Adverse macro conditions cloud the Federal Reserve's policy decision

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A greater number of adverse macro conditions exists today than in June 2004 — the last time the Federal Reserve (Fed) began an interest-rate-hiking cycle. Chief among current concerns is the divergence in monetary policies between the Fed and other central banks, notably the European Central Bank (ECB) and the Bank of Japan (BOJ). But there are other issues.

First, the decline in commodity prices since mid-2014 has been significant and has served as a force moderating any potential inflationary pressures within the United States. The Thomson Reuters/CoreCommodity CRB Index dropped 31% for the 12-month period ended August 2015, and prices of West Texas Intermediate crude oil decreased 44% in that same time period. By comparison, prior to the policy move in 2004, the 12-month changes in commodity and oil prices were +14% and +53%, respectively. (Data: Bloomberg.)

The impact of the commodity price decline has been reflected in both the trade balances of commodity-exporting countries and in the reduction of foreign exchange reserves globally. The year-over-year decline is the first time such a decline has taken place since the series has been monitored. One may view the decline in foreign exchange reserves as being the equivalent of indirectly tightening financial conditions.

To highlight the size of the reduction, global foreign exchange reserves declined by $518 billion in the 12-month period after having reached their peak of $12 trillion (excluding gold) in June 2014. From 2009 until June 2014, world foreign exchange reserves accumulated $5.3 trillion. This accumulation occurred on top of the Fed's quantitative easing–induced portfolio of $4.4 trillion in debt, as well as the ECB's €2.56 trillion portfolio, the BOJ's ¥361 trillion portfolio, and the Bank of England's £0.44 trillion portfolio. The top 15 countries that had accumulated reserves have accounted for a $473 billion decrease since June 2015, or 91% of the total decreased amount. The dispersive declines of reserves in the top five countries (China, Russia, Saudi Arabia, Algeria, and Singapore) were -$315 billion, -$109 billion, -$67 billion, -$32 billion, and -$24 billion, respectively (for a total of -$547 billion). On the other hand, the central banks of Switzerland, India, and Hong Kong continued to accumulate reserves during the same time period, totaling $106 billion. China is the only country in which the decline in foreign exchange reserves is not directly linked to the weakness in commodity export. (Data: Bloomberg.)

Usually foreign exchange reserves are invested in the government debts of the major countries in which liquidity and sovereign credit rating are more favorable. The foreign holding of U.S. Treasurys actually didn't decline since global foreign exchange reserves peaked in June 2014. Foreign official holdings only dropped $70 billion while foreign private entities holding increased $196 billion. The disparity between officials and private entities also was different from the last interest rate hiking cycle in 2004. (Data: Bloomberg.)

Many economists believe that the U.S. economy is least dependent on external trades among the developed countries. The current slow growth and low inflation environment in the U.S. may still be justified for the Fed to move its policy rate before the next economic downturn arrives. However, the U.S. financial market has become more globalized than it was prior to 2007. Using the Barclays Global Aggregate Index, U.S. dollar–denominated debts have increased to 45%, or $24 trillion, from 38% or $15 trillion in 2007. This is another adverse macro condition that the Fed needs to consider before making its policy decision.

IMPORTANT RISK CONSIDERATIONS