# The Great Escape

Tony Crescenzi | PIMCO | December 2014

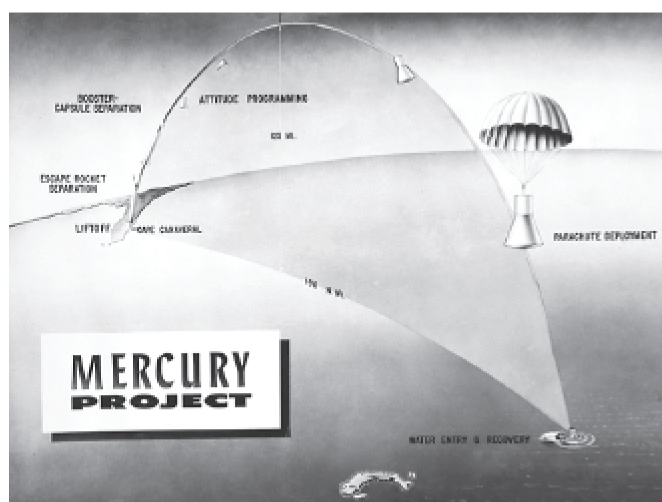
In June 1969, I moved into my childhood home in Staten Island, New York, a month before the United States first put a man on the moon. My neighborhood was aptly named Astronaut Village, where the streets are named after astronauts from NASA's Mercury space program. I lived on Shepard Avenue, named after Alan Shepard, who in 1961 was the first American to travel into space.

Shepard showed he had the "right stuff" when a decade later he became the oldest person to walk on the moon. Fittingly, the Mercury Seven astronaut hit two golf balls across the moon’s dusty plain. They went far – everything does when away from Earth's pull.

In Shepard's maiden voyage in 1961, he saw firsthand that it isn't easy to achieve escape velocity and break away from the Earth’s massive gravitational pull. Indeed, to achieve escape velocity a spacecraft has to move with extraordinary speed, at 6.96 miles per second. That's fast – I can barely walk after a carousel ride!  No wonder I never realised my dream of becoming an astronaut.

Shepard's epic journey – if it can be called that – lasted all of 15 minutes. His spacecraft simply wasn't moving fast enough for the spaceman to journey into the depths of space (Figure 1).

Figure 1:  Alan Shepard's 1967 'escape'




Source:  NASA

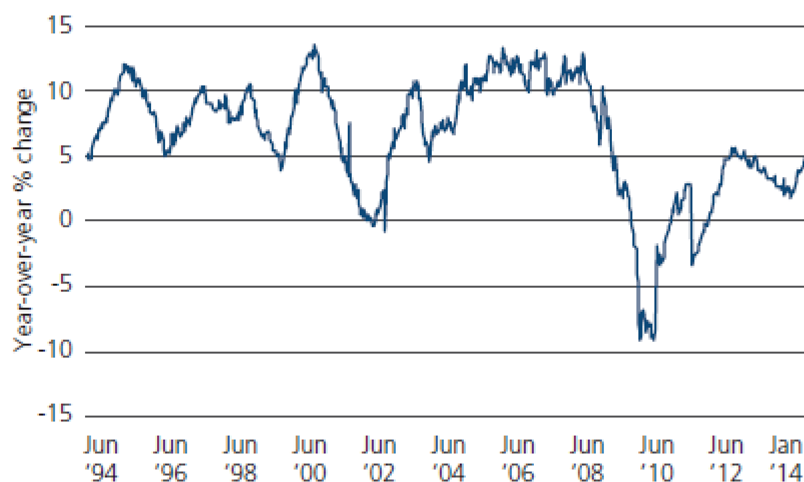
THE THREE GREAT ESCAPES THE FED MUST MAKE

The Federal Reserve must know how Alan Shepard felt when he came so close yet so far from achieving escape velocity. The Fed has tried for six years to achieve its dual mandate of maximum sustainable employment and price stability, working like a team of NASA scientists to figure out how. The central bank is engaged in a colossal effort to smooth the deleveraging process, help put Americans back to work and boost wage growth. Its primary means? Tools old and new aimed at promoting economic growth through the five main channels by which monetary policy typically transmits to the economy:

- Stock prices;
- Bond yields;
- Credit spreads;
- Bank lending standards; and,
- The value of the US dollar.

