

Why Should the Fed Not Raise Rates?

Without a bolt from the blue the Federal Reserve (Fed) looks set to raise interest rates on December 16 for the first time in nine years. Even before it's taken action, the central bank already sounds apologetic. Fed Chair Janet Yellen has assured financial markets that the path of interest rates will be decisively flat. During the week of December 1, she almost painted a picture of "once or maybe twice, and done."

The dovish rhetoric from the Fed is not only at odds with its planned action, but is also logically problematic. No central bank should raise interest rates unless it is convinced that such an action marks the beginning of a tightening process. In this sense, "once or twice, and done" makes no sense to me. By telling markets that rates are not expected to go up much at all next year, the Fed has behaved as if it wants to purposely diminish the impact of its own planned action, even before any such action is taken.

The Fed's awkward posturing can only tell us that the central bank has low conviction on either economic growth or price inflation. Chairwoman Yellen admits that she sees "even risks on both sides" and therefore the planned December liftoff is not a decision based on economic reality. Rather, the decision will reflect the philosophical preference shared by most Federal Open Market Committee (FOMC) members.

The postwar central banking era is deeply embedded in the neoclassical framework of the inflation-growth trade-off. To most central bankers, better growth and a stronger labor market lead to higher inflation. Naturally, the "zero lower bound" is viewed as an emergency situation and zero rates are deemed both abnormal and hyper stimulative. This is probably the key reason why policymakers prefer to move out of zero rates whenever economic growth appears to be normal. The question is, are we already back to normal? I am doubtful for the following reasons.

