Streetwise

You Can't Hurry Rates

by Ben Levisohn

SOME TASKS SHOULD BE ACCOMPLISHED WITH utmost haste. A two-minute drill in football needs to take, well, less than two minutes. When a fire alarm sounds, it is advisable to head immediately to the nearest exit. A shot of cheap tequila should be downed as quickly as humanly possible. A rate hike, however, shouldn't make this list.

You wouldn't know that from some of the rhetoric that was flying following last week's meeting of the Federal Open Market Committee, when the Federal Reserve did what most had expected and left rates unchanged. Janus Capital's Bill Gross, who had put the chances of a rate hike at 50%, told CNBC he was "speechless," and even three Fed governors said they would have liked to boost rates.

But there's no need to get antsy. Economic growth is still sluggish, and inflation is low, leaving no real reason for an increase except a desire to get one done. But as David Rosenberg, chief economist and strategist at Gluskin Sheff, puts it: " 'Hurry up and get it over with' is just about as ridiculous a strategy as you can come up with."

True, which is why the Fed's decision to stay put shouldn't have been a surprise. A rate hike is usually aimed at preventing an economy from overheating, and there's no sign of that—not even close. Housing activity has been disappointing, wholesale inflation is weak, retail sales are declining, and manufacturing activity is slowing. Such a confluence of negative data has never stopped the Fed from tightening rates—the central bank did so in December, even though the economic data looked even worse than it does now—but it isn't exactly screaming for immediate action. "The Fed is paying attention to the data," says Jason Ware, chief investment officer at Albion Financial Group. "But they're also trying to step back and look at the bigger economic picture."

So why are the hawks so hawkish? For starters, their concerns aren't unreasonable. The U.S. unemployment rate has fallen to 4.9%, a level that has, in the past, suggested the country has reached full employment. And concerns that ultra-low interest rates could lead to asset bubbles—a topic that was brought up at Fed chief Janet Yellen's press conference when she was asked about commercial real-estate prices—are real. And we understand the Fed's desire to hike rates, so that it will be able to cut them when the next recession comes.

It is, however, important to separate those fears from reality, Rosenberg says. If the U.S. economy were at full employment, wages would be going up. Instead, they have recently started to decelerate. Rate hikes, meanwhile, are a blunt tool in trying to address asset bubbles. Yes, higher rates could bring down commercial real-estate prices, but tighter financial conditions could also tip the economy into recession.

And boosting rates simply so the Fed can cut them the next time the going gets tough? "That's like shooting yourself in the foot and having a podiatrist standing ready," Rosenberg maintains.

Still, the bigger picture appears be pointing toward a December rate hike, despite the fact that the Fed downgraded its forecast for U.S. economic growth. Ellen Zentner, chief U.S. economist at Morgan Stanley, doesn't necessarily like it—she contends that U.S. economic growth and inflation are still too sluggish to warrant higher rates. But she doesn't expect financial markets to react the same way they did last year—the Standard & Poor's 500 index tumbled 10% during the next 8½ weeks—if the central bank should act.

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The big difference is the Fed's "dots," or its forecasts for the course of monetary policy. When the Federal Reserve raised rates last year, the dots showed it expected to ratchet up rates at least four more times in 2016. That was enough to send the financial markets into a panic, and bring the U.S. economy to the edge of a recession. "We darn near lost the recovery," Zentner says.

This time, however, the Fed doesn't appear to be in such a rush—it projects just two more hikes next year. "The committee continues to recognize extraordinary caution is warranted," Zentner observes. "This continues to be a Fed that wishes to do no harm."

That could be good news for stocks, at least in the short term. With Yellen & Co. remaining on hold at least until December, the focus should turn squarely to third-quarter earnings, explains JPMorgan strategist Dubravko Lakos-Bujas, and they could be much better than the market is anticipating. Sales are expected to grow by just 2%, while margins are expected to shrink by 0.55%. Corporate bond yields, however, have dropped to 3.4% from 4.3%, making financing cheaper for S&P 500 companies, while a stable dollar and recovering oil prices should "improve the odds of more companies beating on revenue and margins," Lakos-Bujas argues. "We see additional upside."

At least until the Fed starts feeling twitchy again. ■

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