Perspectives
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The Federal Reserve: A Policy Update

September 2015

A great deal of attention was paid to the Fed's FOMC Committee meeting which concluded on September 17 with a down-to-the-wire decision to do nothing. While the world does not revolve around the Fed Funds rate, this first tightening action will receive tremendous attention because it has been so long since the Fed has tightened policy (over nine years), other central banks are still engaged in Quantitative Easing (QE), and the US economy appears to be an island of stability in a roughening sea.

Since December 16, 2008, the Fed Funds target rate has been set at a range of 0-0.25% which is referred to as ZIRP, or Zero Interest Rate Policy (see the blue line in the chart below). The Fed then had to initiate new policy measures since the zero bound effectively precluded any further rate cuts. Some of these measures were simple, such as forward guidance which gives the market more explicit information on the Fed's intentions, while other measures were quite revolutionary for the US. Quantitative Easing was perhaps the most notable shift in Fed practice: rather than the *price* of money being changed, the *quantity* of money was being targeted in an effort to boost asset values (i.e. real estate, equities, etc.) while also attempting to flatten the term structure of rates (so ten and thirty year Treasury yields were reduced due to their buying activity). QE soon led to QE2 and then QE3 as the US economy was slow to gain traction, partly owing to declining velocity of money as large segments of the economy still sought to reduce leverage.

Now that QE3 has ended (the "tapering" story from 2014 involved slowly ending monthly purchases, but proceeds from cash flow are still being reinvested) and the US economy is sound, the removal of emergency policies can finally begin...just not quite yet.

Comments from Fed officials have indicated the path to higher rates will be slow and "data-dependent" but the events that appeared to cause this latest delay emanate primarily from overseas: 1) China's equity market swoon this summer has unnerved the Fed since it is coupled with dramatic declines in nearly all commodities, indicating China is slowing more than the official data imply, 2) currency market gyrations have been dramatic this year as China devalued the yuan and other emerging market currencies are weaker mostly due to the commodity action, while some developed markets are favoring weaker currencies to boost exports, 3) domestic inflation measures are still quite low and nowhere near the Fed's 2% target (this is also true in most other major economies where deflation is still seen as the bigger risk).

The Fed meets next in October but there is no scheduled post-meeting news conference, although Janet Yellen's comments left open the possibility of quickly calling one should they decide to act. Still, Yellen generally seeks to avoid surprises so most observers now believe the best chance for a rate hike is the December 16 meeting. There are benefits and risks to raising rates which could be summarized as follows:

Pros

- The Fed has been telegraphing its intent to move off the zero bound as the labor market returns to normal, so acting will restore confidence in Fed communications (they have repeatedly moved the goalposts on their stated targets for the unemployment rate which has added to market confusion).
- Moving toward a more normal short term rate will reduce the potential for bubbles or unintended consequences emanating from the extended easy money policy
- Market participants may feel a sense of relief that the Fed is confident enough in the recovery to begin raising rates.

Risks

- Currency market volatility could escalate and may imperil an emerging market country with dollar-denominated debt or perhaps a major financial institution; history is full of financial crises with currency-related causes.
- Global equity markets could react negatively and curtail household wealth measures which would likely clip consumer confidence.

One new element to the Fed's forward guidance strategy is referred to as "the dots" which is an anonymous compilation of the voting members of the Federal Open Market Committee's opinions on short term rates, long term inflation and economic growth, and the path of future rates. As unfolding economic developments have altered their views on these matters, the dots have shifted and the latest report featured yet another downward shift of members' views. This reflects their on-going concern over disinflation from weak commodities but also their newly heightened unease over international developments.

Nevertheless, we believe the Fed will find ample rationale to begin raising rates before the end of 2015 and will seek to restore a sense of normalcy to policy rates. We also believe the yield curve will react in benign fashion since the downside risks to global economic growth have increased and the Fed will likely move very gradually and cautiously. Past Fed tightening cycles will likely prove of little use in forecasting the next tightening cycle since the global economy is more interconnected than ever and the Fed is well aware that the fate of global growth is in its hands. One strategist recently put it this way: "the FOMC is scared to death of a premature liftoff." **They will be careful to protect what they have so patiently restored.**