

Preparing for Fed lift-off

Anatole Kaletsky | GaveKal | 10 November 2015

Now that last Friday's payroll figures have confirmed the US economy's apparent slowdown as nothing more than a statistical blip, similar to the summer "soft-patches" of 2011 and 2012 and the winter weather hits of 2013 and 2014, the Federal Reserve is near-certain to start its tightening cycle on 16 December – which was what Janet Yellen suggested all along. Apart from praising Yellen for consistency and foresight, instead of castigating her for confusion and indecisiveness, how should investors react?

Beyond the immediate market response, which saw both the US dollar and bond yields tick smartly higher, there ought to be two main reactions. First, think about how far and how fast interest rates are likely to rise; and, second, look at how asset prices have behaved in previous tightening cycles. With all the speculation about exactly when the Fed would make its first move, there has been surprisingly little attention paid to these more important questions. These are big subjects which we have discussed many times before and will doubtless return to in the future, but a quick summary is in order.

We explained two months ago why we believed Yellen when she predicted that rate hikes would be slower and shallower this time than in any previous cycle (see [The Fed Throws EMs A Lifeline](#)). And we will continue to believe this "lower for longer" story, even though we expect US wages and consumer inflation to accelerate from now on. The explanation of this apparent contradiction is simply that the Fed, like the Bank of Japan, is now genuinely determined to push inflation up and to keep it up. To do this, the Fed must remain behind the curve of rising inflation, just as Paul Volcker and Alan Greenspan stayed behind the curve of falling inflation in the 1980s and 1990s, when the Fed's over-riding objective was to push inflation down and keep it down.

Now let us consider how markets have responded to Fed tightening in the past. This is not a matter of analysis but of historical fact – yet, almost everyone seems to believe the wrong answers; that tightening leads to a stronger US dollar, weaker equity markets and trouble in Asia.

Figures 1 and 2 below show how key asset prices performed in the three years after June 2004 and February 1994, the only episodes of US monetary tightening remotely comparable to the one about to begin. In both cases, the Fed started to move after what seemed at the time to be unbelievably long periods of unbelievably low interest rates.

Moreover, in both cases, European and Japanese monetary policy remained much easier than the Fed's, just as it is today.

In the 1990s, the Bundesbank continued to cut rates for more than two years after the Fed had started hiking and, in 2005, the European Central Bank lagged 17 months behind the Fed.

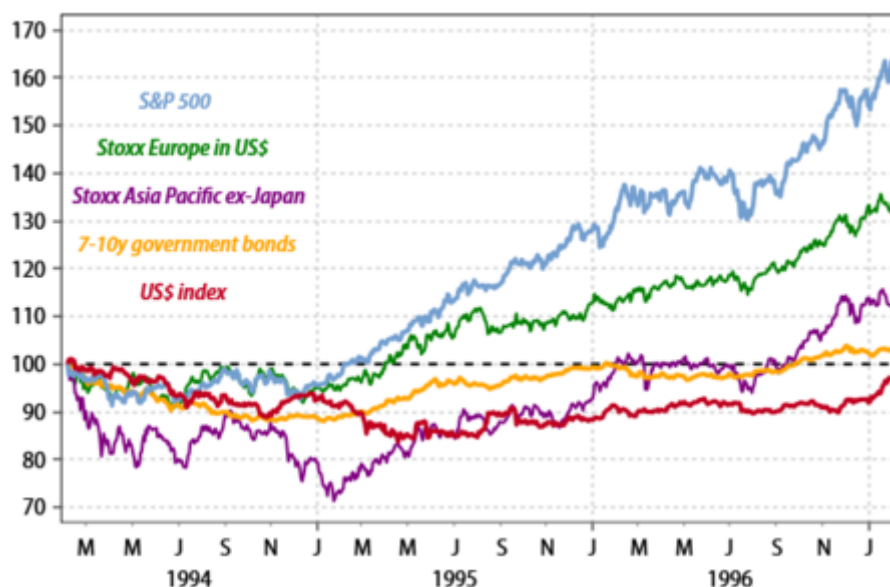
Now look at what happened after the initial Fed moves.

- In both cases, the US dollar (red line) weakened almost immediately after the first rate hike and stayed below its initial level throughout the following three years.
- Equity markets traded sideways for between six and 12 months and after that gained strongly, with the US market massively outperforming in 1995–97, while Europe and Asia did much better than the US in 2005–07.
- On both occasions, bonds went nowhere.

Of course, past performance is no guarantee of future results. Just because the US dollar weakened in both comparable cases of past Fed tightening does not mean it will weaken again. But it does mean that it is far from inevitable that the dollar will strengthen.

This means that my contrarian view on currencies – that rising US interest rates will coincide with a falling or stable dollar – is not obviously stupid. And, if the dollar does stabilise or weaken after the first Fed rate hike, then there will be no plunge in equities, and especially not in Asia. In that case, we should see strong outperformance by Asian and European assets in this tightening cycle – more like 2004 than 1994.

Figure 1: Asset prices after the February 1994 Fed tightening



Sources: Gavekal Data/Macrobond

Figure 2: Asset prices after the June 2004 Fed tightening



Sources: Gavekal Data/Macrobond



Anatole Kaletsky is co-founder of [GaveKal Research](#), GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US\$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.