**China’s Central Bank Cuts Interest Rates**

PBOC lowers benchmark rates for second time in four months

The People’s Bank of China cut its benchmark interest rates for the second time in fourth months. The move is effective March 1. 

By

**LINGLING WEI**

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BEIJING—China’s central bank cut interest rates for the second time in less than four months, in a fresh sign that the country’s leadership is becoming more aggressive in trying to arrest flagging economic growth.

The rate cut by the People’s Bank of China, announced Saturday, came sooner than some analysts and investors had expected and reflects growing worries over the world’s second-largest economy as it struggles with an array of ills: a slumping property market, more money being sent offshore and growing risks of falling prices that, in effect, are pushing up borrowing costs for businesses.

“Deflationary risk and the property market slowdown are two main reasons for the rate cut this time,” said a central bank official in an interview late Saturday.

The cut, effective Sunday, lowers by a quarter percentage point both the benchmark one-year loan rate, to 5.35%, and the one-year deposit rate, to 2.5%. In a statement accompanying the rate-cut announcement, the central bank singled out rising deflationary pressure as a trigger for the move, saying that plunging commodity prices world-wide “provided room” to spur growth by lowering interest rates.

The latest easing step followed a rate cut in November—the first such move in two years—and an across-the-board measure lowering the amount of money banks need to hold in reserve, thereby freeing up more funds for lending. Economists and officials said it shows that the Chinese leadership is increasingly shifting toward using big-bang measures to support growth, which has been decelerating in recent years and last year slipped to 7.4%, its slowest pace in nearly a quarter century.

“There’s a sense of urgency,” said Jianguang Shen, China economist at Mizuho Securities.

China’s political elite gather in Beijing this coming week for the opening of the national legislature’s session, during which the government will introduce broad policy goals for the year and, many economists expect, set a lower growth target of 7%.

“Hitting their expected growth target of 7% this year will be a challenge,” said Mr. Shen.

A sharper slowdown could force the government to further open the credit spigot and increase big-ticket infrastructure spending, the economists and officials said. Such moves, however, entail risks, potentially adding to already high debt levels among companies and local governments and stalling plans to deleverage, reduce industrial overcapacity and force greater efficiencies on state companies.

For much of last year while the economy skittered, the central bank, under its longtime governor, [Zhou Xiaochuan](http://topics.wsj.com/person/X/Zhou-Xiaochuan/7167), insisted on targeted efforts rather than broader moves like rate cuts out of concern that broadly easing credit would worsen debt problems. But increasingly, as a personnel shuffling is sweeping through the central bank’s senior ranks, the central bank is acceding to demands from the Chinese leadership to reduce financing costs for businesses, according to officials and advisers to the bank.

Hu Xiaolian, a deputy governor and a protégé of Mr. Zhou, recently left the central bank to head the Export-Import Bank of China. Jin Qi, a senior assistant to Mr. Zhou, meanwhile, has also left to manage a newly formed $40 billion government-run infrastructure fund, called the Silk Road Fund.

Mr. Zhou himself is also expected to step down soon, according to officials at the central bank. At 67, he’s already passed the retirement age of 65 for senior Chinese officials. The Wall Street Journal [reported in late September](http://www.wsj.com/articles/china-considers-replacing-central-bank-head-party-officials-say-1411566509)that Chinese leaders were discussing replacing Mr. Zhou amid disagreements over the direction of financial policy.

The recent slew of easing measures is “a clear reversal of what Zhou has long insisted on,” the central bank official said.

The move also highlights concerns that earlier measures, particularly November’s rate reduction, mainly helped heavily indebted industries and fed a run-up in the stock market while failing to help small businesses and lift demand and consumption.

“The direct beneficiary of an interest-rate cut would be property developers and others with a heavy debt burden, such as local governments,” said Peng Junming, a former central-bank official who now runs an investment firm in Beijing, Junfan Investment Co. “Credit would remain very difficult to come by for small and private businesses even after the rate cut.”

China’s real-estate market—which together with its associated industries like construction and furniture, contributes about a quarter of the country’s GDP--has been in the doldrums for more than two years.

