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ECONOMIC TALKING POINTS

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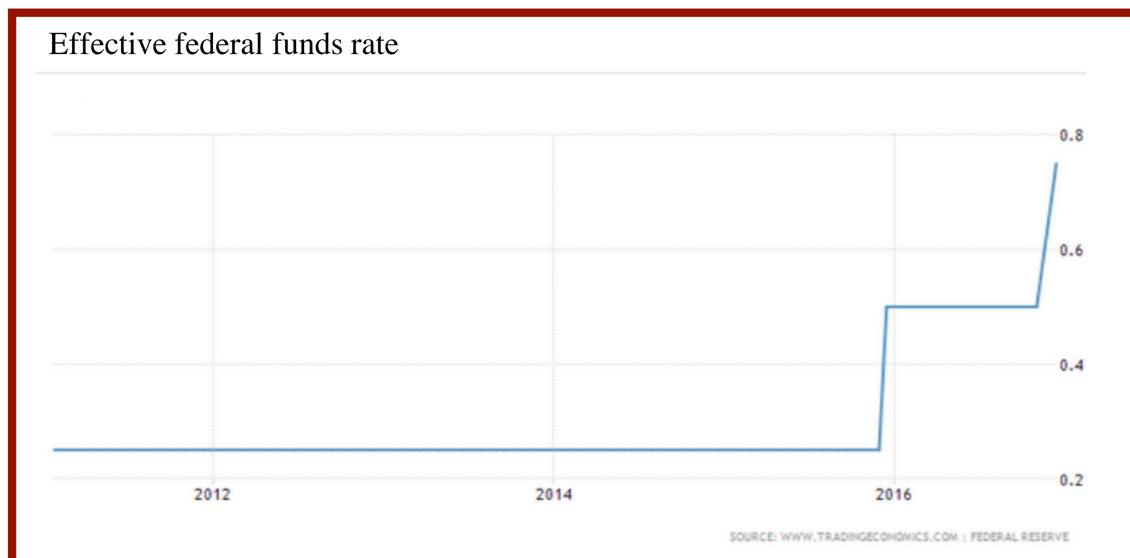
The Fed Flicked Up Rates Another 1/4 pt.
But Don't Expect Another Hike Until Mid-Year 2017

With the economy showing more vigorous growth lately, the Fed chose to finger flick rates up another 25 basis points, to between 0.5% and 0.75%. At the same time, though, policymakers kept the December FOMC statement close to November's wording because there is so much we still do not know about the fiscal policy changes coming from President Trump and the GOP-dominated 115th Congress.

The 25 basis point increase in the fed funds rate was widely expected and appropriate given the strengthening job market and rise in inflation. As for the Fed's statement, the only meaningful change in the text was that wage inflation had "moved up considerably, " an important goal for central bank policymakers.



While the Fed's dot plot hinted of three possible rate increases next year, we never found that poll particularly helpful. Instead, Janet Yellen's responses to reporter questions led us to believe the Fed will now be in a holding pattern until it can see (1) what kind of tax and spending policies actually emerges from Congress, (2) how soon those policies will be implemented and (3) what impact they may have on the economy. Until there is greater clarity on these issues, the FOMC had little choice but to keep its latest economic projections nearly identical from those they issued last September.

Their median assessment for 2017 is that real GDP will increase 2.1%, versus last September's expectation of 2.0%. Interestingly, the Fed sees growth actually sliding back to 2.0% in 2018, and an even lower 1.9% in 2019.

Such conservative projections make perfect sense given all that we know at this point. For even if you assume that all of Trump's campaign promises are approved by Congress (which is very unlikely), the economy will be under pressure to move in two opposite directions!

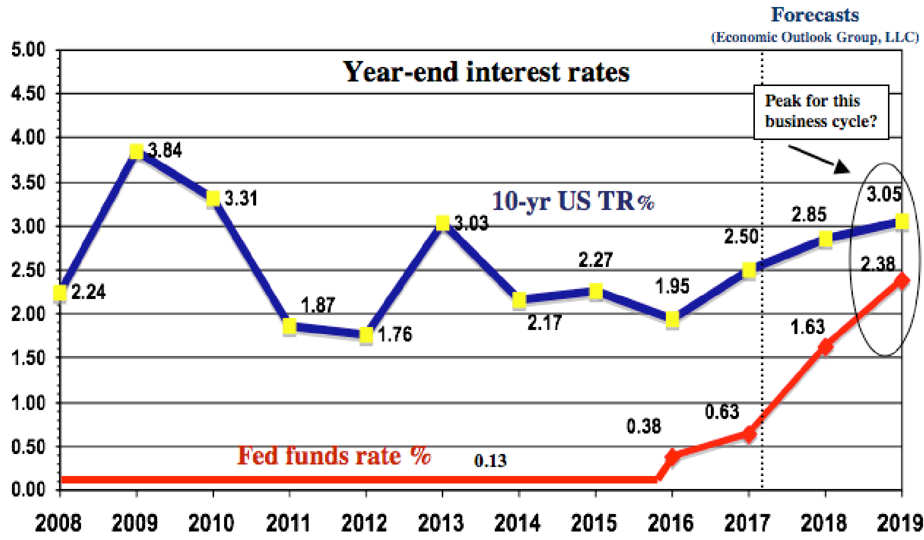
How so? Tax cuts and greater spending on infrastructure and defense will certainly allow for faster growth. But if Trump also carries out his promise to impose substantial tariffs on goods from China and Mexico, it could trigger a trade war, and that can severely depress U.S. economic activity. The net result would be weaker growth, if not recession.

The fact is, however, that many conservative Republicans in the House and Senate are viscerally opposed to the President-elects plans because it will swell the deficit and national debt. This suggests Congress may ultimately approve a far more modest change in fiscal policy, effectively reducing the stimulus.

A third factor on the Fed's radar screen is how much the jump in the dollar and rise in long-term rates in recent months will curb economic growth next year. The dollar's value stands at a 13-year high on the ICE exchange, making it harder for U.S. exporters to sell abroad. That sets the stage for larger trade deficits, which subtracts from GDP growth.

At the same time, the 10-year treasury yield, now at 2.6%, is up more than 100 basis points since mid-summer. Much of that increase took place after the election as investors began to anticipate faster growth and more inflation with a Trump presidency. What is unclear, however, is how consumers will react to this abrupt increase in market rates. Remember, a generation of Americans has been raised in an environment of historically low interest rates and dormant inflation. With higher short and long-term rates underway, consumers may pull back on spending earlier than usual in the interest rate cycle.

For all these reasons we expect no further action by the Fed the next six months. They need time to see what tax and spending policies are ultimately enacted and assess the effects of the dollar's strength and higher credit costs on consumer and business spending.



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