BACK TO BUSINESS

THE VIEW
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Danger of deleveraging

The key risk facing the US Federal Reserve, as it prepares to raise rates, is the behaviour of people at last being prudent and reducing their debt

When the lights go on, the cockroaches scurry for the dark – and some of them get squashed. No one knows what is really going on in the dark recesses of a bull market until rising rates expose all. Some may say that interest is merely another cost on the economy but because it is a cost on money, it is a cost on everything. Interest rate rises in the US are a big deal and markets react accordingly.

It is archaic how such a deeply anticipated decision moment as a Federal Reserve Board meeting still happens just eight times per year.

The governors meet to look at their colouring books; the Green Book (forecasts of the economy), the Blue Book (monetary policy analysis) and the Beige Book (US regional economic conditions). After a huddle, the result is announced imperiously. However, the markets move every second – surely interest rates should go up when they need to, not for the convenience of the Fed governors' diaries.

Each Fed governor is now weighed for their dovishness or hawkishness. One by one they are becoming more hawkish. The latest puffs of smoke indicate that a rate rise before the end of this year looks inevitable.

Markets moved in response to the September 17 non-move about as much as they would have if the Fed had increased. Since then, the S&P500 is down about 6 per cent – the kind of valuation adjustment that you might expect with a 25 basis point rise.

The market worried that no rise in September meant that the economy is worse off than it is, that the recovery is too fragile to tamper with, that the Fed knows something we don't. History tells us that markets do not perform well when interest rates go up, but perhaps the market has already reacted, and when rates go up there may be less negativity.

Alan Greenspan reversed five years of falling rates. Photo: Reuters

A rate rise of 0.25 per cent should be inconsequential. Most commercial transactions, such as mortgages, will be borrowing with reference to the Fed prime rate, which is around 3.25 per cent. So payments will only rise by about 8 per cent – small enough to be counteracted by low inflation and falling oil prices.

On the other hand, a quarter point is almost twice the rate at which the Fed lends overnight to commercial banks. So any institutions coming to the Fed funds tap, for sweetheart interest rates, will have a shock. A 25 basis point rise pushes the overnight rate up nearly three times. There are sweetheart borrowers in the heart of every country's banking system who will be hurt.

> **Everyone tries to sell off just a few assets to pay back their little bit of debt**

I recall February 1994, when the Fed (with Alan Greenspan in the chair) reversed five years of falling rates with what seemed to be a pathetic quarter point rise. Yet the overextended bond markets responded with their worst crash of all time. The conservative municipality of Orange County – a key example of an overleveraged bond investor, and cockroach – went bust.

When the price of money is essentially nothing there is no moral hazard. It feels right to take on a little debt because it is so cheap. A mortgage here, a carry trade there, buy some derivatives, put on a margin trade, because it's only a little bit more debt each time and I'm clever enough to de-risk before I lose too much money.

When the time comes, everyone tries to sell off just a few assets to pay back their little bit of debt. They may be acting on the margin but that is where prices are set. Prices fall sharply, setting off a cycle of selling. The potential for deleveraging is the biggest danger facing the Fed.

But maintaining a zero interest rate policy is no answer because the market has to be weaned off the bottle of cheap money, or it will lead to a bigger crisis down the road. You must repair the roof when it's sunny.

Someone always pays the price in the short term. In 1994 over-leveraged bond investors were hurt as rates rose 2.25 per cent that year, but by the next year, unemployment was down 1 per cent to 5.5 per cent, inflation fell, and the economy and stock market were taking off.

Interest rate rises are like cockroaches – there is never only one. But it is not the rate rise that is the danger here; it is deleveraging. It is the behaviour of people at last being prudent and reducing their debt. Betting on how far this goes, will be the key to investment strategy in the next year.

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