

Time for a Rate Hike

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According to the futures market, there is a 38% chance the Federal Reserve raises rates when it meets in mid-March. If the Fed were to stand by what it has said the past several years, the odds should be much higher. But the market is used to the Fed finding reasons to put off justified rate hikes.

The Fed has consistently said it wants to see the inflation measure for Personal Consumption Expenditures (also called the PCE deflator) at 2%. We won't get an official PCE number for January until the middle of next week, but based on January's 0.6% increase in the consumer price index (CPI), it looks like the PCE index will be up 0.4% in January and 1.9% compared to a year ago. And if that's not close enough, all we need in February is a mere 0.1% monthly increase and the PCE will be over the 2% mark.

Meanwhile, the jobless rate is already 4.8%, exactly the level the consensus at the Fed thinks is the long-run average when the economy is neither "too hot" nor "too cold."

And yet the Fed's short-term interest rate target remains in a range between 0.5% and 0.75%. That's simply too low. Under normal conditions the Fed's target for short-term rates should be a little lower than the trend growth in nominal GDP – real GDP plus inflation. But in the past year nominal GDP is up 3.5% and it's up at a 3.2% annual rate in the past two years.

A gap that large between the trend growth in nominal GDP and short-term rates means there is excess liquidity in the financial system and monetary policy is too loose. No wonder inflation has been heading up and the jobless rate continues to trend down.

Moreover, the yield curve remains unusually steep, with about 180 basis points separating the yield on the 10-year Treasury Note from the Fed's short-term interest rate target, versus an average of 106 basis points since the mid-1950s. The bond market has been holding the 10-year to 30-year spread tight, because it believes long-run inflation will be contained, but clearly the market is pricing in higher short-term interest rates.

The signposts for higher inflation are already in place. In January, the M2 measure of money, which includes currency, checking deposits, savings deposits, small CDs, and retail money funds was up 6.7% from a year ago. By contrast, it was up only 6.2% in the year ending in January 2016 and 6.0% in the year ending in 2015. Wage growth has accelerated as well, with average hourly earnings up at a 2.5% annual rate in the past two years, the fastest since the recession ended.

One argument for waiting past March is that the Fed needs a chance to see what kinds of budget proposals – taxes and spending – are likely later this year. But we highly doubt anything President Trump and Congress come up with will be viewed by the Fed as "contractionary." Instead, they're going to push proposals the Fed views through its Keynesian lenses as "stimulative."

So why wait? Raising rates in March doesn't pre-commit the Fed to raise rates more than three times this year. If circumstances change, there's plenty of time for the Fed to change its mind and skip a rate hike in June, or September, or December.

In addition, raising rates sooner rather than later, gets the Fed closer to dealing with the elephant in the room - its balance sheet. Quantitative Easing has pushed assets on the Fed's books to more than \$4.4 trillion, with over \$350 billion in repos and nearly \$2 trillion in excess reserves.

So far, sluggish monetary velocity, including tight regulation of the banking system, has kept a relatively tight lid on the inflationary impact of those reserves. But, now that the animal spirits are stirring and less burdensome financial regulations are on the way, those reserves pose an increasing inflationary risk.

Fed Chief Yellen's recent congressional testimony left the door open for a rate hike in March. The economy and markets are ready for the Fed to cross the threshold.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|-----------------|---------------------------------|-----------|------------------|--------|-----------|
| 2-22 / 9:00 am | Existing Home Sales – Jan | 5.550 Mil | 5.590 Mil | | 5.490 Mil |
| 2-23 / 7:30 am | Initial Claims – Feb 18 | 240K | 243K | | 239K |
| 2-24 / 9:00 am | New Home Sales – Jan | 0.574 Mil | 0.576 Mil | | 0.536 Mil |
| 9:00 am | U. Mich Consumer Sentiment- Feb | 96.0 | 96.0 | | 95.7 |