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Global stock markets cheer Federal Reserve rate hike, but deeper questions loom for consumers and countries

By Ylan Q. Mui   December 17, 2015

The Federal Reserve's landmark decision to raise its benchmark interest rate is already beginning to ripple through the global economy, boosting international stock markets Thursday, but raising deeper questions about whether troubled countries will be able to withstand higher rate and forcing ordinary households to rethink their investments.

The move by America's central bank is the first step in what is expected to be a protracted campaign to return interest rates — and the nation's recovery — back to normal after seven years of unprecedented stimulus. The Fed pumped trillions of dollars into the economy and slashed the influential federal funds rate to zero during the 2008 financial crisis, sending the cost of everything from a mortgage to corporate debt to rock-bottom levels.

Fed officials have kept markets on edge for months as they dropped hints that they were preparing to end the era of easy money. Investors around the world appeared to cheer the clarity provided when the milestone moment was announced Wednesday.

Japan’s Nikkei index rose 1.6 percent Thursday, while the Hang Seng Index, in Hong Kong, was up 0.8 percent. In Europe, Germany’s Dax index surged 3 percent by Thursday afternoon while the broader Euro Stoxx 50 index gained 2.5 percent. On Wall Street, the major U.S. indices were down modestly by mid-morning Thursday following yesterday’s rally.

“It is important in the sense that it resolves uncertainty,” said Robert Perli, head of global monetary policy research at Cornerstone Macro. “I think that might actually be a good thing, not a bad thing.”

But it will take the Fed years to withdraw its support for the economy, and it could be even longer before the ramifications of its actions are fully understood, both for kitchen table decisions and international policy.

A recent Gallup poll found that 62 percent of those with at least $10,000 to invest were worried about volatility in financial markets, up from just over half in February. Although only about 1 in 5 thought the Fed’s raising rates would be good for the economy, a majority said they would benefit from higher returns on their savings. About 35 percent more said they may pull money out of the stock market to invest in less risky assets.

Higher interest rates could provide some relief to savers — many of them older Americans — who have endured nearly nonexistent returns on bonds and safe investments, such as money market funds and certificates of deposits since the Fed slashed interest rates. Standard & Poor's Research found that retirees need to invest at least a million dollars in 10-year Treasury bonds just to secure annual payments equivalent to half of the national median income.

Portland retiree Don Baack, 78, said the returns on his bonds have been "abysmal," and he doesn't expect that to change quickly. The effect of the expected slow pace of the Fed's raised rates on his interest income probably would translate into "two more beers with your dinner," he joked.

But Baack said he has benefited in other ways from the extraordinary era of low interest rates. Poor returns on his savings encouraged him to invest in upgrading the home he and his wife have lived in for more than four decades. And though Baack doesn't plan to move any time soon, his house is worth more thanks to the support from the Fed.

"I suspect on balance it's been a very positive thing," he said. "It's been good for the economy because it's really helped finance a lot of things. The housing market has really come back because of low interest rates."

Mortgage rates already had started to inch up, however, on the mere anticipation of the Fed's move. The average rate on a 30-year fixed home loan was 3.94 percent in November, according to Freddie Mac, up from 3.8 percent the previous month. Many experts believe mortgage rates will slowly increase as the Fed continues to increase its benchmark rate. A recent survey by Berkshire Hathaway Home Services found that roughly one-third of prospective home buyers would feel discouraged about jumping into the market as rates go up.

But buying a home is a long-term purchase, and the central bank has the most influence over short-term rates. Long-term rates such as mortgages more closely track to 10-year Treasury bonds, which in turn are tied to international demand. That means the tepid global economy could put a lid on how much mortgage rates rise.

“The initial interest rate move will be very modest,” said Greg McBride, chief financial analyst at Bankrate.com. “But the significance is in the potential cumulative impact of whatever interest rate hikes are put into effect over the next 18 to 24 months.”

A Bloomberg News poll of economists found that 80 percent thought mortgage rates will go up over the next year. The cost of a 30-year fixed-rate loan started to rise this fall to nearly 4 percent on anticipation that the Fed would raise rates. An analysis by Realtor.com found that as many as 7 percent of people who bought a home this year would have trouble qualifying for a loan if mortgage rates rose considerably.

The housing market isn’t the only sector of the American economy at risk. The New York Fed estimated that a 1 percentage point increase in the central bank’s target rate will lower auto sales by 3.25 percent.

“If longer term rates increase too much and cools demand for credit, derails the housing recovery, hurts auto sales, and jeopardizes the economic expansion, the Fed may have to quickly reverse course on interest rates,” said **Bernard Baumohl, chief global economist at the Economic Outlook Group.**

Rising rates also could prove perilous for emerging markets, which already have been rattled by a slowdown in China and plunging oil and commodity prices. Many of these countries, rich in natural resources such as copper and iron ore, had counted on voracious demand from China to fuel growth.

Meanwhile, investors poured money into developing markets as they sought out higher returns. At the same time, the Fed held down interest rates. That lowered the cost of credit and accelerated the boom.

Now, both of those dynamics are reversing. China’s appetite for commodities has waned, helping to send Brazil into a deep recession. Investors worry other countries could soon follow.

In addition, some emerging markets fear investors will flee their countries as U.S. rates rise, compounding their pain. The turmoil in global markets late this summer showed just how quickly sentiment can shift: Investors withdrew a net total of $4.5 billion from emerging markets in August after plowing more than $6 billion into developing countries the previous month.

Central bankers in several emerging and frontier markets have warned that they may need to raise interest rates once the Fed makes a move — even though their own economies are under strain.

“The actions of the Fed are not going to be the only thing that determines monetary policy going forward for the Bank of Mexico," the head of the country’s central bank, Agustín Carstens, told Reuters this month. But, he added, the Bank of Mexico “at some point, has to send a signal that it is worried about the value of its currency.”

Many countries and foreign corporations also borrow in dollars, and a stronger greenback would make those loans more difficult to pay off. Governments and businesses also would probably face higher rates on any new debt.

The global ripple effects of any Fed movement are one reason the International Monetary Fund had urged the central bank to wait until next year to start raising rates. Still, some analysts argued many investors in emerging markets anticipated Wednesday's hike, and earlier drops in the currencies of Argentina, Brazil and South Africa reflected that expectation.

In other words, maybe they already ripped off the Band-Aid.

“To a certain extent, this has been built in,” said Steven Hess, senior vice president at Moody’s Investors Service. “The Fed rate hike isn’t going to be a big surprise.”

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