Prices of new homes fell in February compared with the month before, reversing gains recorded in January as demand for homes decline during the Lunar New Year holiday. On an annual basis, average new-home prices fell 3.8% in February, a steeper decline compared with the 3.1% fall in January and the 2.7% drop in December, according to data provider China Real Estate Index System.

The property-market’s troubles are in part due to a housing glut fed by developers taking on too much debt, and many developers are finding it hard to raise funds to complete projects. In Guangrao, a dusty industrial town in eastern Shandong province, a big housing project near a newly-developed industrial park sits abandoned after banks cut off its funding. “We’re trying to get the government involved to get our money back,” said Guo Xiang, a business owner in Guangrao who prepaid for an apartment in the half-built complex, which is ringed by empty roads.

The question now is whether Chinese consumers and companies will take advantage of the latest rate cut or hold fast amid further signs of slowing growth. Many economists and businesses have said that the weak economy—rather than financing—appears to be the biggest challenge. In a survey of 2,006 industrial firms, more than a third reported that supply exceeded demand for their products domestically and internationally during the fourth quarter while only 4% said they obtained new loans.

“As weak demand is the key problem injecting liquidity through loosening monetary policy cannot revive the industrial economy,” said the survey, which was released in February and conducted by Gan Jie, an economist with the Cheung Kong Graduate School of Business in Hong Kong and Beijing.

Several indicators from January including factory production and activity in the services sector suggested that the weakness is continuing. Capital outflows are also increasing, which is squeezing the amount of liquidity in the country’s financial system.

Meanwhile, deflation is looming. Prices at the factory gate have fallen for about three years due to dropping commodity prices and persistent overcapacity problems in a wide range of industries including steel, cement and glass. Consumer prices, at the same time, rose at the slowest pace in more than five years in January.

China is dangerously close to “slipping into deflation,” a newspaper owned by the central bank, Financial News, warned last week.

—Mark Magnier, Liyan Qi and Grace Zhu contributed to this article.

**Fed Up: How Will Rising Interest Rates Affect Stocks?**

By

**JASON ZWEIG**

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Don’t worry about the Fed; be happy.

That is the message from analysts and market strategists. The Federal Reserve signaled this past week that it is unlikely to raise short-term interest rates until at least June. And that rise, when it comes, will be a good thing, investment professionals are saying, since the Fed will raise interest rates only when it is confident that the economic recovery is robust and companies have regained the ability to raise prices.

Furthermore, investment firms point out, stocks have done well in past periods of rising interest rates, gaining an average of up to 8% or 10% annually, depending on the measurement period and how Fed policy is defined. The highest returns have tended to occur when rates have risen gradually from low levels during periods of negligible inflation, much like conditions today.

Perhaps all this helps explain why investors seemed mildly disappointed when the Fed reiterated on Wednesday that it would remain “patient.” Some people seem to want to get the waiting over with so the period of rising interest rates—and presumably even higher returns—can begin.

Not so fast, say Robert Johnson, Gerald Jensen and Luis Garcia-Feijoo, authors of a new book, “Invest With the Fed,” to be published in March by McGraw Hill.

Comparing the returns of U.S. stocks against a wide range of other financial assets and analyzing the Fed’s actions on interest rates back to 1966, the three researchers find that stocks typically aren’t devastated when rates rise. But on average, they show, U.S. stocks barely keep pace with inflation during periods of tightening Fed policy—and, surprisingly, Treasury bonds outperform stocks during such periods.

Mr. Johnson is president of the American College of Financial Services in Bryn Mawr, Pa., which trains banking, insurance and investment professionals; Mr. Jensen is a professor of finance at Northern Illinois University in DeKalb, Ill.; and Mr. Garcia-Feijoo is a finance professor at Florida Atlantic University in Davie, Fla.

The researchers characterized periods as “expansive” (when the Fed lowers both the discount rate and the federal-funds rate, two of the tools it uses to set monetary policy), “indeterminate” (when both of those rates aren’t moving in unison) or “restrictive” (when the Fed raises both). Each of those three conditions accounts for about a third of all the months between January 1966 through December 2013, so there is plenty of data to compare.

