# The Fed's Rate Hike: A Confidence Protection Measure

On 16 December the Federal Reserve Board put an end to the era of the near-10-year zero interest rate policy with a 25 basis point rate hike. The decision was made not by a judgement that the US economic recovery is strong enough to withstand it but by the recognition that yet another delay might dent the confidence in the Fed itself and thereby the dollar. Thus, the decision was a confidence protection measure, necessary precisely because it felt that its confidence was endangered. Ironically, however, the decision is likely to put the very confidence questioned in the future.

**Concern about its confidence was the primary reason for lifting rates**

Certain members of the FOMC (Federal Open Market Committee) have expressed their hawkish views on various occasions, and ahead of every FOMC, the markets naturally anticipated higher rates, albeit with varying degrees. Yet the rates have been kept unchanged for nearly 12 months: just words, no action!

The inaction of the FOMC has come as no surprise due to the lack of strong economic data. Until recently Janet Yellen, the Chairwoman of the FOMC, rationalized its deferral of an interest rise with the excuse that the Fed's decision was 'data dependent'. Did some data she was looking for suddenly become obtainable after the last FOMC in September? The answer is a NO!

The Fed was compelled to raise rates at the last FOMC meeting ahead of the Christmas holiday season because it concerned that leaving the rates unchanged yet again would jeopardise the market's confidence in the Fed.

This concern was clearly mentioned in Page 8 of the minutes summary of the 27-28 October 2015 FOMC which was released on 8 November: *'…a decision to defer policy firming could be interpreted as signaling lack of confidence in the strength of the U.S. economy or erode the Committee's credibility.'*

No doubt that it was the primary reason why the Fed had to go for higher rates. In other words, the objective of raising rates was to maintain the relative strength of the dollar. It was far from a pre-emptive action but a defensive measure.

Besides, its manoeuverability would be limited next year when the next presidential election is scheduled. The December FOMC was the last chance for the action. It had to depend on none other than the seemingly strong and seasonally adjustable labour market data.

At the press conference Yellen indicated there would be further interest rate hikes in 2016 but soothed the markets by emphasing that the following actions will be accommodative. She was forced to keep the anticipation of higher rates lingering in the markets because she and other members are aware and fear that the fragility of the economy will bring down the value of the 'mighty' dollar.

Also, after years of the ultra low interest rates, Wall Street, which has had to shrink bond trading and market making, and find the primary market operations increasingly unattractive, must have nudged the Fed to go for the lift-off.

**The lower oil price is another concern**

Another threat to the strong dollar is the continued weakness of the oil market. For the US, oil is not just about natural resources but demand for the dollar. The world is already flooded with excess supply, and with the global economy heading for recession, the demand for oil is likely to decrease. This will push the price of oil further down, along with other commodities which will lead to lesser demand for the dollar.

The good news is that the shale oil industry, which has largely survived in the much lower price environment for months by increasing production, cashing in hedges and debt financing, is finally abandoning operations. Although it is not likely to become extinct, many players will go bankrupt in the first quarter of 2016. This will substantially reduce the supply and thereby support the price.

However, as the US sanctions against Iran are lifted as expected in mid-January next year, Iranian oil is to come on stream, and it will offset some of the supply reduction.

Thus, with limited decrease of supply and global weaker demand expected, the oil price is likely to take years to recover.

It should also be noted that the conflicts in the Middle East are no longer working as a price-push factor, for they are constantly present and have become a norm after the US invaded Iraq. Also the share of oil exports from Iraq and Iran shrank whereas the Russia has expanded its share in the last decade or so, and this has made the instability in the region less sensitive to the market. The shift from oil to gas in the developed countries in the recent years has also contributed to lesser weight of the region.

Incidentally, on 18 December 2015 Washington lifted the 40-year ban on oil exports by the US. This was made possible by the active lobbying by the oil producers who seek to sell excess supply to new markets. But under the current conditions, it will be difficult to find new buyers and to make profits, and they will lower the oil price even further by themselves. This legislation merely shows how desperate the industry is.

**Halting the shrinking petro-dollar recycling**

Lower oil prices will mean lesser demand for the dollar, and this will shrink petro-dollar recycling which is essential to the US government's debt financing. Washington may be tempted to manipulate the market, but it will be a tall order.

The Fed may have reliable allies or accomplices. Sometime last year, the Fed must have convinced the Bank of Japan and the European Central Bank to go for their respective quantitative easing and thereby to depreciate their currencies. And at the same time it has kept the higher rate card hanging in the air to get the dollar further appreciated. This was the tactic the Fed had to adopt.

