Special Report

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Fed Kicks Off Next Rate Cycle

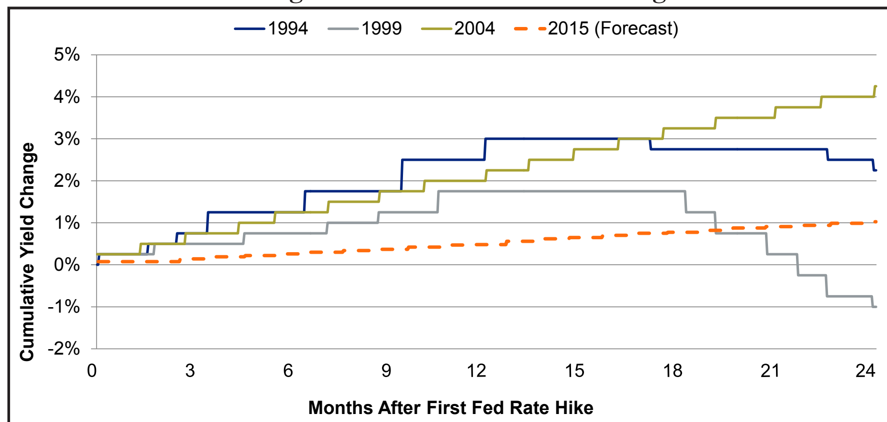
From the Investment Team of PFM Asset Management LLC

Today's action by the Federal Open Market Committee (FOMC) to raise the target federal funds rate for the first time in nine years sets a new course for the financial markets.

As expected, the FOMC established a new target range for the federal funds rate of ¼ to ½ percent, up from 0 to ¼ percent, where it was set exactly seven years ago on December 16, 2008. The Federal Reserve (Fed) also raised the interest rate it pays banks on excess reserves deposited with the Fed ("interest on excess reserves" or "IOER") from ¼ percent to ½ percent.

While the increase in the target federal funds rate by 25 basis points (0.25%) was similar to the first step in each of the last three tightening cycles, those cycles resulted in cumulative increases of 1.75% to 4.25% over the 18 to 24 months following the initial move. Exhibit 1 plots these increases:

Exhibit 1: Fed Funds Target Rate Cumulative Yield Change



Source: Bloomberg; 2015 (Forecast) is composed of Fed Funds Futures contracts.

This time, however, Fed governors have urged investors NOT to look to history for guidance on the pace of tightening or the final resting point for overnight rates. In the past three tightening cycles, the end-point was 3.75% to 5.25%. Most market economists currently forecast a rate of only 1.25% to 1.50% two years from now.

The Fed's decision came after six years of recovery during which U.S. gross domestic product (GDP) grew by an average of 2.2%.

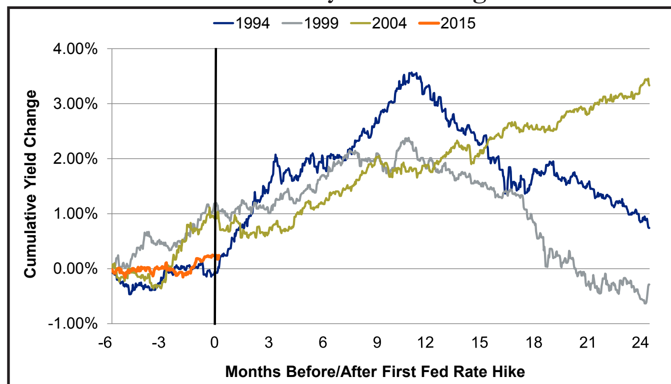
Progress toward achieving the Fed's long-term goals of maximum employment and stable prices guided the decision. While the FOMC does not have a specific definition of maximum employment, the current unemployment rate of 5% — a seven-year low — and average monthly job gains of 235,000 over the past year support the Fed's view that the employment goal has been met substantially.

