First Trust
ECONOMIC RESEARCH REPORT
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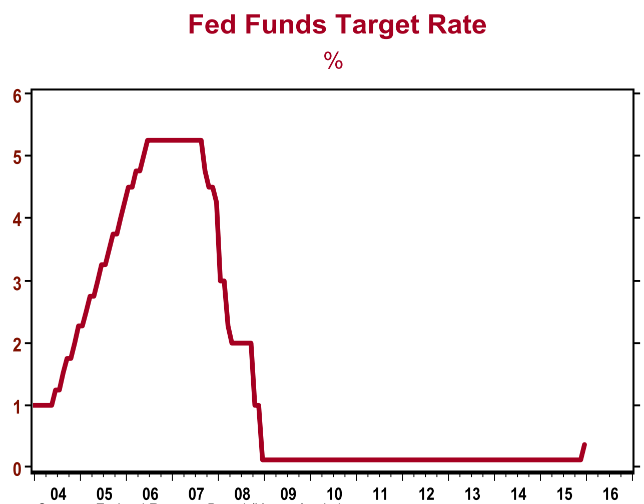
The Fed Launches Rate Hikes

One small step for the Fed, one giant leap for the US economy.

At long last, after seven years of near zero percent short-term interest rates, the Federal Reserve unanimously decided to raise rates by 0.25 percentage points, the first rate hike since 2006. The new range for the federal funds rate is 0.25% to 0.5%, 25 basis points above the prior range.

Meanwhile, the Fed will lift the interest it pays banks to hold reserves to 0.50% from a prior 0.25%. In addition, the Fed will offer reverse repos at 0.25% to help drain reserves from the financial system so they can keep the funds rate at or above 0.25%. Another change was lifting the discount rate to 1.00% from 0.75%.

Although some analysts and commentators are saying the overall Fed statement was "dovish" – perhaps the price Fed Chief Yellen had to pay to get a unanimous policy decision – we don't read the Fed's statement as dovish. On net, if anything, it was mildly hawkish.



Source: Federal Reserve Board /Haver Analytics

The Fed improved its assessment of the labor market, noting "ongoing job gains," "declining unemployment," and wrote that underutilization of workers has "diminished appreciably." It also noted that even after today's rate hike "monetary policy remains accommodative" and that risks to the outlook are "balanced" versus "nearly balanced" in prior statements.

These assertions are hawkish and fully offset some dovish comments elsewhere, including a reference to an edge down in survey-based measures of inflation expectations as well as multiple references to future rate hikes being "gradual."

Ultimately, what matters the most in today's decision for projecting future rate hikes is the "dot plot" from the Fed and that is very close to what the Fed showed three months ago, with the median decision-maker projecting four 25 bp rate hikes next year and another four in 2017. This is completely consistent with economic projections that are very little changed from three months ago and the Fed continuing to assert that policy will be dependent on the data.

Even with today's rate hike and a median projection of four more in 2016, the Fed says the labor market will continue to strengthen and the unemployment rate will hover for multiple years below 4.9%, which is what the Fed thinks is the long-term norm.

At present, the federal funds futures market anticipates only two rate hikes next year. We think rate hikes are much more likely to come in as the Fed now projects, with the Fed raising rates at every other meeting in 2016 (once per calendar quarter). In turn, this means interest rates across the yield curve should rise a bit faster and further than the market now expects.

One open question is when the Fed will start to renormalize the size of its balance sheet, by not fully rolling over principal payments into new security purchases. Today it said it won't do that until normalization of the federal funds rate is "well under way," which probably means not until the start of 2017.

It is long past time for the Federal Reserve to have started raising rates. The unemployment rate is already very close to the Fed's long-term projection of 4.9% and nominal GDP growth – real GDP growth plus inflation – is up at a 3.9% annual rate in the past two years.

Today's rate hike isn't going to hurt the economy; it will help the economy by signaling the eventual end to a policy that has distorted economic decisions for the past several years.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in October suggests that economic activity has been expanding at a moderate pace. Household spending and business fixed investment have been increasing at solid rates in recent months, and the housing sector has improved further; however, net exports have been soft. A range of recent labor market indicators, including ongoing job gains and declining unemployment, shows further improvement and *confirms that underutilization of labor resources has diminished appreciably since early this year. Inflation has continued to run below the Committee's 2 percent longer-run objective, partly reflecting declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation remain low; some survey-based measures of longer-term inflation expectations have edged down.*

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen. Overall, taking into account domestic and international developments, the Committee sees the risks to the outlook for both economic activity and the labor market as balanced. Inflation is expected to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further. The Committee continues to monitor inflation developments closely.

The Committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective. Given the economic outlook, and recognizing the time it takes for policy actions to affect future economic outcomes, the Committee decided to raise the target range for the federal funds rate to 1/4 to 1/2 percent. The stance of monetary policy remains accommodative after this increase, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Charles L. Evans; Stanley Fischer; Jeffrey M. Lacker; Dennis P. Lockhart; Jerome H. Powell; Daniel K. Tarullo; and John C. Williams.