UP AND DOWN WALL STREET-BARRON'S

Yellen Changes Her Tune on Interest-Rate Hikes

With the economy on the mend, she raises the possibility of an increase in the next couple of months. Also, things to worry about this summer.

By
RANDALL W. FORSYTH
May 28, 2016

The choirmaster now seems to be singing the same hymns as the rest of the choir.

In a conversation on Friday afternoon at Harvard University, Federal Reserve Chair Janet Yellen confirmed what a slew of central-bank officials have been saying over the past week or two: Another increase in the Fed's key interest-rate target is coming in the months ahead.

Since the May 18 release of the minutes of the April 26-27 meeting of the Federal Open Market Committee, a parade of Fed governors and district presidents has been reading from the same script on the speaking circuit or in the media. Assuming that the economic data stay close to the Fed's forecasts, especially regarding employment, a second quarter-point rate hike—from the current 0.25%-to-0.5% target set last December, after having been near zero since the 2008 financial crisis—should be expected.

The coordinator of the colloquium, Harvard economics professor Gregory Mankiw, wheedled a comment on policy from Yellen by archly saying that some New York money managers were delaying their departure for the Hamptons while awaiting her thoughts on the matter. (He made it sound as if the academics in attendance were far removed from the 1% headed for the East End or the Cape for the Memorial Day weekend. In reality, Mankiw's economics texts have netted him millions, which have come out of the pockets of students and parents shaken down for thousands of bucks each term in the college-textbook game.)

"It's appropriate," Yellen said, "for the Fed to gradually and cautiously increase our overnight interest rate over time, and probably in the coming months such a move would be appropriate."

That was a rather different tune from the one she sang a couple of months ago. In a speech to the Economic Club of New York on March 29, the Fed leader emphasized the need for caution in raising rates. The "recent financial turbulence," she warned, had raised the risk of slower growth abroad, a resumption in the slide in oil prices, and the rise in the dollar. All of which could hurt the jobs market and prevent inflation from returning to the Fed's 2% target.

What has changed since then? While the central bank insists that its policy is "data-dependent," the financial markets have shifted more than the economic numbers in the past couple of months.

Indeed, on Friday, the Standard & Poor's 500 index wound up its best week since March 4, gaining 2.3%. That brought the large-stock benchmark back to within 1.5% of its record reached just over a year ago, on May 21, 2015.

In contrast, back in March, equities were coming off a dismal first two months of the year, and oil had collapsed into the mid-$20-a-barrel range. Since then, crude has come back big time, trading above $50 last week.

The stock market barely flinched on Friday afternoon in reaction to Yellen's comments that interest-rate hikes could be on the table in the coming months.

The federal-funds futures market, however, continues to indicate doubt that an increase could arrive that quickly. For the June 14-15 FOMC meeting, the probability of a quarter-point boost was only 34% at Friday's close, according to Bloomberg calculations; or in betting terms, two-to-one odds against a hike. To be sure, the probabilities of a June move had been in the single digits earlier this month, so this is a significant rise.

The odds are a bit better than even for a hike after the July 26-27 FOMC confab, a 57.8% probability, to be exact. There is no press conference scheduled after that gathering, and the presumption is that the Fed wouldn't move without explaining its decision to the media. Of course, Yellen could add a presser then, perhaps by conference call, if she deemed it necessary.

Even assuming that the numbers and the stars align for a June rate hike, the presumption is that the Fed would want to hold off until after the United Kingdom's June 23 vote on whether to leave the European Union. While the bookies there put the odds heavily against Brexit, the U.S. central bank might not want to take the chance that the oddsmakers are wrong about what could be a market-roiling event.

THE COMMON TEMPTATION IS to think that if the Fed wants to raise interest rates, things must be going well. That also was the perception ahead of last December's rate hike, observes Savita Subramanian, head of equity and quantitative strategy at Bank of America Merrill Lynch.
The markets then were discounting a rate boost in the coming months, with the S&P 500 near 2100 and the VIX, the stock market's fear gauge, at a quiescent 14. And after the central bank hiked in December (a bit earlier than had been expected), the S&P dropped some 10% over the next eight weeks. "Admittedly, other factors contributed to the decline, but history is rhyming, and we think a rate hike this summer could drive some downside," the strategist writes.

And despite the equanimity voiced by the bullish camp, the market hasn't fully discounted a summer Fed increase.

Subramanian notes that industry groups that typically outperform when rate hikes are pulled forward—including financials, such as banks, capital markets, insurance, and consumer finance—remain cheap. Meanwhile, groups that have outperformed when rate hikes are deferred look richly priced. That includes utilities and real estate investment trusts, plus food, beverages, and household-goods stocks; in other words, the popular cohort of issues that act like bond substitutes.

More fundamentally, interest-rate increases during a profits recession usually don't turn out very well. Since 1971, the Fed has begun tightening during a bona fide profits recession just three other times—in 1976, 1983, and 1986. Two of those three instances saw stocks drop over the next 12 months. Moreover, the BofA ML Global Investment Strategy team adds, a pause for a quarter or two between the Federal Reserve's initial hike and subsequent ones generally has been negative for equity returns.

David Levy, head of the Jerome Levy Forecasting Center, raises the question of why Yellen & Co. would tighten into a profits recession. Probably because their targets are employment first and then inflation, he ventures, while profits carry less weight in their analysis.

"When profits have fallen, yet have evoked relatively little reaction in terms of business cutbacks, and profits continue to fall, one should not conclude that profits do not matter so much or believe that the economy is detached from the 'profits recession.' If, as we expect, U.S. and global profits keep falling, the global business retrenchment will strike markets with surprising suddenness," he concludes.

Similarly, the JPMorgan economics team warned on Friday that its preferred recession-probability indicator for the coming 12 months had moved up to 34%, from 30% in the previous reading, on May 5. The No. 1 reason for the raised recession risk: weaker profits.

GDP report showed an anemic 1.9% annual growth pace in the first quarter, after the 8.1% plunge in 2015's final three months, and a 3.3% decline in that year's third quarter.

Writes JPMorgan economist Jesse Edgerton: "It is true that analysts currently expect some rebound in corporate earnings in coming quarters, which might lead some to dismiss the negative news on [profit] margins. Indeed, if analysts' forecasts are realized, our recession-risk tracker could move back down. But we believe that the current squeeze on margins is already putting downward pressure on capital spending and hiring, and it leaves the business sector more vulnerable to other shocks that might arise."

AS FOR THE DATA on which the Fed professes to depend, the May employment numbers that are slated for release on Friday will be the most important before the coming FOMC meeting.
The consensus forecast calls for a 160,000 increase in nonfarm payrolls, the same as the lower-than-expected total that was reported for April. But, according to RBS economists, the May number will be lowered by an estimated 40,000 by the effects of the Verizon Communications strike, which was tentatively settled on Friday. The jobless rate is expected to hold at 5%, while average hourly earnings are forecast to rise by 0.2%, in line with the recent tepid trend.

Regardless of when or if the U.S. central bank makes a move, a rate hike is just one of the things that the stock market has to worry about this summer, concludes BofA ML's Subramanian.

It's a seasonally weak period, as the "sell in May" saying reminds investors. There are other fundamental, behavioral, and credit warning signs, including a potential renewed retreat in oil, tightening credit conditions, and, last but not least, the U.S. elections, much as many would rather forget about them.

So, try to enjoy the Memorial Day kickoff to summer, if you can.

E-mail: randall.forsyth@barrons.com