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First Trust

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Economic Commentary

The Best Medicine – Fed Rate Hikes

It's now official. The Federal Reserve is done with its interest rate cuts. Despite the jump in the unemployment rate to 5.5%, Fed Chairman Ben Bernanke said on Monday night that he thinks the economy had passed the danger zone and that the Fed would pay "close attention" to inflationary pressures.

The Chairman said "…the risk that the economy has entered a substantial downturn appears to have diminished over the past month or so." Referring to rising expectations of inflation as seen in consumer surveys, Bernanke added that the FOMC "would strongly resist an erosion of longer-term inflation expectations."

This is good news for economic growth. As long as the Fed was in a rate cutting mode, investors, potential homebuyers and businesses held off on making decisions. Why borrow and buy today, if interest rates will fall further in the future?

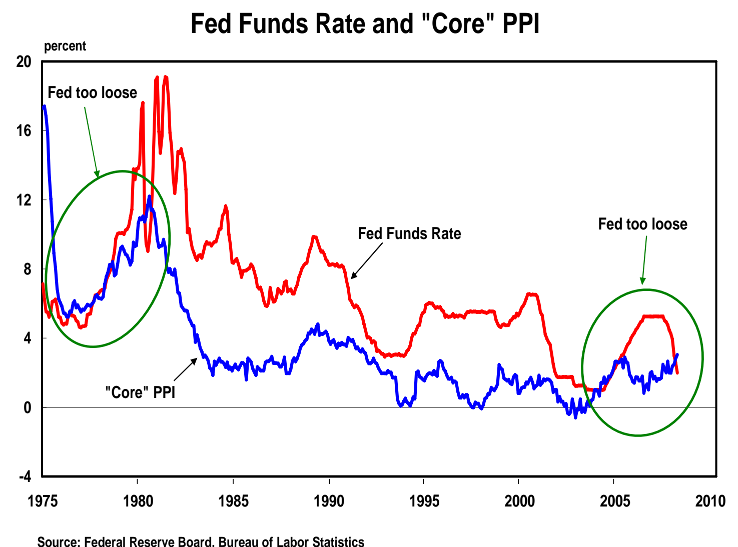
However, there is still a wide open question as to when the Fed might begin to hike rates. The futures markets have priced in a high likelihood of rate hikes as early as August and an almost certain 25 basis point hike by October. But just a few months ago they were suggesting further Fed rate cuts, and Fed Vice-Chairman Don Kohn is arguing that inflation is still not a problem.

If the economy acts as we believe and accelerates toward a 3%+ real growth rate in the third quarter, we suspect a rate hike could come as early as the August or September meetings. Some say the Fed will wait until after the election, but there is no incumbent and it is hard to see how rate hikes would benefit one candidate over another.

Way Behind the Curve

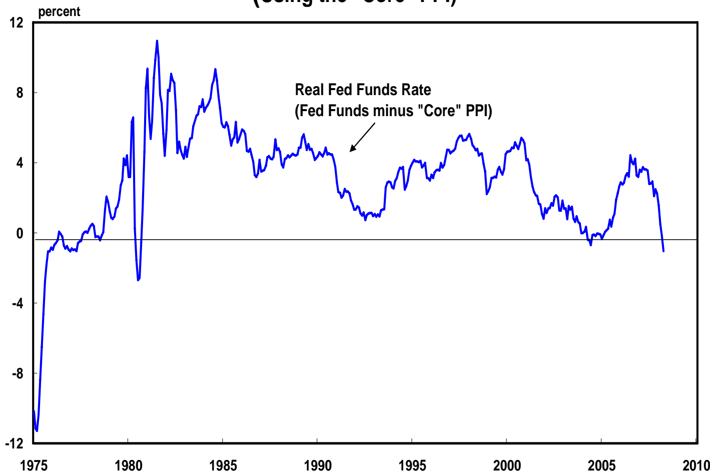
Three things seem certain from our vantage point. First, the Fed is way behind the curve. Second, the longer it waits to hike rates the more inflation will become imbedded and the harder it will be to eradicate. Third, rate hikes when the Fed is behind the curve do not result in bad news for the economy or investors.

In order to judge the real (or inflation-adjusted) federal funds rate, many economists have historically used consumer price data. However, the CPI has come under attack lately for underestimating inflation. Moreover, businesses face inflation from many fronts. So, as an added piece to the analysis of Fed policy we went back and compared the federal funds rate to the "core" producer price index for finished goods.



As the charts on these pages show, the federal funds rate dipped below the "core" produce price inflation rate in late 2003 and then again recently for the first time since the negative real rates of the late 1970s and the early 1980s. In other words, monetary policy in the past six or seven years has been the most accommodative since the misguided policy of the 1970s that Paul Volcker was brought in to address.

In the 1970s, commodity prices exploded to the upside, just as they have in recent years. While Fed economists continue to blame global demand pressures on inflation, the truth is staring them in the face. Monetary policy is just too easy.



Negative real interest rates are an unambiguous sign of excessively easy Fed policy and they must be corrected to get inflation under control. While some analysts, including economists at the Fed, argue that inflation is likely to stabilize on its own, history suggests otherwise. Inflation is caused by easy monetary policy, and therefore until the Fed tightens and pushes up real rates, inflation will continue to rise.

The question is: how high? One way to think about this is to compare real interest rates during periods of benign inflation. During the 10 years ending in 1999, the average real federal funds rate (using the "core" PPI) was 3.3% and in that period inflation was benign.

Adding this 3.3% to today's "core" PPI increase of 3.0% suggests that the federal funds rate should be lifted to 6.3% in order to simulate the same policy of the 1990s. This is slightly above the 5 - 6% rate we arrive at with our nominal GDP model.

Bad for Stocks?

Recent declines in the stock market, especially in financial stocks, have increased concerns that Fed rate hikes will hurt equity values. But this is not supported by history. Between mid-2004 and mid-2006 when the Fed lifted rates from 1% to 5.25%, the S&P 500 increased roughly 15%. And with the real federal funds rate (using the "core" PPI) averaging 4.4% during the 20 years ending in 1999, the S&P 500 climbed 12-fold.

On the other hand, the stock market has performed miserably in the past nine months as the Fed has cut rates. The high real rate policy of the 1980s and 1990s was good for equities, while the low real rate policy of the 1970s and the 2000s has been bad for equities.

There are many reasons for this. Low inflation lifts P-E ratios, while high, or rising inflation reduces them. In addition, high inflation increases the odds that the Fed will have to fight aggressively to bring it down, raising the specter of a Fed-induced recession.

Conclusion

Contrary to conventional wisdom, Fed rate hikes would be the best medicine for what ails the US economy today. If we are right, and the Fed starts hiking rates later this year, the dollar will rise, commodity prices will fall and equity markets will recover strongly. The best course of action is not always the easiest.

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