For investors, it pays to keep watch on the Fed’s rates intentions

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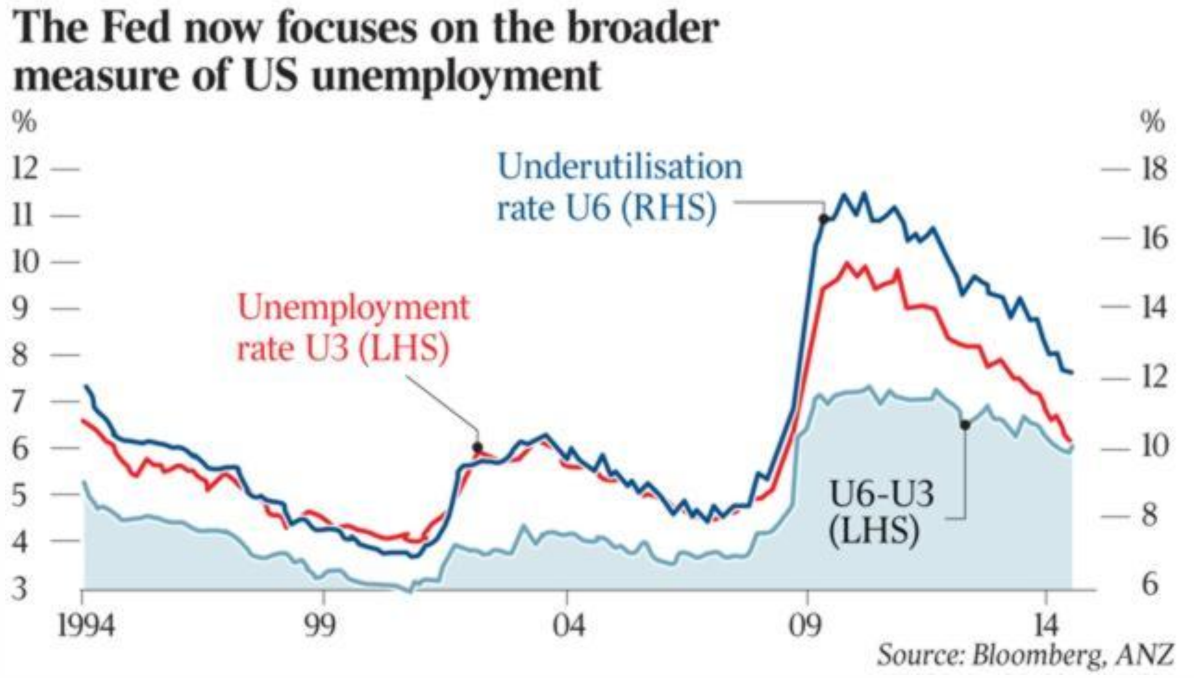

US unemployment *Source:* TheAustralian

HERE and abroad, investors have been enjoying good returns on shares and bonds. Average prices of residential property have also been rising. But interest rates on at-call and term deposits remain unusually low. Investment markets have been boosted by the extremely easing settings in monetary policy in the major economies — notably in the US, where the cash rate has been kept at a near-zero level since the worst days of the global financial crisis in late 2008.

Recently, the US central bank repeated its intention to keep the cash rate low for longer. Following that statement of its “forward guidance”, US share prices moved to their 25th record high for the year and the yield on 10-year US bonds dropped to a skinny 2.6 per cent.

But is the Fed doing the right thing in maintaining a highly accommodating monetary policy for an extended period? And is the Fed satisfactorily answering its growing band of critics, which now include the Bank for International Settlements, often called the central bank’s central bank?

As investment markets are likely to react strongly when the US cash rate is first raised from its near-zero level — or, more correctly, when markets come to anticipate such a move — investors need to be aware of what the Fed is saying and doing.

The US congress charges the Fed to deliver on the “dual mandate” of high employment and low inflation. The unemployment rate in the US has fallen from its 2009 cyclical peak of 10 per cent to 6.1 per cent in June. However, a broader measure of unemployment (called labour utilitisation) and which includes people in part-time work who would like a full-time job and people who want work but have not been active recently in looking for a job, is running at 12.1 per cent. In the Fed’s view, the substantial slack in the labour market indicated by the broader measure of unemployment will keep a lid on wages and inflation for a considerable time; it expects the US labour force “participation rate”, now at its lowest point in 35 years, to rebound quite strongly in the next year or two. And the Fed says its target for low inflation, expressed in terms of a 2 per cent lift in the deflator for core items in consumption spending, is not at threat from the recent acceleration in the consumer price index.

Critics say the Fed is too relaxed about prospects for inflation; that the fall in the participation rate reflects structural rather than cyclical influences (including the effects of population ageing); and it’s the number of people in short-term unemployment — which is now falling — that determines the pace at which wages are rising.

The Fed also rejects arguments it should raise its cash rate to cool the booming asset markets — and thus reduce the risk of financial instability developing again. Fed chairwoman Janet Yellen says there are “pockets of increased risk-taking across the financial system” but adds: “I do not presently see a need for monetary policy to deviate from a primary focus on attaining price stability and maximum employment, in order to address financial stability concerns.”

These worries could be handled, she suggests, by macro-prudential measures (such as regulation of banks’ loan-to-valuation ratios). Alas, the history of such direct control is not reassuring.

Most investors expect the Fed to leave its cash rate unchanged for an extended period — perhaps a year or so. But when push comes to shove, the Fed may have to move earlier to raise rates — or risk moving too late and allowing the return of inflation and/or financial stress.

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