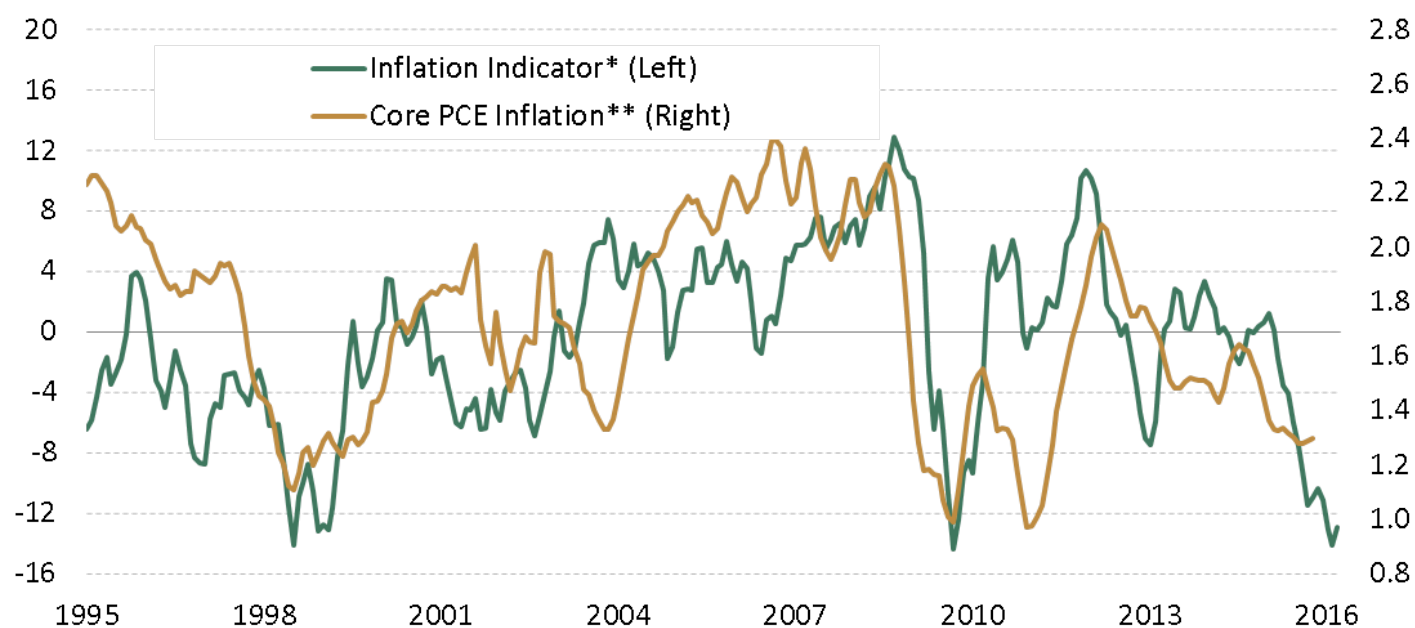
Reason 1

The U.S. economy is most likely at sub-trend, with corporate profits and manufacturing businesses already in recession and disappointing levels of corporate capital expenditures. Although the federal funds rate is at zero, monetary conditions are tightening via a strong U.S. dollar and widening corporate spreads. The lack of pricing power is prevalent and bank lending standards are gradually tightening as the "equity-bond" swap frenzy has reshaped capital structures by driving up corporate leverage.

Arguably, the only bright spot is the labor market where job creation is robust and wage growth is gaining momentum, but this is hardly a justification for lifting rates now. Indeed, average hourly earnings (AHE) growth has broken out to 2.5% from its recent trend of 2.0%, but we should not confuse AHE with inflationary pressure. Wage gains have to be assessed against productivity. Nonfarm labor productivity growth was 1.8% in the third quarter, which means that wage growth is barely inflationary.

Historically, AHE hardly predicts core personal consumption expenditure (PCE) inflation, which is targeted by the Fed. The dollar certainly plays a role in determining the inflation rate. Our inflation indicator (shown in [Chart 1](#)), which combines wage, productivity, and the direction of the U.S. dollar, suggests that core PCE inflation may head even lower before hitting a bottom in the coming months.

Chart 1: U.S. Inflation Will Stay Down *Annual % Change; As of 11/30/2015*



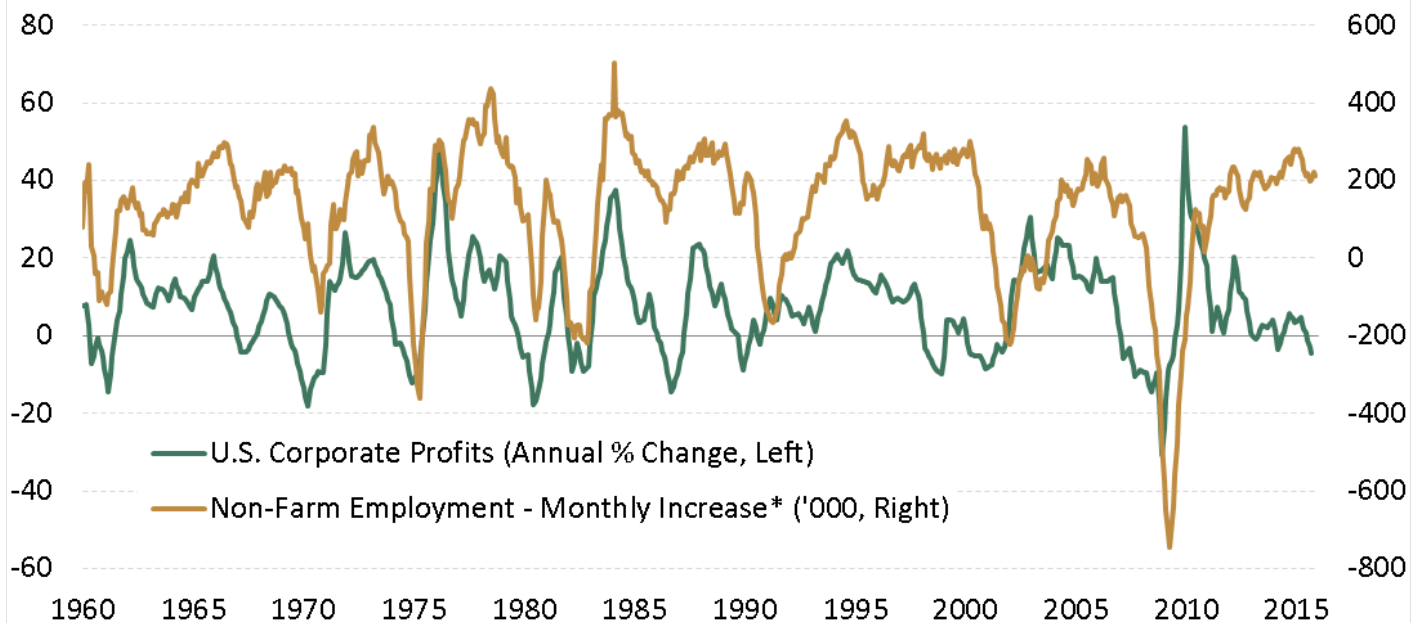
**Based on U.S. non-farm average hourly wages, productivity growth and trade-weighted dollar*

