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Macro View

Markets and Fed watchers are increasingly discussing the possibility of a US June rate rise, with Fed officials stating that 'conditions are almost met for June tightening' (FT 5/22/16).

While everyone frets about whether the Fed will raise rates, it is questionable whether this leads to a 'tightening' of monetary policy, as is generally assumed. As I have discussed in my past Crisis Notes, and shown in the 'Failure of Macro Economics' study, the ability of Interest Rate Policy to impact money supply ceased in 1999 when Japan entered its Liquidity Trap. Interest Rate policy since then has the opposite-to-desired impact on money supply, as rate increases attract carry capital from liquidity-trapped countries, and vice-versa. With Europe and Japan currently having NIRP, (negative yield government debt now exceeds $10T) US rate increases will only serve to attract even more money to the US, increasing US Money Supply, and decreasing the money supply in NIRP countries.

After initial knee-jerk selloffs in US markets, this should result in continued asset inflation in the US, (historically with a 30 day lag), with counter-balancing declines in foreign markets. As such, when viewed globally, changes in asset valuations resulting from changes in central bank interest rate policy are a zero sum game, since there is no positive velocity of money (money multiplier) in most countries – net money flows determine asset appreciation and depreciation.

Impact on Financial Assets and US Yield Curves

A 25bps rate increase in the Fed Funds is mostly symbolic. However, if foreign equities sell off, there could be a powerful 'flight-to-quality' into US Treasuries. Thus, I suspect the US yield curve will rally and flatten, with the short end being anchored by the new FF rate.

A small rate rise is not likely to have much impact on most financial assets. It might impact levered assets like Agency MBS Reits, as well as brokerage firms, as funding cost increases could crimp their net margins, in which case Agency MBS spreads are at risk as well from deleveraging and selling (as during the Bernanke Taper Tantrums of 2013). Banks are unlikely to pass on any rate increases to their deposit base, and so should not experience any significant increase in funding costs. Whether their asset yields, and thus net interest margins, increase, is questionable, as a flight to quality to USTs might actually reduce asset yields.

Non Agency MBS, as well as other securitized credit spreads, might also come under temporary pressure if there is selling due to redemptions in anticipation of higher yields. Any such widening is likely to be temporary, as we believe this sector offers attractive relative value in comparison to other fixed income assets, and any Non Agency MBS assets, which are scarce in block size, will be scooped up by unlevered investors.

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