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Over that full history, after inflation, the S&P 500 returned an annual average of 6%, including dividends.

In expansive periods, when the Fed was cutting rates, stocks did even better, gaining 12% annually.

During indeterminate periods, when the Fed was on the monetary fence, stocks returned an annual average of 7%.

But in restrictive periods, when the Fed was raising rates, stocks generated an annual average of only 0.8%.

Meanwhile, the researchers found, cash and 10-year Treasury notes returned an annual average of 0.9% and 3%, respectively, over the full period from 1966 through 2013. But when the Fed was raising rates, cash returned an annual average of 0.5% and bonds 1%. (All of the above returns are approximated after inflation.)

“It’s not so much that bonds do well as that stocks do poorly,” Mr. Jensen says. During past periods of rising rates, he explains, many investors have fled the greater uncertainty of stocks for the relative safety of Treasurys—causing bonds to perform less badly than stocks. Most investors, trained to believe that rising rates are bad for bonds, expect the opposite. Cash also tends to do relatively well while interest rates are going up.

Although bonds usually beat stocks when rates rise, they haven’t always. The most extreme exception: the period from 1979 through 1982, when then-Fed Chairman Paul Volcker was increasing rates to snuff out inflation. Stocks outperformed bonds by a wide margin during that time.

Of course, financial history never repeats itself exactly, although it does rhyme. And the Fed’s monetary policy is just one of a multitude of factors that influence the stock market, so you would be foolish to base your investment decisions on that alone—especially because the central bank’s predictions of what it will do don’t always come to pass.

In December 1993, for example, the Fed’s monetary committee said a rise in rates had become more likely “at some point but not necessarily in the very near term.”

Only 45 days later, in response to surprisingly rapid economic growth, the Fed began jacking up rates. In 1994, stocks gained 1.3%, cash returned 4%, and 10-year Treasurys lost 8%.

Considering that U.S. stocks aren’t far below their all-time peak prices and are selling for a historically high multiple of profits, the past effects of rising rates are another reason for investors to be cautious. Differences in future returns depend mainly on how cheap stocks are in the present. So a rise in interest rates, if it took stocks down a peg, could be welcome for long-term investors.

“None of this means you should bail out of the stock market,” Mr. Johnson says. “But people should condition their expectations and temper their enthusiasm.”

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Beware of Investing Based on Rising Interest Rates

**RICK FERRI:** Short-term interest rates are low relative to historic norms. One-month Treasury bills have historically yielded about 0.3% over inflation prior to the financial crisis. This would put the T-bill at a 2% yield rather than where it sits at about 0.01%. The Federal Reserve has been keeping short-term interest rates well below inflation since 2008 to stimulate the economy. This policy of “financial repression” helped drive the economy forward.

2015 will likely be the year when short-term interest rates begin to rise toward a positive inflation-adjusted return. Recently published [**economic projections**](http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20141217.pdf) by Federal Reserve Board members and Federal Reserve Bank presidents show the median expected mid-point for federal funds rates rising from 0.125% to 1.0% during 2015, increasing again to 2.5% in 2016, and finally to 3.5% in 2017. These are projections and not certain to occur.

Many investors have been incorrectly predicting the rise in short-term interest rates for several years and have kept their fixed-income investments short term. They feared a rise in rates would harm the value of their portfolios if they held intermediate- and long-term bonds or bond funds. However, interest rates have not moved higher, and investors who avoided all but short-term bonds have missed out on higher interest payments. The opportunity cost of not investing in intermediate-term bonds has hurt investors who bet early on rising rates.

Given the Fed’s projections, is now the time to go short term? I’m not optimistic that this is the time. First, there’s no guarantee the economy will continue to perform at a rate that warrants higher interest rates. Second, even if short-term rates do rise there’s no guarantee that intermediate- and long-term rates will also rise.

