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Interest Rates - US

Rate Hike Reflects Economic Growth; US Borrowing Costs to Rise in the Long Term

Summary

The US Federal Reserve's 25-basis-point (bp) increase in the federal funds rate today is its first move on rates since a quarter-point increase a year ago, an action that ended a seven-year, post-crisis stretch during which the Fed held its target range at zero to 0.25%. The rate hike is consistent with our expectation of a moderate strengthening of the US economy in 2017. By itself, the Fed's action will have little effect on US government borrowing costs, although a sustained tightening cycle would raise net interest expense in the long term. The impact of the rate hike will vary across emerging markets sovereigns.

Rate hike reflects strengthening US economy. The rate hike confirms that the US economy is performing well. We continue to expect US GDP growth of around 2.2% in 2017 and 2.1% in 2018. There is upside potential to this baseline forecast in the short term and downside risks in the medium to long term, subject to potential policy changes following the US election. Assuming economic growth is moderate and inflation rises slowly, we expect the Fed to tighten at a very gradual pace, with two to three more rate increases pushing the fed funds rate to around 1.25%-1.5% by the end of 2017.

Gradual tightening will raise US government interest costs over the longer term. A gradual tightening in US monetary policy is already incorporated into our base case for the US government (Aaa stable). Today's rate increase will have only a negligible impact on its debt servicing costs. However, with a somewhat shorter average maturity of outstanding US Treasury securities than we observe in other highly rated sovereigns, the US's interest burden will rise relatively rapidly as the fed funds rate increases and/or if inflation expectations rise further. We expect the government's net interest expense to rise to 12.7% of total spending in fiscal 2025—a level last seen in the early 1990s—from 6.6% in fiscal 2016, in line with Congressional Budget Office forecasts.

Emerging markets to benefit from firmer US growth, but still vulnerable to volatile capital flows. Emerging markets exporters will benefit if US growth translates into higher import demand. However, a resurgence of heightened cross-border capital flow volatility in response to the Fed's tightening could have negative spillovers for those with large external funding needs, high leverage, macroeconomic imbalances, or uncertainties around politics and policies.

Rate hike reflects strengthening US economy

The 25-bp increase in the fed funds rate reflects the Fed's expectation of somewhat stronger GDP growth and provides confirmation that the US economy is performing well. We expect US GDP growth of around 2.2% in 2017 and 2.1% in 2018, up from an estimated 1.6% in 2016. There is upside potential to this baseline forecast in the short term and downside risks in the medium to long term, subject to potential policy changes following the US election.

Underlying our expectation for US economic growth is the continuing strength of consumer spending, even in the face of somewhat weaker business investment. Determinants of consumer spending—employment prospects, real wage growth, household wealth, overall household debt levels and credit availability—are expected to continue to improve. Strength in the US labor market, as reflected by the low unemployment rate and growth in jobs and wages, should support house prices and residential investment. Business investment will pick up modestly as the drag from the pullback in the energy and mining sectors fades.

Inflation remains under control. Key inflation measures are still below the Fed's medium-term target, but headline and core inflation measures will continue to firm as the remaining effects of the sharp fall in energy prices wane and wage pressures build. The Fed's preferred inflation measure, core personal consumption expenditure inflation, is currently at 1.7% and should continue to edge up towards its medium-term target of 2%.

Consistent with this view of moderate growth and rising inflation, we expect the Fed to pursue monetary tightening at a very gradual pace, with two to three rate increases in 2017. We expect the fed funds rate to be around 1.25%-1.5% by the end of 2017. Further out, we expect the equilibrium federal funds rate to converge to 3% and the 10-year yield to settle around 4% in the long term, reducing the slope of the yield curve over the next few years.[1] Over the next few quarters, however, the yield curve could steepen further, driven by higher inflation expectations and risk premia.

Even with these increases, rates will remain historically low. The central bank's near-zero post-crisis monetary policy fits in with a secular decline in nominal and real interest rates over the past three decades. We expect that a near-term cyclical revival in investment and an increase in inflation will gradually raise nominal yields, but to levels still below historical norms.

Market rates have already risen, with a bond market selloff following the US presidential election driving the 10-year US Treasury yield up 58 basis points to 2.43%. This has increased the slope of the yield curve. Much of this increase in the term premium is driven by expectations of increased investment spending and higher deficits from substantial infrastructure-related fiscal stimulus and other policy actions. However, these may not develop on the scale and within the time frame that the market expects, which could lower yields. For now, we maintain our forecast of an average 10-year Treasury yield of 1.94% in the fourth quarter of 2016 and 2.10% in the first quarter of 2017.

