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THE VIEW
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Will Fed be brave on rates?

Ramping up rates brings inevitable tantrums, so the Federal Reserve will have to stick to its guns

Will interest rate rises be the match that fireballs our fuel-soaked stock markets? Global stock markets are floating on an incendiary tide of surplus liquidity generated by nearly a decade of economic growth seeking. Printing money was something traditional economists from the second world war to 2008 said should never happen.

The party will stop, suddenly as always, if only at the end of a bubble caused by excessively cheap money. Interest rate rises to check the exuberance before it becomes irrational are inevitable.

The big economic question of our age is: what is going to happen when interest rates go up?

History tells us that bull markets rarely survive interest rate rises as they impact economic growth in the classic "J" curve or "hockey stick" manner.

There is pain before the gain. A rise from 1 per cent to 3 per cent is a three-times increase in interest costs. This passes throughout the economy through the cost of capital embedded within the viability of all investment projects.

Well-run companies will adapt to the new normal by managing the hit to their investment returns. The foolish who rode their luck by over-borrowing at historically low interest rates will be crushed.

The Fed seems to be using market psychology more. Photo: Bloomberg

> **History tells us that bull markets rarely survive interest rate rises**

The challenge is that the classical global rotation of markets during an economic recovery means that the US is well ahead of the rest of the world – and indeed is already entering the mid-cycle period of consolidation.

Europe's recovery in this cycle was much delayed by the difficulty of coordinating the response of 27 countries to follow the US example of increasing liquidity. Both Europe's economy and their heavily indebted governments are as yet too fragile to handle higher rates. Any rate rises are therefore likely to be asymmetrical – led by the US and much later followed by others.

That imbalance means the Fed has to be careful not to encourage such a large disparity that everyone flocks to the US dollar, leading to unprecedented highs against the euro. Such moves would damage the nascent European recovery, causing for instance large price rises in commodities in euro terms, even if prices fell in US dollar terms.

So the Federal Reserve Board has a dilemma: how to increase the cost of capital to levels more appropriate for current US economic growth and employment while not damaging growth in parts of the world to which the US is closely connected.

In a calm and rational world, US short-term interest rates would be nearer 4 per cent rather than the 0.5 per cent today. The Fed would put rates up 3.5 percentage points and interest payers would adapt to the higher payments by economising, by using the lower oil price, or by deleveraging. A few of the foolish would go bust, without impacting anyone else.

In reality, Wall Street would panic into an irrational shock – and quite likely damage economic confidence in Main Street. All the focus would be on the first part of the "J" curve and the Fed would almost certainly lose its nerve too early and rescind the rate rise.

For we know that no modern policymaker is brave enough to take the risks of unintended consequences that might cause a domino-like fall into the unknown. The short-term pain would be too great for anyone to wait for any long-term gain.

The Federal Reserve could make its first big rise a full 1 per cent – but sugaring the pill by saying that further rises would be minimal. The Fed does seem to be making more use of market psychology this time – encouraging public debate about rate rises – though it needs to become a lot more savvy. By talking to the market and signalling likely action, the Fed could administer a short, sharp shock, while reassuring the market that the pain is limited.

Most likely the Fed will choose the "coward's strategy", raising rates by the minimum 0.25 per cent a time on a regular basis to say 1 per cent. Market psychology remains critical. The more they talk about it, the more the market will accept and adapt to the rises in the same way that the tapering of quantitative easing became a non-event.

The key question is whether the Fed will be brave enough to continue with the coward's strategy of a continuing programme of rate rises as the first part of the "J" curve bites.

There will inevitably be "ramper tantrums" as interest rates are ramped up. It will be imperative for the Fed to stick to its guns and continue to ramp, despite temporary 10 per cent or 20 per cent falls in the stock market. If they capitulate and pull back at the first sign of resistance, confidence will be lost in the Fed's ability to manage the low interest rate stock market bubble – and we saw in 2008 where that ended up.

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Illustration: Henry Wong