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Fed roils markets with decisions about interest rates

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On Dec. 16, 2015, the Federal Reserve decided to raise interest rates by one-quarter percent. Never mind that signs of a lowering global economy were evident. Never mind that Christine Lagarde, managing director of the International Monetary Fund (IMF), and others warned against a rate increase. Never mind that the Chinese economy was slowing and the Chinese yuan was falling in value, causing commodity prices to fall worldwide. Never mind that emerging economies were struggling and become weaker because of a strong dollar. Never mind that a strong dollar was creating problems for U.S. businesses.

In fall 2015, the Fed set the table for a rate increase and then backed away at the last minute, losing credibility. In December the Fed felt it had to raise rates to restore credibility. Fed speakers took to the rubber chicken circuit to preach the gospel of rate increases; four was the number most mentioned. So having backed itself into a corner, the Fed felt compelled to raise rates. Fed officials cited job growth and inflation expectations as the catalyst. Never mind that the new jobs were mostly for young and old job seekers, suggesting that they were temporary. Only a small portion of the new jobs benefited the 25-45 age group. Inflation remained benign.

Equity and bond markets reacted almost immediately to the Fed decision, with the equity markets going on a sustained rout; the broad market fell into correction territory and some sectors plummeted into bear market territory (down 20 percent or more). The bond markets shook off the rate increase, and bond yields dropped instead of increasing. Expectations for rate increases were pushed off once more, with the bond markets expecting only one more rate increase in 2016 – late in the year. The market was literally not buying the Fed decision.

The dollar rose only slightly, as currency traders speculated that the Fed would have to back off its forecasted rate increases. The Fed had simply done the right thing at the wrong time. Members of the Fed wondered aloud if they had made a mistake. Speculation arose that they had made a serious financial mistake; investors bought bonds, pushing down interest rates.

As interest rates dropped, in blatant rejection of the newly implemented Fed policy, equity markets tumbled and the investment mood turned sour. Was a recession looming? Would the Fed at its January meeting have to recant its rate raise, as so many other central banks had?

Gross domestic product grew just 0.7 percent for the fourth quarter of 2015 – another quarter of anemic growth – after the U.S. economy gained trillions of dollars of support. The Fed stuck to its guns in January, again citing job growth and incipient inflation, and brushed past its critics, leaving not only the rate increase intact, but also a March rate increase on the table. Never mind that the bond futures showed about a one in 10 chance that the Fed would raise rates in March. While the Fed acknowledged that it might not be able to hold to its plans for rate increases this year, it did not commit to hold off further rate increases. The Fed's muddled comments roiled the markets, and as investor confidence waned, the equity market dropped further. Notwithstanding a 397-point (3 percent) rally in the last two trading days of the month, January 2016 finished as the worst month for performance since 2010.

With the global economy still weak and the U.S. economy tepid at best, it is hard to see how the Fed can raise rates further. One would expect to see strong job growth and evidence of inflation to support more increases; neither seems likely. Of course, if OPEC reversed course and reduced oil production, that would make a difference. So far, Saudi Arabia, the leading country in OPEC, has shown no signs of abating production. Similarly, strong job growth would support a rate increase; that is why the jobs reports will have such an impact.

To add to the Fed travails, on the last day of the month, the Bank of Japan announced negative interest rates. The U.S. equity markets jumped; however, that statement was certainly not what the Fed wanted to hear. A major economy cutting interest rates puts more upward pressure on the U.S. dollar. This is bad for U.S. business, which is already suffering. Other Asian countries, especially emerging markets, will have downward currency pressure, trouble paying bills, and may have to devalue their currencies. A financial accident could follow.

Of course it would be helpful if we had a more business friendly environment, but government policies at nearly all levels are counterproductive. The costs of Obamacare have reduced employment and hours worked. Laws raising the minimum wage have produced hiring declines in services industries, where job growth has become job reduction. In retail, we have seen Wal-Mart close nearly 200 stores subject to minimum wage increases. It is hard to pull oneself up the economic ladder without a job. Job creation should be politicians' economic goal, but that does not appear on the horizon.

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