***Shown as a 3-month moving average*

Source: Thomson Datastream; "Inflation Indicator" calculated by Brandywine Global

Importantly, with corporate profits contracting and nominal gross domestic product (GDP) growth at no more than 3%, it appears that nonfarm payroll growth is more likely to weaken than strengthen. **Chart 2** shows that payroll growth usually lags profit growth. If this correlation holds, nonfarm payroll growth may top out soon.

Chart 2: Profit Contraction Could Weaken Job Growth *As of 11/30/2015*

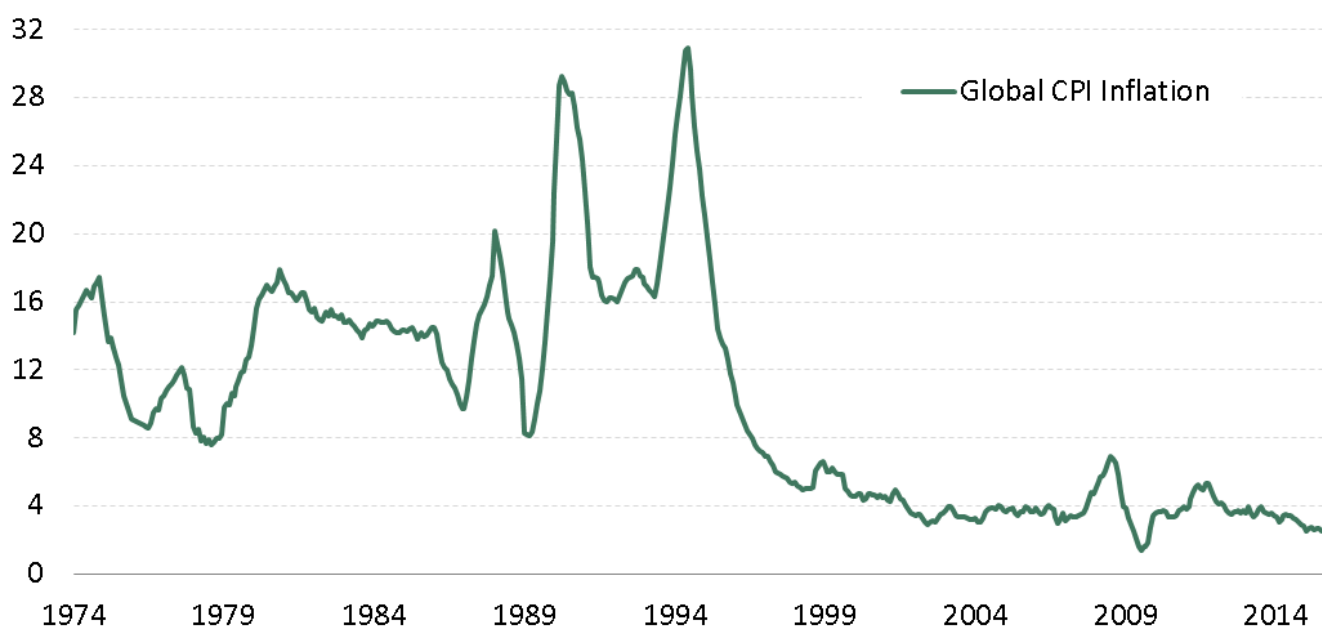


**Shown as a 6-month moving average
Source: Thomson Datastream*

Reason 2

The Fed should be more concerned about deflation than inflation. After eight years of quantitative easing (QE) and zero-bound rates, the inflation rate has drifted ever lower in all major economic blocs around the world (as shown in [Chart 3](#))— I find this trend disconcerting. Chairwoman Yellen attributes the low inflation, or even deflation, to significantly reduced energy costs and the impact of a strong dollar. This may be true, but her observation is not entirely convincing.

