Special Report

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Proceed Carefully Forecasting Fed Hikes

Scotiabank Economics continues to forecast the mildest hiking cycle on record with the first increase in the Fed funds target rate coming in December of this year and ending next year around 1½ %. Chart 1 compares past cycles starting with the first hike to the dashed black line that depicts our forecast for the current cycle through to the end of 2016.

With quarterly US growth averaging 2.3% from 2014Q1-2015Q3 and 3.3% if the mystery surrounding persistent Q1 disappointments is removed, it's hardly apparent that growth is so much weaker than past cycles as to justify emergency levels of stimulus. That held true in Q3 because GDP growth excluding a constructive inventory drag would have been about 3% as consumer spending grew by over 3% for the second consecutive quarter. That emergency stimulus is not needed is further reinforced by this cycle's unprecedented unconventional stimulus and the lowest starting point ever for the target rate. Further, we project headline and core inflation — using the Fed's preferred measures — to rise to around the 1½% range y/y throughout next year and thus well above emergency era lows. As always, our rate call is significantly predicated on Fed guidance in addition to our views on how we expect the US and global economies, inflation and markets to evolve.

The main purpose of this note, however, is to emphasize recent developments as reasons for treading carefully in projecting rate hikes — especially in the near-term.

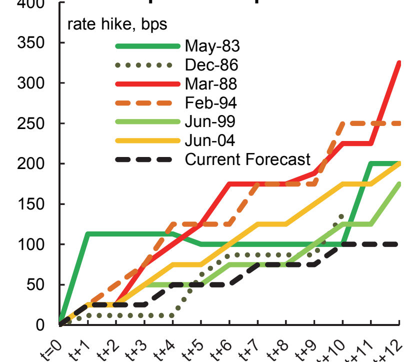
1. Policy and markets may have already over-tightened

The shadow fed funds rate that translates changes in unconventional policy such as forward guidance and ending asset purchases has already risen by quite a lot (chart 2). We wrote about this on page 10 here.

Further, the shadow rate doesn't incorporate the USD that has come on stronger than forecast. There was a time when I was writing about how the appreciation in the USD wasn't enough to truly matter but that was before the Fed's broad dollar index climbed to its highest since 2003 (chart 3) and turned out to be much stronger than most had forecast. While the US economy is among the most closed in the world by way of its trade dependence as a share of GDP, the magnitude of the USD run-up can no longer be discounted as a knock on growth and inflation. The currency is doing the Fed's work.

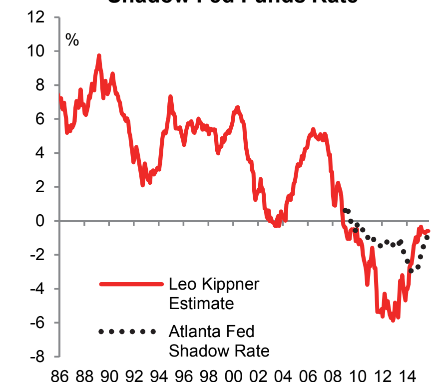
In addition, credit market conditions have tightened. High-yield debt spreads have widened markedly and sit at their widest since 2012 when, for example, European contagion risk was a global concern (chart 4). The Fed should be worried about aggravating tighter access to financing within the context of a moderate exit from crisis-era deleveraging.

Chart 1



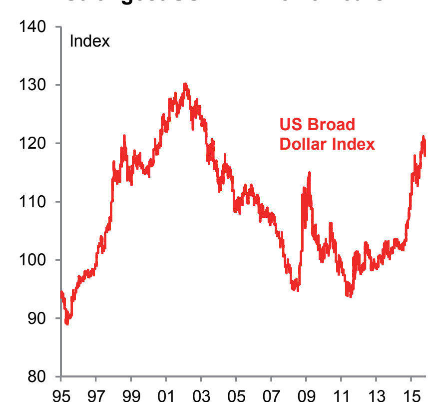
Source: Scotiabank Economics, U.S. Federal Reserve. (t = months)

Chart 2



Source: Scotiabank Economics, Federal Reserve, Bank of Atlanta, RBNZ

Chart 3



Source: Scotiabank Economics, Federal Reserve

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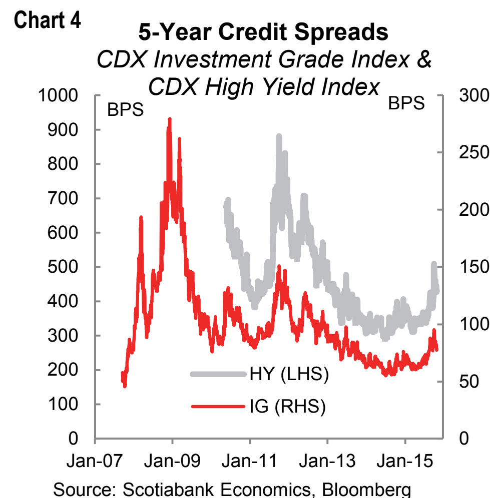
2. Bucking the herd

