

The 0.1% Solution

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Conan Doyle fans will recognize the reference to the eminent denizen of 221B Baker Street in the title of this note, but it isn't for the benefit of Dr. Watson that we are penning this brief. Rather, it is for Dr. Yellen.

Economic stimulation in the form of low rates has been the focal point of pundits and the public alike for quite some time now. For months, years, in fact, the Fed and the markets have been agonizing over whether and when the Fed will lift the discount rate from near zero by twenty-five basis points. This has all seemed rather silly to us, since twenty-five basis points isn't much and, in all but the most unsound leveraging schemes, would have minimal impact on credit creation or availability. By far the more serious consequence of a rise could be the effect on the market for the entire term structure of interest rates, if participants come to believe that the first bump in rates is the start of a long process of relentless upward movements. If that were the case, because of the astronomic level of sovereign debt all over the developed world, the agonizing would be well worth it.

So the conundrum for the Fed is to get off the dime, on the one hand, without spooking the markets into discounting an endless stream of twenty-five basis point increases, such as we witnessed in the 2002 to

2006 period when Fed rates went from 1.25% to 5.25%. Fortunately, there is a simple solution, a 0.1% solution, if you will. There is nothing magic about 0.25%. Twenty-five basis points became the minimum increment in an era of much higher interest rates than currently. Although small on an absolute basis, twenty-five basis points is enormous in relative terms given the current zero interest policy (ZIRP). By raising rates a mere ten basis points the Fed, in a single stroke, would be indicating that the economy is strong enough to begin the long process of interest rate “normalization” while at the same time indicating that the process will be minimal, gradual and very long, indeed. As the great detective was fond of saying, “When you eliminate the impossible, whatever remains, no matter how improbable, is true.” Well, for years now, the Fed has found it impossible to escape the box into which it has put itself by raising rates the standard twenty five bps. Start with ten basis points, then.

It’s elementary, my dear Yellen.

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