KANAWHA
CAPITAL MANAGEMENT

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THE WAIT FOR THE RATE

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pa·tient \ *adj* \ *manifesting forbearance under provocation or strain; not hasty or impetuous*

Even in today's era of instant mass communication, it is hard to imagine the intense scrutiny that envelops every Federal Open Market Committee (FOMC) policy statement. Meeting eight times a year, the policymaking arm of the Federal Reserve follows each session with a synopsis of the group's economic views and resulting monetary prescriptions.

The Fed's official Twitter channel (@*federalreserve*) has only 250,000 followers, so most must be getting the press releases the old fashioned way — via the website. There's a cottage industry of media and analysts who then take a new statement, superimpose it on the previous one, and note every grammatical change, no matter how subtle. In fact, the *subtle* changes generate the most intrigue and conjecture.

Federal celebrities

Intriguing? U.S. government Ph.D. economists and their pronouncements? Only because so much money is tied up in stock and bond markets. That, and the need for breathless financial news correspondents to continue to demonstrate their own relevance to viewers.

Federal Reserve policy moves, conventional and unconventional, have proven critical drivers of the economic recovery. And a tailwind for stock and bond prices. But they are nearing the end of their lives. Yellen and company embarked last October on a path to begin normalizing policy, ceasing the massive bond-buying program. Fed watchers are now trying to discern the timing of the first interest-rate increase.

For months, the financial community had engaged in a frenzied debate about the FOMC's next signal. In December, the wordsmiths at the Fed subtly changed their tone. They switched from pledging to wait a "considerable time" before raising rates to remaining "patient" before doing so. Traders pulled out their thesauruses that afternoon and determined that the two terms were essentially interchangeable. Extremely low interest rates would persist. That afternoon, the Dow closed up by almost 300 points, and the following session by another 400.

Bad news is good news

The Fed last raised short-term rates in 2006. How long would they promise to remain *patient* before allowing short-term rates to increase again? Well, as it turned out, only until the mid-March FOMC meeting. The term was stricken from that press release. At the same time, however, policymakers tempered their outlook for economic growth. Bad (economic) news is good news as far as interest rates are concerned. The Dow ended the day 200 points higher.

There have been three tightening cycles in the United States over the last twenty or so years. No doubt the Federal Reserve would like to avoid a reprise of the 1994 episode, when markets were surprised by the size and swiftness of the interest rate hikes. As short rates were manipulated higher, long-term rates quickly moved from 5.5% to 8% — and bond investors got hammered.

Fortunately, the Delphic utterings of then-Chairman Alan Greenspan have been replaced by the "transparency" of the Bernanke-Yellen regime. Over the post-financial-crisis period, both central bank leaders have attempted to hint more clearly at the bank's intentions.

Long-range weapon

The consensus view anticipates short-term rates beginning to move up this year. This will likely be one case where the group is (finally) correct. But the Fed controls only the short end of the curve. What will happen to long-term rates?

Looking again at other recent tightening cycles, the 1999-2000 period unfolded in textbook fashion. Short-term rates moved up two percentage points and the 10-year by about the same amount. In fact, long-term rates started rising beforehand, in anticipation of the Fed policy rate changes. Fairly smooth and no surprises; a model preferable to the 1994 case.

The 2004-2006 chapter proved the odd case. Despite aggressive tightening by the Fed (the Fed Funds rate rose from 1% to 5.25%), long-term yields hardly stirred. Greenspan seemed perplexed by such a "conundrum." This dichotomy was later attributed to massive foreign central-bank purchases of U.S. Treasuries, which had the effect of depressing yields. Perhaps if long-term rates *had* risen, some of the air would have been kept out of the housing bubble since, presumably, mortgage rates would have been higher.

Looking for a bubble

If the 2015-20xx interest-rate cycle plays out like that of the late 1990s, the economy and securities markets should be able to handle the adjustment. Yet with most everyone focused on "higher" rates, few are considering the possibility that, like 2004-2006, long-term rates do not budge. That would represent an undesirable outcome. 10-year rates persisting at current levels may seem appealing, but would eventually find another bubble to inflate. And if short-term rates actually surpassed long ones, the yield curve inverts and typically foreshadows recession.

But assuming interest rates do in fact rise across the board, the ultimate question relates to how that will impact the outlook for U.S. and global growth. This issue explains the manic tendency of the crowd to parse every Fed statement.

Many market participants seemed to have staked out the position that rising rates *per se* will dampen economic growth and stock prices. Not so fast. The imminent start of the next rate cycle is not about heading off a surge in inflation; rather, it is about reversing an unprecedented monetary experiment. Short and long-term interest rates in the United States are much too low. The levels are inconsistent with a healthy and well-functioning economy.

Try our low, low rates!

Moreover, because any increases would be coming off a very low base, there's room for rates to push higher before dissuading borrowers or aggravating debt-service burdens. Indeed, according to J.P. Morgan, when 10-year yields are below 5%, rising rates are typically associated with *rising* stock prices. This phenomenon occurs because the move in rates is signaling a reflating economy. Above 5%, rising rates tend to correspond to falling stock prices.

The 10-year Treasury yield stands at about 1.9%. It wasn't this low even during the Great Depression. Historically, yields have generally been 2 to 4 percentage points above the core consumer inflation rate. With core CPI running at a 1.7% annual rate, one would expect 10-year bonds to be yielding at least 3.7%. Clearly there has been a disconnect between interest-rate levels and underlying economic fundamentals — unless one expects inflation to drop to zero or even turn into deflation. That appears unlikely in the United States today.

It certainly seems to be the fear in Europe, though, judging from the rate environment on the continent. The benchmark 10-year German bund is changing hands at a yield below 0.25%. Meanwhile, the Swiss government recently became the first country to actually issue a 10-year sovereign bond with a *negative* yield (-0.06%). Think about that for a minute: Buyers were *paying* for the privilege to own that bond (and perhaps more importantly, the Swiss franc).

All over the map

The global backdrop has continued to become more complex, most notably with respect to monetary policy and its feedback loop. U.S. and U.K. central banks are now on hold. In contrast, countries that collectively account for most of the balance of global GDP and stock market capitalization have seen policy rates come down.

Stock market investors have been very skittish this year. Besides uneven economic growth, they have also had to factor in a sizable, months-long shift in the value of the dollar as well as in the price of oil. Remarkably, the S&P 500 went 28 trading days, from mid-February to late March, *without* being able to put together back-to-back gains. Such a streak has occurred only two previous times, in 1970 and 1994. The S&P 500 finished both years with modest gains.

U.S. economic growth moderated in the first quarter, in part due to the severe weather that hung over much of the country. The slowdown also simply reflects the vagaries of this grudging recovery of ours. Not surprisingly, corporate earnings forecasts have come down. This is particularly true for energy companies, for obvious reasons, but also multinationals whose foreign sales now translate into fewer dollars.

No more easy street

It seems likely that interest rates and inflation will stay relatively benign for a while. If economic growth picks up later in the year, the backdrop will support stock prices. One could argue that stocks are somewhat expensive, but valuation remains in the eye of the beholder. In our view, the easy money has been made. Prices are not low enough to ensure further gains but, by themselves, are not the major obstacle to stocks moving higher, either.

It is no wonder that investors have been scratching their heads. Many must feel like the pilot of a skiff, buffeted by unpredictable and competing winds and currents. Should one head for the solidity of the shore or ride it out? We advise that investors take their cue from the Fed and try to remain patient.

— Christopher J. Singleton, CFA, Managing Director

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