Central bankers run in packs. We've seen that time and again. With the PBOC having eased and likely to continue doing so, the ECB and BoJ likely to ease in future, and with smaller central banks like the Riksbank, RBA and Bank of Canada having been engaged in easing cycles, it may prove difficult for the Fed to hike. This may show that these other central banks are getting their own houses in order and alleviating Fed worries about international risks, but lumped in with those international and market risks is the impact on the greenback. Hike while others are loading up on stimulus and you may well wind up with the strongest USD since at least the past couple of decades and thus rivalling the strength of the USD at the peak of the dot-com bubble.

The overwhelming bias across central banks around the world is to prefer a softer currency as a beggar-thy-neighbour approach to improving their trade competitiveness and punting disinflationary pressures to the Federal Reserve. This is a currency market straight jacket to the Fed and it punts the aftermath of the US-centric crisis right back to the US.

Chart 4

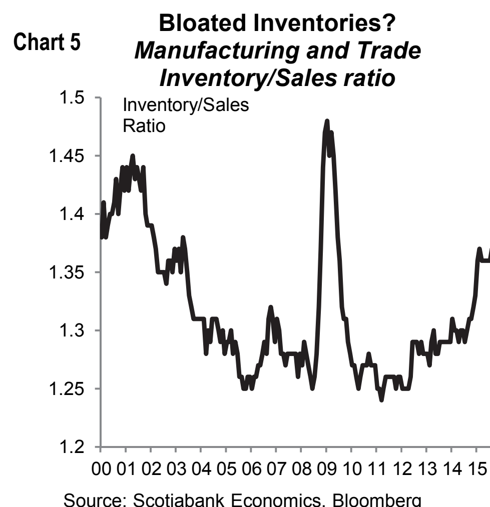


Source: Scotiabank Economics, Bloomberg

3. The US inventory cycle is bloated

The economy-wide inventory-to-sales ratio is at its highest since the depths of the crisis in 2009. Not as high, but moving in that direction as per chart 5. Optimism about the cycle resulted in a desired inventory build that, well, is not so desired now because it simply got carried away. Ergo, softness in industrial readings like industrial output and manufacturing surveys in order to work off this excess. A period of inventory disinvestment may be upon us and I'm not sure that's something that should be looked through. The magnitude of the run-up bucks the trend that was in place until the crisis hit back when just-in-time-inventory management systems and technology were putting downward pressure on inventories. Note that in the Q3 GDP report, inventories continued to climb at an annualized pace of US$57 billion following large gains of about $113 billion in each of the prior two quarters. Inventory investment dragged about 1½ percentage points off of Q3 GDP growth because the rate of investment slowed, but they still continued to climb. Thus, as yet, there has been little to no progress toward bringing inventories back in line with sales as purchasing managers simply became too optimistic and overshot on their order books. I've often quipped that the worst thing that can happen to a forecast for a rebounding economy is that too many people actually believe it too strongly.

Chart 5

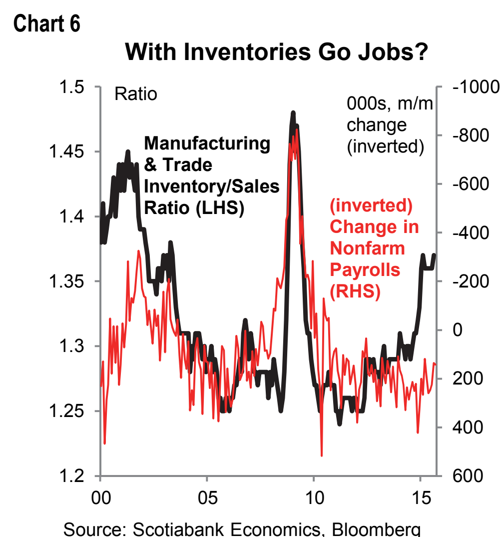


Source: Scotiabank Economics, Bloomberg

4. Uncertain job market outlook

A bloated inventory cycle could result in an extended period of weak job growth and that would provide added reason not to look through the inventory cycle. That has tended to be the pattern over time. It could well be a coincidence as other forces have influenced both the inventory and jobs cycles. But there is information in the correlation between the two (chart 6), and it suggests that a downdraft in employment growth that began over the past couple of months may have further legs to it on a trend basis. We need more information to assess the risks to employment growth before pulling the trigger. One might think that if job growth unexpectedly slowed and we don't really have a firm handle on why in all honesty, then one should be concerned about possible future trend weakening and perhaps even harsher outcomes rather than to stubbornly look through the past two months of softer job gains.

