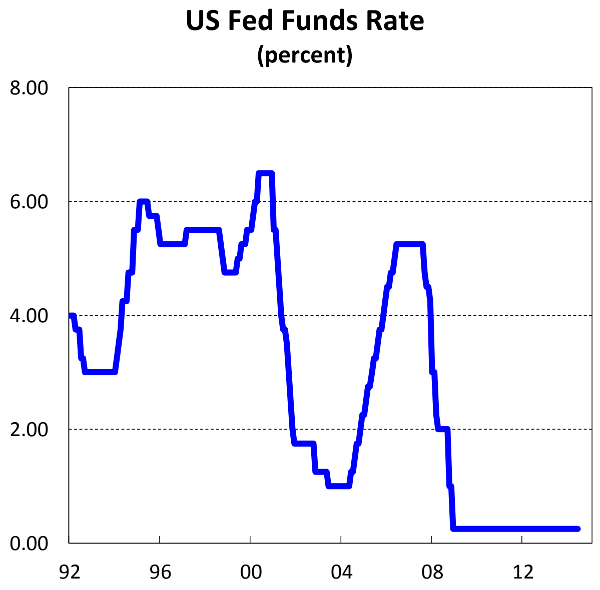
In this article, we focus on the Federal Reserve and the implications of policy normalisation in the US for global financial markets and Australia.

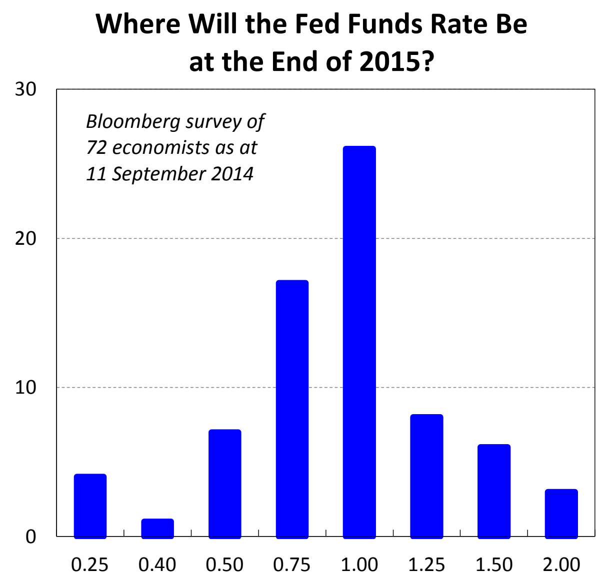
The End of an Era?

The Federal Reserve has kept the Federal Funds rate at a target of between 0 and 0.25% for an unprecedented period of time, almost six years. Moreover, the Fed has also undergone unconventional measures to provide additional stimulus through its various quantitative easing programs. Given the extraordinary amount of stimulus currently in the economy, the path for returning to "normal" policy settings is more uncertain than in earlier periods of policy normalisation.

An improving US economy has driven the Federal Reserve to take the first step in pulling back stimulus, by tapering its quantitative easing program (or QE) by $10bn each month and the Fed is expected to announce an end to asset purchases in October. However, a move to raise the Federal Reserve's main benchmark interest rate, the Fed funds rate, should have a more significant tightening impact on the US economy than bringing an end to QE.

Market pricing shows that the first rate hike is fully priced in for July next year and there is more than a 50% probability attached to a move as soon as March next year. We expect that the Fed will begin raising the Fed funds rate in the June quarter 2015, reflecting a gradually improving US economy.





Rising Interest Rates – What's at Risk?

If the US economy evolves as expected, and the Fed indeed, raises its benchmark interest rate mid-next year, it would be the first rate hike by the Federal Reserve in almost eight years. As the Federal Reserve edges closer to tightening financial conditions, it also poses challenges for the broader global economy and financial markets, as risk tends to be repriced.