Chart 3: Global Inflation At Very Low Levels *Annual % Change; As of 10/31/2015*

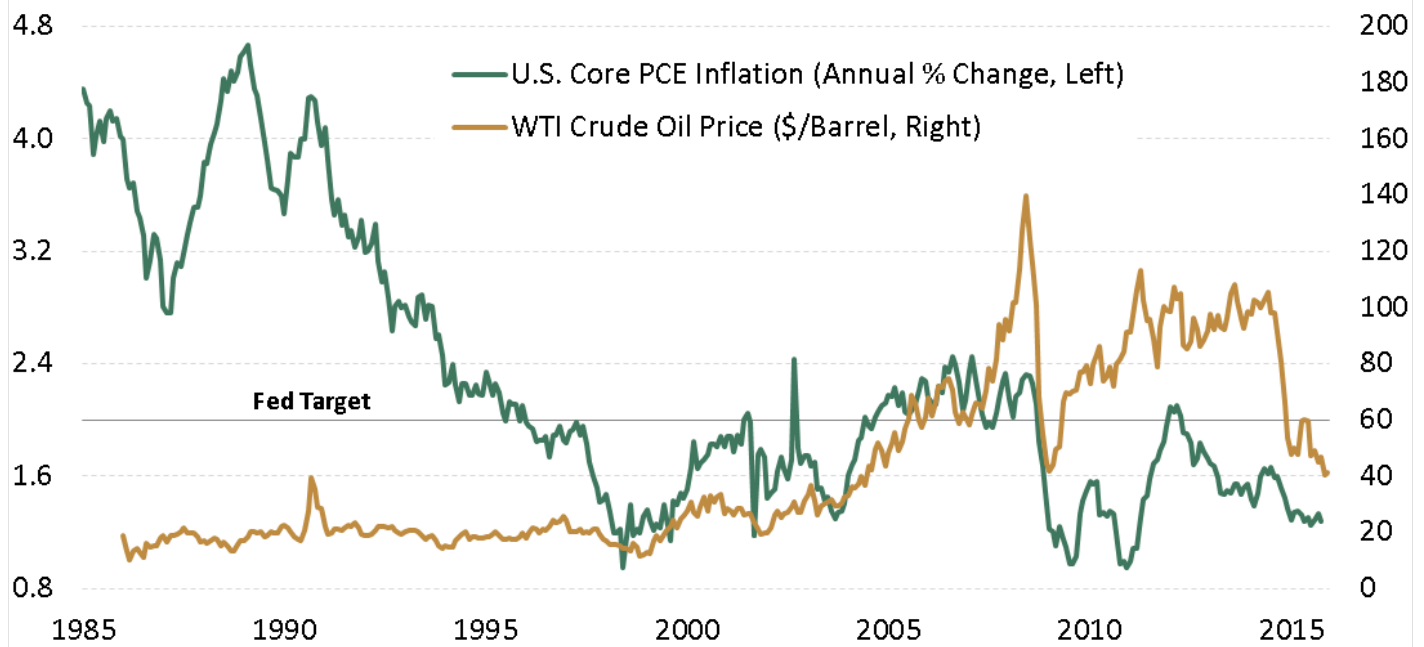


Source: Thomson Datastream

Throughout the last decade, oil prices were soaring and the dollar was falling—the completely opposite situation from today. Yet inflation stayed at roughly 2.0-2.5% for much of the 2000s and there never was an oil-inflation spiral, as many had often feared. In hindsight, deficient aggregate demand, productivity growth, and a continued upward shift in the global supply curve kept inflation at bay. Today, this broad trend is being enforced by acute over-saving and/or under-investing around the world.

Chart 4 shows that core PCE inflation has fallen sharply since 2011 in the U.S., while oil prices only began to collapse starting in 2014. The lag in the collapse in oil prices suggests that the falling inflation trend has been largely explained by forces other than oil. In my view, a lack of demand is the key.

