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ECONOMIC TALKING POINTS

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If the Fed Does Raise Rates in December, What Happens Afterwards?

The longest drum roll in central bank history will likely come to an end in December. After months of feverish speculation, fueled in part by a marathon of speeches lately by Fed officials (six of them today alone), I expect they will at long last vote to finger flick the benchmark rate up a notch, from 0.125% to a midpoint target of 0.38%. Doing so before the end of this year would make perfect sense for both economic *and* political reasons.

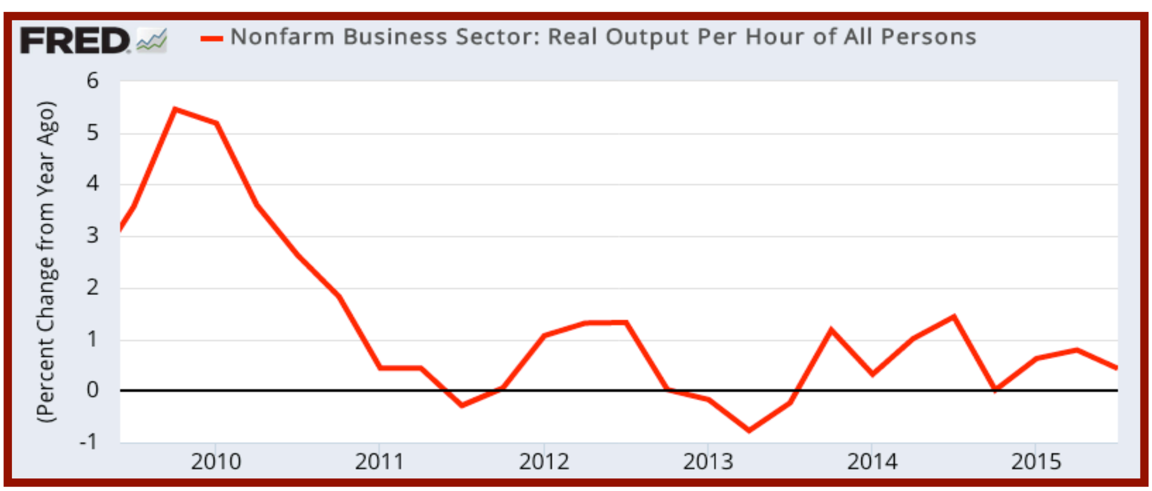
Let's start by looking at the economic justification for a rate hike. The Fed will evaluate three broad factors:

1. Have the two key Fed mandates --- full employment and stable inflation --- been met?

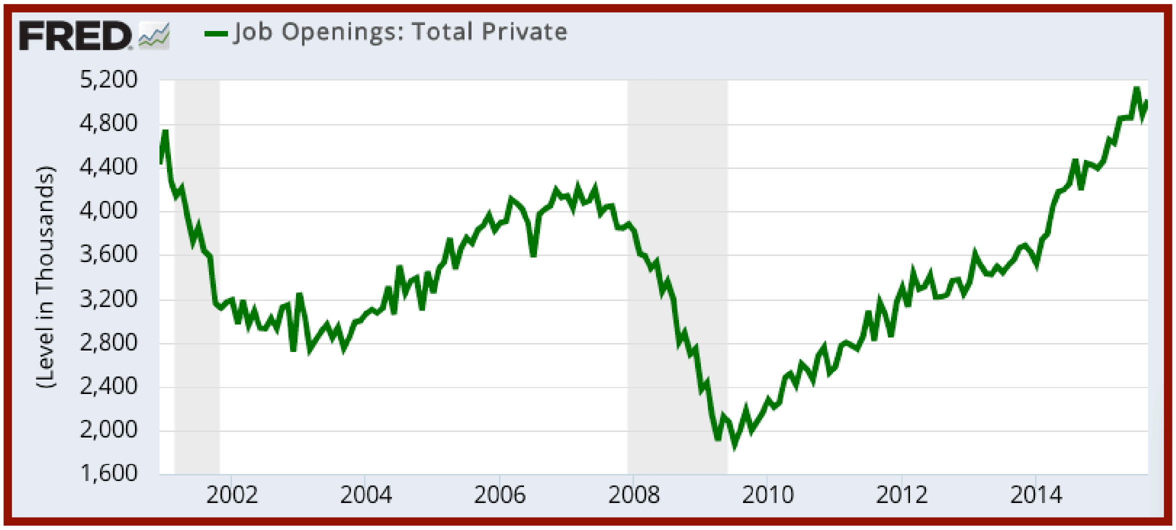
In terms of employment, you can check off that box. October's 271,000 increase in payrolls, 99% of which took place in the private sector, was the biggest jump of the year. Moreover, upward revisions the two previous months added another 12,000 to the initial estimates. Those revisions were hardly a surprise given the messy seasonal tallies that occur during the summer.

