Normalised US interest rates will still be low

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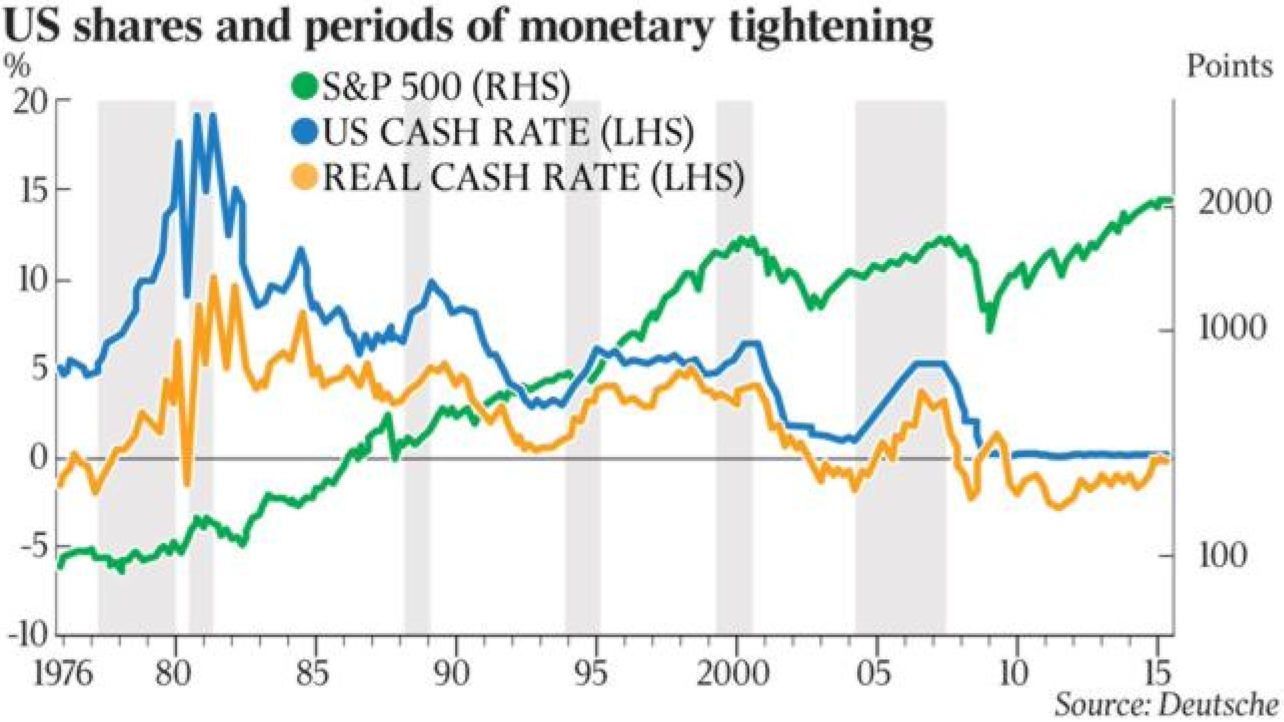

US shares and money tightening. *Source:* TheAustralian

Investors around the world held their breath last week as the US Federal Reserve considered whether to increase the world's most important interest rate, the cash rate.

The Fed decided against moving the cash rate higher at this stage. But the central bank remains on course to begin "normalising" the US cash rate soon, from the near-zero level it has been at since the horror days of the global financial crisis almost seven years ago.

Clearly the preoccupation in financial markets with what the Fed says, when the initial move is likely to be made, and what the prospective "trajectory" of the US cash rate in the next year or two is likely to be, will continue.

Is this preoccupation overdone? There's no reason to doubt the primacy of US monetary policy. But 12 months from now, the US cash rate could well be sitting at a still modest 1.25 to 1.5 per cent — that's higher than is now priced into fixed-interest markets, but need it seriously unsettle sharemarkets?

There’s a widespread belief among investors that increases in interest rates generally cause sharemarkets to weaken. That’s because higher interest rates reduce the valuations put on future income streams and they dampen plans to spend.

In fact, the relationship between interest rates and average share prices is much more complex that the popular view allows, and US interest rates and share prices have gone up together more often than not.

The shaded areas in the chart show periods when the Fed raised its cash rate; the green line shows how the US sharemarket tracked. The Deutsche Bank researchers who prepared the report conclude: “During the past four monetary tightening cycles, long-term bonds came under pressure while equities were among the winners … empirical research does not support the assumption that rate hikes will send equity markets down.”

Ashley Owen of Philo Capital has delved into the 27 spikes in US bond yields since 1945. He finds share prices rose in 59 per cent of the bond spikes, and “all of the bond yield spikes that started when nominal bond yields were low were accompanied by high nominal and real returns from shares during the spike”.

In recent years, the Fed has made a greater effort than has ever been attempted by a central bank to share its thinking on the outlook for the cash rate it sets.

Several years ago, the Fed committed not to increase the cash rate for a “considerable” time. Last year, it frequently stated the initial move would be “data-dependent”. By mid-2015, the Fed was saying it expected job numbers had improved enough for “the first step” in normalising the cash rate to be taken “at some point later this year”, and subsequent increases were likely to be “gradual”.

At the September meeting, the Fed had good reasons to hold back from raising the cash rate. It has a dual mandate — to achieve maximum employment (measured unemployment has halved since its peak and is now 5.1 per cent of the workforce) and to keep inflation at 2 per cent (the relevant measure of inflation is now 1.25 per cent).

The Fed believes the tightening jobs market will boost inflation, but there’s little sign yet of general price increases. Moreover, although the Fed’s legislated responsibilities in setting its monetary policy relate to US jobs and inflation, it could not ignore the impact of raising the cash rate on the fragile global economy or on financial stability. In my view, sharemarkets will often be choppy as expectations of the Fed's moves change.

In coming months, the Fed will begin to normalise the US cash rate. Those moves will limit the upside potential for US shares. But the environment for shares will remain positive, not least because even in a year's time US monetary policy will remain accommodating and the cash rate could still be set at a historically skinny 1.25 to 1.5 per cent.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.