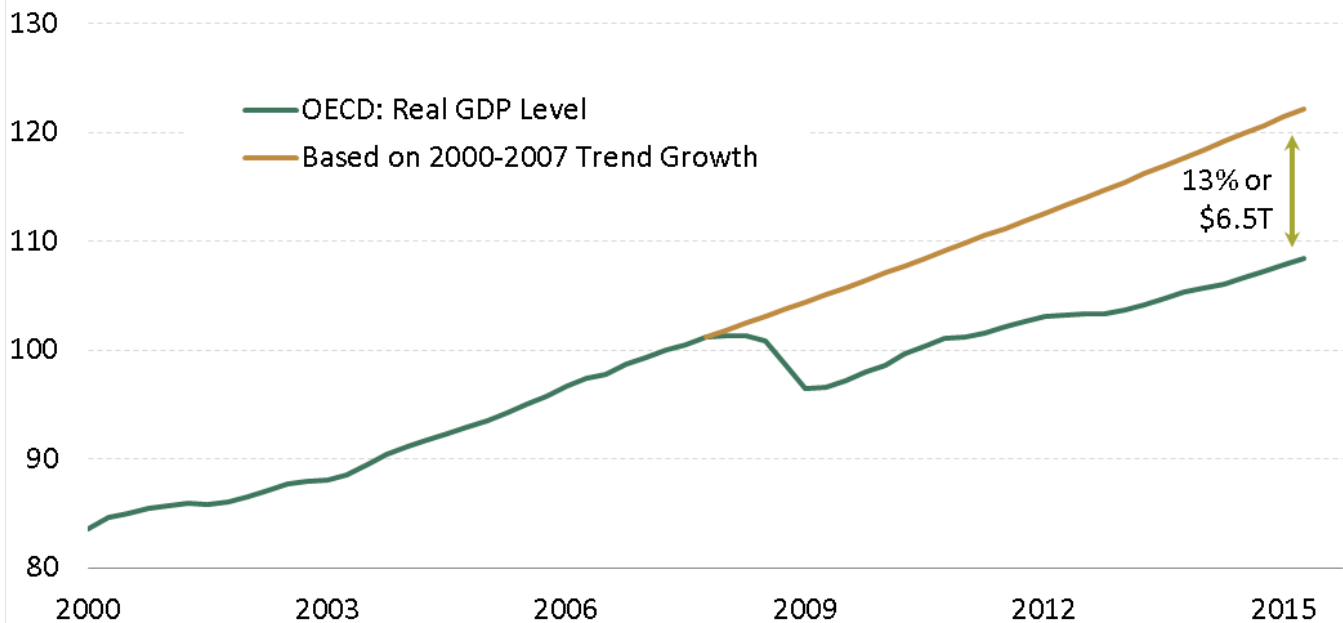
Chart 4: U.S. Inflation & Oil Price *As of 12/7/2015*



Source: Thomson Datastream

The world economy has undergone a profound shift in demand: last decade, consumer demand growth from the West and capital spending from China were the two engines behind global economic growth. Since 2008, however, private consumption from the West has shifted downward because of deleveraging in the U.S. and endless financial crises in Europe. The total permanent loss in income amounts to over \$6.5 T (see [Chart 5](#)). Additionally, capital investment from China has slowed sharply as its economy reached the middle stage of industrialization, where the economy has become saturated with low-end manufacturing capacity.

