

The View From The Outer

David Jarman – Chief Investment Officer

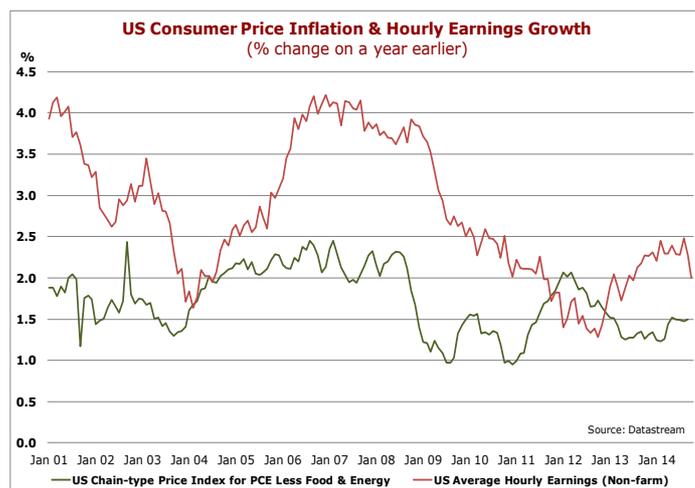
Wednesday 26 November, 2014



Interest Rates: Still “Lower for Longer”

- In our **The View From The Outer of 31 July, 2014** we wrote of the likelihood that the **FOMC (Federal Open Market Committee)** would hold the **Federal Funds Rate “lower for longer”** while a broader range of measures of the **US labour market** indicated continuing significant slack remains. (Broader, that is than the headline unemployment rate or the undeniable strength of the monthly payrolls employment growth.)
- In particular we noted Fed Chair Janet Yellen’s references in earlier Congressional Testimony to the importance price of labour (that is wages growth) as a gauge of the slack in the labour market.
- So what has changed since?
 - The Fed’s preferred core inflation measure has remained unchanged at around 1.5% and average hourly earnings growth has slowed from levels already regarded as too low. (See chart below).
 - The oil price has fallen precipitously. (See chart page 2).
 - The US dollar is appreciating. (See chart page 3).
 - Market pricing of 5 year inflation expectations (which was already below the 2% target) has fallen further.
- Inflation outcomes outside the US have also tended to slow and surprise on the downside. Disinflationary pressures continue to circle the world economy.
- We expect the Fed Funds Rate to remain on hold until September–October 2015. We also expect the Australian Official Cash Rate will remain unchanged until 2016.

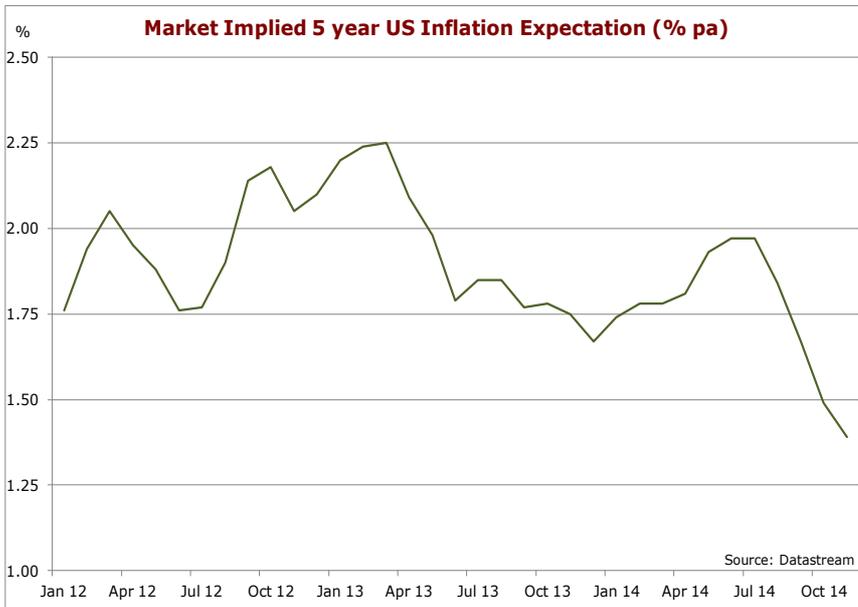
Reading the above, one might well question how this sits with what happened in September. You may recall that in the first half of September there was a re-appraisal of the course of US monetary policy at the same time as weak data pointed to further monetary easing elsewhere (ECB, BOJ and PBOC.) The USD strengthened, global capital flowed into the US and away from carry trade beneficiaries (such as Australia). By month’s end, the AUD/USD had fallen by over 6% and the S&P/ASX200 Accumulation Index had lost over 5%.



To our mind, the “lower for longer” interest rate thematic is still very much alive and well. By way of analogy, we are reminded of Mark Twain’s notable cable from London to the US press following premature publication of his obituary: “reports of my death are greatly exaggerated.” If we are wrong in our view of the timing of interest rate increases in the US and Australia, it is more likely to be later than sooner.

