Is a fed rate hike a foregone conclusion?

By Adriaan Pask

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Currently, US expansionary monetary policy is supportive of economic growth. If this support is removed by the next administration, one has to wonder what policy action or potential drivers of economic growth could take over the baton from monetary policy. There have been comments that the envisaged replacement driver will be fiscal policy, but the Federal Open Market Committee (FOMC) must wonder if that will be sufficient to ensure sustainable economic growth.

Although markets have started pricing in a December rate hike by the US Federal Reserve (Fed), we believe there is a strong argument to be made that they shouldn't.

Markets took their cue from Fed chair, Janet Yellen's testimony before the Joint Economic Committee of Congress on November 17, where she hinted at a hike.

She said the election of Trump as US president-elect did nothing to change the Fed's plans for a rate increase "relatively soon".

Indeed, the Fed's own predictions are that 10 out of the 17 Federal Open Market Committee (FOMC) members, who will determine whether or not to change interest rates, believe a rate hike of 25 basis points should take place in 2016. Four members believe it should be a larger increase, while only three of the members believe the rate will stay where it is.

Against this background, and seeing as the Fed has not hiked rates this year, many believe December is the appropriate time.

Data on the strength of the US economy, the strength of the labour force and inflation are some of the important statistics which informs the FOMC’s decision.

We believe that although US inflation is moving closer to the targeted 2%, and although unemployment numbers have improved dramatically, population growth and labour productivity numbers makes a rate hike in December less likely than commonly believed.

Although we support the sentiments that keeping rates unsustainably low for prolonged periods does pose a potential threat to monetary policy efficacy over the long term, a sense of more sustainable economic growth could take precedence over more short-term inflation and labour data numbers.

In addition, there have been remarks that future policy will be aimed at a more closed approach to international trade, which could compromise the contribution of net trade to GDP. Also government spending has been a negative contributor to GDP growth in recent times.

Even though there might be those who expect the Fed to hike interest rates now, the Fed will need to know who will step in to support monetary policy if they make this decision now. President-elect Trump has indicated that fiscal policy could be this support, but no clear indication has been given about what exactly this fiscal support will be. The US cannot really rely on government spending, because this has not truly contributed to GDP growth.

In our view a clearer outlook on fiscal policy combined with improved corporate earnings should support economic growth over the medium term. The FOMC could opt to wait for clarity regarding these numbers, and also rather wait for inflation numbers to approach the 2% target, to ensure a firmer footing before starting a further rate hike cycle.

In short, we don’t believe the Fed should hike US rates just yet. Although there has been a marked improvement in key areas of the US economy, we believe the Fed could wait for additional data or reforms that will support the sustainability of the improving trend, once monetary policy support has been reduced.

ABOUT THE AUTHOR

Adriaan Pask is the chief investment officer at PSG Wealth. He joined the investment industry in 2005 as a portfolio analyst after completing his degree in financial analysis at the University of Stellenbosch. In 2006 he was appointed as national manager of investments, tasked with managing the company's range of Funds of Funds. Adriaan completed his master's degree in business management (with specialisation in investments) during 2009.