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THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

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Interest rates: Will the Fed pull the trigger?

Published August 18, 2015

Eager to get the controversy regarding a Federal Reserve interest rate increase behind them, the market and economists seized upon the latest job growth numbers.

Most economists are expecting – even calling for – a rate increase. The Federal Funds Futures have tipped into expecting a September rate increase. Fed speakers are calling for a rate increase. The Federal Reserve Board and its chairman, Janet Yellen, want an increase. Clearly the consensus is developing for a September one-quarter point increase.

We have been close (to an increase) before, but the Fed has not made the leap. Economic data keep getting in the way. Now, the recent jobs report shows that the economy added 215,000 new jobs in the past month. This positive report seemed to clear the way for a rate hike.

The problem is that the recent job report is really a tepid report. For years it has been thought that 250,000 was the minimum number needed to absorb the new participants in the work force. We are in the midst of the worst expansion since World War II. Second quarter GDP growth was a modest 2.3 percent. Unemployment remains at 5.3 percent; however, the labor force participation rate is stuck at 62.6 percent, the lowest since 1977. The rate is low in part because baby boomers are reaching retirement age and because of "structural changes" in the labor force. More people have learned to live without jobs; most often income from work is replaced by government entitlement programs. As more people look to the government for their income, the political center of gravity in the U.S. changes (think Greece).

The Federal Reserve predictions about the economy are not coming true, as they have repeatedly over-promised and under-delivered. Recent leaked documents from the Federal Reserve staff indicate the staff is less optimistic than the Board. Christine Lagarde, head of the International Monetary Fund, has warned against a rate increase, saying the global economy is weak and the U.S. Federal Reserve cannot afford the risk. What would happen, for instance, if the weak economy weakened even more after a rate increase? Would the Federal Reserve lose credibility? Credibility is very important to the Central Bank. Alan Greenspan learned that lesson the hard way. The Chinese government is learning that now. The Fed seems trapped in a situation of its own making with the only way forward being a rate increase, which the economy may not be able to absorb. Clearly, stronger data would be preferred, but it does not appear to be forthcoming.

The Fed does need to raise rates, as there are distortions in the economy brought about by low rates, which have been unusually low for an extended period of time. The "recovery" is now late in the cycle. If we were to receive a "shock to the system," which can come at any time, or fatigue in the cycle, we could be in for a very difficult time. The Fed would lack the tool of cutting rates. Since the recession ended in 2009, the economy has grown at a meager 2.1 percent annual rate. We may have to learn to make money at a 2 percent to 2.5 percent growth rate. This meager growth is reflected in the tepid employment numbers and wages. Hourly wages in July increased by a nickel, after falling a penny in June. Inflation

remains benign. The fall in commodity prices raises the specter of deflation again. Slowly, the stock market reacts to this fatigue, as sector after sector runs out of steam. The Fed seems unable to generate strong growth. They can take comfort in meeting their twin obligations of controlling inflation and reaching full employment, but they need more growth in the economy to sustain an expansion, however tepid.

Right now the markets remain nearly flat on the year. We are truly going to have to make our money work harder to move ahead.

On Tuesday, Aug. 11, the Chinese government announced overnight our time to devalue their currency. This had a profound effect on the markets, with the Dow dropping 212 points. Emerging markets and other Asian markets fell. The stocks of companies selling into China fell, while those manufacturing in China rose. Commodities dropped, with oil down 4 percent. Mining stocks dropped. Emerging market and Asian currencies dropped, with some reaching levels not seen since the last Asian crisis 17 years ago. Clearly, the message is that the Chinese government is very worried about the Chinese economy. We should be, too. If the second largest economy in the world is struggling, what does that mean for the rest of the world?

This puts the question of the Fed rate increase back on center stage. Can the U.S. raise interest rates in the face of a slowing global economy? Increased interest rates will strengthen the U.S. dollar, making U.S manufacturers less competitive.

As Gilda Radner famously said, “It’s always something.”

Concentrate on the best stocks in the best sectors. Remain diversified.

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