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ECONOMIC TALKING POINTS

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History is made: The Fed finally acts to lift rates – just don't call it "monetary tightening" yet.

Regardless of whether you describe the Fed's action as "lift-off," or "limp-off," the fact remains they finally chose to raise the fed funds rate by 25 basis points, to a new effective mid-point target of 0.375%.

Two other important changes were made: they increased the penalty rate financial institutions pay to borrow from the discount window by another quarter point, to 1%, and agreed to pay banks an extra quarter point on excess reserves, to 0.5%. That latter step could prove to be politically problematic for the Fed, since it creates the appearance the Fed is now paying (or as some have more crudely charged "bribing") lenders billions of dollars not to lend.

Equally interesting has been how the Fed crafted the new language in its concluding statement. It was unambiguously dovish. The term "gradual" is used twice along with other synonyms to hammer the point home that the upward slope of short-term rates will be extremely shallow. In other words, prepare for an interest rate cycle that will look different from those in the past.

The FOMC specifically acknowledged the economy was "expanding at a moderate pace" and that the slack in the labor force had "appreciably diminished."

They also were "reasonably confident that inflation would rise over the medium, to its 2% objective" --- though, in a somewhat baffling u-turn, the Fed pull back from

that point when it also inserted "some measures of longer term inflation expectation have edged down."

Nonetheless, the central bank statement ended with its main message for the markets: "The committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the fed funds rate."

So what happens next in terms of monetary policy?

Our forecast calls for the Fed to lift rates twice more in 2016, once in March and a second time in mid-December, to end the year with an effective fed funds rate just below 1%. Since core CPI inflation is 2%, the real fed funds rate will remain well into negative territory next year, which means monetary policy should stay exceptionally accommodative at least the next two years.

Of course, some analysts thought it wrong to increase rates at this time, citing several concerns: there's an emerging liquidity crisis in the high yield debt market, higher US rates could further destabilize the troubled economies of China and other emerging countries, and finally because the Fed's own two mandates have not yet been met.

But these arguments have little merit in our opinion.

Frankly, the Fed should have ended its zero bound rate policy earlier this year. We have seen faster growth in employment and household incomes. Moreover, consumer spending has risen an average of more than 3% during the past four quarters, with gross private business investments up nearly 4%. Auto sales are on course to be the best ever this year. Construction spending (residential and commercial combined) is presently at an 8-year high. Home building alone is headed to be the strongest since 2007. Last, but certainly not least, the Fed's two mandates are in fact moving in the right direction. The jobless rate is arguably at full employment --- and inflation is slowly making its way higher. We said above that core inflation has risen to 2%, and history has shown that core and headline do converge. Indeed, headline CPI in November rose 0.5% over the year, the fastest pace in 2015, and there are expectations the Fed's preferred inflation measure, the PCE price index, will shortly accelerate as well.

So why didn't they move earlier? We suspect the primary reason the Fed punted had to do more with events overseas, specifically the unknown spillover effects from the sharp slowdown in China and a potential fracturing of the Eurozone. Worries about both have since lessened.

Should the scarcity of liquidity in the high yield bond market have deferred a rate increase? No.

While nerves have recently been frayed over the lack of liquidity in the high yield debt market, it hardly justifies postponing a Fed rate increase. We say this because

it's important to make a distinction between events in the financial economy (that is, the trading of stock and bonds) and the real economy (which focuses on the purchases of goods and services by consumers and businesses). As we noted above, the real economy (outside of the energy and export sectors) is actually gaining momentum.

Secondly, let's remember it is precisely because rates have been so low for so long that led retail and institutional investors to spice up returns by adding more high yield debt securities to their portfolios. As a result, the average spread of junk bonds over comparable Treasuries narrowed to an utterly unsustainable 250 basis points in June of last year. That spread has since shot up to more than 700 basis points after money management firms began to suspend redemptions from high yield funds. The widening of credit spreads away from earlier unrealistic levels also reflects a return to a more rational pricing of risk.

Third, most of the damage in the high yield debt sector has been limited to the energy market. While companies outside of energy that also issued high yield bonds did experience some contagion, they should still be able to service that debt since the broader U.S. economy still looks quite solid.

