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## **No interest rate hikes until 2012?::**

Financial Ramblings from The Rock by Nathan Kowalski

The more recent economic data coming out of the US points to a slowing in economic growth. Many government stimulus programmes are fading, tax rates are set to increase in 2011, and the inventory cycle is beginning to end. All these factors look to put pressure on growth for the second half.

Although it is unlikely we will see a double-dip recession, it is almost certain that we will have a growth slowdown in the back half of the year. As a result there is likely to be no near term risk of rising inflation.

The Federal Reserve has changed its wording in its press statement in which it indicates growth and inflation forecasts are coming down.

The Consumer Price Index (CPI) has actually been deflating since January and clearly indicates no inflation. The money supply data is also anaemic and shows very little growth.

M3 money supply data has shown contraction of about 5.5 percent year-over-year, and this is accelerating. A major reason why all this data is weak is the job market. A major risk for rising inflation is higher wages.

With the enormous slack in the job market, there is essentially zero wage pressure. In fact average hourly earnings as of the latest report were still down and point to a continuing depressed wage market.

Consumer debt levels also pose as an obstacle because the reversal on leverage tends to be a deflationary force as the consumer spends less and assets prices which are heavily geared, such as housing, tend to be capped in any form of price appreciation.

Other factors that slowly feed into inflation have also been deflating. Commodity prices are under pressure. Oil has fallen below \$75 from over \$90 earlier this year. Copper continues to slide too and is now under \$300 a pound from a recent high of over \$360 per pound.

Mild deflation is not such a bad thing, however. Lower prices offer respite for a weak consumer. Falling gasoline prices, for example, acts as a tax break for many consumers.

The less spent on fuel allows increased consumption on other items and tends to support retail sales. Deflation is also great for bonds.

It is no surprise that we are seeing a major rally in US treasuries to record low yields. The two-year bond recently hit a new low of less than 0.6 percent (Japan's notes, for example,

hit a low of .024 percent at one point).

Low levels of deflation are historically great for stocks as well. According to Crestmont Research, periods of low inflation or even subdued deflation generated environs supportive of higher price-to-earnings ratios for stocks.

In periods where the CPI is greater than zero but less than one percent, the market price-to-earnings ratio tends to average 16 times. The S&P 500's current forward ratio of only 12.5 times earnings looks favourable in this light.

It would seem that any rate hikes in interest rates are a long way away. The implied Federal Funds rate now does not anticipate a rate hike until mid-2011

A recent San Francisco Fed study strongly hints that we will not see hikes until 2012. It also states that rates should actually be minus five percent under the bank's "rule of thumb" measure of capacity use and employment.

Given the Federal Reserve's dual mandate — full employment and price stability — it would seem that rate hikes are not necessary at this juncture or in the near foreseeable future. Right now deflation is more of a fact and inflation is simply an opinion.

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