As of Dec. 29, 2014, the [**yield curve**](http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield) is steep. There’s a 1.71% yield difference between one-month T-bills (0.01% recent yield) and the benchmark five-year Treasury note (1.72% recent yield). This spread grows to 2.21% when T-bills are measured against the benchmark 10-year Treasury note. These spreads are high historically. An argument can be made that rising short-term rates are already priced into intermediate- and long-term bond prices.

Bond investment decisions shouldn’t be based on the expectation of interest rates. They should be matched to one’s need. Short-term bonds make sense for cash needed over the next couple years and for an emergency fund. Longer-term bonds are best suited for investments meant to meet longer-term liabilities such as retirement accounts. Investors in retirement may wish to have a mix of both short- and intermediate-term bonds and bond funds.

Rick Ferri is founder of [Portfolio Solutions](http://www.portfoliosolutions.com/) LLC and the author of books on low-cost index fund and ETF investing.

**Fed Flags Midyear Rate Hike—Or Later**

Central Bank Faces Confounding Landscape of Solid Domestic Economy but Troubles Abroad

The Federal Reserve voted unanimously to keep interest rates intact until at least the summer. WSJ's John Hilsenrath has analysis. Photo: AP.

By

**JON HILSENRATH**

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The Federal Reserve signaled it would keep short-term interest rates near zero at least until midyear, while also setting the stage for tough decisions in the coming weeks about whether it should wait even longer.

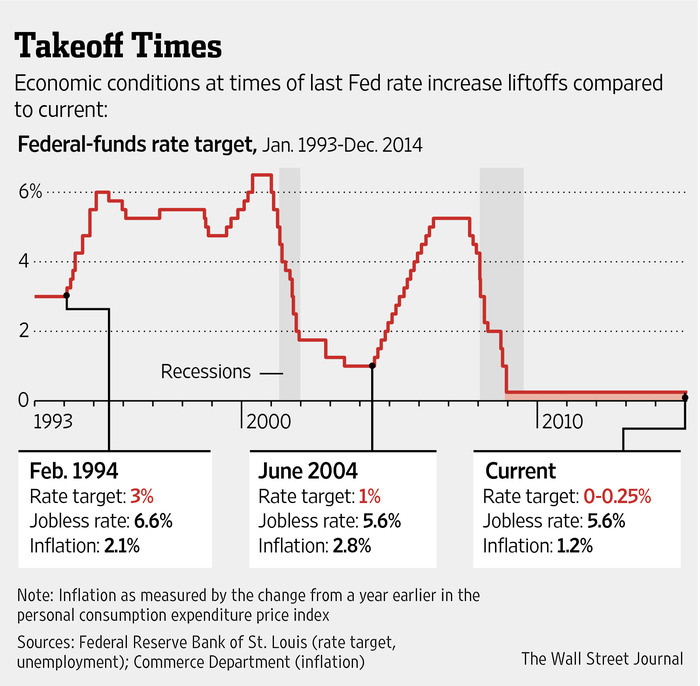
Economic activity is expanding at a “solid pace” and job gains are strong, the Fed said in its statement Wednesday, providing a relatively upbeat assessment of current U.S. growth and labor-market conditions. At the same time, however, the central bank hinted at wariness about low inflation, slow global growth, a stronger U.S. dollar and international market turbulence.

The Fed “is in a wait-and-see mode,” said Michael Gapen, chief U.S. economist at Barclays Capital and a former researcher in the central bank’s monetary-affairs division.

Investors are now focused on whether the Fed will move at a time when other central banks around the world are moving to lower their own interest rates and weaken their currencies to combat soft growth and inflation.

Initially, investors reacted mildly to the Fed statement, but later in the day markets fell. Currency traders saw the statement as affirmation that the central bank would increase rates this year and sent the dollar higher against the euro. That accelerated a fall in crude-oil prices, which dropped to a near-six-year low. In turn, energy stocks and major stock indexes tumbled, with the Dow Jones Industrial Average ending the day down 195.84 points, or 1.13%, at 17191.37.

The Fed “judges that it can be patient in beginning to normalize the stance of monetary policy,” officials said, in the key phrase of the statement. The central bank has held its benchmark short-term rate near zero since December 2008 in an effort to bolster borrowing, spending, investing and hiring.



