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Not So Fast, Kovacevich: Why Raising Rates Will Be Hard

By
DAVID LEVY
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The financial community is engaged in an intense debate about the ideal schedule for normalizing the federal funds rate without ending the economic expansion. Hawks argue that the Federal Reserve will be "behind the curve" if it fails to take action, left to contend with still-negative real interest rates as inflation accelerates past the Fed's 2% target. Doves say the Fed should wait some months to raise rates and then proceed slowly and gradually, giving the economy time to adjust.

In fact, both of these arguments suffer from the same misconception. Regardless of whether the Fed begins increasing rates this year, there almost certainly is no way that the Fed can raise the federal funds target to what is widely considered to be a "normal" level — north of 3% — without triggering a global recession and international financial crisis. In fact, it's likely the Fed will find it difficult to raise the funds rate at all.

The reason why interest rates cannot rise by much without destabilizing the economy involves the size and structure of private balance sheets at home and, especially, around the world. Large balance sheets require large profits to support them, both to meet investors' expectations and to provide cash flow — directly or indirectly — that services debt.

This requirement is presently minimized by zero interest rates in the U.S., since lower interest rates reduce both the necessary rates of return on equities and debt-service requirements. The Fed's zero-interest-rate policy has also supported profits by enabling a considerable re-expansion of balance sheets over the past few years, especially on the asset side. Barring a vast trade surplus or huge government deficit, large profits come only as a result of rapid *further* expansion of private balance sheets, thus creating a subsequent need for even greater profits.

Thus, the problem now facing the economy is that any increase in interest rates would in all probability immediately begin to undermine asset valuations and reduce profits. Higher rates would also gradually increase financial strains by raising the cost of servicing debt. Asset prices would come under pressure in the U.S. as interest rates rise. Indeed, even as the Treasury yield curve steepens in anticipation of a Fed rate increase, it applies downward force on asset prices. Every time the market steepens the front years of the yield curve, it stretches an elastic band that eventually must snap back, and then some. This band can be stretched neither very far nor for very long.

Historically, stock prices have often risen along with interest rates. But that would probably not be the case this time. The increases tend to occur during the early part of an economic expansion when profits are also rising rapidly. These rising profits reflect business capital investment, inventory building, residential investment, and consumer credit purchases — all profit sources that tend to grow much faster than the economy as they recover from recessionary lows.

Later in business cycles, rising interest rates tend to coincide with, or soon lead to, market peaks. Therefore, five years into the recovery, stock prices appear vulnerable to rising interest rates. Since rising interest rates raise the required rate of return in all asset markets and also make it more expensive to maintain leverage, other asset prices are vulnerable as well, including those of commercial real estate, corporate debt, single-family homes, and precious metals.

Based on our forecasts, corporate profits are unlikely to increase at all over the course of 2015. Such a soggy profit performance will not create the kind of buoyancy in stock prices or confidence in executives that can offset the negative influences of rising interest rates. Thus, the prospect of rising interest rates is dangerous for the economic expansion.