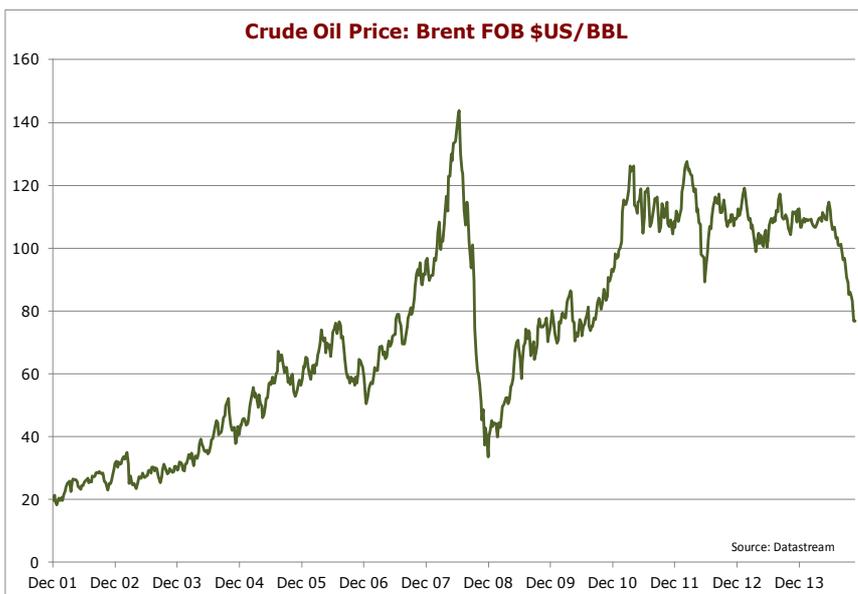
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Recent comment by Fed officials and the latest FOMC Minutes reference the decline in market based compensation measures of future inflation. This is commonly done by subtracting the market based measure of real treasury yields (the US Treasury Inflation Protected Security (TIPS) yield) from a nominal US Treasury yield of the same maturity. The chart below shows this for the shortest available constant maturity securities (5 years).

We note that market pricing of the implied average annual inflation rate for the next five years has actually declined from 2.0% in July to 1.4% in November. The recent decline is clearly significant in the context of recent years.



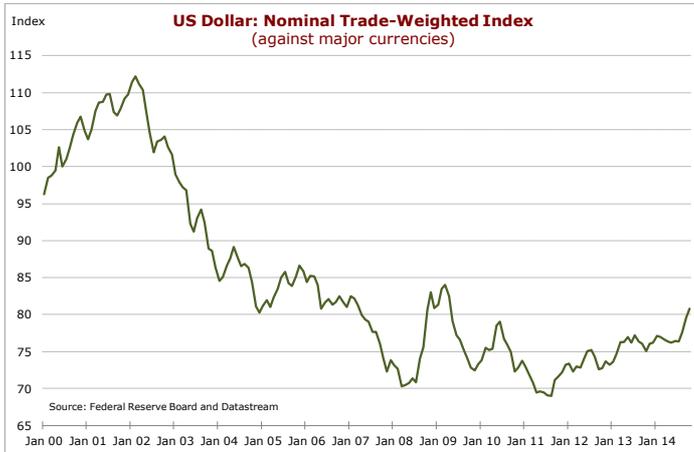
A number of factors are at work. Disinflationary pressures are sweeping the globe. Growth has been weaker than expected in China, the Euro-zone and Japan. The decline in the oil price from over \$US110 to below \$US80 per barrel is clearly a major driver of lower inflation. Further, it looks to us as though the recent lower level of oil prices will be with us for some time. US oil production is back near previous peak levels, thanks to the surge in “unconventional” shale oil. We presume that Saudi Arabia (and OPEC producers more generally) are sensibly emphasising profits over price maintenance, perhaps testing the profitability of US shale oil production at the margin.

The chart on page 1 highlights the benign US inflation rate and wages growth. The Federal Reserve’s preferred measure of inflation is the Private Consumption Expenditure Price Index. The core measure has remained steady at 1.5% per annum since May. Meanwhile Average Hourly Earnings, which had been trending at 2.25% to 2.5% p.a surprised by slowing to 2.0% through the year to September. A monthly aberration presumably, but more generally, inflation continues to surprise on the low side of expectations globally. The CPI over the last twelve months is currently running at only +0.4% in the Euro Area, +1.3% in the UK and +1.6% in China.

More fundamentally, whilst US Non-farm Payrolls Employment continues to grow at its strongest rate in years, both wages growth and inflation need to accelerate to levels more consistent with a normal recovery before we expect the Federal Reserve to start lifting rates. Given the extended period of sub trend growth in both, we would be very surprised to see the Federal Funds Rate target lifted before we see wages growth running at 3% per annum. As the chart on page 1 shows, even 3% wages growth would be well below the average level in the 2000’s prior to the GFC, and still consistent with 2% inflation. The risk to tightening earlier is that household income growth would be insufficient to maintain the requisite demand from the household sector (private consumption and housing) as interest rates normalised.

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Yes the degree of excess slack in the US labour market is diminishing, but seemingly not enough to trigger higher wages growth anytime soon. For a Federal Reserve with a dual mandate to maximise employment consistent with price stability (that is 2% inflation) that much speculated first lift in the Federal Funds rate is more likely to continue to be delayed.

The Trade-Weighted value of the US dollar has increased by 9% over the last twelve months. Further we expect this trend will continue. This, too, will reinforce the prospects of short rates remaining “lower for longer” via disinflationary pressure on pricing and wages in the trade exposed sectors.

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