It hasn't been easy for the Fed. Its conventional tool – setting short-term interest rates – has provided about as much fuel to lift the US economy as a heavy-duty battery could to light up the streets of New York City. The Fed's zero percent policy rate, implemented in December 2008, failed to provide liftoff strong enough for the Fed to achieve its objectives on growth and inflation because it failed to sufficiently boost bank lending (Figure 2).

Figure 2: Break-adjusted loans and leases in bank credit: all commercial banks




Source: Federal Reserve as of 25 June 2014

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There are three escapes the Fed must make in order to declare its mission a success:

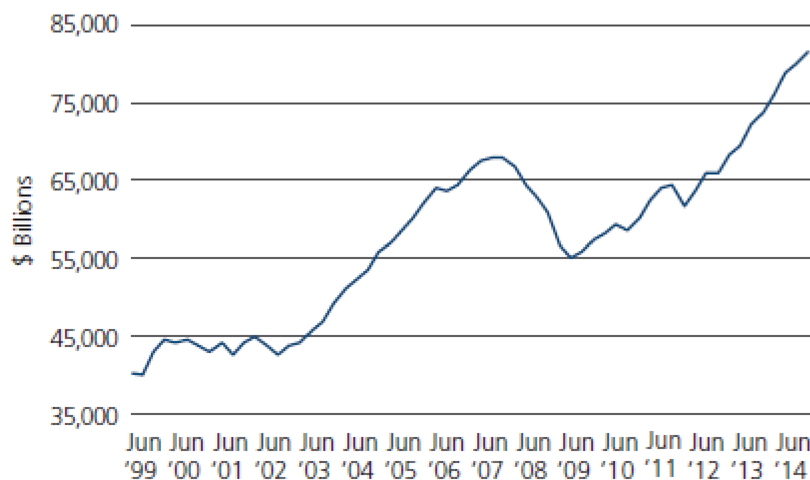
1. Escape from a liquidity trap – get banks to lend;
2. Escape from quantitative easing – stop the bond buying program; and,
3. Escape from the zero bound – hike the policy rate above zero.

The Fed realised long ago that to achieve its objectives, rate cuts wouldn't cut it, so it augmented its conventional tool with an unconventional one – bond buying. Did it work? Ground control to Major Tom – did it? No one knows. This is a flight that has yet to land.

Yet, what we do know is that bond buying by the Fed, as well as by the European Central Bank, the Bank of England and the Bank of Japan, has been a powerful rocket booster, not so much for economic growth (no surprise there because central banks can only produce one thing – inflation), but by influencing the five transmission effects of monetary policy shown above. The Fed's bond buying created financial conditions that made it as if it was still cutting rates.

US households have certainly benefited. Household net worth has increased $26 trillion to $81.5 trillion from its 2009 low (Figure 3). Mind you, not all Americans have been lucky enough to collect these moon rocks and rebuild their wealth. The moonshot in stock and bond prices has benefited primarily the wealthiest of rocketeers, with 54% of household wealth held by the top 3% of income earners, and about 75% held by the top 10%, according to data from the Federal Reserve.

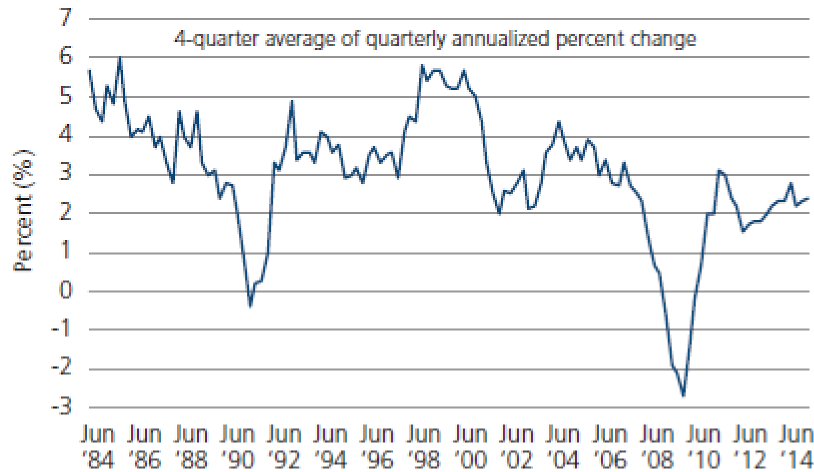
Figure 3: US household net worth




Source: Federal Reserve as of 30 June 2014

Nevertheless, rising asset prices have boosted economic activity somewhat by prompting personal consumption, although only to levels that are historically subpar (Figure 4).

