# Market Insights

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WhittierTrust

INVESTMENT & WEALTH MANAGEMENT

## The Fed's Dilemma

Federal Reserve Chair Janet Yellen faces one of the most difficult decisions of her career this week at the upcoming policy meeting.

The Fed has voiced its preference for raising overnight interest rates in 2015 and moving toward "policy normalization". In July, Yellen made the following statement:

*"If the economy evolves as we expect, economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target."*

But recent market weakness, in response to a global growth scare, suggests the Fed should avoid acting prematurely and exacerbating the global slowdown. The upcoming interest rate decision is particularly difficult for Yellen because she has multiple excuses to hold off on raising rates. Inflation remains low, commodity prices have fallen substantially and the U.S. Dollar is already strong against global currencies. These developments argue that the Fed should be in no hurry to implement restrictive policy. While the Fed wishes to move toward a more normal interest rate environment, market forces are conspiring to put the first move on hold.

And yet the Fed desires to return to more normal interest rate levels for a number of other reasons. The Fed wants the flexibility to stimulate the economy during the next recession, which is difficult to do when the starting point is at the zero bound. The Fed also wants to stay ahead of excesses that may build up from sustained zero interest rates, such as inflated commercial real estate prices or irresponsible borrowing by investors. The combination of a mature U.S. economic recovery with unemployment approaching 5%, job openings at the highest level in twenty-five years, and commercial real estate prices at all-time highs supports the Fed's desire to move closer to normal interest rate policy.

## The decision, however, is not that simple.

Yellen and the Federal Reserve Board are grappling with global challenges that materialized after her July comments. A global economic slowdown is now being indicated by several factors. Global equities have fallen by more than 10% from recent highs, a recession is unfolding in many commodity-producing countries such as Canada, Russia and Brazil, oil prices are back below $50/barrel and China has devalued its currency to spur exports and offset domestic weakness. These developments give the Fed many reasons to continue accommodative monetary policy and delay meaningful interest rate increases.

Janet Yellen is facing her first real test as the Chair of the Federal Reserve Board. It has been nine years since the Fed last increased interest rates, which is twice as long as it has ever gone without a rate hike and also a period with unprecedented zero interest rates. The Federal Reserve Board will meet three times for the remainder of the year in September, October and December. While there is a lot of debate over the timing of the first interest rate increase, we believe the more important discussion is the path that the Fed chooses to take with increasing interest rates. The events that transpired in August will push the Fed to be accommodative with monetary policy, likely postpone the initial rate increase further out on the calendar and force the path of subsequent rate increases to be elongated.

**The implications of recent market developments are threefold.**

1. The Federal Reserve Board will remain accommodative.
2. The U.S. economy will continue to operate in a historically low interest rate environment.
3. The delay in interest rate policy normalization will lead to a prolonged economic cycle, which is constructive for equities.

Whether the Fed increases rates later this year or early next year, we expect the U.S. economy and stock market to benefit from an accommodative Fed and a lower interest rate environment than the historical norm.

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