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WHY THE FED WILL NOT HIKE RATES IN 2015

Summary

This is NOT a contrarian piece with an eye-catching title, neither is it a report based on the notion that if the consensus is so overwhelmingly behind the expectation of the Fed hiking, then there must be something wrong. This is a research report on why, when the Fed comes nearer to take the hike decision, the hike will be postponed with low rates staying low for, at least, in 2015.Higher rates are, supposedly, needed to bring order back to the markets and allow market pricing of assets, and also because macro developments in the US do not justify anymore near zero rates. We outline why these arguments are one-sided and over-simplified.

Investment Conclusions

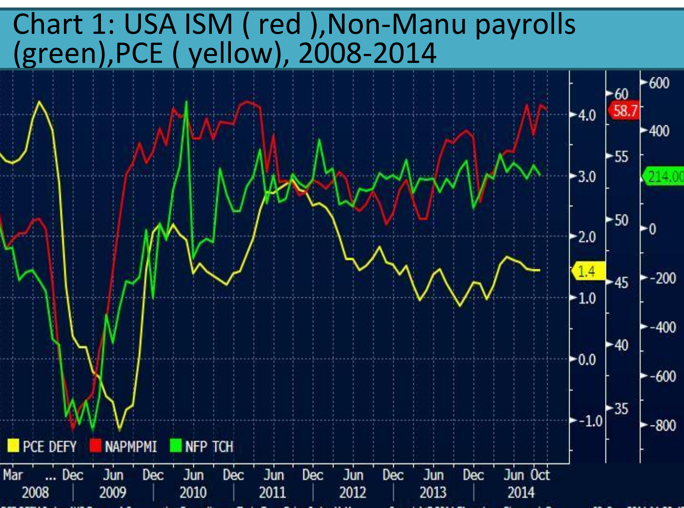
Should the Fed delay hiking in 2015, or hike once but then recoil from more, then expect a surge in US equities and in longer term UST prices with subsequent positive reactions in the rest of the global markets. However, given that USD interest rates are not as closely linked, as it is generally believed, with Asian rates, the positive impact on Asian equities and forex could be short- lived. The increased volatility, particularly in the global forex markets, may diminish. While the Fed stays put, the positive “surprise” effect of low rates may begin to dissipate.

Why hike in 2015 ? Why not hike ?

Why hike. First, the macro signs are benign, and while far from pre-crisis levels, they do not point to an economy in recession. As the data in Chart 1 show, the manufacturing ISM has been on an uptrend and clearly above 50 level (red), non-farm payrolls have stabilized above 200,000 per month (green) bringing down the unemployment rate (NB but with low participation indicating longer term structural issues) and with no threat from inflation (yellow).The economy, does not necessarily need zero short term rates at this stage of the cycle. **Second,** the zero rates were necessary while the financial system was restructuring and recovering from the 2008-9 crises. There are no signs of financial stress now and, hence, no need for low rates. **Three,** zero rates distort the markets by making the cost of funding artificially low as well as lowering the true cost of the fiscal deficit. As the fiscal deficit is now under control den and shrinking, and there is no crisis in the domestic markets, then there is no reason why the cost of funding should not be established by markets and not by the Fed.

Why not hike? First, the markets have shown how volatile they may get when faced with hikes (May 2013, October 2014).Once the Fed has hiked, the expectations will be for more hikes thus introducing a double uncertainty as to “when and how much” at the time that US economy is recovering and G2 economies are in recession. **Secondly**,there is deflation at work in the global economy with oil prices staying low indefinatley because of structural reasons, while cyclical and weather factors have caused, respectively, steep falls in hard and soft commodities prices. **Thirdly**, longer term UST yields will likely fall rather than rise after the Fed hikes as more funds will flow to USD as volatility rises.

Chart 1: USA ISM (red),Non-Manu payrolls (green),PCE (yellow), 2008-2014



Source: Bloomberg

Matters get more complicated

The Fed can be expected to take into consideration only domestic and not global issues when deciding a hike. “The USD is our currency but it is your problem” as the well-known saying goes. However there are a number of issues here to consider. **First,** UST longer term yields have shown an unnerving habit of falling when there are rumors of short term rates rising. The upheaval in the global markets, once the Fed hikes, may well lead not to temporary but to longer term low UST yields as the funds flow into the potentially higher yielding UST.As Chart 2 shows, in the course of 2013 the USD (green) kept flat as UST yields (red) declined, but in 2014 the USD strengthened despite the falling trend in UST. Note also the sharp fall in yields with the sharp increase in volatility (blue) during the October 2014 crisis On the

FACT BOX :Mel Brooks on financial markets

In his film “The Producers” Mel Brooks has one key character, a naive accountant about to be snared into a financial scam, undergo a hysteric crisis when confronted with what he is about to get involved. As he screems and rants “I am hysterical,I am hysterical” a large glass of warer is thown on him in an effort to calm him down.Upon which he rants anew “ Now I am wet AND hysterical” ! Precisely what the US and global markets will say, metaphorically speaking that is, afrer the Fed hikes for the first time.”Now are still hysterical but with higher rates”

basis of past behavior, there is a strong chance that the Fed, after the hike, will end up with lower yields, a stronger dollar, which will ensure that these yields stay down, and volatile markets at home and abroad. **Second,** the equity market plotted its own course, rising in 2013 and 2014.There is clearly a divergence of views with the Fed announcing at regular intervals that rates will rise, with the USD reflecting this but not with equities and UST. Dismissing this underestimation of the markets of the Fed’s intentions, is simply saying that May 2013 and October 2014 were just baby rehearsals as to what would happen when the markets are faced with actual hikes. The Fed may have not managed expectations properly and may pay for this when it hikes. Hence the need of more preparation and delay.

Chart 2: Legend(*)

Source: Bloomberg

Summing up

The global economy is moving at several directions at the same time. The EU and Japan are now committed to low rates “for ever” (poetic license here).The Fed keeps saying that it will hike, but with markets clearly not paying attention. When they do pay attention, all hell breaks loose. However much the Fed intends to pursuit policies which suit the US economy, and very likely will do so, the consequences of these policies for the US may be negative in terms of lower UST yields and a stronger USD. The latter may not matter in terms of a negative impact on exports, as the US not exports driven, but will be the consequence of more funds flowing into UST precisely because the rest of the G20 economies will continue to have low to zero rates. Add on top of that the potential for eye-popping volatility, and the costs to Fed for not waiting longer till the global economy is more stable or the expectational situation in the US is better- suited to a hike, will very high. And all this during a period of global deflation. Without diluting at all our initial position, the Fed may hike just once, and then recoil for the rest of 2015 having seen the consequences. This is not about weaning the markets from low rates but when and how to do it. And the situation in 2015 just does not seem to be the right time.

(*)USA,S&P(yellow),UST10Y(red),USD(green)Volatility(Blue).Andrew Freris (wrting completed 4/12/2014)