Fed Lift-Off: Reason to Worry?

The prospect of the first Fed interest rate hike in more than nine years is weighing on global financial markets. Many investors fear that a Fed rate hike, coinciding with a sharp slowdown in Chinese economic growth, could undermine the post-crisis recovery in the U.S. and trigger outflows from domestic and international risk assets.

Two main concerns appear to drive investors' worries about the impending rate hike. First, higher interest rates are perceived to be generally bad for risky assets. Second, the global economy remains vulnerable following the Great Recession and might be unable to withstand a policy tightening. We believe that the historical evidence shows that risks from rate hikes are less severe than feared.

Negative Anchors: 1994 and the “Tantrum”

What is the reason for the disconnect between history and market perception? We believe that painful memories of two episodes that caused losses for a wide variety of portfolios -- the 1994 Fed rate hike and the 2013 "taper tantrum" -- are at least partly to blame for investors' apprehensiveness.

During the "taper tantrum" in May 2013, risky markets sold off when Chairman Bernanke unexpectedly hinted at an imminent tapering of the Fed’s asset purchases. Investors’ concern that a decline in Fed liquidity support would hurt flows into riskier assets triggered a sharp sell-off. Yet the tantrum, lasting only two months, was too short-lived to justify current fears of sustained losses following a Fed tightening.

In 1994, Fed hikes triggered widespread losses across global markets. The Fed policy rate had been kept at emergency levels (3% at the time) for an extended period. When U.S. GDP growth surged unexpectedly, markets and the Fed had to rapidly revise their rate expectations higher. The prospect of significantly higher rates took markets by surprise and triggered a sharp and sustained sell-off across many bond and non-U.S. stock markets. A year after the first rate hike, non-U.S. developed equities were down 13%, U.S. Treasuries had returned -2.4%, and EM bonds had lost 21%. The S&P 500, however, rebounded from initial weakness to finish up nearly 2%.

Neither the “taper tantrum” nor 1994 are a suitable blueprint for the current situation. In both cases, a revised outlook favoring tighter policy surprised markets, leading to sharp and sudden upward revisions of rate expectations. In 1994, markets feared significant damage to the economy from tighter policy designed to prevent a sudden pickup in inflation. Today, investors already expect interest rates to rise, and there is little impetus for a surge in inflation.

Our benign view of impending Fed rate hikes depends on our expectation that inflation will remain subdued. For the current Fed, inflation is unlikely to become a binding constraint in the short to medium term. Rather, the Fed has stressed that any policy tightening will be conditioned on the continuation of the economic recovery. Combined with a remarkably easy policy stance, this cautiousness is a formidable safeguard against any policy-induced damage to the U.S. economy. It should help to support risky assets in the U.S. and abroad.

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