Market Monitor

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Sowing the Seeds to Lower Interest Rates

Last week, for the third time in a row, the Federal Reserve Board (the Fed) met and decided not to raise short-term interest rates. This pause comes after the Fed raised rates 17 times over the last two years. Our themes for today are these:

- Why central banks around the globe have been raising short-term interest rates recently,
- How these higher rates have caused global economic momentum to slow, and
- What this slower pace of economic growth will likely mean to short as well as long-term interest rates over the next few months.

For starters, the Fed has been on a quest to raise short-term interest rates from the abnormally low levels we saw earlier in this decade to what it considers a more normal level. As you know, the Fed can do this by changing the Fed funds rate, which is the overnight interest rate banks use to borrow or lend their excess reserves. As a result, the Fed funds rate now stands at 5.25% versus the extremely low 1% that prevailed before the middle of 2004.

In doing this, the Fed also wished to forestall any rise in inflation expectations that it thought might come from strong economic growth and higher energy prices. It was aware that once inflation expectations – and inflation itself – ratcheted higher, it was very difficult to push them lower. In the early 1980s, for example, in order to lower the high and entrenched inflation expectations that started in the 1970s, the Fed had to raise short-term rates to over 20%, an act that led to a deep recession. Earlier in this current decade, the Fed was also concerned about a housing price "bubble" due to very low long-term mortgage interest rates. Housing prices began to rise at double digit rates nationally, and in some places at 30% annual rates. So by raising short-term rates the Fed believed that it could take the pressure off the housing bubble as well as combat a more general rise in inflation expectations.

The Fed has largely been successful with its tightening campaign as signs of the economy slowing continue to proliferate. Retail sales have tapered off, housing prices are in decline, business investment is less vigorous, and inventory investment is contributing less to growth. In short, higher interest rates have put a damper on demand, by making saving more attractive than spending, by raising the cost of financing, and by adversely affecting financial asset prices. All of this has resulted in an economy that now is on a slower growth track, resulting in fewer worries about inflation rising and the housing "bubble" continuing to expand. Indeed, at least in some quarters, the worry now seems to be too little growth and a higher risk of recession and it is precisely this worry that prompted the Fed to forego additional rate hikes at its meetings in August and September. And, with the economic data still pointing to slow growth, it was no surprise that the Fed adhered to this holding pattern at last Wednesday's meeting. Now that interest rates are where they want them to be and the economy is slowing, the Fed is now probably quite comfortable, absent significant downside or upside growth shocks (e.g., an overexcited stock market or a rapid rise in oil prices).

Other central banks, however, have been in somewhat different positions compared to the Fed, largely because their economic recoveries in this decade lagged behind the U.S. For instance, economic growth languished in the Euro area and in Japan and didn't begin to take off until early 2005. As a result, monetary tightening by the central banks in those areas lagged the U.S. considerably, with the European Central Bank (ECB) first raising rates in December 2005 and the Bank of Japan (BoJ) just this past July.

Even so, global growth now seems to be on a slower track. For the last few months, the Organization for Economic Cooperation and Development (OECD) developed country leading indicators, which are designed to forecast economic performance over the next few months, fell, first in the U.S, but then progressively in other major OECD economies. For instance, slowing in Europe just seems to be materializing, while Japan has been slower since early this year. In part the slower growth in those areas is reflecting the less vibrant conditions that have been in place in the U.S. for much of this year. Also, the stronger Euro and the British pound probably played a role in creating the slower conditions now evident in Europe.

In any event, these slower economic conditions plus lower oil prices of late place some limits on how much more foreign central banks will tighten, despite the fact that they only started raising rates fairly recently (very recently in the case of the BoJ). In the ECB's case, there are probably at most three more tightening moves ahead of it. And in Japan, with the economy on a much slower track, the BoJ will probably remain on hold, keeping its targeted rate at just ¼ of a percentage point above zero. Indeed, if global growth stays on its current slower track, we should not be surprised that the current global tightening cycle ends early next year. We might even see the Fed begin a program of limited rate reductions sometime in the second half of 2007. In fact, right now we see yields on long-term U.S. Treasury bonds in the 4.7% range, about a half of a percent less than the Fed funds rate. This abnormal condition – called an inverted yield curve – has in the past sometimes presaged a significant recession, but in this case we believe it reflects both the current slowdown in economic activity as well as bond market expectations of possible short-term rate reductions next year. If so, we could also see next year more pronounced and sustained rallies in both bonds and equities.

In summary, after two years of the Fed and other central banks tightening, the global economy has slowed, sowing the seeds for central banks to begin easing interest rates in the middle of 2007, thus providing the impetus for a modest rise in financial market prices later next year. But just as a reminder, the forecast for next year could change considerably if economic growth takes off unexpectedly or if an unforeseen negative economic or political shock pushes the economy closer to recession.

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