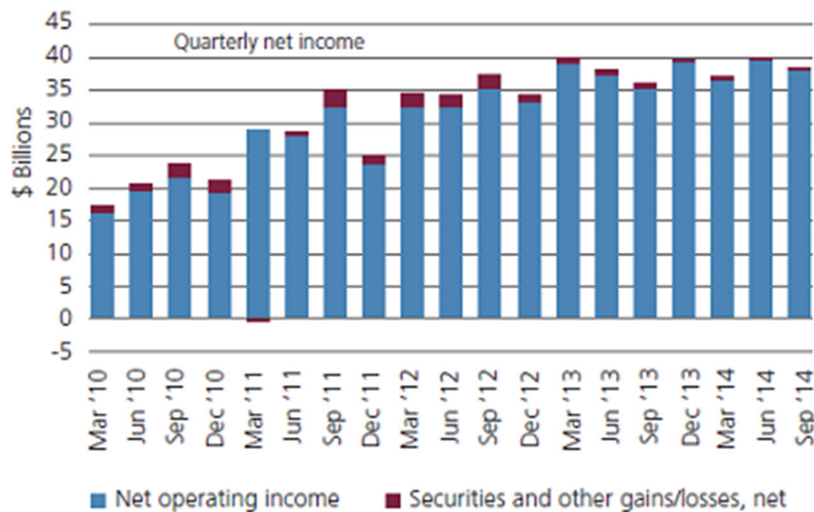
Figure 4: US Personal consumption expenditures




Source: Bureau of Economic Analysis as of 30 September 2014.

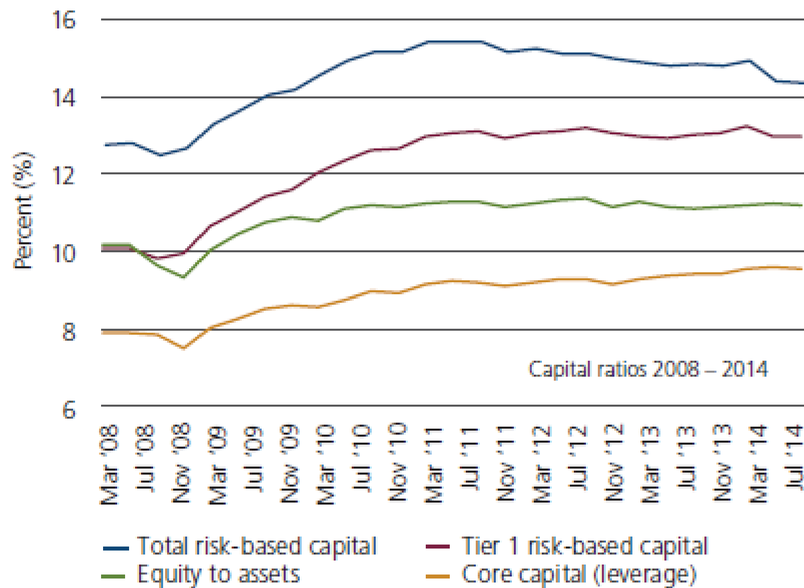
Financial institutions have benefited from higher asset prices, too, particularly US banks, which have seen a solid increase in profits (Figure 5) and increased capital buffers (Figure 6) since the financial crisis. This has slowed the deleveraging process, which can be wretched when it moves rapidly.

Figure 5: Bank profits in the US today are much improved from four years ago




Source: FDIC as of 30 September 2014.

Figure 6: Bank capital ratios have also improved




Source: FDIC as of 30 September 2014.

## CONVINCING BANKS TO LEND

Consider what happens when banks in a fractional reserve banking system such as the one we live in decide to deleverage en masse (that is, they decide to stop replacing repaid loans with new ones) – money vanishes, literally. It's the opposite of what happens when banks make new loans, and they made lots of them for decades.