The October unemployment rate has dropped to 5%, the lowest in 7 years, and now close to full employment. Sure, some will comment that this is a flawed metric because the labor force participation rate (LFPR) is at a 40 yr low. But I disagree with that criticism and have explained why in earlier reports. (Among the reasons cited, is that more of the aging baby boom generation are retiring. Second, many eligible workers have returned to colleges, vocation and technical schools to pick up skills more suitable for today's marketplace. Third, the "sharing economy" has greatly muddled the definition of who is and who is not in the labor force. Fourth, the Great Recession and weakest recovery in post-WW II history forced many unemployed Americans into the underground economy. To pay for food and shelter, millions have set up their own cash-driven businesses, doing computer repairs, carpentry work, tutoring, selling in flea markets and the like. This shadow economy by our estimate has climbed in size close to 10% of US GDP, or nearly $2 trillion. The point behind all these factors is that the slack in the labor market is, in fact, shrinking!)

On the mandate regarding inflation, the Fed can also feel more at ease now that wage growth is accelerating. Average hourly earnings rose 2.5% over the last 12 months, the most we have seen since July 2009. At the same time, though, nonfarm productivity remains dismal (up just 0.4% over the year). The combination of faster wage growth and poor productivity will inevitably push inflation higher. Our own forecast calls for headline inflation to approach a 1.5% rate by mid-2016. We're already there on core inflation and history has shown that headline inflation does eventually converge to the core rate.



The prospect of wage inflation received another boost this week from two other reports. The National Federation of Independent Business (NFIB) released its October survey on small business confidence. Remember, these firms hire 7 out of 10 new workers so NFIB report deserves study. While the overall optimism of these companies was unchanged in October (96.1), if you dig deeper into the release, you see the difficulty they have finding qualified workers. The percentage who said they found few or no qualified applicants jumped to 48%, the highest since 2007. The Labor Department also just put out its Job Openings and Labor Turnover Survey and showed that job vacancies in the private sector jumped to 5.02 million in September (from 4.88 million in August), the second highest in the history of this series (since 2000). Thus the competition to find scarce workers will only get more intense in the months ahead and push wages even higher.



2. How precarious are foreign financial markets?

The second major issue under consideration has been the fragility of global financial markets. Here the Fed has begun to ponder whether a rate increase in the U.S., at a time when other major central banks are easing, will significantly destabilize world equity, bond, and currency markets. Historically, the Fed would not overtly comment on global economic conditions to avoid conveying the impression that it is effectively the world's central bank (ahem!…which it is).   Nevertheless, the last few FOMC statements demonstrate how foreign economic concerns have become part of the discussion on US monetary policy. For instance, the Fed held off any rate action last June because of heightened concerns about a Greek debt default and its impact on the Eurozone and world capital markets. The Yellen-led group chose to punt again in September following China's sudden devaluation of the Yuan and the bursting of their equity bubble.

However, foreign economic and financial conditions has since calmed down, giving the Fed an opportunity to proceed with a rate increase. In fact, many emerging countries have pleaded with Janet Yellen and Stanley Fischer to get on with it simply to end the chronic uncertainty over US monetary policy, which has bled these economies of private capital, slashed foreign exchange reserves and pummeled their currencies.

