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The US Federal Reserve is riding a tiger by raising interest rates

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The Yellen Fed has a near impossible task extricating the world from years of zero rates and QE

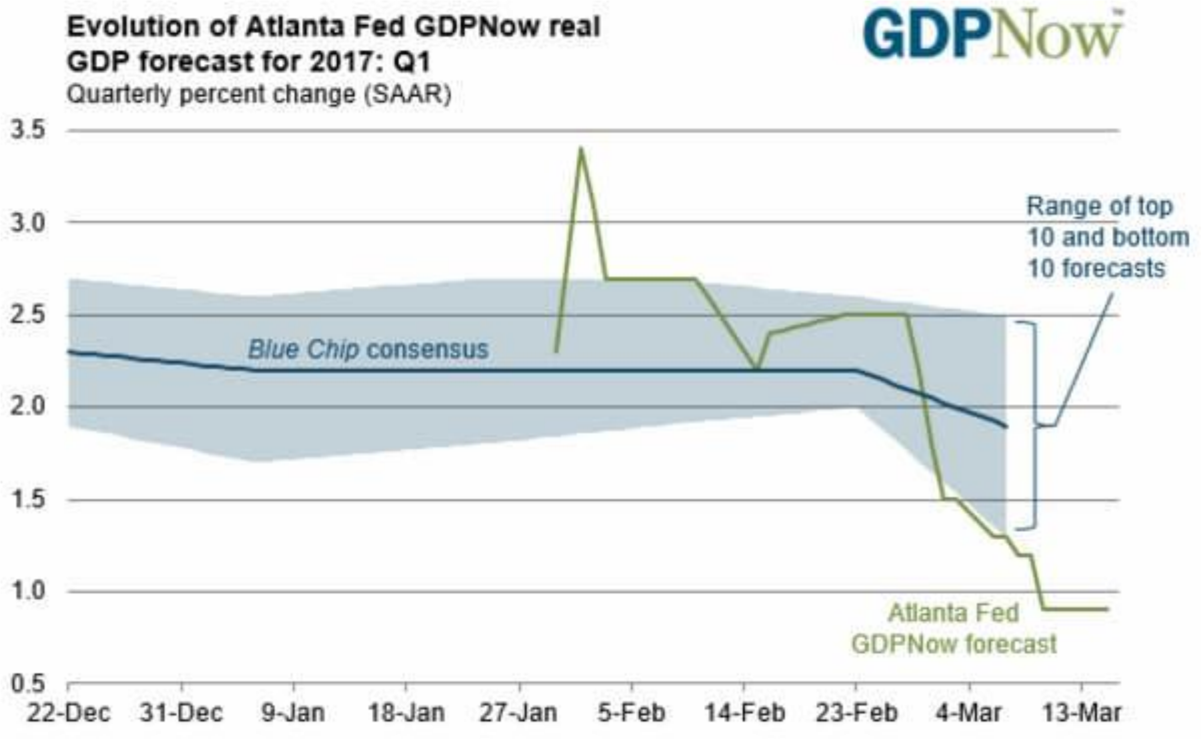
On three separate occasions since 2013 the US Federal Reserve sent shock waves through the global financial system when it tried to tighten monetary policy, and each time it was forced into partial retreat to halt the mayhem.

The Fed has since come to terms with its unwelcome role as the world's central bank, a monetary superpower that cannot set liquidity conditions for the US alone. The international blow-back into the US economy from any mistake is instant and brutal.

Over recent months the Federal Open Market Committee has been careful to take the global pulse before acting. It now hopes the coast is clear. Today's quarter point rise in the federal funds rate to 1pc has been so loudly signalled in advance that investors have already adjusted.

Emerging markets seem better prepared, so far able to shrug it off. China has restored confidence in its exchange rate regime. Capital flight appears to be under control. Europe's shift towards bond tapering reduces the risk of a rocketing dollar. "We're not overly worried about downside shocks," said Janet Yellen, the Fed chairman.

Yet nobody really knows whether the world can handle a total of six rate rises over the course of 2017 and 2018 as sketched in the Fed's 'dot plots' scenario.



The Atlanta Fed's instant GDP tracker for the US is not looking healthy CREDIT: ATLANTA FED

"Our highly levered financial system is like a truckload of nitroglycerin on a bumpy road. Don't be allured by the Trump mirage of 3pc to 4pc growth and the magical benefits of tax cuts and deregulation," says bond guru Bill Gross from Janus. This is a year to hold onto your money, he tells clients, not to seek a return on money.

On the face of it, a 1pc rate is risibly low a full eight years into the economic expansion. It is deeply negative in real terms. Savings are being whittled away.