Additional risks to US macroeconomic forecasts depend on the direction of economic policies of the incoming administration. There could be an upside to growth from increased fiscal expenditure, especially infrastructure spending, and tax cuts, but the impact will depend on the details of these policies. Specifically, it will depend on how much fiscal spending or tax credits related to infrastructure are associated with new projects. In case of income and corporate tax cuts, the impact on growth will depend on whether households would spend the additional income and whether and by how much corporates would increase investment spending. A protectionist stance on trade and immigration would be detrimental in the medium term.

Gradual tightening will raise US government interest costs over the longer term

Today's rate increase will have a negligible impact on the US government's debt servicing costs. As mentioned, a gradual tightening in US monetary policy is already incorporated into our base case for the US. The rate increase will not have any implications, either positive or negative, for the US government's economic strength or fiscal strength, two of the factors that determine the sovereign rating.

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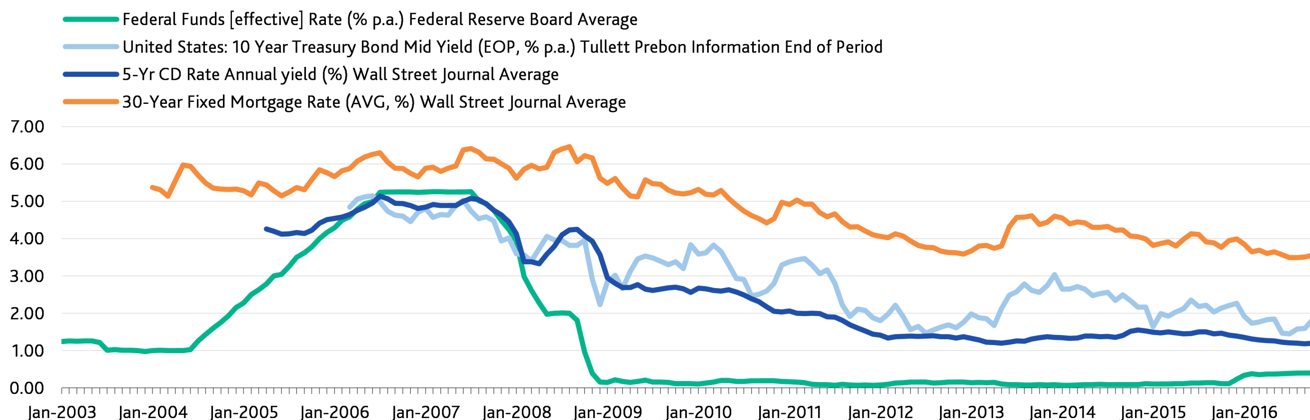
However, we think that the US is at an early stage of a longer-term tightening cycle for monetary policy. Longer-term interest rate trends determine the interest burden and, therefore, contribute to shaping fiscal strength. US government funding costs can vary considerably, even with stable official rates, owing to variations in term premia and medium-term inflation expectations.

Exhibit 1
Fluctuations in US Government Funding Costs



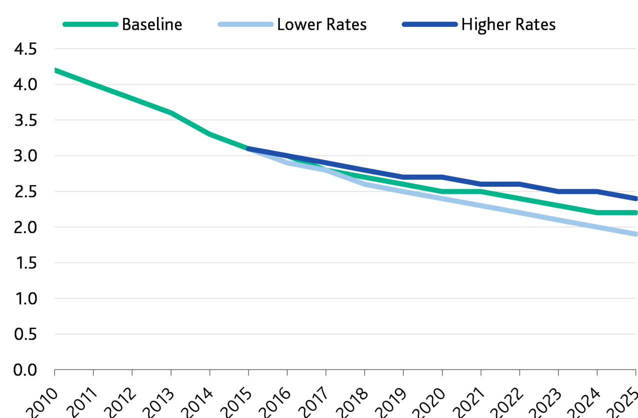
Source: Haver Analytics

At 70 months, the country's weighted average remaining time to maturity for marketable US Treasury securities is slightly lower than what we observe in other highly rated sovereigns, which is generally at least six to seven years. Therefore, the US's interest burden will rise relatively rapidly as funding rates increase and/or if inflation expectations rise further. In recent weeks, inflation expectations as measured by market breakeven inflation rates have risen materially. Since early November, the five-year breakeven inflation rate has increased by about 30 bps, accounting for around two thirds of the rise in five-year nominal yields.

Our central expectation for the government's net interest expense is in line with that of the Congressional Budget Office (CBO). We expect it to rise to 12.7% of total spending in fiscal 2025—a level last seen in the early 1990s—from 6.6% in fiscal 2016. This incorporates an assumption that the fed funds rate and average Treasury yields will not rise to the average levels that were observed in the 25 years before the Great Recession.

