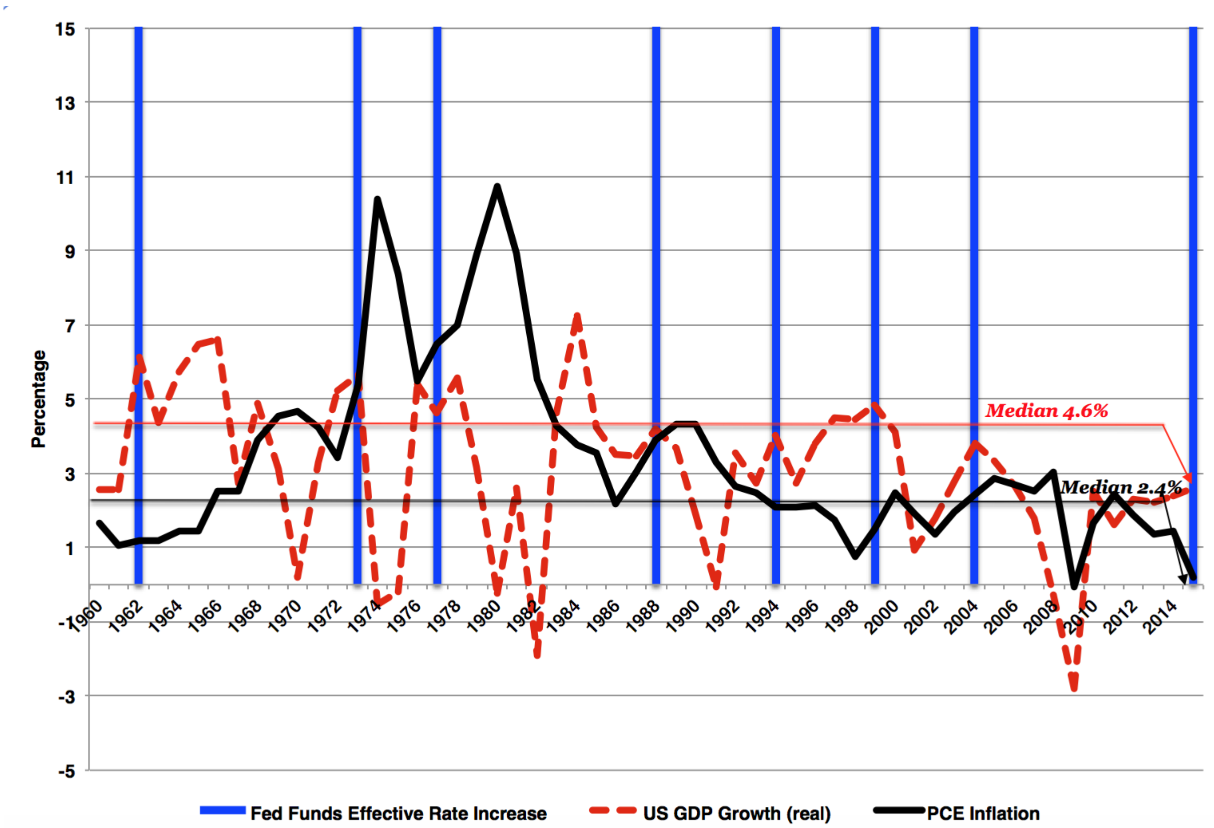
Why the Fed will not Follow Through on Further Rate Hikes

By James Hickman Follow | 01/05/16 - 08:14 AM EST

The **Federal Reserve's** recent increase in the targeted federal funds rate constitutes the latest chapter in the central bank's foray into uncharted territory. The December 2015 increase marks the eighth distinct episode of rate tightening since 1960 (distinct episodes of rate tightening defined as an increase in the average annual effective federal funds rate following at least two consecutive years of declines, excluding a small uptick in 1984, the third year of a six-year downtrend). All of those increases happened in unambiguously robust economies. The current increase is the first *ever* in the absence of above-average inflation or GDP growth (see chart below). Median GDP growth in years when increases commenced was 4.6%. That compares with average annualized real growth of less than 2.2% in 2015 with one quarter remaining. An increase had never occurred in a year in which real GDP growth was below 3.8%. U.S. GDP is into a sixth year of recovery, but one that has only averaged 2.1% per annum, the 12th worst six-year period of growth out of all 81 observations since 1935. The median increase in the Personal Consumption Expenditures Index, used by the Federal Reserve as the primary measure of inflation was 2.4% in the years of rate hikes, vs. 0.3% in 2015. The strength of labor markets frequently cited as a rationale for rate increases is a fiction requiring willful dismissal of historic numbers of displaced nonparticipants in the labor force.

Inflation and GDP Growth During Historical Fed Funds Rate Increases



The Fed finally decided the risk of asset bubbles, excessive risk-taking and what might be called "rainy day angst" -- fear of having no room to reduce rates from zero if a U.S. recession occurs -- outweighed that of tripping a shaky U.S. economy into recession. This rationale for raising rates contrasts starkly with the historical practice of countering the threat of an overheated economy, excessive inflation, tight labor markets and accelerating wages -- none of which are currently evident.

