



Special Report

December 2016

Federal Reserve Raises Rates in Light of Improving Economic Indicators and Market Optimism for 2017

After an unusually long period of 12 months, the Federal Reserve (Fed) raised the target range for the federal funds rate by 0.25% on Wednesday, December 14. The U.S. central bank established a new target range of 0.50% to 0.75% — up from the 0.25% to 0.50% range set in December 2015. Federal Open Market Committee (FOMC) members noted further progress made toward their dual mandates of price stability and full employment as a catalyst for the increase. The Fed is now comfortable that inflation is trending toward its goal of 2% while the labor market is now closer to full employment.

According to the statement released by the FOMC, job gains have been solid in recent months, and the unemployment rate has declined. In addition, household spending has risen moderately. While inflation remains below the Fed's target of 2%, the members expressed confidence that it will move toward its target in the medium term. The FOMC expects monetary policy to remain accommodative with the fed funds rate increasing gradually and remaining below its long-term level over the next several years.

The rate increase was clearly telegraphed by FOMC members in recent weeks and was reflected in the notable rise in interest rates this quarter. The yield on two-year Treasury notes had risen 40 basis points (0.40%) since September 30 to 1.16% as of the morning of December 14, and the yield on the 10-year Treasury had risen 84 basis points (0.84%) to 2.43%. These rate indicators anticipated not just today's central bank move, but also the chance of additional hikes in 2017.

The immediate reaction of bond and equity markets to the move was somewhat muted. Two-year Treasury yields rose about 10 basis points (0.10%) while U.S. stocks gave up modest pre-announcement gains. The Fed's expected trajectory of future short-term rates was slightly more aggressive than had been anticipated, forecasting three ¼ percent hikes in 2017, and another three in 2018. With the exception of a modest projected improvement in 2017 U.S. gross domestic product (GDP) and unemployment, the Fed's other economic forecasts were relatively unchanged.

In December 2015, when the Fed raised rates for the first time since 2008, it indicated that an additional four hikes could follow in 2016. Investors never fully bought into this outlook, and neither Fed funds futures prices nor the market-implied level of forward interest rates reflected such a hawkish path. Rising levels of global risk, uncertainty due to Britain's "Brexit" vote in June to leave the European Union, and the U.S. presidential election in November — combined with economic data that were mixed for most of 2016 — stayed the Fed's hand in further raising rates for most of the year.

In a significant indication of recent economic improvement, the GDP grew at a rate of 3.2% in the third quarter — the strongest growth in two years and a notable acceleration from the second quarter's pace of just 1.4%.

The U.S. labor market added 180,000 jobs in November, continuing a trend toward two million new jobs this year. In another positive sign, the unemployment rate fell to 4.6% — a new post-recession low. Consumer spending rose 0.3% in October, and the consumer price index (CPI) climbed 0.4% to 1.6% in October (the latest figures available). Nearly every measure of inflation has moved higher this year, including the CPI, producer price index (PPI) and personal consumption expenditures (Core PCE) price index. Oil prices just reached their highs for the year as the oil-producing nations reached an agreement to reduce output. Housing prices have now returned to 2007 levels as measured by the national average, and wages have also shown moderate increases.

The Fed's decision to raise rates on December 14 also likely took account of the increased financial market optimism about President-elect Donald Trump's promises to reduce government regulations, cut taxes and boost infrastructure spending after he takes office on January 20, 2017. U.S. stocks, bond yields and the dollar have all risen since Trump's presidential election victory. However, we would note that the year ahead will offer an unusually high level of uncertainty as it is still unknown what policies the Trump administration will pursue and the ultimate form of those policies.

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