Are the Interest Rate Increases Over?

By: Joe the Investor

When deciphering what central banks are going to do, there are 3 main aspects to observe. The first one is what decision was made at the latest meeting. The second one is what language is being used in the speech following the decision and whether there are any changes that suggest a different direction or maintaining the same direction. The third indicator is whether the actions of the central bank are in line with the reality of the day and with the economy in general. This third aspect sometimes calls into question the language of the second aspect, thereby showing the bluff. The Federal Reserve is the most watched central bank, but most countries have a central bank and this methodology would apply to all of them. The Western economies of Canada, the United States, the United Kingdom, Europe, Japan, Australia and New Zealand have been moving in lockstep over the last several years, which is an added feature because if one central bank deviates, the others may follow.

With regard to the first aspect, this would entail what was decided with respect to interest rates. Did they raise or lower the benchmark rate (1) and by how much? The benchmark rate is the rate at which commercial banks borrow and lend to each other overnight. There are a series of other interest rates for borrowing and lending over different time periods, and depending on who the counterparties are, the time period and creditworthiness will determine the risk inherent in the loan and the interest rate that would be applied to it. The benchmark rate can be thought of as the lowest interest rate upon which all other interest rates are set.

Central banks have 2 tools are their disposal in all situations. They can raise or lower the interest rate by a certain amount, and they can “jawbone” or bluff the markets into believing they will act but not necessarily do so. The lingo for central bankers is if they are lowering rates, the tone is “dovish”, and if they are raising rates, the tone is “hawkish”.

For the second aspect, the speech following the interest rate decision would be examined to see if there are any changes in the interest rate path. As an example, the latest Federal Reserve meeting (the Federal Open Market Committee or FOMC) announced an interest rate increase of 75 basis points or 0.75%. The speech after this announcement (2) is indicating that the Federal Reserve is taking into account the cumulative effect of its interest rate hikes over 2022. The market interpreted this as positive because interest rate increases may be coming to an end. At the same time, the announcement is saying that inflation pressures remain elevated and are far beyond their intended target of 2%. This created a mixed reaction in the markets.

The third aspect is the most interesting one, because the reality or overall picture can be examined to try to make sense of what is going on. There are a number of issues with the big picture which will be brought up here. In order to “beat down” inflation, the interest rate would have to rise to a level higher than the inflation rate. The reason why is that anyone lending money would need to have their money back plus interest to make it worthwhile to make the loan. The current inflation rate is running between 6% and 8% according to the U.S. Bureau of Labor Statistics (BLS).(3) Should the Federal Reserve raise interest rates to this level, the interest payments on the national debt would offset a significant portion of revenues collected by the U.S. government each year. In other words, the U.S. government would be closer to being bankrupt.(4) Another aspect of the story that is not making sense is that the U.S. economy is presumed to be strong and raising interest rates would cool it down. Does this jibe with the mass layoffs from corporations, low mortgage demand, lower real estate prices and low consumer confidence? A third indicator that something is not adding up is the changing narrative on inflation. Inflation at the start of 2022 was ignored, then was called "transitory", followed by inflation being a "positive development", then was called "peaking" in mid-2022 and now is considered an issue which is prompting aggressive rate hikes. Why all of the changes in the narrative?

Getting back to the title of this article: Are the interest rate increases over? It is always reading a crystal ball, but the Bank of Canada has provided a clue. The issues in the Canadian economy are similar to the U.S. economy, including the high inflation numbers and determination by the Bank of Canada to fight inflation. But at the last Bank of Canada meeting (6), interest rates were raised only 50 basis points or 0.5% instead of the expected 75 basis points (0.75%) or possibly 100 basis points (1%). Why? There is no reason indicated, but the market believes this is a signal that the interest rate increases are almost over. The Bank of Canada has indicated that it is expecting inflation to come down by 2023, but is also saying that it will raise interest rates further. The Australian Central Bank has also slowed its interest rate hikes to 25 basis points at a time versus 50 basis points earlier in the year. (7). The Australian Central Bank indicated that higher interest rates were affecting the housing market negatively.

1) https://www.investopedia.com/terms/f/federalfundsrate.asp
2) https://www.federalreserve.gov/newsevents/pressreleases/monetary20221102a.htm
3) https://www.bls.gov/cpi/latest-numbers.htm
4) https://www.thebalancemoney.com/interest-on-the-national-debt-4119024
5) http://www.shadowstats.com/
6) https://www.bankofcanada.ca/2022/10/fad-press-release-2022-10-26/
7) https://money.usnews.com/investing/news/articles/2022-11-01/australias-central-bank-raises-rates-by-25-bp-as-expected