But we are not dealing with normal circumstances. The Atlanta Fed's Wu-Xia 'shadow rate' suggests that the combined tightening so far this cycle is equivalent to thirteen rate rises, once you include the withdrawal of stimulus from quantitative easing and dovish forward guidance. If so, we may be near the end-game.

The Wu-Xia model and others like it show a relentless fall in the natural rate of interest over the decades. Each peak and each trough is lower. It is the deflationary consequence of a deformed world of over-capacity (China), under-consumption (Europe), excess savings (inequality), and lack of demand.

Former US treasury secretary Larry Summers thinks the natural rate has dropped to minus 3pc in his grim vision of secular stagnation. Is he wrong? Have we put this episode behind us at last? We don't know.

Mrs Yellen said tonight that the long-term neutral rate has dropped to 1pc in real terms but could be zero at the moment as the economy battles the lingering headwinds of the financial crisis. "It reflects slowing population and productivity growth," she said.

What we do know is that the post-War world has never been so leveraged to the dollar or so sensitive to US borrowing costs. Offshore dollar debt in US currency has risen fivefold to $10 trillion since 2002.

This is the fruit of globalisation and the Fed's own policies of zero rates and QE, which unleashed a flood of cheap and irresistible dollar liquidity into emerging markets and lured them into the West's debt experiment. This Faustian Pact has closed in on the Fed. The institution cannot easily extract itself.

When the Lehman crisis hit, China and emerging markets were able to buffer the global economy. Today they too face varying degrees of credit exhaustion. Debt-to-GDP ratios have risen by 41 percentage points in the developing countries since 2008, and risen by 33 points in the rich countries.

This leverage is an accident waiting to happen. Analysis from Bank for International Settlements suggests that the potential trigger is a strong dollar, which automatically causes a contraction of bank balance sheets through the structure of hedging contracts. The Fed must move with extreme care.

What is striking about this rate rise is that the US economy itself appears to be slowing already. If you are bearish, you can find plenty of warning signals. Commercial bank loans have contracted over the last three months. The Atlanta Fed's instant GDP tracker has abruptly dropped to an annual growth rate of 0.9pc for the first quarter. "GDP is a pretty noisy indicator," said a slightly nettled Mrs Yellen when taxed on this point.

The broad M3 money supply has been trending down steadily to a 55-month low and is starting to flag late-cycle fragility. The inventory-to-sales ratio for cars has reached 3.0, a level rarely seen over the last twenty years. "The last thing they should be doing is thinking about rate hikes," said Patrick Perret-Green from AD Macro.

Simon Ward from Henderson Global Investors say his gauge of the US money supply - six month real narrow money - has dropped to near zero. This would normally portend a marked slowdown over the late summer.

The same indicator for the biggest G7 rich countries and E7 emerging economies together peaked last August and has since been falling briskly.

These may prove to be temporary setbacks. Bulls point to surging capital investment, evidence that companies are picking up the baton of economic growth after sitting on their hands for so long.

Yet the FOMC's new zeal is slightly odd and this is being picked up by falling yields on US Treasuries. Krishna Guha from Evercore ISI says that for the first time in years the Fed is not being forced into action by market pressure or its own past rhetoric. This is a "discretionary move", a sign that the FOMC has the bit between its teeth and is determined to drive real rates back to zero in short order.

It is another way of saying that the Fed fears falling behind the curve on inflation and having to slam on the brakes later. Hawks say interest rates should already be 3.9pc under the Taylor Rule.

Whether there really is any such price pressure is less obvious than it looks. Headline inflation has certainly spiked but that is a one-off effect of past rises in oil costs. Crude has fallen back to December levels. The commodity rebound may already have stalled. From now on stealth tightening by the Chinese central bank will take its toll.

Core PCE inflation in the US has ticked up slightly to 1.7pc but it is hardly on fire. Much the same is true in Europe and across the world. The US jobs figures and consumer confidence are healthy, but these are lagging indicators.

Just as pertinent is the decline in US real wages in both January and February. If there really is inflation in the US, it is stagflation. That is not a pretty prospect for equity markets betting on a coming economic boom. The Shiller CAPE price earnings ratio on Wall Street is 28.66, higher than at any time in 130 years other than the extreme peaks of 1929 and 2000.

“The market is way over-priced,” said the creator of the index, Nobel laureate Robert Shiller. It is discounting fiscal stimulus and radical tax reform by the Trump administration before a deal is close, and the outcome will be thinner gruel than first supposed if it happens.

One almost wonders whether the Fed is really raising rates to check or even puncture the asset boom, out of moralistic urges, just as it did from 1928 to 1929 after the US economy had already begun to slow. The institution certainly succeeded in pricking that bubble.

For now the markets think they have been given a reprieve. The dot plots could have been worse. Wall Street is soaring again. Such are the Pavlovian reflexes.