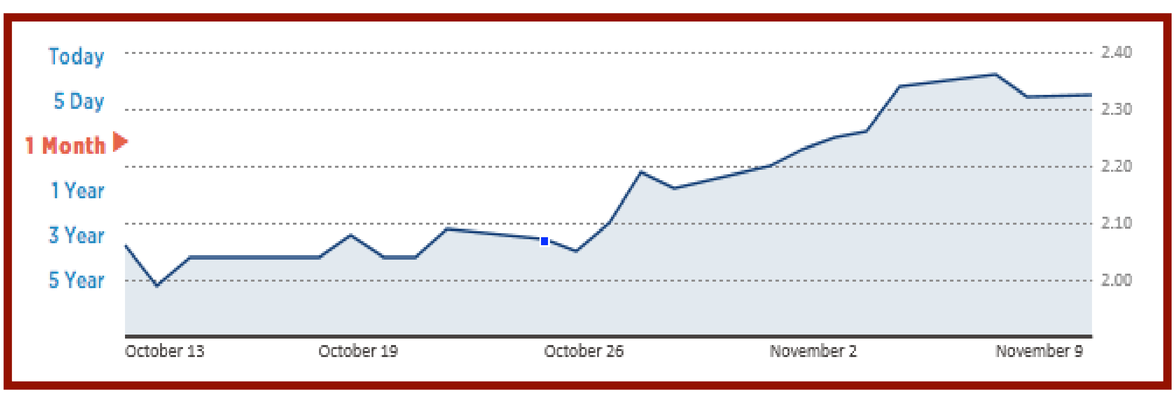
3. The great whisper...politics.

The third reason is one Fed officials recognize as taboo in any public forum but likely whispered in the corridors of the institution. Does the central bank really want to commence the first monetary tightening cycle in a decade in 2016, smack in the middle of a highly charged Presidential campaign? Wouldn't the Fed then become an all too easy target by those seeking the White House? Janet Yellen and her colleagues are not oblivious to the political fallout that would follow a rate increase at this delicate political juncture. Lifting rates in December, would allow the Fed to maintain a lower profile for most of the coming election year.

What happens after the first rate increase?

And that leads to my next point. If the Fed does proceed to raise the benchmark target next month, I see little chance of a follow up with multiple increases next year for reasons other than political. Policymakers will first have to closely monitor what impact an initial rate increase will have on longer term rates and the dollar, since both can potentially magnify the effects of a tightening move. For instance, the 10-yr Treasury yield is a key benchmark for many other borrowing costs, like mortgage rates and corporate debt. If the yield climbs too much or too quickly, it could derail the economic expansion. We have already seen a sell-off in Treasury notes just on the expectation of a rate hike. The 10 yr yield jumped about 30 basis points in the last month, to 2.33%, a four month high. If the yield continues its climb long after the Fed acts, it could put a chill on home sales, consumer spending, and business capital investments in 2016.

Chart: Yield (%) 10 Year Treasury Note



Similarly, higher U.S. rates can attract more foreign demand for dollar financial assets. Should the greenback undergo another round of appreciation, the U.S. trade deficit would swell, drag down GDP growth, and greatly compound the problems of multinationals. Not only would a much stronger dollar further imperil U.S. sales overseas, but profits will take another hit after these companies convert foreign earnings back into dollars.

So I expect to see a long pause before the Fed raises rates a second time. They very last thing they want to do is tighten too quickly, and then feel pressure to reverse course and return to zero again.

For all these reasons, we expect the Fed will take its first small step to normalize rates next month --- and then stand pat for much of 2016.

How will the stock market react to a rate increase?

I want to answer this first by saying the normalization of interest rates must be viewed as a good thing. It reflects confidence that the economic fundamentals of the U.S. are not only solid, but that business activity appears to be gathering steam. Fresh evidence this morning of higher than expected spending on wholesale inventories and sales in September tells us that 3rd quarter GDP will be revised up. Consumers have ramped up spending on autos to historic high levels and using some savings from lower gas prices on eating out more. The NFIB survey noted that small businesses are planning to increase capital outlays the next three to six months, which reflects their own confidence in the business outlook.

Moreover, while a rate hike might initially trigger a negative reaction in the stock market, if history is any guide, any such downturn will likely be temporary. Since 1982, there have been 7 interest rate tightening cycles by the Fed and the S&P 500 ended up higher a year later in every single instance by an average of 6.4%. The bottom line is the U.S. continues to be the bright spot in the world economy and that should be our predominant focus. There's no need to quiver over a rate increase of one quarter of one percent.