Finally, there is still ample liquidity in the broader economy.

- Banks have access to more than $2.6 trillion in excess reserves (compared with just $2 billion prior to the last recession), funds that can be converted into credit fairly quickly.

- Nor should we ignore the fact that nonfinancial companies are sitting on a $1.8 trillion pile of cash, and that household have now accumulated $762 billion in personal savings, the most in three years.

- The Fed has chosen to still maintain an easy monetary policy by allowing the fed funds rate to remain below inflation. (It also makes political sense to do so. With several leading Presidential candidates seeking to curb the Fed's independence, we suspect Janet Yellen and her colleagues would prefer a low profile during the coming election year.)

- Furthermore, given the strong demand from institutional and foreign investors for US official US debt, we expect yields on 10 year Treasuries to remain inside the range 2% to 3% range most of next year.

In the end, the Federal Reserve concluded that the problems in the high-yield debt market pose no marcoeconomic or systemic financial threat.

So what challenges does the Fed face from here on?

Now that the process of normalizing rates has begun, the hard work of the Federal Reserve truly begins now. There's no shortage of risks to monitor on their radar screens. Here are a few we see:

1. How will investors around the world react to the Fed's new forward guidance? As far as the equity market is concerned, we can look back at recent history for some hint. Since 1982, there have been 7 interest rate tightening cycles and the S&P 500 ended up higher a year later in every single instance by an average of 6.4%.

At the same time we have to be cognizant that interest rates are now rising at a time when corporate earnings are declining and this could take some air out of the stock market next year. In addition, we now have a generation of traders that never operated in a rising interest rate environment and this lack of institutional memory could also bring more volatility to the markets.

2. The decision to raise rates at this FOMC meeting was unanimous. But will subsequent speeches and testimonies by Fed governors and FRB district presidents continue to show unanimity on the outlook for monetary policy? Or will their public utterances in the coming months show a widening divide on what should happen next. Financial markets will not react well to that kind of uncertainty in this new interest rate regime.

3. If, as we expect, the US and international economy pick up speed in 2016, there is an outside chance that yields on Treasury notes and bonds could climb faster than anticipated.

The danger is sharply higher yields and a stronger dollar would magnify the tightening effects of monetary policy more than what the Fed intends. Should these events occur and cool demand for credit, derail the housing recovery, hurt auto sales, and jeopardize the economic expansion, the Fed may have to quickly reverse course and lower rates again.

4. Stronger economic growth could boost credit demands. In the past, when banks sought to ramp up lending, they would often raise wholesale funds in the capital markets by selling shares or issuing debt. These intermediate steps took time and that provided the Fed an opportunity to take steps that would prevent credit creation from causing sharply higher inflation.

But the rules of the game have changed given the swollen amount of excess reserves. If banks believe they can make profitable loans, the need to raise fresh funds lessens because they can now tap some of their massive reserves. That shortens the Fed's reaction time and they may, out of an abundance of caution, rush to tighten monetary policy sooner than expected. But that could also inadvertently trigger a recession.

5. Another concern for the Fed is that short-term rates rise faster than the yield on longer maturities. A flat or inverted curve has been a reliable predictor of economic

weakness and recession. Banks, for instance, would be reluctant to provide credit under such circumstances because net interest margins would shrink to levels that make lending unprofitable.

What to do? The Fed would have two awkward choices: either return to zero bound short term rates --- or sell off longer dated government debt from its balance sheets to increase their supply in the secondary market. That latter would depress prices and promote a rising yield curve.

6. Then there is the global question. Just how much of a divergence in monetary policy will we see among the world's major central banks next year?

The Eurozone, Russia, China, and Brazil are some of the countries we expect to lower rates in 2016, while the US and UK are likely to raise them. Will this trigger severe dislocations in foreign exchange markets, drain even more capital from troubled emerging countries and worsen recessionary conditions in those economies?

Clearly, economists at the Fed have to track lots of moving parts in the months ahead. So while one major chapter in the history of U.S. monetary policy now closed, the next phase is fraught with a host of global economic and geopolitical dangers. They will have to carefully navigate through a crisis-prone world economy. For investors and business leaders, the new environment brings a host of new risks and opportunities to consider.

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