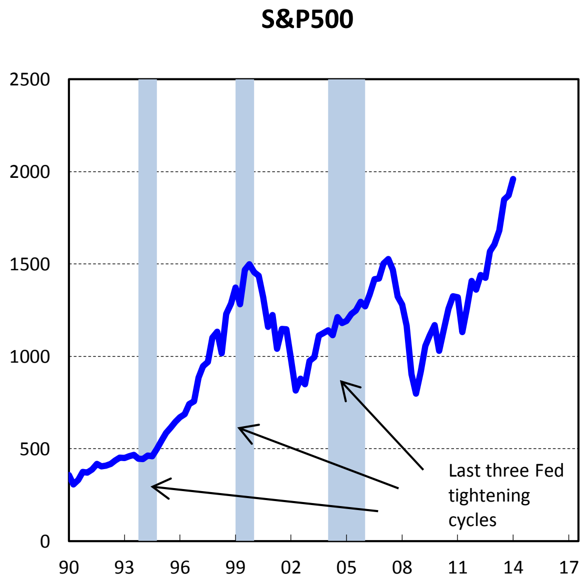
Lessons from the Past

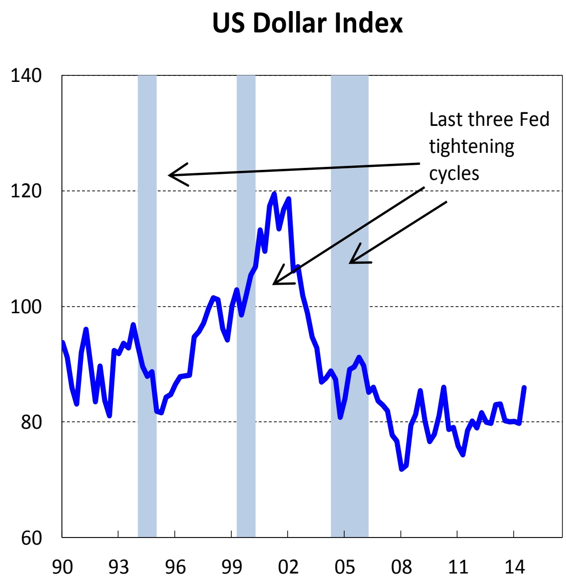
We can examine past experiences to get a sense of what may come when the Fed starts to tighten monetary policy. The last three tightening cycles by the Federal Reserve occurred in 1994, 1999, and most recently in 2004.

In the tightening cycle over 1994, the Fed first raised benchmark interest rates from a low of 3.00% in February 1994 and lifted them to a high of 6.00% by February 1995. Yields on 10-year treasury notes rose from 5.64% at the end January 1994 to a peak of 8.03% in November 1994. The US dollar index actually fell during that time, from a peak of 96.97 in January 1994 to 85.93 at the end of February 1994. However, it trended upwards in the lead up to the first hike and the January peak was a 2½-year high. The S&P500 tracked sideways for much of 1994, but then rallied in 1995. The tighter financial conditions globally around this time has been partly blamed for triggering a long series of financial crises in a wide range of emerging market economies including Mexico, Russia and Asia.

In 1999, the Fed started raising rates from a higher starting point. The first rate hike occurred in June 1999 from a Fed funds rate of 4.75%, and the Fed continued tightening until rates reached 6.50% in May 2000. At the end of June 1999, US 10-year government bond yields were at 5.78% and rose to a peak of 6.79% in January 2000. The US dollar index was at 102.85 at the end of June 1999 and rose to a peak of 118.58 in October 2000. Meanwhile, the S&P500 edged slightly higher over this period.

The most recent tightening cycle was from a Fed funds rate of 1.00%. The first rate increase was in June 2004 and rate hikes continued until the Fed funds rate reached 5.25% in June 2006, the last time the Fed hiked rates. Yields on 10-year treasuries initially rose from a low of 3.68% in March 2004 to 4.87% in June before ranging sideways for over a year. In 2006, yields rose to a peak of 5.24% in June 2006. There was no clear direction in the US dollar index, which seemed to trend sideways and the US share market gradually lifted.





While there are factors other than the Federal Reserve which influence financial markets such as economic conditions in other parts of the world, past experience seems to suggest the following:

- There will be upward pressure on bond yields
- Share markets don’t necessarily fall and could rise with an improving economy
- The US dollar has tended to rise, although the timing of when this happens is uncertain

- Financial tightening can expose vulnerabilities

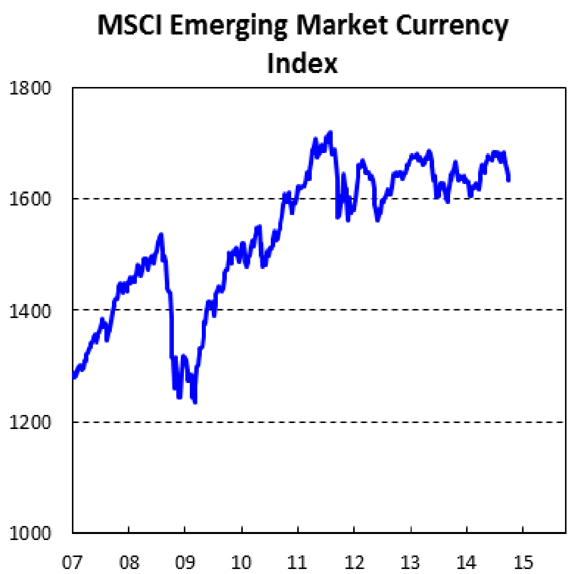
Are Emerging Economies at Risk Again?

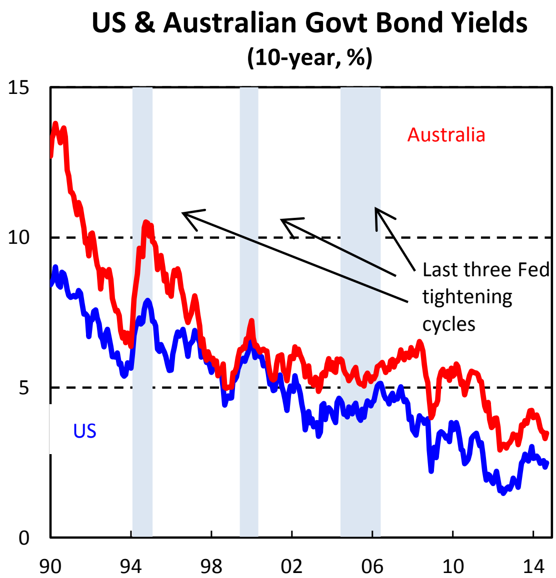
Ever since the GFC, loose monetary policy settings in advanced economies have significantly boosted investor demand for investment within emerging market economies. This strong demand has boosted both private and public sector debt in emerging economies. The growth of corporate debt stands out – net issuance of emerging market corporate debt tripled from 2009 to 2013 according to the IMF, although household debt has also increased rapidly.