On the inflation side, the FOMC's long-term goal is for core inflation (which excludes food and energy prices) to rise to 2%. The core inflation rate has under-shot the 2% target, with the most recent reading of the core personal consumption expenditure (PCE) price index up only 1.3% year-over-year. Some economists had urged the Fed to hold off raising rates because of low inflation. However, it is clear that the Fed is not raising rates to combat rising inflation, but as a vote of confidence in the progress that the U.S. economy has made since the Great Recession ended in 2009.

Since the Fed also indicated that the pace of future increases will be gradual, we might expect most of the effects to be focused on short- and intermediate-term rates. Long-maturity bonds and equities will not necessarily be hurt badly by modest tightening. Moreover, a look back at past market reaction reveals that investors anticipate Fed action, with markets adjusting to a Fed move in advance. As the accompanying charts show, rates typically began to rise about six months prior to the first move. In this cycle, the same has been true, with the two-year Treasury note yield rising from a mid-year low of 0.54% in July to a level of 0.99% just before today's announcement.

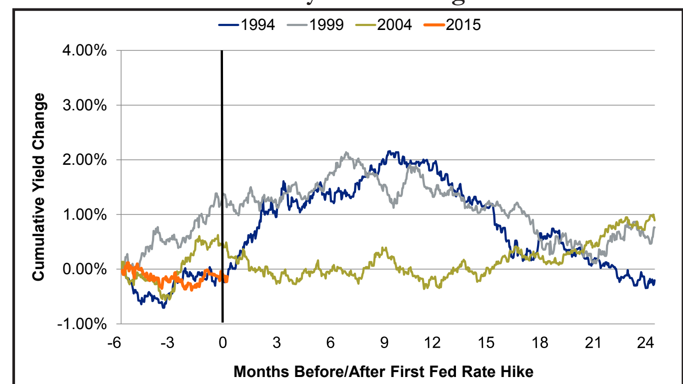
Exhibits 2 and 3 plot rates from six months prior to the beginning of recent tightening cycles, to 24 months after the first tightening. In the six months prior to the first move, two-year Treasuries rose by an average of 54 basis points — although the starting point was much higher than in the current cycle. Ten-year Treasuries rose by an average of only 31 basis points.

Exhibit 2: Two-Year Treasury Yield Change



Source: Bloomberg

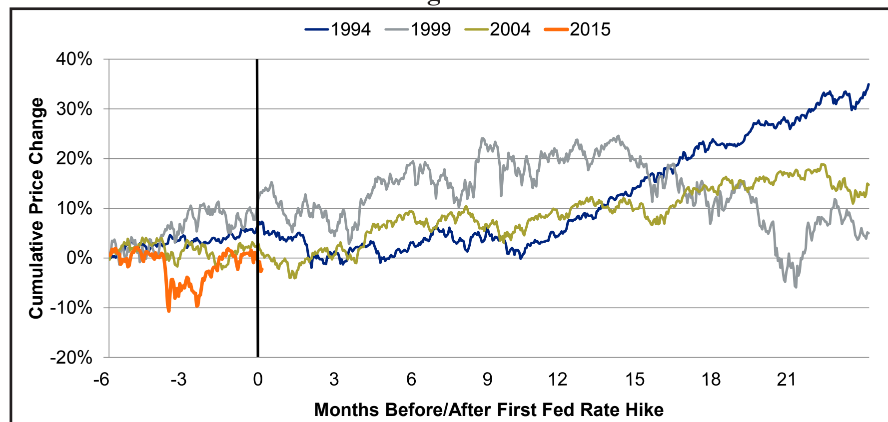
Exhibit 3: 10-Year Treasury Yield Change



Source: Bloomberg

Despite concerns that a Fed move might push interest rates sharply higher and potentially hurt equity markets, a look at performance of the S&P 500 Index during the last three rate cycles suggests otherwise. Two years after the first move, equities were higher by 5% to as much as 35% (Exhibit 4).

Exhibit 4: S&P 500 Index Price Change



Source: Bloomberg

The Fed has taken the first step in normalizing what has been ultra-easy monetary policy. Investors will now turn to expectations for moves in 2016. The FOMC's next meetings are January 26-27, March 15-16, and April 26-27.

Important Disclosure Information

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