Concurrently, with the BoJ's help, the GPIF (Government Pension Investment Fund), the largest public pension fund manager in the world, sold the Japanese Government bonds it had held to the BoJ and used the

proceeds to increase their exposure to the Treasuries. This has kept the US bond market stable. The US long-term interest rates could have been taken higher without it, particularly when China dumped the Treasuries in mid-summer.

Now that the GPIF's portfolio shift to the dollar-denominated assets have been completed, the next target the US has set its eye on is 'Kampo', Japan Post Insurance, whose portfolio restructuring is expected to be finished by the end of Q1, 2016.

For the record, the GPIF recorded a spectacular loss of Yen 8 trillion in Q3 this year. Kampo may well be the last attractive asset left in Japan which Wall Street can plunder.

**A rate hike: the last option**

Then the Fed will have no more allies or measures left to keep the dollar strong…except the rate hike. Despite the paucity of strong data to warrant the lift-off, the Fed had to trigger this last option.

The only statistic available for the data-dependent officials to justify their action was the headline numbers of non-farm payrolls which was showing steady 'improvement' of the labour market. However, the reality is that the loss of decent full time jobs was replaced by the growing number of low-paid part time jobs. Besides, the rate of the increase of the part timers is steadily declining over the year before. Achieving the 2% inflation target is out of question, no matter how hard they try to dress it up.

Yellen also mentioned auto sales have been strong. Admittedly, the number of new car sales has been exceeding every month the ones achieved last year and has gone over 15 million units as of the end of November. Pickup trucks and SUVs have been particularly popular.

This has been possible, however, not because the consumers' disposable income has increased but because in addition to the cheap credit offered by the manufacturers' financing arms, the long-term loans and leases were aggressively provided by the banks and insurance companies.

The total auto loan volume has been record high since 2012 and has reached $1.03 trillion as of Q3 this year, but 11% of this was offered to those who have poor credit profiles, namely subprime borrowers.

Head of Comptroller of the Currency, the regulator, Thomas Curry, recently sounded an alarm bell, saying that, "What's happening in the auto loan market reminds me of what happened in mortgage-backed securities in the run-up to the crisis."

So far, the delinquency rate is only 5.2%, and thus the loss of the loan originators and/or investors has been limited. Also, the size of outstanding car loans is over $1 trillion, which is 6% of GDP, compared to the 10 times larger of the housing loan market which reached 70% of GDP in 2008. But as the overall fragile economy weakens and defaults increase, the debt-fuelled auto market will see sudden credit contraction and sharp decline of unit sales. Unlike the housing market, the waning of the car industry will have far wider ripple effects in the economy.

Surely Yellen has to be aware that the auto market's bubble has been inflated by the Fed's own policies. Or is she the 'Maestra' who would keep the Fed's well-established tradition of 'identifying a bubble after it burst'?

Furthermore, there is no evidence that the US economy is suddenly and undoubtedly improving in Q4 and with global deflationary pressure and economic slowdown to be intensified, the Fed will find it increasingly difficult to pick positive data in the next 12 months to justify further rate hikes.

**The Fed may be forced to reverse the policy, and its confidence could be dented next year**

Since its lift-off was well discounted in the markets and Yellen reiterated dovish comments at the press conference, the markets have largely remained calm. The officials must have been relieved with their successful historic decision ahead of the holiday season.

The symbolic 0.25% rise of interest rate is likely, however, to shake the already-crumbling junk bond market and bring down the whole debt market. Mortgage rates will rise, and the number of foreclosures will increase. The middle class, which has substantially shrunk since the last crisis, will not be able to increase spending even with the price of gasoline below $2 per gallon. The car loan delinquency rate will rise and unit sales will lose momentum, and it will hit the financial institutions and manufacturers which extended looser credit to consumers. This should result in the worsening of the labour market condition which will allow little room to manipulate with seasonal adjustments.

Then the Fed is likely to consider a rate cut, rather than additional rate hikes in the months to come. Even without a policy turnaround, it will find it difficult to maintain the dollar strength. Its credibility will also seriously be questioned.

In a previous London Money Report issued on 8 April, I argued that ‘A Fed’s rate hike would be suicidal’. It seems to me that the Fed has been forced to take a dangerous course to keep the relative strength of the dollar. This is a consequence brought about by the so-called ‘Triffin Dilemma’ which arises from the reality that the US dollar is the largest global reserve currency.

The Fed is not the only central bank which has pushed itself into a corner, however. The confidence in the Bank of Japan looks far more fragile. There are a number of experts who predict the dollar collapse is imminent, but among the major currencies, the Yen could be the first to be attacked by the markets.

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