Think of banks as factories. They create money out of thin air. Imagine bringing $100 to a bank teller to repay a loan. If the bank doesn't replace your loan with another one, the $100 leaves the financial system for good and can't be spent. This condition is known as a liquidity trap, where loan growth stays weak despite low interest rates. The US began working its way free of the trap in 2011, but loan growth has been weak.

Slow credit growth is a major reason to believe the Fed in its next cycle likely won't raise interest rates as much as it might have in the past. More on this later.

## LEAVING QE BEHIND

Having engineered an escape from the liquidity trap, the Fed in 2013 set its sights on its second great escape, its escape from quantitative easing. Fed Chair Ben Bernanke indicated as much in May 2013 when he said the Fed planned to taper and eventually end its bond buying if it achieved substantial progress on its objectives on employment and inflation.

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It has.

The US jobless rate has fallen two percentage points to 5.8% since the Fed launched its round of bond buying in September 2012. At the time of writing (December 2014), it is close to the 5.2% to 5.5% range that the Fed says represents full employment, where everyone who wants a job has one.

So, the Fed on 29 October 2014 declared success when it announced an end to its bond buying program, escaping from quantitative easing.

One escape remains - from the zero bound. It's visible on the horizon.

## LAUNCHING OFF OF ZERO. DESTINATION: NOT FAR

> "If all goes according to our forecast and the US economy continues to make progress toward the Fed's dual mandate goals of maximum sustainable employment and 2% inflation, the Federal Reserve will likely begin to raise its federal funds rate target off the zero bound sometime next year." - William Dudley, President of the Federal Reserve Bank of New York (7 November 2014)

Heed Dudley's words. The timeline for the Fed's first rate hike will likely hold.

That said, don't get too wrapped up in the exact timing of the Fed's first move. Focus instead on the speed and magnitude of future hikes. We believe the Fed will boost its policy rate by 25 basis points every other time it meets, or by a percentage point per year, with the speed dictated partly by the reaction in financial markets, and the rate peaking at levels well below previous peaks of 5.25%, 6.5% and 6.0% in 2006, 2000 and 1995, respectively. If the Fed moves faster than this, the odds of the policy rate peaking in the mid-2s will increase, because the Fed will likely act all the more quickly to slow the economy and limit the need for more significant rate hikes later.

An early first hike can't be ruled out if economic data are stronger than the Fed expects. The Fed has stressed that the timing of the first hike depends on the speed of progress made toward its goals. Data have in fact been strong, and the jobless rate has fallen faster than the Fed expected.

Yet, with inflation low and wage growth weak (Figure 7), the Fed can afford to be patient. A pickup in wage growth in 2015 likely won't change matters, either. Can anyone imagine Janet Yellen saying to Americans if wages do accelerate: "For six years you hurt through 2% annual wage growth, a full percentage point below normal, but over the past six months you've all done pretty well, so we at the Fed are going to raise rates aggressively to put a stop to it!" No way!

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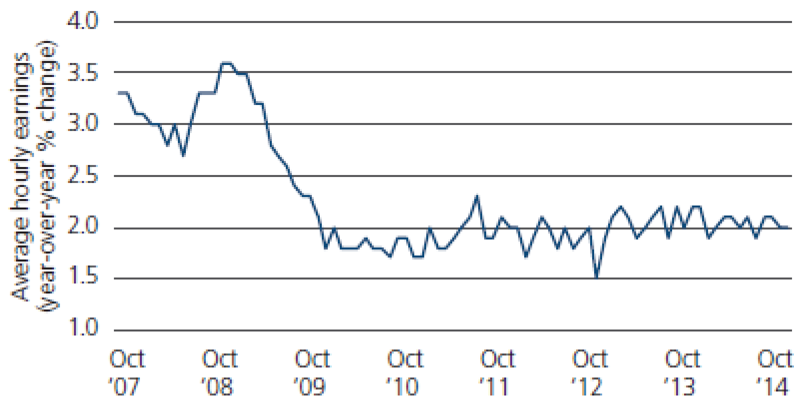
Figure 7: Wage growth remains weak




Source: Bureau of Labor Statistics as of 31 October 2014.

More likely the Fed will let the US economy "run hot" a bit, as William Dudley said, by keeping its policy rate below where it normally would when the unemployment rate has fallen. The Fed is leery of the risks of moving too soon. It recognises the difficulties of resuscitating growth once it falters. In contrast, inflation worries are more readily doused if they surface.

