Can the Fed Really Raise Rates?

On August 5th, the Labor Department reported a second straight month of better-than-expected gains in the job market. Investors cheered as this report was a welcome sign that the economy was continuing its expansion and a recession was not imminent. Unfortunately, this report triggered concerns that it may force the Federal Reserve to raise interest rates. Because the global economy is still fragile, we do not expect the Fed to raise rates anytime soon.

The Labor Department's non-farm payrolls report showed a strong labor market. The report revealed employers added 255,000 jobs in July, far exceeding consensus expectations, and the unemployment rate remained a low 4.9%. While this report was a good sign for the economy, it did suggest that the Fed would be more likely to raise interest rates. According to Bloomberg, as of August 10th, the probability that the Fed raises interest rates is as follows for the next three meetings: September 21st (22% probability of a rate increase), November 2nd (23.7%), and December 14th (41.9%).

Although the financial markets suggest an almost 42% chance of the Fed raising rates this year, we believe the Fed is unlikely to raise rates this year for a variety of reasons. First, inflation remains extremely low. Yes, there have been recent signs of wage inflation, however, overall inflation remains modest. Second, a rise in interest rates would likely cause the US dollar to appreciate, hurting US exports. Third, raising interest rates during an election year could impact the results. Lastly, we do not believe the global economy is on a solid enough footing to withstand an increase in interest rates. While the first three reasons are fairly straightforward, let's turn our attention to the global economy.

We believe the global economy remains mired in a long-term period of middling growth. U.S. and German factory orders continue to be weighed down by weak global demand. U.S. exports continue to be weak as June's report showed the lowest reading in 2016, while China reported that imports fell six percent from a year ago period. Finally, global purchasing managers' indices, which are surveys regarding the state of the economy and have proven to be leading indicators of economic direction, have not shown any signs of significant growth. These are just a sample of recent readings suggesting that the global economy, despite labor market strength, remains in a mediocre growth environment.

The recent employment report suggested to some investors that the global economy is booming. While we acknowledge pockets of strength do exist, such as consumer spending and housing, we do not believe the report is enough to force the Fed to raise rates. The probability has increased, but it remains difficult to raise interest rates due to a lack of inflation pressure, the impact on the dollar, hesitation during an election year, and most importantly, the weak global economy. These all suggest that the Fed is likely to stay on hold for the balance of this year. With this mind, we expect interest rates to trade in a range and expect only a possible slight uptick in bond yields. We would position fixed income allocations with a slight defensive bias (less interest rate sensitivity and an overweight to spread product). Lastly, since we expect the global economy to remain mired in an uneven recovery, data reports are likely to be mixed as investors react either positively or negatively. We would incorporate alternative investments in portfolios to help mitigate against potential market volatility.

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