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HAWK Talon

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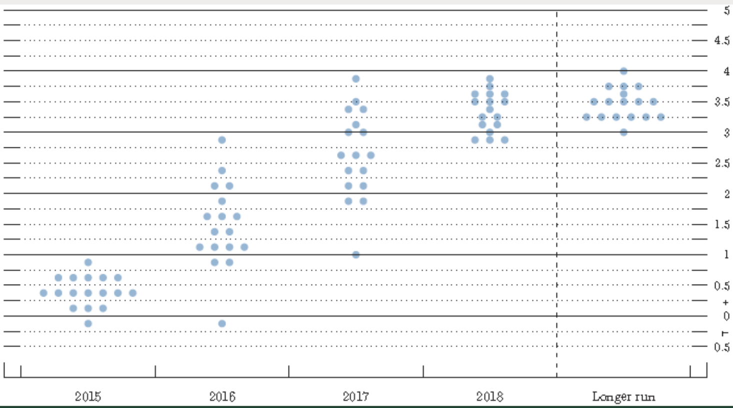
To #DIV/0! And Beyond!

In the original Pixar blockbuster, *Toy Story*, Buzz Lightyear famously boasts limitless capability "to infinity and beyond." Learning his limits bruises Buzz's ego. The Federal Reserve's Federal Open Markets Committee (FOMC) may continue to boast zero-rates to infinity or test whether egos can bear a pragmatic rate hike.

The FOMC sets the fed funds rate at which member banks lend among each other. Investors are eager to see what the FOMC unwraps at about 2:15 PM ET December 16 when the next FOMC meeting ends. Futures market prices indicate expectations are that the FOMC will hike the fed funds rate to 0.25%. Any rate change will significantly deviate from the near zero rate policy held since December 2008.

The FOMC lately hints at rate hikes. We show what FOMC members' say about appropriate amounts and timing of fed funds rate changes. Most would raise rates now; none would keep zero rates after 2015; most would set rates above 1% in 2016; yet one member suggests a negative rate.



Range of FOMC members' judgment for appropriate rate target.
Source Federal Reserve.

The meaning of #DIV/0!. Users of Microsoft's Excel spreadsheet program recognize #DIV/0! as the result when a formula divides a value by zero. Excel is not intended for such calculus so it returns an error. Investment analysts widely use Excel to analyze data and formulate expected values. Since December 2008, some models that have previously served as valuation bedrock return #DIV/0! in place of relevant information. Analysts must work around the error to make investment decisions.

Even the most amateur investor knows to expect (i.e., require) higher rates or return when assuming higher investment risk. At the core, investment models assume an investment with no risk. Analysts estimate what return to expect from that risk-free investment then build incremental expected return for taking incremental risks (e.g., inflation, business). Building from zero reduces precision for estimates of risk factors and can overstate the comparative attractiveness of any asset that provides any return.

Does #DIV/0! Equal infinity. Financial asset prices have reached record highs during seven years of zero rates. Absent traditional valuation techniques, investors reasonably disagree about whether markets are over, under, or near fair value. Markets can continue rising if based upon firming economic conditions. On the other hand, even the ardently bullish must admit their fortune rests largely on FOMC accommodation. All are uncertain what lies beyond zero while the Fed divests $4.5 trillion.

Millennial investors who came of age with Buzz Lightyear may find their own egos bruised when they learn that the Fed is not boundless and rates are not infinitely zero. Investors should watch the response as closely as they follow the FOMC.

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