US Fed's tricky rates decision complicated by greenback's rise

by John Kehoe, Mark Mulligan and Patrick Commins

So long has it been since interest rates were lifted in the United States – an incredible nearly nine years – that one senior market player meeting the AFR Weekend in New York this week observed that many bank, investment and hedge fund professionals had never experienced a rate rise. And nobody can ever remember US rates taking off from zero.

It's one of the unknown factors that makes the chief task ahead for Janet Yellen and the US Federal Reserve board so tricky: how to raise rates in the world's largest economy without unleashing too much chaos across currency, equity, commodity and credit markets. And now a fresh complication is making the task even more difficult: the US dollar is surging against the world's currencies, denting the earnings of US multinationals, causing sharemarkets from New York to Sydney to gyrate wildly, weighing down commodity prices and threatening a rush of money out of emerging
economies.

When things get moving in the US – like the hottest jobs market since the late 1990s – the rest of the world feels it. And they feel nothing more immediately than the US dollar. The greenback is the world's reserve currency. Prices of commodities such as oil and Australia's key export, iron ore, are priced in US dollars. This week the greenback touched a 12-year high against the euro and the Australian dollar fell on Wednesday to US75.61c, its lowest since May 2009.

Adjusted for inflation, the US dollar has soared 30 per cent from its low in 2011 compared with the currencies of major trading partners.

It is marching higher in anticipation the Fed will start lifting rates from near zero in coming months – possibly as early as June. But the dollar's surge before a rate rise has a series of major consequences – some good and some not so good – for the world economy. Like moving around on a water bed, everything else is getting bounced around.

Barry Bosworth, who has the chair in international economics at the Brookings Institution in Washington DC, says the stronger greenback is a reflection of the US economic recovery and other central banks loosening monetary policy.
"The price of the [US] dollar can be expected to rise even further in relative terms," Bosworth says. That will provide even more of a "blessing" for American consumers, he says, as their purchasing power is boosted.

It has another less welcome implication for the US, however.

The Fed is looking for proof that America's economic recovery is firm underfoot before it takes interest rates higher, but a stronger dollar is a headwind for US economic growth as exports become less competitive and imports cheaper.

US multinational companies including Caterpillar, Microsoft and Procter & Gamble have cautioned that their earnings will be hurt by the strong currency.

S&P 500-listed firms in the US earn about 45 per cent of their revenues abroad. So when they repatriate the offshore sales in a rising currency environment, US dollar earnings are lower.

A Duke University global business survey of more than a thousand US chief financial officers published this week shows they are worried about falling victim to currency wars.

The European Central Bank has joined Japan in fighting disinflation by embarking on a huge stimulus program to drive down long-term interest rates. Denmark, Sweden and Switzerland have resorted to negative rates. Currencies are consequently plummeting against the US dollar.

"US exporters are being punished by these competitive depreciations and this will lead to lower profits and less employment," Duke business school professor Campbell Harvey says.

So while money is flooding into the US and pushing up the greenback because markets are anticipating higher rates, that flood of money could paradoxically push out the date the Fed starts to lift rates.

A second major implication is being felt well outside the US. The dollar's surge is a problem for emerging economies with large external debts in the US currency, such as Brazil, Russia, South Africa and Turkey.

Emerging markets are already well versed in the sort of chaos that can be unleashed by the prospect of higher US rates, having experienced it most recently in May 2013.

Referred to as the "taper tantrum", the episode was triggered by the Fed chairman, then Ben Bernanke, flagging plans eventually to taper off its $US4 trillion quantitative easing program and move towards monetary tightening.

Asset prices and currencies tumbled from Brazil to South Africa and Turkey as developing economies that had benefited from years of yield hunting by cashed-up global investors succumbed to capital flight.

Market volatility persisted into early 2014, making investors fussier about which
emerging markets were worth the risk. Since then, picking winners has been ever more complicated by tanking commodity prices and a turbo-charged greenback.

"We think there are some selective emerging market opportunities," says Michael Hasenstab, an emerging-market bond specialist at Franklin Templeton Investments. "However, it's not uniform like it was in 2009, when you'd almost buy any emerging market asset and over the next three years you'd make money."