In either case, the Fed can't wait indefinitely and likely will feel compelled to get started around the middle of 2015. We expect it to pivot somewhat from its predominant risk management focus of recent years, which has centered on the risks of moving too soon. The Fed simply doesn't know at what point inflation pressures will kick in – it is probing for the answer. Yet, the more the jobless rate falls, the more the Fed will have to tend to the possibility that inflation may accelerate. While this means escaping from zero, don't expect the rate rocket to go too far.p

## HOW FAR?

The Fed itself sees its policy rate staying very low for years to come, projecting in its most recent quarterly Summary of Economic Projections a policy rate of around 2.5% at the end of 2016, even as it projects success in reaching its goals on employment and inflation. This is striking, considering that the Fed normally maintains a neutral policy stance when it believes economic conditions are ideal, which to the Fed translates to a policy rate of 3.75%. Janet Yellen and the Fed obviously want to keep their thrusters open so that Americans can get fatter paychecks, which have been moving in slow motion, like a man walking on the moon.

Our view is that the New Neutral policy rate is closer to 2% than to the old neutral of 4%. There are many potent reasons for this. Here are five provided by the Fed in the minutes to its 19 March 2014 meeting:

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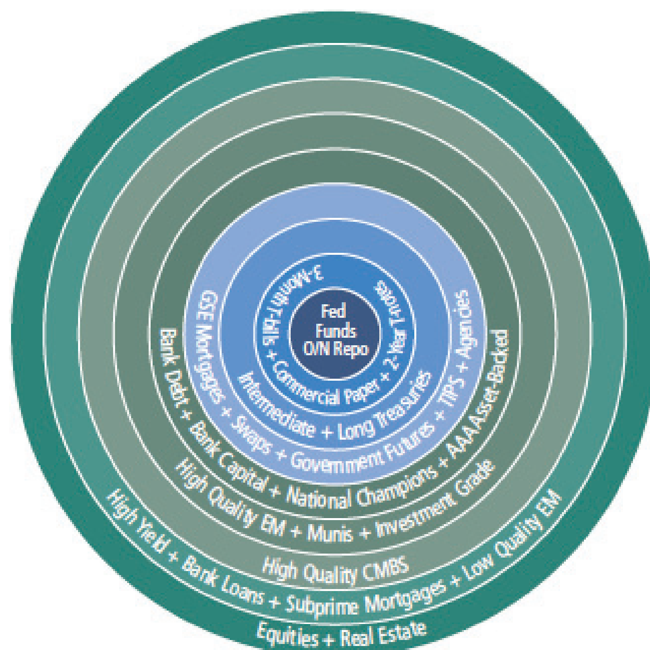
1. Higher precautionary savings by US households;
2. Higher global savings;
3. Demographics;
4. Slower growth in potential output; and,
5. Restrained credit growth.

These potent secular headwinds are important for investors to stay mindful of when constructing investment portfolios. Be leery of getting caught up in the very convincing optimistic cyclical outlook and the tendency to over-extrapolate the longer-term outlook from shorter-term trends.

## INVESTMENT IMPLICATIONS

As just mentioned, focus on the big picture by centering portfolio construction on the speed and magnitude of future rate hikes. This means constructing portfolios that are likely to benefit from low policy rates not only in the US but also in Europe, where markets are priced for both the European Central Bank and the Bank of Japan to keep their policy rates under 1% for the rest of the decade. Investors in such a climate are likely to continue reaching for yield and higher returns by moving outward along the risk spectrum (Figure 8). These assets are expected to remain well-supported for some time.

Figure 8: Asset risk spectrum




Source: PIMCO

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All that said, asset prices don't move in a straight line and there are short-term considerations to heed, not the least of which is the launch of the Fed's rate hike cycle, which could well be disruptive to the many assets that have taken flight from the Fed's monetary fuel. Investors can be opportunistic if they stay mindful of the destination for rates in the US and globally when market sentiment inevitably occasionally sours against assets that are likely to benefit from today's era of low interest rates.

So will the Fed achieve its great escape? Probably. Yet like other central banks, it is not likely going very far, so it will feel like it never left.

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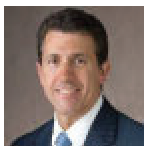

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