Chart 5: Permanent Loss of Output In OECD: \$6.5 Trillion *As of 6/30/2015*



Source: Thomson Datastream

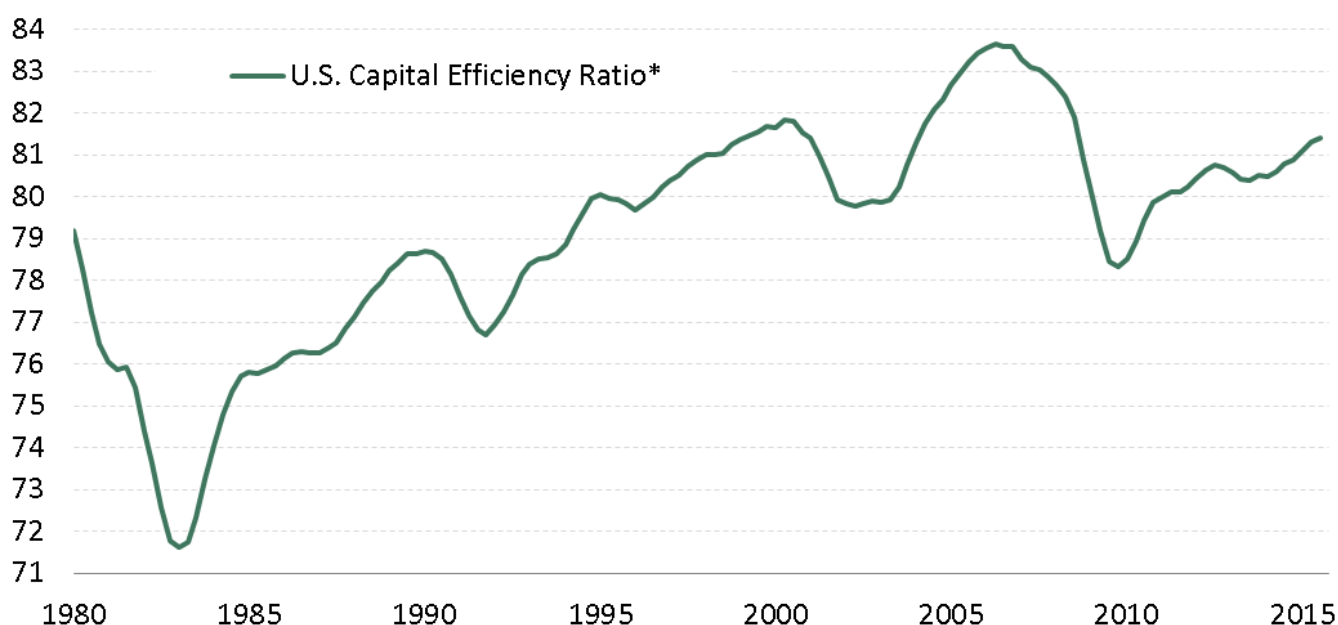
These changes to the world economy have forced the supply side to downsize production, cut prices, and liquidate inventories. The problem is that supply-side adjustment takes a long time and as such, deflationary pressures will remain in the global system. This is why globally traded-goods prices have been falling for several years—in my view, Fed monetary tightening will not help the situation.

Reason 3

Former U.S. Treasury Secretary Lawrence Summers has postulated that equilibrium real rates in the U.S. might have turned negative since the late 1990s because of the chronic problem of over-supply. I have much empathy with his thesis. The world has simply become too productive, produced too much savings but required too little investment to generate ever increasing amounts of goods and services.

Chart 6 below highlights the fact that capital efficiency in the U.S. economy has steadily increased since the 1980s, suggesting that to produce the same amount of goods and services, an incrementally smaller amount of capital is required. This is powerful evidence of the fundamental imbalance between rising savings (income) on the one hand and declining investment demand on the other. The equilibrium solution here is a negative real rate or a decline in price levels.

