Markets hail “gradual” moves by Federal Reserve

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The US Federal Reserve kept its official interest rate on hold at the conclusion of its two-day meeting yesterday, as expected, in a further indication that any return to “normal” conditions will be very gradual.

The main decision to come out of the meeting was to start winding back its holdings of the $4.5 trillion in financial assets, accumulated as a result of the program of quantitative easing. This decision was also expected as the Fed had indicated back in June that it would start the wind down.

But the pace will be very slow—Fed chairwoman Janet Yellen has previously likened the process to “watching paint dry.”

The financial markets were clearly pleased with the decisions as both the Dow and the S&P 500 indexes finished the day at new record highs.

Yellen said that although the Fed had decided to maintain its target interest rate at the current level of 1 to 1.25 percent, it expected that the “ongoing strength” of the economy would warrant gradual increases as inflation moved towards the target range of 2 percent. This was taken as an indication that a further rise of a quarter percentage point could be carried out in December.

But the Fed’s open market committee is divided on the issue. While Yellen claims that inflation has remained lower than expected because of one-off factors, such as reduced charges for phone services, these effects are transitory.

But others maintain that with inflation at below the target rate of 2 percent for the past five years and with significant falls over five months this year before an upward spike in August, low inflation is the result of structural changes in the economy. Official policy is still based on the so-called Phillips curve which maintains that as unemployment falls inflation should rise due to increased wages. But wages in the US, as in other major economies have either remained stagnant or fallen in real terms since the 2008 financial crisis.

During her press conference, Yellen did remark that the fall in inflation this year had been something of a mystery and it was not easy to explain why it had remained low.

The other key economic factor behind the Fed’s reluctance to move on interest rates is the low US growth rate which still remains at around 2 percent. Reflecting this trend, the Fed brought down its median estimate for the so-called neutral interest rate—the rate which neither boosts nor retards economic growth—from 3 percent to 2.8 percent.

Yellen said the neutral rate was “likely to remain below levels that prevailed in previous decades.”

On the wind-back of the Fed’s assets holdings, Yellen indicated that the process would start next month. From October to December the reduction in assets—treasury bonds and other forms of debt—would be $10 billion a month, thereafter rising to $50 billion a month starting in 2018.

Yellen was anxious to assure financial markets that this would not bring about an end to the flow of cheap money.

“By limiting the volume of securities that private investors will have to absorb as we reduce our holdings, the caps should guard against the outsized moves in interest rates and other potential market strains,” she said. The Fed would be prepared to resume investing in financial assets should a “material deterioration in the economic outlook warrant a sizeable reduction in the federal funds rate.”

All of this was music to the ears of the financial markets which rose after the decision. But there are concerns about how long the stock market rise can continue, and, even more significantly, what will be the political consequences of a downturn in the US economy.

In an op-ed piece published in the *New York Times* on September 15, Nobel prize-winning economist Robert Shiller noted that, according to his cyclically adjusted price earnings ratio (CAPE), market valuations were very high.

"The CAPE ratio is above 30 today, compared with an average of 16.8 since 1881. It has been above 30 in only two other periods: in 1929, when it reached 33, and between 1997 and 2002, when it soared as high as 44."

While he described the present level as "troubling," Shiller maintained that the present situation was not like that which preceded the Great Depression because there was not the same mass psychology and while valuations remained "very high" there did not seem to be a worry by investors that others were on the verge of selling.

But as a student of economic history, Shiller would be well aware that market crises have generally been preceded by the claim that "this time it's different."

"Why people are so calm about the high-priced market is a bit of a mystery. On this I can only speculate. … I don't really know."

In an interview with the business channel CNBC on Tuesday, he noted that the CAPE for the US market was the highest of 26 countries. "I wouldn't call it healthy, I'd call it obese," he said.

A different kind of warning, directly related to underlying class relations in the US, was issued by hedge fund manager Ray Dalio. Speaking to CNBC on Tuesday, he said that perhaps the biggest economic issue of our time is a social one.

With less than 1 percent of the population having a net worth that is equal to the bottom 90 percent of the population combined, "what is a big deal is if you had an economic downturn because we have two economies."

Pointing to the presidential election result and other signs of political turbulence in the US, along with the rise of class tensions, he said: "If you were to have a downturn, I really do believe that the wealth conflict, the left, the right and all of that would be intolerable."

Dalio repeated earlier comparisons he has made with the year 1937 when, after a recovery from the Great Depression, the US economy again experienced a major downturn. While he did not make specific references to the events of that time, 1937 saw major class battles, particularly in the steel and auto industries.

Dalio said economists generally dealt in averages. But averages could be misleading and while the economy was showing growth, the situation for 60 percent of the population was "terrible."