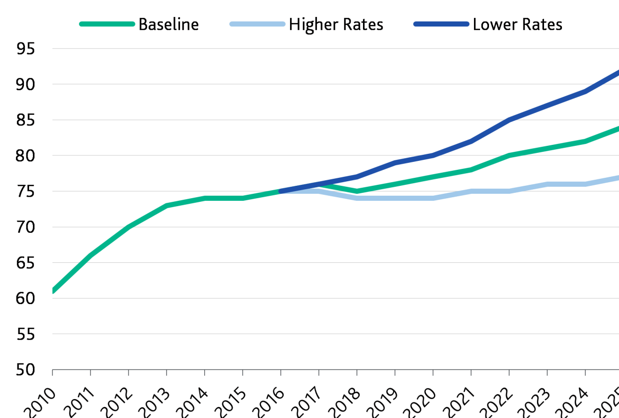
A move to interest rates more in line with historical averages would cause the interest burden to rise more rapidly. For example, the CBO estimates that the 30-year average real 10-year interest rate is set to decline by an average of 9 bps per year over the next decade. Were the pace of interest rate normalization to be faster than currently anticipated so that the decline in the 30-year average is 7 bps per year, the federal government's debt-to-GDP ratio would be approximately eight percentage points higher in 2025 than in the baseline scenario. Conversely, the rise in the debt burden may be largely arrested under unchanged fiscal policy as long as the 30-year average real 10-year interest rate declines by an average of at least 11 bps per year through 2025. We believe that risks around our (and the CBO's) baseline are broadly balanced and the December rate increase does not make either scenario more or less likely.

Exhibit 2
Illustrative Interest Rate Paths for 30-Year Average Real 10-Year Interest Rate
(%)



Source: Congressional Budget Office

Exhibit 3
Alternative Debt Trajectories Under the Three Illustrative Interest Rate Paths
(% of GDP)



Source: Congressional Budget Office

Emerging markets to benefit from firmer US growth, but still vulnerable to volatile capital flows

Emerging market economies are poised to return to modestly faster average growth in 2017 after five years of steady deceleration, with G20 emerging markets' growth expected to average 5% in 2017 and 2018, from an estimated 4.4% in 2016. Firming growth in the US, if it increases import demand, could further accelerate growth in emerging market exporters. Even so, overall emerging market growth will likely remain considerably lower than it was in the years leading up to, and shortly after, the financial crisis.

On the other hand, emerging markets remain exposed to potential negative effects of rising US interest rates, if these result in a more sustained repricing of global financial assets and tighter global financial conditions. The most direct impact will be on those countries that have high external financing needs relative to their foreign exchange earnings and reserves. However, even economies with more resilient balance of payments positions could suffer due to increased linkages between domestic and global financial conditions.

Past announcements from the US Federal Reserve, related to tapering in 2013 and the interest rate increase in 2015, have indeed affected capital flows to and from emerging markets, with some experiencing sharp exchange rate depreciations. However, depreciation did not generally lead to an offsetting increase in export growth, because it occurred across exporting economies and in a period of sluggish trade growth.

The specific emerging market currencies that witnessed the biggest declines have varied somewhat in each episode of global financial volatility, and may continue to change over time. For instance, while Brazil, India and Indonesia witnessed sharp depreciations in 2013, more recently in 2016 it was Malaysia, Mexico and Turkey that saw their exchange rates fall significantly.

Nonetheless, emerging markets that proved most exposed to global financial volatility have generally shared some common characteristics. These have included fiscal or current-account imbalances or uncertainties around growth, policy or politics and/or a high private- or public-sector reliance on external financing.

Looking ahead, tighter global financial conditions will have negative spillovers for growth and financial stability in emerging markets that exhibit one or more of the above characteristics. The spillovers may manifest themselves in different ways. For instance, in some, pronounced currency depreciation could pass through to higher inflation, which, along with the threat of sustained capital outflows, could force central banks to raise interest rates or otherwise refrain from monetary easing to mitigate slowing growth. For others, particularly economies with high leverage or pockets of high leverage, the lack of domestic fiscal or monetary space to offset tighter global financing conditions could dampen growth or pose risks to domestic financial stability. On the other hand, relatively less open and more diversified emerging markets, with moderate leverage, large domestic markets and sound policies supportive of faster long-term growth, will fare better.

Moody's Related Research

- » Global Macro Outlook 2017-18: Global Growth Outlook Stabilizes at Low Levels; Medium-Term Risks On the Rise, 14 November 2016
- » Cross-Sector – US: Federal Reserve's First Rate Hike in Nine Years Will Have Limited Credit Implications, 15 December 2015
- » Moody's: Possible Federal Reserve rate hike demonstrates strength of US recovery but potential volatility in emerging market capital flows, 16 September 2015

Endnotes

1 If economic data warrant a change in our assumptions of key factors that influence interest rates, such as growth and inflation, then we would reassess our forecasts for the yield curve.

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