The first Fed rate increase in almost a decade raises the question: What are the economic implications of interest rates "normalizing?"

Huge Sums of Capital Will Have to Be Reallocated to Pay Higher Interest Expense

The 10-year Treasury currently yields 2.3%, vs. a long-term median of 5.6%. Using the 10-year as a proxy for the rate increases required for normalization broadly -- a 3.3% increase -- the hit to spending power in the U.S. economy on $64.5 trillion of all-sector debt equals $2.1 trillion, or 11.8% of current GDP per year! That is a monstrous potential hit to spending on more productive areas of the economy, and does not account for the true unfunded federal liabilities of the U.S. economy, a number 10 times larger than the official $18 trillion debt figure included in the all-sector debt balance. The direct increase in government spending would be $620 billion, more than the entire Defense budget and equal to a 17% increase in total federal spending, or 3.5% of GDP. Current federal interest expense is roughly $230 billion. Corporations would need to divert more than $180 billion annually to debt service based on current outstanding debt of $5.5 trillion, a direct hit to GDP before accounting for any effects of lower capital spending that would likely result.

What About the Stock Market?

The general perception that interest rates are inversely correlated with stock market performance is based on the notions that higher yields on bonds will attract/redirect capital from stocks as well as slow economic growth and earnings, causing the former to outperform the latter. There are lag effects and myriad other factors that can and do muddy this relationship. But has the Fed effectively conceded, after 15 years of compounded real GDP growth of around 2%, that that rate is the new normal? The long-term real rate of growth is roughly 3.3%. All else being equal, a one-third drop in growth expectations for cash flows of an asset will cause a commensurate drop in valuation. Stock market investors requiring historical stock market returns to compensate for the inherent risk of equity, eventually, will demand a higher dividend yield to compensate for lower growth. Setting aside the risk of a secular downshift in full-cycle earnings multiples, how much longer can frothy valuations and historically high corporate profit margins persist in the face of decelerating gross world product growth, poor demographic trends and catastrophic fiscal deficit trajectories now that interest rate normalization has begun?

All else is never equal, of course. Stock market valuation is driven by aggregate investor expectations on a number of factors affecting free cash flows besides top line growth. The table below summarizes our take on the directional pressure on stock market value based upon actual or likely trends for each value driver. Not one factor points to higher stock market values over the next five to 10 years.

Market Value Drivers' Directional Trends

Market Value Driver	Directional Impact	Notes
Top-line Growth	Negative	Tracks GDP Growth
Capital Turnover	Unchanged	LT Returns on Capital Capped by Competition
Operating Margins	Negative	
Duration of Returns Exceeding Cost of Capital	Unchanged/Negative	Tracks US Relative Competitive Advantage
Tax Rates	Negative	Tracks LT Fiscal Deficits and Politics
Discount Rate	Negative	Rates/Cost of Capital Rising

Companies in the **S&P 500** index paid out $411 billion in dividends (an all-time high) and $566 billion in share buybacks during the 12 months ending September 2015 (historical record was approximately $620 billion in four quarters ended in the fourth quarter of 2008). The average dividend yield has been roughly 2% since 2009, compared with a long-term average of more than 4%. Record dividends have accompanied near-record earnings, notwithstanding energy-driven declines in 2015. Payout ratios, in fact, have been below-normal at around 36% since 2001, compared with a longer-term median of 50% between 1960 and 2000. Companies have been historically stingy on dividends since the tech bubble.

Dividends accounted for about 40% of total stock market returns from 1930 to 2010. But from 2011 to 2015, they only accounted for 15% (using the S&P 500 Index as proxy), a period in which prices appreciated almost 63% -- a compounded annual appreciation rate above 10%. That performance is better than five of the eight decades ending with the 2010s. Earnings growth since 2010 was 2.4% compounded. Hence, the market's incredible rise has been driven by Fed policy since the financial crisis, not by underlying fundamentals. As more company cash flow is diverted to paying higher interest expense, at the same time sales may be declining owing to the nearly 12% decline in spending power associated with average historical rates and current all-sector debt levels, dividend growth will be challenged and cuts are a real possibility. Higher yields necessary to offset structurally and cyclically slower corporate free cash flow growth -- and perhaps declines -- will likely have to come by way of lower stock prices.

Lastly, record mergers and acquisitions have been another consequence of both a profound lack of optimism among corporate capital allocators in the organic growth opportunities of their core businesses coupled with historically low interest rates. M&A activity has been a significant contributor to stock market performance, and its normalization constitutes yet another market headwind.

All signs point to a market correction to levels offering higher dividend yields to compensate for slower growth/stock price appreciation. Investors should be budgeting for significantly below-trend stock market returns over the next decade, even if the inevitable decline takes a while to materialize.

The more likely scenario? None of the possibilities outlined in this article come to pass, because the Fed is unlikely to follow through with further rate increases.

This article is commentary by an independent contributor. At the time of publication, the author held no positions in the stocks mentioned.