At the basket-case end of this spectrum are countries such as Venezuela and Nigeria, which rely on oil for virtually all their export income and are living hand to mouth.

Russia, too, is suffering – from the twin blows of lower oil prices and economic sanctions. The US dollar's rally has only exacerbated capital flight from Moscow, helping drive the rouble down an astonishing 67 per cent against the greenback since July.

At the other extreme is Mexico, a country whose fortunes have long tracked those of its much richer northern neighbour, thanks to tight trade links and migrant remittances.

This time around, and unlike the notorious tequila crisis of 1994-95, the US-dollar-denominated debt exposure of the public and private sectors in Mexico seems manageable. Indeed, the currency's 20 per cent fall against the US dollar since July is considered a boon to exporters, and helped bring back some production lost to cheaper Asian factories.

And although investors and analysts look at emerging markets case by case, most agree they all have something in common that should preclude any repeat of the contagious financial meltdowns of past decades.

"One thing we've been quick to point out: in contrast to previous leverage cycles in the emerging markets, this one has actually been disproportionately financed in local debt," says Joseph Lupton, senior global economist at JP Morgan. "This is not to say there is no US dollar-denominated debt in these countries, but the exposure risk is not the same as in the past."

This does not allow countries such as Brazil off the hook, however.

As well as being battered by lower commodity prices, South America's erstwhile poster child for emerging market growth and development is about to pay for years of fiscal prime-pumping, generous tax breaks, welfare increases and infrastructure spending with a period of stagflation, according to most analysts.

The collapse of Brazil's currency the real against the greenback – to 11-year lows – in recent months is a double-edged sword.

"Exporters will benefit from the cheaper real, but set against that, many businesses have borrowed in dollars and will see the cost of debt service rise," says Richard Lapper, principal of the Financial Times' Latin Confidential reports. "Some of these
dynamics will get worse when the Fed starts to increase US rates."

Another challenge for Brazil – and the big change for the rest of the world – is the third major effect of the dollar's rise: commodity prices quoted in US dollars tend to fall whenever the greenback strengthens. The reason is demand and supply: a jump in the US dollar means a Russian oil producer, say, now receives more for their product in rouble terms and so is prepared to pump and sell more. Its European customer, however, is less prepared to buy the oil as it now costs them more euros to buy the same amount. When higher supply meets lower demand, the US dollar prices fall to clear the market mismatch.

So from Brasília, to Moscow, to the Sydney headquarters of the Reserve Bank of Australia, which has been hoping for a weaker Australian dollar to jumpstart the local economy, Fed watchers will be paying close attention to Yellen next week.

The Fed's two-day policy meeting wrapping up on Wednesday will decide whether to ditch the pledge to be "patient" before raising rates.

Such a move would make a rate rise in June a live option. Bond markets are pricing in a less than one in three chance of lift-off then. But they may be underestimating the Fed's preference to normalise extreme monetary policy sooner rather than later.

"We expect a removal of the word 'patient' in March and a June increase in the Fed funds rate, which should provide a signal to private agents upon which to make thoughtful decisions," says Wells Fargo Securities chief economist John Silvia.

Wall Street is largely ignoring such warnings. The 1.3 per cent rally in the S&P 500 on Thursday to recoup steep losses earlier in the week was predicated on the release of weak retail sales data. Traders bet, perhaps wishfully, that the Fed would defer raising rates.

Fed doves may also be overstating the negative impacts of a strong US dollar. Fed vice-chairman Stanley Fischer has said the strong dollar is a "sign of the strength of our economy". The US economy is also relatively closed, with exports accounting for just 13 per cent of gross domestic product – far lower than most economies.

Erik Weisman, a fixed-income portfolio manager at MFS Investment Management, says the dollar is rebounding from very low levels. So the 15 per cent rise on a trade-weighted basis since the middle of last year is a natural rebalancing.

"We would need to see a very sharp and powerful move in the [US] dollar for the Fed to be concerned," Weisman says. "It's going to depend upon how much more the dollar appreciates."

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