The increase in leverage in some areas could pose risks, when the Federal Reserve decides to hike rates. A rise in US bond yields tends to translate to higher borrowing costs globally, therefore tightening financial conditions across the world. Those countries which could be vulnerable are those which rely heavily on external financing including Brazil, Indonesia, South Africa and Turkey. Additionally, a lift in borrowing costs combined with slower growth in these economies could see difficulties arise in the corporate sector particularly within Argentina, Turkey, India and Brazil.

Currencies in these countries have already come under pressure in line with a strengthening US dollar, suggesting an adjustment to tighter monetary policy is already occurring. A greater issue can arise if the outflow of capital is sudden and large relative to the size of these economies.

The "taper tantrum" in May 2013 could be seen as a dress rehearsal of the potential shake up that could occur in financial markets. This occurred when Fed Chairman Ben Bernanke first announced plans to taper its quantitative easing program; yields on 10-year US treasuries rose sharply from a low of 1.63% on 2 May to 2.99% on 5 September. A number of emerging economies were hit hard including Brazil, Indonesia, South Africa and Turkey. India, Thailand and Malaysia were also hit, although their external positions are now much more favourable and are therefore less susceptible to capital outflows.





Implications for Australia

In Australia, a strengthening US dollar and a bout of risk aversion are factors behind the Australian dollar's recent fall from above 93 US cents in early September to below 87 US cents on 1 October. The growing prospect of Federal Reserve tightening is expected to provide upward pressure on the US dollar, and result in a trend decline in the Australian dollar over the next few years.

Additionally, any further increase in volatility in financial markets or an increase in risk aversion would also tend to put downward pressure on the Australian dollar.

As in past tightening episodes, as US bond yields head higher, the risk increases that Australian bond yields will also lift as they move closely with yields in the US.

Is This Time Different?

While it seems more than likely that bond yields will start heading higher and the US dollar will continue to strengthen, there is reason to believe that this tightening cycle will not be the same as those in the past. This is because:

- **This tightening cycle would follow a substantial quantitative easing program –** Bond yields have been kept lower than they otherwise would be due to the direct purchase of treasury bonds by the Federal Reserve. The Fed has indicated that it will continue to reinvest these bonds as they mature, and could therefore limit the rise in yields in the near-term. However, once the Fed begins to raise rates and allows its balance sheet to reduce over time, there will be a greater risk that bond yields will lift more quickly.

- **There is better transparency and communication by the Federal Reserve –** The Federal Reserve has been clearer in communicating its intentions over the past few years, such as its commitment to keep interest rate low for a "considerable time". The Federal Reserve also now publishes forecasts for the trajectory of the Fed funds rate as of a few years ago. This enhanced communication strategy should mitigate the potential for surprises or sharp movements in financial markets.

- **Most emerging countries are more resilient –** Over the past decade, emerging economies have grown larger relative to global economy and suggests that they should be more resilient to a sudden outflow of capital. Additionally, there are only a handful of emerging nations which are reliant on external funding in comparison to the mid to late 90s.

- **There remains a significant amount of global monetary policy stimulus –** Commitments to provide substantial easy monetary policy by central banks in Japan and Europe will help keep global financial conditions relatively loose and support a high level of liquidity in the global financial system.

- **The expansion in the US economy is less robust than in previous recoveries –** While substantial progress has been made in the US economy, growth remains disappointing. Last year, the US economy grew by 2.2% and is expected to grow at just 2.1% in 2014, although next year growth is expected to lift to 3.0%. The slow pace of recovery suggests a more gradual path of rate increases by the Federal Reserve.

Conclusion

Financial markets have already begun to position themselves for an eventual tightening by the Federal Reserve. As the time for the Fed to begin raising rates draws closer and actually tightens policy, the risk of a further adjustment within financial markets will increase. We expect that this will result in a trend increase in bond yields and long-term interest rates across the globe. The US dollar is also expected to strengthen further.

Next year is also likely to mark the beginning of the tightening cycle for other central banks, such as the Bank of England and the RBA. A higher RBA official cash rate would also further tighter financial conditions in Australia, but we will save that discussion for another time.

Note: This article also appeared in our quarterly economic report released last week.

Janu Chan, Senior Economist
Ph: 02 8253 0898

Contact Listing

Chief Economist

Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist

Hans Kunnen
kunnenh@bankofmelbourne.com.au
(02) 8254 8322

Senior Economist

Josephine Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

Senior Economist

Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898

The Detail