Chart 6: US: A Secular Rise in Capital Efficiency Ratio %; As of 9/30/2015



**Real GDP divided by corporate sector capital stock
Source: Thomson Datastream*

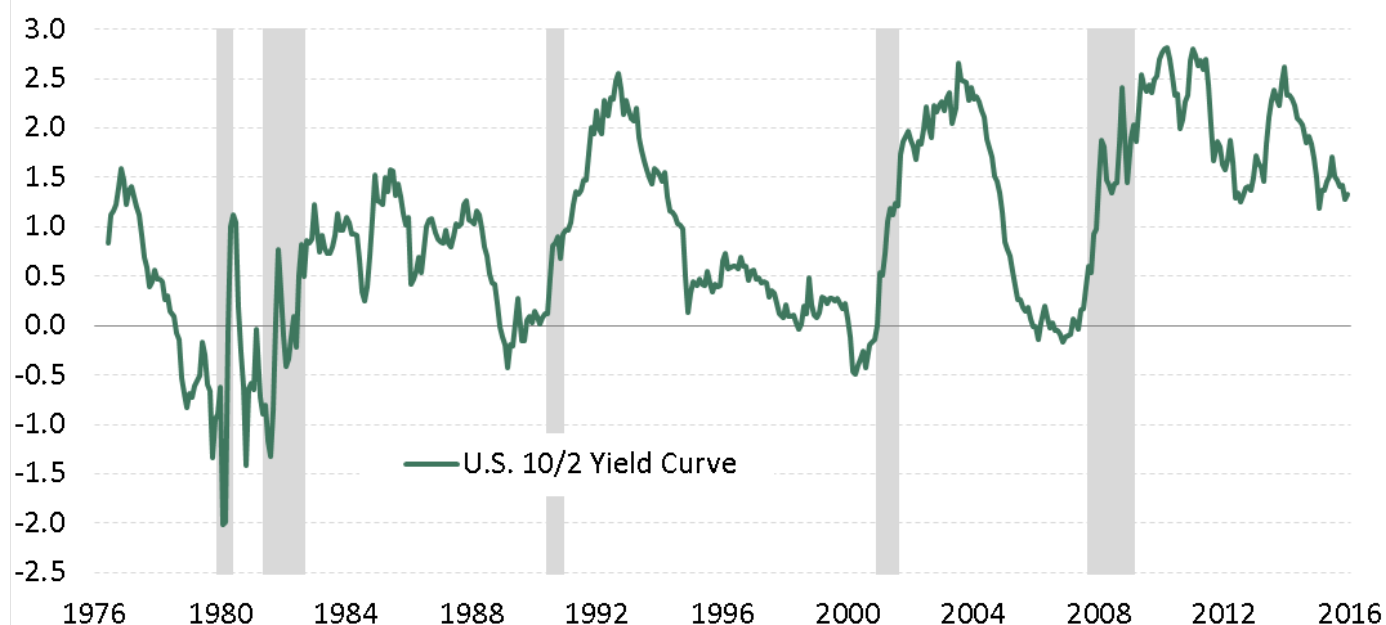
All of these factors are saying that zero rates are not "emergency rates" but are simply what are required by the underlying economy. This is precisely why eight years into QE and zero rates, inflation continues to undershoot its targets in virtually every economy around the world. The European Central Bank (ECB) has even cut its nominal rates to negative in order to push banks to lend again. Therefore, the odds are that the equilibrium real rate in G7 countries remains in negative territory—which is why I believe a December Fed liftoff may prove to be premature.

Reason 4

The Fed has consistently misread the Philips curve, which outlines the trade-off between the inflation and unemployment rates. The curve was positively sloped in the 1970s and 1980s when accelerating growth often came with rising inflation. The curve has flattened substantially since the 1990s as the technology boom and globalization have sharply boosted productivity growth. This decade, the Phillips curve might become negatively sloped as the world economy moves ever closer to deflation. In other words, it is entirely possible for many countries to experience deflationary growth.

History has shown that the Fed has consistently overestimated potential inflation by pushing up rates too much, plunging the economy into recession from time to time. The evidence of the "over-tightening" is manifested by the repeated inversion of the yield curve since the 1960s, as shown in [Chart 7](#).

Chart 7: US: Treasury Yield Curve %; As of 12/6/2015



Source: Thomson Datastream

The flattening of the yield curve in the U.S. since 2013's Taper Tantrum is important and should be regarded as a "warning shot" that monetary tightening could be premature and a policy mistake. So far, the shape of the curve does not signal an impending recession, but any undue rate hikes could trigger a sharp rally in the long end of the yield curve, signaling a recession.

What does all of this mean for financial markets?

The dollar may be close to a top versus the euro and yen. While the Fed is preparing for December liftoff, the central bank has also sounded dovish. The ECB, however, has become more upbeat on growth, while extending its QE program. These differences in posturing and actions suggest that policy divergence is slowly drawing to an end. If so, the dollar could be close to a top against the euro. In the meantime, the Japanese yen is undervalued and Bank of Japan will unlikely augment its QE program. With real GDP expected to resume growth next year, the yen will have limited downside.

The U.S. stock market will continue to be caught in a tug of war. On one hand, low nominal GDP growth, a lack of pricing power, significantly increased corporate leverage, and uncertainty over Fed policy will restrain stock prices from advancing. On the other hand, lower energy costs are boosting real income, and thus supporting economic expansion.

In the end, if my judgement is correct, the Fed will likely give up its hawkish assessment on inflation and abandon its monetary tightening, which could pave the way for equity prices to break out to a series of new highs on the back of a weakening dollar, and improving real income growth. But until then, investors should be prepared for very limited price gains and lots of market volatility in the S&P 500.

In the current environment, I believe longer-dated Treasury bonds are fairly valued. If the world faces chronic over-saving and the disinflation/deflationary process continues, it is hard to see bond yields moving up substantially. Should the Fed make a mistake, long-term bond yields could still fall substantially. Therefore, I believe long-term bonds can still be regarded as a valid instrument against deflation risk and policy mistake.

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