Federal Reserve begins “dovish tightening” with first rate hike in nine years

By Barry Grey
17 December 2015

As widely anticipated, the US Federal Reserve Board on Wednesday announced a quarter percentage point increase in the federal funds rate, the interest banks charge one another for overnight loans of reserves kept at the central bank. It was the Fed’s first increase since June 2006 and it lifted the benchmark rate from a range of zero to 0.25 percent, where it had remained since the height of the financial crisis in December 2008, to a range of 0.25 percent to 0.50 percent.

The Fed’s policy-setting Federal Open Market Committee (FOMC) and its chairwoman, Janet Yellen, took great pains to characterize the increase as small and stress that further increases would be gradual and incremental, and that the Fed would hold rates below normal for an indefinite period and continue to pursue an “accommodative” monetary policy.

That this was what the financial markets wanted to hear was obvious from the response of US stock indexes. The long-signaled shift to what is being called “dovish tightening,” with the emphasis on “dovish,” triggered a run-up of prices on all three major indexes.

The Dow Jones Industrial Average, which had risen by 76 points before the FOMC released its statement at 2 PM, spurted upward and continued to climb during Yellen’s press conference, ending the trading day with a gain of 224 points (1.28 percent). The Standard & Poor’s 500 index and the Nasdaq had similar trajectories, ending the day with gains of 29 points (1.45 percent) and 75 points (1.52 percent), respectively.

Ever since the previous Fed chairman, Ben Bernanke, had signaled his intention to move toward a normalization of monetary policy by hinting in December of 2013 that the central bank would begin to “taper” its massive bond-purchasing and money-printing program, known as “quantitative easing,” the banks and hedge funds had exerted pressure against any increase in interest rates.

That they were generally prepared, after two years, to accept small and gradual increases was bound up with mounting signs that the regime of virtually free credit, which had generated windfall profits and a further shift of wealth from the bottom to the very top, had produced a new debt and credit crisis that threatened once again to bring down the financial system.

Since December 16, 2008, when the Fed slashed the federal funds rate to near-zero, the Dow has risen by 96 percent, the S&P 500 by 124 percent, and the Nasdaq by 214 percent. Over this period, the Fed has pumped $3.5 trillion into the banking system. The wealth of the 400 richest Americans has doubled. Meanwhile, the destruction of decent-paying jobs and wage cutting across the economy have decimated working-class living standards.

But the ongoing slowdown in the real economy globally, reflected in collapsing prices for oil, gas, metals and other basic committees, declining trade, and slumping demand for manufactured goods, is now destabilizing the US bond market and threatening to collapse the financial house of cards that has been built up by the policies of the Fed, the Obama administration and central banks and governments in Europe and Asia.

Over the past week, a mounting crisis in the US high-risk, high-yield junk bond market came to a head with the closure of three energy-based junk bond funds. Their collapse was triggered by the decline in oil prices to well below $40 a barrel and a wave of client redemption orders that the highly leveraged firms could not fulfill.

Funds managed by Third Avenue, Lucidus Capital Partners and Stone Lion Capital barred redemptions, triggering a selloff on the $1.3 trillion junk bond market. This high-risk market, based on bonds issued by firms with low credit ratings and high levels of debt, has expanded prodigiously since the Fed lowered rates to near zero and took other measures to force down long-term interest rates.

These policies, far from reining in speculative and parasitic financial activities, subsidized their expansion. Hedge funds and similar financial operations, such as exchange-traded funds that track bond markets, seeking new ways to realize high returns after the collapse of the subprime mortgage bubble, turned to junk bonds. According to Dealogic, US junk bond issuance hit a record $361 billion in 2013, more than double the volume in the years before the financial crisis.

Last week, junk bond funds were hit with $3.5 billion of withdrawals, the most for 70 weeks. And the crisis is spreading beyond junk bonds. Prices of bonds issued by firms in the pharmaceuticals, media, telecommunications, semiconductor and retail industries have fallen in recent months.

The *Financial Times* on Wednesday cited Bonnie Baha, head of global developed credit at DoubleLine Capital, as saying: "It brings back memories of 2008 all over again and that's what has been fueling this. Defaults are ticking up. Energy is leading the way but it's starting to spread to other sectors. It's not just an energy or metals and mining issue."

In a report Tuesday, the US Office of Financial Research found "elevated and rising credit risks" among nonfinancial companies and emerging market borrowers. The agency warned that a significant shock that impacted credit quality "could potentially threaten US financial stability."

That the widening crisis in corporate bonds played a role in the Fed's decision, after multiple delays, to begin hiking rates was indicated in the language of the FOMC statement. Discussing future rate increases, the statement included among the factors the Fed would consider "financial and international developments." The reference to financial developments, in particular, was a departure from previous FOMC statements.

The FOMC statement gave a generally upbeat appraisal of the US economy, and Yellen, in her press conference, was, if anything, even more sanguine. She began by declaring that the move to begin hiking rates was a vote of confidence in the strength of the US economy and its recovery from the Great Recession.

Yellen and the FOMC all but ignored the sharp slowdown in US manufacturing and industrial production in recent months, which has been exacerbated by the rise in the exchange rate of the dollar resulting from expectations of monetary tightening by the Fed. The higher dollar has further depressed US exports. The actual launch of rate hikes will likely cause a further increase in the dollar and heighten the impact on US exports.

Earlier this month, the Institute for Supply Management reported that manufacturing in the US contracted in November, falling to its lowest level since June 2009. Industrial production contracted in three of the last six months, and data released Tuesday showed that factory activity in New York State declined for the fifth straight month in December.

Yellen was asked at her press conference about the rout in junk bonds and the closure of Third Avenue's Focused Credit Fund last Thursday. She noted the pressure on junk bonds while brushing off the Third Avenue collapse as a one-off event.

Another reporter challenged the Fed's claim, reiterated in Wednesday's FOMC statement and Yellen's opening remarks to the press, that the drastic fall in oil prices and low inflation rate were "transitory" phenomena that would dissipate in the coming months, bringing the inflation rate close to the Fed's goal of 2 percent. The reporter noted that the Fed has been making this assessment for some two years, and it has never materialized.

Yellen seemed flustered and largely dodged the question. She could not provide a convincing answer because the collapse in oil and commodity prices and the persistence of ultralow inflation reflect the reality of economic slump and the failure of the Fed and the other major central banks to engineer a genuine recovery in the real economy, despite the funneling of trillions of dollars into the banking system.

The continuing threat of deflation, more than seven years after the Wall Street crash, is an expression of the systemic crisis and breakdown of the capitalist system itself, something Yellen can neither address nor acknowledge.