Fed Chairwoman [Janet Yellen](http://topics.wsj.com/person/Y/Janet-Yellen/5513)said in December that the reference to being patient means the central bank isn’t likely to raise rates at its next two policy meetings. By including it Wednesday, the Fed effectively took a rate increase off the table for its March and April meetings, but remained open to moving at the June 16-17 meeting.

Yet this week’s meeting put the U.S. central bank on a course for a tougher debate at its March 17-18 policy gathering. Officials at that time will update their forecasts for economic output, inflation, unemployment and interest rates. They also need to decide whether to formally open the door to rate increases in June by removing or altering the patience language.

Ms. Yellen won approval of the statement in a 10-0 vote after facing three dissents at a December meeting that pointed toward rate increases this year. The newfound unanimity could partly reflect the change in the membership of the rate-setting Federal Open Market Committee, which votes on the statement, due to the annual rotation of district bank presidents on the panel. All three dissenters in December aren’t voters this year.

Whether June remains a possibility for a rate increase will depend on how the economy and financial markets behave in the weeks and months ahead. The Fed on Wednesday described economic growth as “solid,” which in the dry parlance of central bankers is a notably more enthusiastic assessment than in December when it described the pace as “moderate.” The central bank hasn’t described economic activity as “solid” since October 2007, right near the end of the last U.S. economic expansion.

Economic output, as measured by gross domestic product, rose at a robust annual rate in excess of 4.5% in the second and third quarters last year and many economists estimate it increased at around a 3% rate in the final three months of the year. The Commerce Department will release new estimates for GDP growth on Friday. Moreover, the Fed noted “strong job gains” and a lower unemployment rate, which reached 5.6% in December, as positive economic signs.

“It is pretty clear they are impressed” with the economy’s performance, said Peter Hooper, chief U.S. economist at Deutsche Bank.

As the jobless rate comes down, Fed officials are expecting wage and inflation pressures to slowly build and they see themselves raising rates in anticipation of those developments.

Right now, however, inflation is going in the other direction, thanks in part to oil prices that have fallen by nearly 60% since June, something that has seriously complicated the Fed’s rate decision.

“Inflation is expected to decline further in the near-term,” before gradually moving back toward its 2% target in the medium-run, the Fed said.

Consumer prices were up 1.2% in November from a year earlier, according to the Fed’s preferred measure of inflation, below its target for the 31st straight month.

For now the oil-price drop is boosting household purchasing power—something that helps explain the robust growth of late. Officials expect inflation to stabilize later this year and move back to 2% in the next couple of years. However, they are on watch for signs that households, businesses or investors expect inflation to stay down beyond the latest gas-price-drop windfall. If expectations of below-2% inflation become embedded in public sentiment, the Fed fears, it might be harder to keep consumer-price gains on target in the long run.

It’s one scenario that could convince officials that they should wait before raising rates.

The policy statement acknowledged officials are seeing confounding signals on this front. The central bank noted market-based measures of expected inflation have “declined substantially in recent months,” a reference to falling yields on U.S. Treasury securities.

For now the Fed appears unlikely to be alarmed about this development because public surveys of expected inflation, such as the University of Michigan’s monthly survey of households, suggest long-run expectations “have remained stable.”

In another subtle note of caution, the Fed said it would be watching “international developments” as it considers its next step. Officials recently had avoided pointing to myriad pressures overseas—including an economic slowdown in China, financial instability in Greece or the European Central Bank’s launch of a new bond-buying stimulus program—that weigh on the U.S. outlook.

Most notably, those developments are putting upward pressure on the dollar, which is in turn weighing on U.S. inflation and could curb U.S. exports.

Many other global central banks are easing monetary conditions to combat their own problems with low inflation and slow growth. The latest example Wednesday was the Monetary Authority of Singapore, which sought to weaken its currency Wednesday to support its competitiveness with other Asian economies.The divergence between the Fed and other central banks could unsettle markets and further complicates the U.S. central bank’s calculus.

“Markets are really looking at a stronger dollar and having a hard time seeing the Fed being ready to go in June,” Mr. Gapen said.