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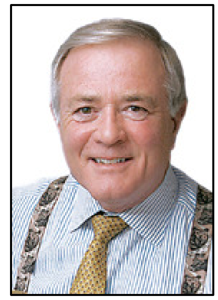

William Rutherford

Federal Reserve prolongs wait for interest rate hike

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The Federal Reserve decided at its June meeting not to raise interest rates. The vote was 10-0, with all but two members of the 17 full board expecting a rate rise by the end of the year. Four who previously wanted two rate increases this year now favor one rate increase. It is believed that the chairwoman, Janet Yellen, was one of those. If so, Yellen's shift would be an important change in the center of gravity for the board, because it tends to support the chairwoman's views. In this manner, the Fed has prolonged its push-me, pull-you teasing of the market about rate increases.

The Fed has long signaled a desire to raise rates, but facts keep getting in the way. The Fed has proven overly optimistic about its efforts to heal the economy. Indeed Yellen in May expected the economy to improve and that the Fed would be able to begin "normalizing monetary policy." At the June meeting, she described the labor market as still cyclically weak, and that while they might see data that would justify a rate increase this year, there were no guarantees.

The Fed sharply lowered its forecast for growth this year from a range of 2.3 to 2.7 percent in March to just 1.8 to 2.0 percent now.

The Fed also predicted that unemployment would be 5.2 to 5.3 percent by year end. Three months ago the Fed thought that unemployment would drop to a range of 5.0 to 5.2 percent by the end of the year. The current rate is 5.5 percent.

The Fed has kept rates at or near zero since December 2008. The economy has grown ever so slowly – not fast enough to give the Fed comfort. During the first quarter, we experienced negative growth in the U.S. Global economic growth was weak too. If other economies do not pick up, that could be a drag for the U.S. The drop in oil prices, which led to lower capital expenditures and a strong dollar, has had a negative effect on the U.S. economy: shale oil investment slowed, and American exports became more expensive to overseas buyers. The second quarter results are not in, but this year looks surprisingly weak. Unemployment rates are going down, but how much of this is a result of people dropping out of the workforce? Job creation is strengthening, as are wage and salary growth, but is it enough?

The Fed does not want a repeat of 1937, when the U.S., just emerging from the Depression, raised rates, plunging the U.S. economy back into recession. We are not in a position to weather another recession. The London "Economist" in its June 13 cover story says "Watch out – the world is not ready for the next recession." Not ready to be sure. Economies throughout the world are growing at a weak pace. Greece, as of this writing, may default on its bonds.

Forecasts for U.S. growth, the engine of the global recovery, are tepid. Bond markets are sluggish. Banks are loaded with cash, but cannot lend. The Fed cannot lower rates further. All they can do is print money, and that will be like pushing on a string.

We simply cannot afford another recession and certainly not the experience we just went through. So, faced with these realities, the Fed blinked again. U.S. equity markets surged, with the NASDAQ hit a new all-time high.

What are the prospects for a rate rise now? Five policy makers expect one rate increase this year; five see two increases and five predict three increases this year. Two don't expect any increase this year. Christine Lagarde, president of the IMF, has cautioned the Fed not to raise rates this year, because the global economy can't take it. If the U.S. subsequently had to cut rates again, like New Zealand did, credibility would be lost. She is a very smart woman, and the Fed would be wise to heed her admonition.

John Williams, president of the San Francisco District Federal Reserve and a voting member of the rate-setting open market committee, sees a rate rise by the end of the year. He believes the economy is growing, that wages and employment are growing, and inflation is rising. For now probably all of these things are true, but can the economy survive the rate hike? However, if not now, then when? The Fed has long wanted to raise interest rates, and it really needs to. Low-cost money is distorting growth in several asset classes. With interest rates low, yield-hungry investors are reaching further out on the scale of risk. The Fed needs to get the genie back in the bottle.

Why is there all this fixation on when rates will be raised, Yellen wants to know. She says rates will go up sometime, but we don't know when. Stay alert, she admonishes; every Fed meeting is "live", she says. It is a process, not a conclusion, according to Yellen. By the way, Yellen says, the expectation is to be accommodative, even after raise rise. Also, rates will rise slowly, in an attempt to blunt the impact. All this talk of increased rates discounts the actual event, so that by the time it occurs, it will be well anticipated.

The Fed needs some dry powder to weather the next downturn. No doubt we will have one; the market has been strong for years as it compensated for the decline of 2007-08. Risk has constantly been re-rated; people are willing to take more risk in the quest for yield. Now the market is up 212 percent since its low on March 9, 2009. It is due for a correction.

Yes, the economy will no doubt have a downturn, but, in the meantime, what do investors do? As the former CEO of J.P. Morgan once said, "as long as they play the music you have to keep dancing." Of course, he famously lost his job in the downturn, but the point remains: Where should you invest if a downturn is coming? Since we don't know the timing of the downturn, there is risk in cash, as there is a risk in gold, Treasurys and equities. Pick your poison. I am still betting on the U.S. economy as the best house on a bad block, and U.S. equities as the best place to be. Pick your sectors and stocks wisely and remain diversified.

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