Liberty Asset Management, Inc.

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Much Ado About Nothing

Ever since the U.S. Federal Reserve ("the Fed") ended its latest quantitative easing program in late 2014, people from all over the world have debated when it should try to increase interest rates. It seems like every financial news outlet and economist has spent the past year discussing when a rate hike could happen and the potential impact of getting it wrong. Various forecasts and models been used to "prove" each argued outcome of a hike—everything from rapid U.S. growth to global financial disaster. The market became so obsessed that the mere suggestion of an earlier-than-expected September hike caused market volatility to jump in August and helped pushed the S&P 500 down 10 percent in a week.

The arguments and analysis continued until December 16, when the Fed finally raised short-term interest rates for the first time in almost a decade. The world held its breath and financial markets prepared for anything.

But, the day passed and nothing bad happened—almost nothing happened at all. The rate was raised and people carried on. Despite months of frenzied coverage and concern, everything was calm and average.

Why did nothing happen?

The most important thing to understand about the December rate hike is that "nothing" was the Fed's goal. Although it was the first increase in nine years, the Fed made worked hard to make it as comfortable as possible and gave people the opportunity to prepare. In fact, the Fed had so clearly signaled the hike was coming, it would have caused problems if it left the rate unchanged.

In addition to the heavy signaling and preparation time, the hike was designed to be very small. The target rate was moved from a range of 0–.25 percent up to a range of .25– .50 percent. By using these ranges, the Fed gave rates the opportunity to move closer the new target before the actual hike took place. This allowed the real rate to change even more gradually than the official quarter-percent move.

The other important thing to recognize is that economies have momentum. It can take years to alter their courses or change how they grow. The Fed's short-term interest rate holds a lot of power, but it's only designed to work as an economic nudge. To influence the economy, the Fed must continuously use its short-term rate changes to reflect a consistent, long-term goal for the United States.

Staying on the same page

The Fed wasn't the only party hoping for "nothing" from the rate hike. Banks and investors were doing everything they could to ensure a smooth transition. Changes to interest rates, even ones meant to promote economic growth, can be disastrous for those caught trading in affected markets.

Wall Street has been watching the Fed particularly closely over the past several months. Every document produced by Fed leaders was examined for details, while every economic indicator was analyzed for its impact on future interest rates. As the data came in, institutions and investors changed their market exposure for a post-hike market and, in doing so, created a market was already adapted for the new rate.

Ultimately, the December rate hike didn't cause any major disruptions to the market because both sides were careful. The Fed opted for a small, obvious rate hike, and the markets listened to its signals and prepared accordingly. After years of struggle to move the economy forward, no one wanted to derail the country's progress or lose money in a needlessly chaotic market.

No one knows what the future will bring for the economy and what will happen as the Fed continues to slowly normalize interest rates, but December was an important first step. The hike proved that as long as both the Fed and markets communicate and work together, they can accomplish "nothing"—which can be a very valuable thing.

the market at a glance

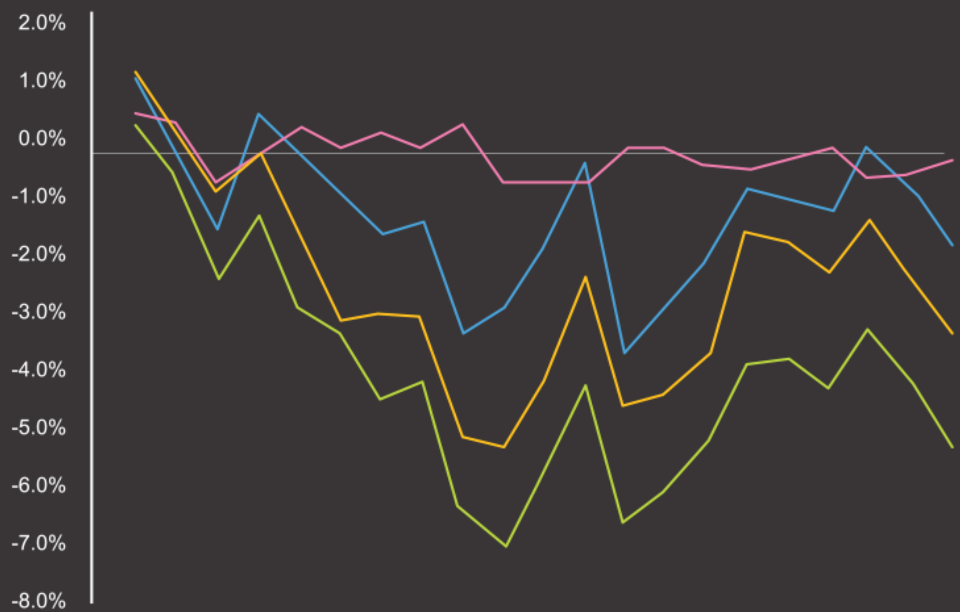
DECEMBER

U.S. Large Cap
(S&P 500)
2,043.94 (-1.75%) ▼

U.S. Mid/Small
(Russell 2000)
1,135.89 (-5.19%) ▼

Foreign Large
(NYSE International 100)
4792.37 (-3.22%) ▼

Bond Market
(Dow Jones Equal Weight U.S. Issued Corporate Bond Index)
341.40 (-0.35%) ▼



Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly.

the market in action

- The U.S. Department of Labor revises up a number of third quarter economic statistics from the previous month, including raising annual productivity growth from 1.6 percent to 2.2 percent and annualized GDP growth from 1.5 percent to 2.1 percent.
- Following the birth of their first child, Facebook founder Mark Zuckerberg and his wife announce a plan to donate 99 percent of their Facebook shares to charity during their lives. At the time of the announcement, the shares were worth over $40B, making it one of the largest charitable pledges in history.
- Chemical industry giants Dow Chemical Co. and DuPont agree on a $130B merger. One of the most significant aspects of the merger is the age of the companies; Dow Chemical is nearly 120 years old, while DuPont is over 210 years old—one of America's oldest companies.
- Finland's government starts a proposal to replace its current welfare system with a government-provided monthly income of €800 (around $10,000 annually) for every adult citizen. Despite being untaxed, the guaranteed income system is projected to improve the Finnish government's budget.
- American pharmaceutical company Pfizer Inc. makes plans to acquire Irish competitor Allergan, Inc. and move its corporate headquarters to Ireland. Pfizer is using the move to take advantage of Ireland's low-tax environment and has become one of the largest U.S. companies to emigrate using a "corporate inversion."
- A report from Pew Research Center reveals that the U.S. middle class no longer represents the majority of the country, comprising just under 50 percent of the adult population. The report shows that the middle class has been steadily shrinking since it included 61 percent of people in the 1970s.
- An early MasterCard SpendingPulse™ report shows that holiday retail sales (sales between Thanksgiving and Christmas) rose 7.9 percent from the same time last year. Online sales continued to become increasingly important to retailers, growing 20 percent since last year.

2016: The Year of the Raise

In the years since the Great Recession, America has seen numerous financial benchmarks return to positive levels: housing prices have largely recovered, unemployment has dropped to half its peak, new automobile sales have been pushed to record highs and most of world stock markets have significantly surpassed their pre-crisis values.

But despite all the major improvements, the recovery has been largely absent from wage growth. According to the Economic Policy Institute, U.S. workers have averaged annual wage increases of about 2.0 percent since the recovery started in 2010. That growth is around half the 3.5–4.0 percent seen in a healthy U.S. economy.

Why have wages stayed so low?

High unemployment has been the main reason for the low wage growth, but the sluggish consumer spending, low inflation and even corporate expansion strategies are also to blame. The recession slammed the economy, putting many companies out of business and taking huge tolls on the revenue of almost everyone else. Low on earnings, many companies cut or froze salaries during the decline and have only felt comfortable with smaller raises ever since.

Under normal economic conditions, absent or slow wage growth would quickly cost a company many of its employees; however, persistently high unemployment and a poor job market have kept workers from quitting and robbed them of power when negotiating salaries. Additionally, low inflation has hurt the argument for higher wages. The recovery's 2.0 percent wage growth is historically low, but it has outpaced its 1.4 percent average inflation rate. Wages are growing slowly, but employers can argue they still are growing in real value.

Why many think 2016 will be different:

There are several reasons to think that 2016 will be the year wage growth gains traction. In the last months of 2015, the unemployment rate dropped to 5 percent, a level the government associates with "full employment." There were also over 5 million job openings at year's end, with many employers complaining they couldn't find enough skilled workers to fill critical positions. This tightening labor pool suggests that employers will need to fight to keep employees in the coming years—and one of the best ways to do that is raising their wages.

This isn't necessarily bad news for businesses. The economy has been steadily improving and consumer spending has been climbing. Many businesses have also consolidated in the past year, improving their efficiency. While companies may need to pay employees more, most should be making more money and many will be paying fewer employees for the total amount of work being done.

Some of the compensation increases have already started happening, though not in the traditional form of pay raises. Data from the Bureau of Labor Statistics shows that companies have recently increased spending on benefits and bonuses in an effort to improve employee satisfaction, motivation and work-life balance.

Why 2016 might be the same:

There is no guarantee that 2016 will be year that wages move back to their pre-recession growth rates. The economy still faces many uncertainties. While the current unemployment rate reflects "full employment," the number of discouraged and underemployed workers is still abnormally high. Some economists believe that these potential employees may keep wages depressed until they find good jobs. Business mergers, while good for company efficiency, could actually contribute to this problem. Large mergers can lead to major layoffs, increasing the number of people looking for work.

In the end, the ability to get a raise always comes down to the value employees provide to a company. If their skills are valuable and unique, their employer will happily pay more to keep their talents. A smart business cannot ignore the workers that make it successful.

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