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Market **Perspectives**

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The Fed's Dilemma

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Twice in the past 30 years the U.S. Federal Reserve has faced the prospect of prematurely abandoning tightening during market turmoil. Today, global currency devaluations, market volatility, and plunging commodity prices have trapped the Fed in a similar policy dilemma.

In 1987, the central bank aborted rate rises and reversed course after a stock market crash. Again, in 1998, after the failure of Long-Term Capital Management (LTCM), a highly leveraged hedge fund, the Fed abandoned its planned rate increases to stabilize markets and avoid a global crisis. In both cases, the unintended result of delaying was inflated asset prices, which ultimately destabilized the economy, and led to severe financial consequences and recession.

In 1986, inflation slowed as oil prices collapsed, raising serious concerns about U.S. economic expansion following the worst postwar recession up to that time. Policymakers were slow to raise rates, allowing for a surge in equity prices in early 1987 as energy prices rebounded.

After falling behind the curve, aggressive Fed actions to address inflation inadvertently pricked the stock market's speculative bubble. In October 1987, U.S. equities plummeted more than 30 percent. The Fed quickly reversed course and reduced rates.

By mid-1988, markets stabilized and the Fed again raised rates to head off inflation. By this time, more than four years of accommodative monetary policy had led to a commercial real estate boom with a glut of new properties. As the economy tumbled toward recession in 1990, a sharp decline in property values caused defaults and the failure of financial institutions. The government-sponsored Resolution Trust Corporation was set up in response to resolve troubled banking assets.

After the ensuing recession and another period of accommodation, the Fed again raised rates in the mid-1990s. During this time, many Asian nations had pegged their currencies to the U.S. dollar. By 1997, the pressure to maintain these pegs amid rising U.S. rates became too much for some. Thailand was first to break its peg, allowing the baht to collapse and increasing pressure on neighboring economies in a dramatic round of competitive devaluation.

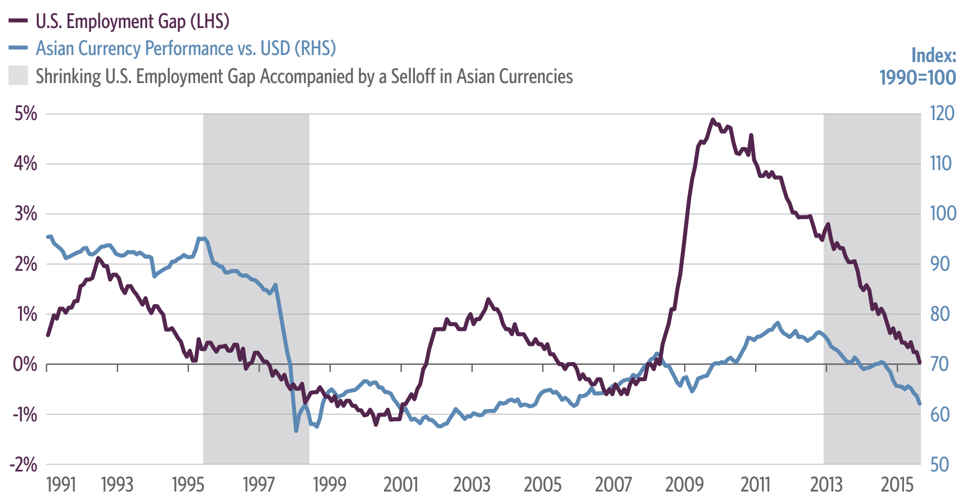
By 1998, contagion from emerging markets reached the United States, pressuring domestic markets. A collection of 14 major financial institutions convened by the Fed intervened to stem the collapse of the LTCM hedge fund that threatened the solvency of the global financial system.

Once again, the Fed aborted plans to raise rates, allowing equity prices to skyrocket. When the Fed finally tightened, stocks began a long, deep slide. Numerous companies that flourished amid the speculative wave failed.

Today, policymakers are caught in this familiar dilemma. Labor markets are moving toward full employment, and declining energy prices and a stronger dollar have resulted in languishing inflation. Still, questions remain about the viability of sustained economic expansion in the United States and around the world, and volatility is rising.

Since 2009, the U.S. employment gap has been shrinking continuously, as the U.S. Federal Reserve intended. The employment gap is now approaching zero, a signal that supports a rate hike, but China's slowdown is causing major market turbulence, especially in Asia. This puts the Fed in a similar position to the Asian financial crisis in the late 1990s. Then, the U.S. employment gap was approaching zero while dramatic currency devaluations among Asian countries threatened to destabilize the global economy. In that instance, the Fed abandoned its plans to tighten, inadvertently setting the stage for the Internet bubble.

Shrinking U.S. Employment Gap amid Selloff in Asian Currencies



Source: Haver Analytics, Bloomberg, and Guggenheim Investments. Note: Asian currencies include China, Japan, Korea, Taiwan, Thailand, Philippines, Malaysia, India, and Indonesia. The index is based on monthly currency data. Past performance is not indicative of future results. Data as of 8/31/15.

At the same time, currency devaluation, particularly in Japan and the euro zone, is putting pressure on countries to devalue to improve export competitiveness. Those countries slow to devalue, like China, are feeling economic pressure at home, driving down asset prices and increasing deflationary pressures, escalating the risk of financial contagion abroad.

The Fed is hard pressed to justify a rate increase based on its self-prescribed metrics, which include rising inflation and an improved employment situation with clearly rising wages. At best, policymakers can argue that the prospects for wage growth and inflation are improving, but clear evidence is lacking.

A preemptive rate increase seems risky and opens the Fed to potential criticism given the fragility in financial markets and the prospect that rising U.S. rates could exacerbate foreign economic turbulence. But while prices and wages remain tame, the risk of another asset bubble is increasing. If policy remains highly accommodative, the likelihood grows that asset classes including commercial real estate, equities, or certain categories of bonds could become dangerously overvalued.

Regardless of the path the Fed chooses, after seven years of accommodation and now facing volatile global markets, the likelihood of regret is high.

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