Chart 6



Source: Scotiabank Economics, Bloomberg

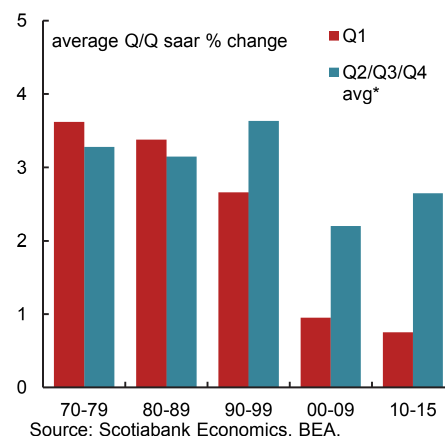
5. Inflation in 2017

Headline inflation will rise into next year in terms of the Fed's preferred measure which is the price deflator for personal consumption expenditures. That's a function of shaking out the year-ago base effects of lower commodity prices. But then fast forward to 2017 — or the second half of next year for that matter — and it's unclear what happens to inflation and yet that's the time frame for lagging influences of monetary policy adjustments that could be entertained later this year or into early next year. Scotiabank Economics forecasts 2%+ headline inflation in 2017 with core PCE inflation just a few tenths behind and at a non-emergency rate, but as always the inflation forecast that far out is subject to a wide forecast range. A transitory upswing in the near-term inflation readings could prove as transitory as the downswing over the past year. How transitory various influences may be upon headline and core measures of inflation and over what time frame is being interpreted in varying ways by different global central banks and in the context of high uncertainty surrounding inflation projections at the best of times.

6. A seasonal soft patch may be looming

As chart 7 demonstrates and as we've written about over the years, we're now going into the funky period of growth disappointment and nobody really understands why. First quarter economic growth in the US economy has persistently disappointed expectations and began to do so long before the global financial crisis, so we're not just talking about fleeting effects of factors like harsher-than-normal winter weather in some of those quarters. Some, like economists at the San Francisco Federal Reserve, think it's a seasonal adjustment problem (here) and, if so, the Fed should look through such a distortion. They adjust for this by seasonally adjusting seasonally adjusted data. We feel your pain in reading that sentence. Others, like economists at the Board of Governors of the Federal Reserve itself (here) and the NY Fed (here) dispute this reasoning. That suggests the Fed is not likely to fully look through potential Q1 growth disappointment. The bottom line? There remains considerable uncertainty over why the first quarter tends to disappoint but facing this uncertainty should result in a cautious Fed policy bias.

Chart 7



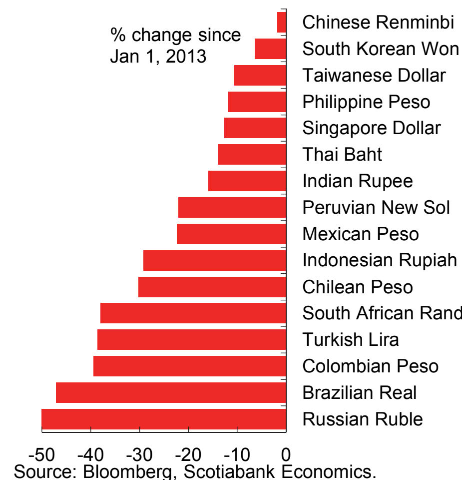
Source: Scotiabank Economics, BEA.

7. What bubble?

There is no pressing overall urgency to act toward tightened policy now from the standpoint of asset price imbalances.

High-yield spreads are rich as previously alluded to. Sovereign bonds are richly priced but higher grade corporate spreads have also widened materially over the past year with Moody's BAA corporate index yield up by about 100bps to 5.3% now. US stock markets are around the upper end of fair value by the eight valuation measures we use and, in our opinion, not close to the periods of extreme over-valuation like the dot-com era and 1987. Emerging markets have come well off their past excesses as evidenced by equities and currency moves (chart 8).

Chart 8



Source: Bloomberg, Scotiabank Economics.

In conclusion, nothing about the Federal Reserve is forecast in a rates vacuum. A rates forecast is subject to its own risks, but is also heavily dependent upon forecasts for US and international growth and inflation, the USD and other currency market developments, commodity prices, and broader financial market developments. Each is subject to random shocks. It is this interdependence of forecast variables that makes the Fed's job challenging — and along with that the jobs of those forecasting the Fed. Reasons cited in this note provide a case for caution and we feel that is adequately demonstrated in what amounts to projecting the slowest and most plodding path for rate hikes in modern times. In my opinion, the balance of risks as understood at this moment is skewed toward being more cautious in projecting the first few rate hikes and potentially more bearish than our longer term rate views.